



State of California

Internal Control and Compliance Audit Report
for the Fiscal Year Ended June 30, 2017

Report 2017-001.2





CALIFORNIA STATE AUDITOR

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March 28, 2018

2017-001.2

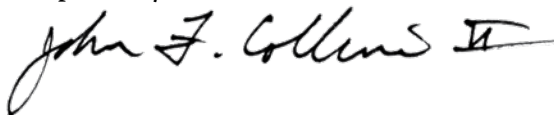
The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As required by Government Code section 8543 et seq., the 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, 2017.

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 two deficiencies in internal control over financial reporting that we consider to be material weaknesses. 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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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, 2017, 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 March 21, 2018. 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 five 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 82 percent of the assets and deferred outflows, and 53 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 Safe Drinking Water State Revolving fund, that represents 12 percent of the assets and deferred outflows 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 84 percent of the assets and deferred outflows, and 51 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.

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. 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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section 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. We did identify certain deficiencies in internal control that we consider to be material weaknesses as described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements—items 2017-1 and 2017-2.

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*.

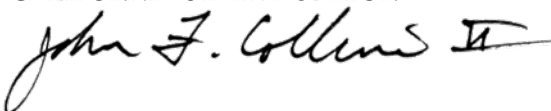
State of California's Response to Findings

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 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



JOHN F. COLLINS II, CPA
Deputy State Auditor

March 21, 2018

**STATE OF CALIFORNIA
SCHEDULE OF FINDINGS FOR THE FISCAL YEAR ENDED JUNE 30, 2017**

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?	No
Noncompliance material to financial statements noted?	No

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

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DEPARTMENT OF HEALTH CARE SERVICES

Reference Number: 2017-1

Condition:

The Department of Health Care Services (DHCS) overstated Medi-Cal expenditures and revenues for fiscal year 2016–17 in the Federal Trust Fund by \$4.5 billion. Additionally, DHCS overstated Medi-Cal expenditures and revenues for fiscal year 2016–17 in the General Fund by \$3.8 billion and \$1.2 billion, respectively. Lastly, DHCS overstated expenditures and revenues in the Hospital Quality Assurance Revenue Fund by \$343 million and \$1.6 billion, respectively. 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. 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 Comprehensive Annual Financial Report. The following sections provide more detail about DHCS' misstatements by program.

Overstated Accruals for Medi-Cal Managed Care Program

DHCS overstated expenditures and related revenues in the Federal Trust Fund by \$2.4 billion, and it overstated expenditures and revenues in the General Fund by \$3.7 billion and \$1.2 billion, respectively, for the Medi-Cal Managed Care (Managed Care) Program. Managed Care health plan providers help Medi-Cal beneficiaries find doctors, pharmacies and health education programs. These 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 using its Capitation Payment Management system (CAPMAN). To prepare its GAAP accrual, DHCS properly identified and accrued the unpaid invoices for services provided by June 30, 2017 using a query of CAPMAN to obtain this data. However, for fiscal year 2016–17, the CAPMAN data also included recoveries of previous federal payments. These recoveries became necessary due to retroactive rate reductions related to the additional adult population covered under the federal Affordable Care Act. Given that staff preparing the accrual were unaware of how these recoveries were reflected in the CAPMAN data, they were improperly accrued as additional expenditures. This resulted in DHCS overstating Federal Trust Fund expenditures and related revenues by \$2.4 billion and overstating General Fund expenditures by \$2.5 billion. The remaining overstated General Fund expenditures and related revenues of \$1.2 billion occurred due to the improper classification of reimbursements pertaining to the Managed Care program.

Overstated Accruals for 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 \$343 million and \$1.6 billion, respectively. Additionally, DHCS overstated expenditures and related revenues for this program by \$336 million in the Federal Trust Fund. Lastly, DHCS overstated expenditures for the HQAF program by \$124 million in the General Fund. California Welfare and Institutions Code Section 14169.52 imposes a quality assurance fee on certain hospitals to obtain additional federal funding for supplemental payments to hospitals and for 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 for the program, and then disburses both the quality assurance fee revenues and federal funding back to hospitals as Medi-Cal payments. Additionally, this program reimburses the General Fund for the 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 Specialty Mental Health Services Program

DHCS overstated expenditures and related revenues in the Federal Trust Fund by \$922 million for the Specialty Mental Health Services (Mental Health) program. The Mental Health program provides specialty mental health services for 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 2016–17, DHCS erroneously accrued payments for services provided during fiscal year 2015–16 even though DHCS had largely paid for these services by June 30, 2017.

Overstated Accruals for Other Medi-Cal Programs

DHCS overstated expenditures and related revenues for three other Medi-Cal programs by a total of \$866 million in the Federal Trust Fund. Specifically, \$436 million of this overstatement pertains to the Medi-Cal Administrative Activities program. This program provides federal reimbursement of administrative costs related to the Medi-Cal program to various local entities, such as local governmental agencies and local educational consortiums. In addition, DHCS overstated expenditures and related revenues by \$290 million for the Medi-Cal Provider Supplemental Reimbursement program. This program provides federal funding for outpatient hospital services to publicly owned or operated hospitals. Finally, DHCS overstated expenditures and related revenues by \$140 million primarily related to the Health Care Coverage Initiative of the Low Income Health Program. This program makes federal funding available to counties for costs of providing health care services to eligible low-income individuals. These misstatements occurred because of various errors in DHCS' accrual methodologies.

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. 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). 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 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 for the reimbursed fund.

Recommendation:

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

- Improve internal communications among program and accounting staff who prepare the GAAP accruals.
- Update existing accrual methodologies as needed.
- Provide additional guidance and training to program and accounting staff on the requirements of GAAP.

Department's View and Corrective Action:

- Improve internal communications among program and accounting staff who prepare the GAAP accruals.

DHCS Response:

DHCS agrees with the recommendation. DHCS Accounting staff have already begun efforts to improve communication between program staff and Accounting staff. Accounting's practice has been to provide annual training on the GAAP accrual process, including samples and checklists, emphasizing the importance of accurate reporting, for program staff. The training not only explains the process but also provides an opportunity for program staff to secure answers to their questions on this process. In addition to this training, accounting staff will coordinate initial and interim GAAP accrual process meetings with program staff to ensure their understanding and awareness of specific issues and findings related to their reported accruals and to discuss expectations going forward.

- Update existing accrual methodologies as needed.

DHCS Response:

DHCS agrees with the recommendation. The GAAP teams for the upcoming fiscal year 2017–18 accruals have been selected, and updated finalized methodologies will be in place by August 2018.

For the Managed Care Accrual, the Managed Care Operations Division (MCOD) will update existing accrual methodologies as follows:

- » Meet with accounting to establish parameters for the Managed Care (MC) Accrual extract.
 - MCOD staff will meet with Accounting close to the date of the FY 17–18 MC Accrual extract. A more robust picture of other accruals CSA is reviewing with other divisions will aid MCOD in creating more effective parameters for the FY 17–18 MC Accrual extract.
- » Run the MC Accrual extract after the September 2018 Capitation Run.
 - Per CSA's recommendation, MCOD will complete the next accrual extract after the September 2018 capitation run. This will provide the most up-to-date payment information available by MCOD's due date of October 15, 2018 and should eliminate several of the issues identified by CSA.

For the HQAF accrual, internal meetings will be coordinated with the various divisions, including Accounting, to develop a methodology that better reflects the HQAF process and aligns with GAAP standards. An example of an update to the methodology may be on how to best reflect the enhanced population in the GAAP accrual. DHCS expects meetings and the related methodology discussions to commence sometime in July 2018, prior to the next GAAP accrual period.

- Provide additional guidance and training to program and accounting staff on the requirement of GAAP.

DHCS Response:

As stated above regarding improving internal communications, accounting staff, have been and continue to be, committed to providing guidance and training to program staff on the GAAP accrual process. The training for both Accounting and program staff who participate in the GAAP accrual process for state fiscal year 2017–18 is planned for June of 2018. Accounting staff will schedule initial and interim meetings with the individual programs to provide guidance throughout the GAAP accrual process.

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DEPARTMENT OF SOCIAL SERVICES

Reference Number: 2017-2

Condition:

The Department of Social Services (Social Services) initially understated intergovernmental revenue and health and human services expenditures in the Federal Trust Fund by \$6.9 billion for fiscal year 2016–17. Specifically, Social Services made an error when preparing its generally accepted accounting principles (GAAP) adjustments for the Federal Trust Fund, resulting in \$6.9 billion dollars in food stamps issuances being recorded as \$6.9 million.

According to Social Services this error occurred when staff prepared the GAAP adjustment worksheet to provide the food stamps issuance figure to the State Controller's Office (Controller's Office). Staff improperly keyed the figure in millions instead of billions when rounding the figure for presentation in the worksheet. After we brought this error to its attention, Social Services submitted a correcting entry to the State Controller in December 2017.

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 and entries for the funds they manage.

Recommendation:

Social Services should follow its procedures for preparing and reviewing the GAAP entries it submits to the Controller's Office to ensure the entries are accurate. It should also provide additional guidance and training to accounting staff on GAAP requirements.

Department's View and Corrective Action:

Social Services concurs with this finding. To mitigate the risk of errors in reporting, Social Services will revise its GAAP entry procedures to include additional review steps prior to submitting to the State Controller's Office. The steps will include variance testing, current data interfacing, and downloading techniques to minimize keying errors. Additionally, Social Services is currently developing a training plan and will provide additional training of proper GAAP reporting to its accounting staff. Social Services conversion to FISCAL will help to mitigate this type of risk.

March 2018

Date: March 28, 2018

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