State of California

Internal Control and Compliance Audit Report
for the Fiscal Year Ended June 30, 2023

December 2024

REPORT 2023-001.1

CALIFORNIA STATE AUDITOR
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Grant Parks *State Auditor*
Mike Tilden *Chief Deputy*

December 20, 2024
2023-001.1

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 pertaining to our review of the State of California's internal controls and compliance with state regulations for the fiscal year ended June 30, 2023.

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 six deficiencies in internal control over financial reporting that we consider to be material weaknesses and eight other deficiencies that we consider to be significant. Deficiencies in the State's internal control system could adversely affect its ability to provide accurate and timely financial information.

Respectfully submitted,

Linus Li

LINUS LI, CPA
Deputy State Auditor

Contents

Grant Parks *State Auditor*

Mike Tilden *Chief Deputy*

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, 2023, 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 December 5, 2024. Our report qualifies an opinion on the Federal Fund and Governmental Activities for the following reasons.

The Employment Development Department had inadequate internal control over its financial reporting for federally funded unemployment insurance (UI) benefits, including not properly estimating the total population of ineligible payments. As a result, the department was unable to provide complete and accurate information for certain accounts within the federally funded portion of its UI program. We were therefore unable to obtain sufficient and appropriate audit evidence to conclude that the department's balances representing 100 percent of Other Liabilities within the Federal Fund are free from material misstatement.

The issues pertaining to the Federal Fund also affect Governmental Activities. Therefore, we were unable to obtain sufficient and appropriate audit evidence about the Federal Fund balances that represent 98 percent of Other Current Liabilities within Governmental Activities.

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 1 percent of the assets and deferred outflows, and less than 1 percent of the revenues of the governmental activities.
- Certain enterprise funds that, in the aggregate, represent 85 percent of the assets and deferred outflows, and 60 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.

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Fund Financial Statements

- The following major enterprise funds: Water Resources, State Lottery, and California State University.
- 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 87 percent of the assets and deferred outflows, and 52 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 Works Board Building Construction Fund, the State Lottery Fund, and the Campus Foundations of the University of California, which represent 14 percent of the university's total assets and deferred outflows of resources and 4 percent of its revenues, were not audited in accordance with *Government Auditing Standards*, and accordingly, this report does not include reporting on internal control over financial reporting or compliance and other matters associated with the Golden State Tobacco Securitization Corporation, the Public Works Board Building Construction Fund, the State Lottery Fund, or the Campus Foundations of the University of California.

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) as a basis for designing 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 have not been identified. However, as described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements, we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a 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 2023-1 through 2023-6 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 deficiencies described in the accompanying section entitled Internal Control and Compliance Issues Applicable to the Financial Statements and State Requirements as items 2023-7 through 2023-14 to be significant deficiencies.

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 financial statements. 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

Government Auditing Standards require the auditor to perform limited procedures on the State of California's response to the findings identified in our audit and 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 other 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 results 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

Linus Li

LINUS LI, CPA
Deputy State Auditor

Sacramento, California

December 5, 2024

STATE OF CALIFORNIA
SCHEDULE OF FINDINGS FOR THE FISCAL YEAR ENDED JUNE 30, 2023

Summary of Auditor's Results

Financial Statements

Type of auditor's report issued	Qualified opinions for Governmental Activities and Federal Fund, and Unmodified opinions for all other opinion units
Internal control over financial reporting:	
Material weaknesses identified?	Yes
Significant deficiencies identified that are not considered to be material weaknesses?	Yes
Noncompliance material to financial statements noted?	No

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

EMPLOYMENT DEVELOPMENT DEPARTMENT

Reference Number: 2023-1

Condition:

Similar to the past three fiscal years, the Employment Development Department (EDD) did not properly estimate the total population of ineligible unemployment insurance (UI) benefits paid using pandemic program funding from the federal government. As a result, EDD was unable to provide accurate and complete financial information for fiscal year 2022–23 for the federally funded portion of its UI program. The lack of appropriate estimates resulted in possible material misstatements in EDD's year-end financial reports and led to the modified opinions we expressed on the Federal Fund and Governmental Activities within the State's Annual Comprehensive Financial Report (ACFR).

As noted in our prior year's internal control report, EDD's approach for preventing ineligible payments had significant weaknesses during fiscal years 2019–20 and 2020–21, including paying claimants with suspicious addresses or unconfirmed identities. Furthermore, in fiscal year 2021–22, certain weaknesses persisted, including a 10-month delay by EDD in implementing a U.S. Department of Labor (Labor) requirement to verify the eligibility of claims from self-employed individuals. During fiscal year 2022–23, EDD continued to make payments to ineligible claimants by not completing the required verifications of proof of employment or self-employment, and compliance with certain other eligibility requirements.

Although EDD prepared an estimate of total ineligible payments as of June 30, 2023, errors in its process and a lack of final eligibility determinations on certain claims have resulted in this estimate being unreliable. Specifically, based on this estimate, EDD accrued more than $46 billion in paid ineligible benefits as due to the federal government. However, EDD did not complete its eligibility determination work for a significant number of claims. This included claims for which the claimant did not submit required documents and claims for which the claimant submitted documents but EDD did not review them. In other instances, EDD received conflicting information regarding a claimant's eligibility, but it did not take action to address the conflicts. When preparing its estimate, EDD was inconsistent in how it treated these claims and excluded some of them from its estimate and included others. In addition, EDD's process for preparing the estimate of ineligible payments contained errors that inappropriately excluded certain payments for claims that EDD had determined to be ineligible, and it also incorrectly included some eligible payments. Because of these issues, there are possible material misstatements in the beginning balances and liabilities in the financial reports of the Federal Fund and Governmental Activities.

Furthermore, in *Note 22: Subsequent Events* of the State's fiscal year 2022–23 ACFR, EDD states that it should be able to recognize the outstanding liability related to ineligible payments in the Federal Fund as a forgiveness of debt during fiscal year 2023–24. However, when we met with Labor, it did not confirm EDD's position. Moreover, EDD did not provide any additional evidence to support its assertion. Therefore, EDD did not provide sufficient and appropriate evidence to support its statement in the notes to the financial statements.

Lastly, in the prior fiscal year, we had reported that EDD did not complete its bank reconciliations or reconcile its accounts to the State Controller's Office's (State Controller) records in a timely manner. Although it has made progress in this area, EDD did not complete these reconciliations within the required 30 days during fiscal year 2022–23. Further, EDD's reconciliation of the UI program to the State Controller's records was missing certain information needed to reconcile. After we raised this issue with EDD, it corrected the reconciliation.

Criteria:

Government Code section 12461 requires the State Controller to issue an ACFR that is prepared in accordance with generally accepted accounting principles (GAAP).

Codification of Governmental Accounting and Financial Reporting Standards section 1600 states that the financial statements for governmental funds should be presented using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues should be recognized in the accounting period in which they become available and measurable. Expenditures should be recognized in the accounting period in which the fund liability is incurred.

Codification of Governmental Accounting and Financial Reporting Standards section N50 states that federal funding should only be recognized as receivables and revenue after all applicable eligibility requirements are met.

Recommendations:

To prevent misstatements from recurring in its financial reports, EDD should take the following actions:

- Revisit its methodology for estimating ineligible payments to ensure that it includes ineligible claims and excludes claims confirmed to be eligible. EDD should implement multiple levels of review during each step of the estimation process.

- Provide guidance and training to both program and accounting staff on the requirements of GAAP.

- Seek clarification from Labor regarding the possibility of recognizing the liability to the federal government associated with ineligible payments as forgiveness of debt.

Department's View and Corrective Actions:

EDD agrees with the recommendations. EDD stated that each year, it leverages the knowledge acquired from the efforts of previous fiscal years to proactively establish and validate refined business requirements for the ineligible payment datasets. Furthermore, EDD stated that although it had developed mechanisms for validating the ineligible payment datasets, it would continue working towards strengthening its review processes. Additionally, EDD stated that it would continue updating its internal GAAP procedures and monitor for any GAAP-specific trainings that staff can attend. Finally, EDD indicated that it had requested clarification from Labor about forgiveness of debt for the liability to the federal government and is currently waiting for a response.

DEPARTMENT OF FINANCIAL INFORMATION SYSTEM FOR CALIFORNIA (FI$CAL)

Reference Number: 2023-2

Condition:

We identified pervasive findings in the overall information technology (IT) general controls and application controls environment of the Financial Information System for California (FI$Cal). Details of these findings are being withheld pursuant to Government Code section 8592.45, which prohibits disclosure of certain information related to the FI$Cal IT infrastructure. Accordingly, and consistent with applicable auditing standards, we decided not to publish these details. Twenty-six (26) out of forty-eight (48) control deficiencies have Plans of Action and Milestones (POAMs), which were not remediated as of the end of the audit period. Further, sufficient compensating controls were not in place to reduce the impact of these findings on the IT general and application controls environment.

The primary cause of these issues was that the department's control processes lacked the necessary level of maturity to consistently achieve its objectives. This was due to inadequate documentation or documentation that was not retained, gaps in established processes, or a lack of monitoring and feedback mechanisms to identify and implement process improvements in a timely manner.

The deficiencies result in pervasive risks at the entity and system-level to automated controls and configurations of the FI$Cal system, which potentially impact the ability to rely on FI$Cal data used for financial reporting. Lack of IT general controls could compromise the reliability and integrity of financial data and increases the risk of misstatements in the financial reports.

Criteria:

The *Financial Audit Manual* (FAM) 240 states in relevant part:

(.13) IS [Information System] controls consist of those internal controls that depend on information system processing and include general controls, application controls, and user controls. Information system general controls (implemented at the entity-wide, system, and application levels) are the structure, policies, and procedures that apply to all or a large segment of an entity's information systems. General controls help ensure the proper operation of information systems by creating the environment for effective operation of application controls. General controls include security management, access (logical and physical), configuration management, segregation of duties, and contingency planning controls. An effective information system general control environment:

- provides a framework and continuing cycle of activity for managing risk, developing security policies, assigning responsibilities, and monitoring the adequacy of the entity's computer-related controls (security management);

- limits or detects access to computer resources, such as data, programs, equipment, and facilities, thereby protecting them against unauthorized modification, loss, or disclosure (logical and physical access);

- prevents unauthorized changes to information system resources, such as software programs and hardware configurations, and provides reasonable assurance that systems are configured and operating securely and as intended (configuration management);

- includes policies, procedures, and an organizational structure to manage who can control key aspects of computer-related operations (segregation of duties); and

- protects critical and sensitive data, and provides for critical operations to continue without disruption or be promptly resumed when unexpected events occur (contingency planning).

- (.14) Application controls, sometimes referred to as business process controls, are those controls incorporated directly into information systems to help ensure the validity, completeness, accuracy, and confidentiality of transactions and data during information system processing. An effective application control environment includes:

  - general controls implemented at the application level (i.e., security management, access controls, configuration management, segregation of duties, and contingency planning);

  - controls over transaction data input, processing, and output as well as master data maintenance;

  - interface controls over the timely, accurate, and complete processing of information between information systems; and

  - controls over the data management systems.

State Administrative Manual (SAM) section 5300.5, states:

California has adopted the National Institute of Standards and Technology (NIST) Special Publication (SP) 800-53 as minimum information security control requirements to support implementation and compliance with the Federal Information Processing Standards (FIPS). Each state entity shall use the FIPS and NIST SP 800-53 in the planning, development, implementation, and maintenance of their information security programs.

SAM section 5305, states:

Each state entity is responsible for establishing an information security program. The program shall include planning, oversight, and coordination of its information security program activities to effectively manage risk, provide for the protection of information assets, and prevent illegal activity, fraud, waste, and abuse in the use of information assets.

Each state entity shall:

1. Align the information security program, its activities, and staff with the requirements of this Chapter;

2. Establish a governance body to direct the development of state entity specific information security plans, policies, standards, and other authoritative documents;

3. Oversee the creation, maintenance, and enforcement of established information security policies, standards, procedures, and guidelines;

4. Ensure the state entity's security policies and procedures are fully documented and state entity staff is aware of, has agreed to comply with, and understands the consequences of failure to comply with policies and procedures;

5. Identify and integrate or align information security goals and objectives to the state entity's strategic and tactical plans;

6. Develop and track information security and privacy risk key performance indicators;

7. Develop and disseminate security and privacy metrics and risk information to state entity executives and other managers for decision making purposes; and

8. Coordinate state entity security efforts with local government entities and other branches of government as applicable.

Recommendations:

The department should take the following actions:

- Perform a comprehensive risk assessment to re-evaluate the department's governance in accordance with SAM, NIST SP 800-53, FIPS, financial reporting, and other State and Federal requirements.

- Update the System Security Plan (SSP), to accurately align with critical policies and procedures associated with the execution and monitoring of controls;

- Continue to update policies and procedures, which demonstrate management's controls in place to monitor and prevent risk as designed within the SSP.

- Incorporate a process to make consistent progress against open POAMs and to actively pursue remediation of findings, which incorporates post-implementation monitoring.

- Coordinate and establish validation and verification of controls identified in the SSP.

- Conduct information, communication, and monitoring activities to promote awareness of updated processes.

Department's View and Corrective Actions:

The department agrees with the California State Auditor's (State Auditor) comments and is committed to addressing any remaining findings in a timely manner. The security of the system is our highest priority and we greatly value the State Auditor's feedback and take the concerns stated in the report seriously.

To safeguard the system and data, the department is vigilant against external threats, including emerging threats and operational security, and has made consistent progress in closing the POAMs and improving our security posture. The independent security assessments performed by the California Department of Technology and the California Military Department have demonstrated continuous advances in our security posture.

The department's emphasis on both external threats and internal control process improvements continued during the State Auditor's audit for fiscal year 2022–23, which concluded in October 2024. We are happy to report the department has made several improvements to our risk assessment and governance processes, internal controls, policies, procedures, and documentation review/update processes to address the findings and further improve our maturity in internal controls and compliance. The department will continue to advance the maturity of our internal controls to fully meet the compliance requirements.

We look forward to continuing our collaboration with the State Auditor to continue to ensure the security and highest standards of the FI$Cal system and the financial data for which we are entrusted.

STATE CONTROLLER'S OFFICE

Reference Number: 2023-3

Condition:

Each year, the State Controller's Office (State Controller) is responsible for reconciling amounts from various departments related to the State's minimum funding guarantee to schools and colleges, known as Proposition 98, and recording any necessary entries into its reporting system for the State's Annual Comprehensive Financial Report (ACFR). This reconciliation is necessary for ensuring that the amounts reported by the multiple departments involved in the spending for schools and colleges reconcile to the most current information made available by the Department of Finance. The minimum funding guarantee for fiscal year 2022–23 is $67.8 billion. However, the State Controller made material errors during this reconciliation process. Specifically, the State Controller omitted certain amounts from the reconciliation, and by extension the ACFR, or it could not support certain amounts included in the ACFR that required reversal. These errors led to misstatements in the ACFR totaling approximately $11 billion. The material nature of these errors in the State Controller's reconciliation indicates that it does not have sufficient controls in place to ensure the complete and accurate reporting of the minimum funding guarantee within the ACFR.

Criteria:

The State Controller is responsible for maintaining a system of controls over financial reporting. The design and operation of these controls should permit management and staff, in the normal course of performing their duties, to prevent, or detect and correct, misstatements to the financial reports, in a timely manner.

Recommendation:

The State Controller should redesign its reconciliation process to ensure the complete and accurate reporting of the minimum funding guarantee.

Department's View and Corrective Actions:

The State Controller stated that the Proposition 98 minimum funding guarantee reconciliation is inordinately complex work which annually requires the State Controller to consider both Budgetary/Legal basis and GAAP basis adjusting journal entries to over 100 individual education budget appropriations, some of which are continuous appropriations spanning across multiple fiscal years. The reconciliation also entails coordination with non-accounting program staff from several state departments, requiring the State Controller to interpret significant amounts of program data into accounting entries from a perspective that often offers inadequate insight into the operational details of the programs themselves. For the year ended June 30, 2023, in addition to the normal complexity, the reconciliation also required the State Controller to (1) determine the accounting treatment for the Public School System Stabilization Account (PSSSA), which was recently created by the Department of Finance in 2019, but saw an escalation of activity in fiscal years 2021–22 and 2022–23; and (2) determine the accounting treatment of multiple types of budget deferrals involving the PSSSA (in which funds currently scored against the minimum funding guarantee and disbursed to Local Education Authorities were allocated to future budget periods) through considerable communication with Department of Finance budget personnel. Lastly, while acknowledging that material errors were made in the Proposition 98 reconciliation process, the State Controller made efforts to address them in response to the State Auditor's communication. Ultimately, all the errors were corrected in the financial statements.

The State Controller acknowledges the need for more extensive process flow documentation, enhanced reconciliation and tracking tools, more detailed procedures, improved communication with departments, and additional staff training over the Proposition 98 process. The State Controller plans to improve the reconciliation process by adjusting the timing of communication with departments to allow for more thorough understanding, implementing an additional standardized analysis process designed to identify and prevent material errors caused by missing the effects of prior year Budgetary/Legal and GAAP entries, changing staffing composition to align with the workload, and further standardizing the review process.

The State Controller is committed to continuously improving quality assurance and internal controls and will continue to evaluate business procedures and staff training to ensure trust and confidence in the reporting process. The State Controller recognizes that accurate and timely financial reporting is critical to support the State's overall financial objectives and will continue to prioritize the publication of an accurate and timely ACFR.

CALIFORNIA DEPARTMENT OF EDUCATION

Reference Number: 2023-4

Condition:

For fiscal year 2021–22, we reported that the California Department of Education (Education) did not properly recognize expenditures and related revenues pertaining to its spending of funding from the federal government under the Coronavirus Response and Relief Supplemental Appropriations Act of 2021. Specifically, Education made payments to various local educational agencies (LEAs) participating in the Elementary and Secondary School Emergency Relief program. This program provides LEAs with emergency relief funding to address the effects of the COVID-19 pandemic on elementary and secondary schools. In compliance with federal requirements, LEAs incur actual costs allowable under the program, which they report to Education. In the prior year, Education had understated its expenditures and related revenues in the Federal Fund by $952 million by not reporting its obligation to reimburse LEAs for the additional costs they had incurred. In the current year, Education reported these reimbursements, but did not acknowledge they were associated with costs incurred in the prior year. As a result, Education incorrectly reported the $952 million of payments as an advance to the LEAs.

In addition to this misstatement, when providing its year-end reports to the State Controller's Office (State Controller), Education chose to include financial activity duplicating a task being performed centrally by the State Controller. By doing so, Education did not adhere to the State Controller's instructions. Moreover, Education did not clearly identify this activity as being included in its financial reports. As a result, the duplicated activity caused overstated expenditures and related revenues in the Federal Fund of $15.7 billion. After we brought these issues to the attention of Education, it made the necessary corrections.

In the two previous years, we similarly reported that Education misstated its expenditures and related revenues in the Federal Fund. We recommended that Education develop written procedures to ensure that it prepares and adequately reviews activity included in its financial reports to ensure compliance with generally accepted accounting principles (GAAP). Although Education once again revised its written procedures, these revisions are not sufficient. We also recommended that staff preparing the financial reports receive proper guidance and training on the GAAP requirements. However, Education confirmed that this training has not yet occurred.

Criteria:

Education is responsible for maintaining a system of controls over financial reporting. The design and operation of these controls should permit management and staff, in the normal course of performing their duties, to prevent, or detect and correct, misstatements to the financial reports, in a timely manner.

Codification of Governmental Accounting and Financial Reporting Standards section N50 states that for nonexchange transactions, recipients should recognize revenues, and providers should recognize expenditures, when all applicable eligibility requirements are met. This includes incurring an allowable cost under an expenditure-driven grant.

Government Code section 12460 requires the State Controller to issue an Annual Comprehensive Financial Report (ACFR) in accordance with GAAP. In its year-end financial reports manual, the State Controller provides instructions to departments on the preparation of their year-end financial reports, which form the basis of the ACFR. As part of these instructions, the State Controller specifically instructs departments not to include entries reversing the prior year accruals, because the State Controller prepares these entries on their behalf.

Recommendations:

To ensure that its financial statements are not materially misstated in future years, Education should do the following:

- Revise its written procedures to ensure that it prepares and adequately reviews entries to report expenditures in accordance with GAAP.

- Ensure that the staff preparing and reviewing financial reports receive adequate guidance and training in GAAP requirements.

Department's View and Corrective Actions:

Education agrees with the finding and recommendations. Education is committed to strengthening its existing processes to ensure compliance with all reporting requirements. Specifically, Education has worked with one of the State Controller's contractors to develop written procedures for reporting expenditures and related revenues in accordance with GAAP. Education noted that it had shared these new procedures with us in November 2024. Additionally, Education stated that it has implemented internal training on GAAP requirements for staff responsible for preparing and reviewing financial reports.

Comment:

To provide clarity and perspective, we are commenting on Education's response to our finding.

Because Education provided its additional updated procedures in late November 2024, there was insufficient time for us to review them before the State's deadline for issuing the fiscal year 2022–23 ACFR. Therefore, we plan to review the procedures during the upcoming fiscal year 2023–24 audit.

DEPARTMENT OF HEALTH CARE SERVICES

Reference Number: 2023-5

Condition:

The Department of Health Care Services (DHCS) overstated Medi-Cal expenditures for fiscal year 2022–23 in the General Fund by $6.5 billion. Additionally, DHCS understated Medi-Cal expenditures and revenues in the Federal Fund by $5.4 billion. 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 Annual Comprehensive Financial Report (ACFR). The following sections provide more detail about DHCS' misstatements by program.

Errors Pertaining to the Managed Care Program

DHCS understated Federal Fund expenditures and revenues, and it overstated General Fund expenditures by $5 billion for the Medi-Cal Managed Care (Managed Care) Program. Additionally, DHCS understated the Federal Fund's and overstated the General Fund's accounts payable liabilities by $3.6 billion and $3.9 billion, respectively. Finally, DHCS overstated the Federal Fund's liability to the federal government by $1.3 billion and understated the Federal Fund's receivable from the federal government by $3.6 billion.

DHCS contracts with managed care plans (plans) to provide health care coverage for Medi-Cal beneficiaries. The plans provide enrollees with most Medi-Cal covered health care services, including hospital, physician, and pharmacy services. DHCS pays these plans monthly, predetermined rates—referred to as capitation rates—for each individual enrolled with them. DHCS uses its Capitation Payment Management System (CAPMAN), which contains the capitation rates, to generate monthly invoices for each plan.

California provides state-funded full scope Medi-Cal services to certain populations who meet all eligibility requirements except for their citizenship status, and who therefore are generally not eligible for federal funding. Specifically, the federal Medicaid law prohibits states from claiming federal funds for services other than pregnancy and treatment of an emergency medical condition for individuals with unsatisfactory immigration status (UIS). However, DHCS reported to the federal Centers for Medicare & Medicaid Services (CMS) significant overpayments of federal funding for the UIS population. In response, CMS provided DHCS with a corrective action plan that required DHCS to develop capitation rates specific to the UIS population for services rendered from July 2019 through June 2023. Subsequently, the U.S. Department of Health and Human Services' Office of the Inspector General performed a review of the State's expenditure claims for nonemergency services provided to individuals lacking satisfactory immigration status and confirmed that DHCS inappropriately claimed federal funding for nonemergency and nonpregnancy services for the UIS population.

As DHCS was developing UIS-specific capitation rates, it determined that during the period from July 2019 through June 2023, it had over-claimed federal funding for the UIS population. Furthermore, DHCS identified additional amounts owed to the plans for services rendered during this period. Finally, DHCS identified a population of enrollees with satisfactory immigration status for which DHCS had under-claimed federal funding for services rendered from July 2017 through June 2019.

When calculating its original accrual related to the issues noted above, DHCS used an incomplete listing of UIS-specific capitation rate changes from CAPMAN. Specifically, DHCS omitted updates to the UIS-specific capitation rates that it recorded in CAPMAN in December 2023. Furthermore, DHCS did not appropriately structure its accounting entry. For example, DHCS included amounts owed to the plans within the amount owed to the federal government. Finally, DHCS recorded the accrual twice in its financial statements because it used incorrect query parameters when extracting data from CAPMAN to determine the accrual associated with unpaid invoices at year-end. These errors occurred mainly because of the lack of detailed, GAAP-compliant accrual methodologies and insufficient communication between program and accounting staff. After we raised these issues with DHCS, it prepared a more detailed accrual methodology and corrected its General Fund and Federal Fund accruals.

Overstated Accruals for Behavioral Health Continuum Infrastructure Program

DHCS overstated its Behavioral Health Continuum Infrastructure Program (BHCIP) expenditure accruals in the General Fund by $1.5 billion. California Welfare and Institutions Code sections 5960 and 5960.05 authorized DHCS to establish the BHCIP, as part of which DHCS may award competitive grants to qualified entities to construct, acquire, and rehabilitate real estate assets or to invest in needed mobile crisis infrastructure to expand the community continuum of behavioral health treatment resources. However, DHCS' initial accrual methodology for this program was not GAAP-compliant as it did not address the GASB Codification section N50 requirements regarding expenditure recognition for reimbursement-based grant programs. As a result, DHCS initially accrued the entire budget appropriation for this program without considering the extent to which grantees met the eligibility requirements of the program. After we brought this issue to DHCS' attention, DHCS revised its accrual methodology for this program and reduced its initial accrual by $1.5 billion.

Understated Accruals and Errors for Other Medi-Cal Programs

DHCS understated expenditures and related revenues in the Federal Fund by $415 million for the Specialty Mental Health Services (Mental Health) program. The Mental Health program provides specialty mental health services for Medi-Cal beneficiaries who meet certain medical necessity criteria. DHCS uses estimates in the accrual for the payments it expects to make in future years. The misstatement occurred because DHCS's original estimate for the service year costs was too low. Moreover, when actual payment data became available, DHCS did not reassess the estimated payments used in the accrual to ensure that the amounts were reasonably close to actual payments.

Additionally, DHCS made an error when preparing its accrual for the Fee-For-Service program. Fee-For-Service beneficiaries visit health care providers, and those providers submit claims for reimbursement to the Medi-Cal Program for administered services. Although the amounts DHCS determined for the accrual were reasonable, it used the wrong liability account when preparing the accounting entries. Specifically, DHCS incorrectly recorded the entry to the Due to Other Governments account. Because the Fee-for-Service program makes payments to health care providers, rather than governmental entities, DHCS should have recorded the entry as an accounts payable liability. After we brought this issue to DHCS's attention, accounting staff subsequently revised the accrual to correct this error.

Criteria:

State Administrative Manual (SAM) sections 8340 and 10608 require departments to accrue expenditures at fiscal year-end and record liabilities in accounts showing to whom amounts are due. SAM section 7981 requires departments to review their expenditure accruals periodically for material changes.

California Government Code section 12461 requires the State Controller's Office (State Controller) to issue an annual financial report 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. To prepare its financial report, 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 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 nonexchange transactions, recipients should recognize revenues, and providers should recognize expenditures, when all applicable eligibility requirements are met. This includes incurring an allowable cost under an expenditure-driven grant.

SAM section 7630 requires amounts due to private persons or organizations for outstanding obligations for goods and services received that have not been paid, to be recorded as Accounts Payable.

Recommendations:

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

- Develop detailed accrual methodologies and update them annually.

- Update its initial accrual calculations for material changes that occur prior to the issuance of the ACFR.
- Improve internal communications among program and accounting staff who prepare the GAAP accruals.
- Provide additional guidance and training to program and accounting staff on the requirements of GAAP.

Department's View and Corrective Actions:

DHCS stated that it is committed to reviewing and updating its accrual methodologies annually. Furthermore, DHCS indicated that its accrual methodologies will include clearly defined preparation steps and robust review of accounting entries. Additionally, DHCS stated that its GAAP procedures will include review of previously submitted entries for material changes prior to the issuance of the ACFR. DHCS also plans to improve internal communications in relation to the GAAP accruals. According to DHCS, its accounting staff currently engage program partners in the GAAP process starting mid-fiscal year to train program staff, understand changes to programs' funding and expenditures, and amend procedures as applicable. Finally, DHCS asserted that it currently provides annual training to program and accounting teams on the importance of GAAP accruals. Nevertheless, it plans to review current training documents and update them accordingly to include guidance related to GAAP requirements and provide direction to review prior-period accrual entries for any potential adjustments or updates.

VARIOUS DEPARTMENTS PREPARING YEAR-END FINANCIAL REPORTS

Reference Number: 2023-6

Condition:

Multiple state departments did not prepare their year-end financial reports in accordance with generally accepted accounting principles (GAAP). Most of these departments operated programs during fiscal year 2022–23 that incurred expenditures material to the State's financial statements. Additionally, nearly all of these departments have encumbered significant amounts on active contracts expected to incur additional costs in future fiscal years. For example, departments operating programs within the Environmental and Natural Resources Fund reported $19.6 billion in encumbered agreements at June 30, 2023. The preparation of financial reports based on improper policies and procedures raises the risk of material misstatement to the State's Annual Comprehensive Financial Report (ACFR). As a result, many of these departments reassessed their year-end practices and submitted the necessary corrections to the State Controller's Office (State Controller), which factored in the ACFR's late publication. For the remaining departments, we performed additional procedures to mitigate this risk.

The state departments we reviewed limit their reporting of liabilities to invoices received from grantees or contractors during a brief predetermined period. However, we found that in many instances, these entities are not submitting timely invoices to the State. Rather, they may be waiting months or years before requesting payment. In such circumstances, departments are required to estimate the liability the State owes for these unbilled incurred costs.

The lack of necessary estimates is a recurring issue for many of these departments. We issued a finding for fiscal year 2021–22 recommending that five departments—the California Air Resources Board (CARB), the California Energy Commission (Energy), the California Department of Parks and Recreation (State Parks), the State Water Resources Control Board (SWRCB), and the Department of Housing and Community Development (HCD)—adopt GAAP-compliant policies and procedures. Three of these departments—CARB, Energy, and State Parks—reassessed their year-end processes for fiscal year 2022–23 only after submitting their financial reports to the State Controller. However, these revisions were still limited to the reporting of received invoices. In addition, the invoices that State Parks received from July through December 2023 included $28 million of costs incurred prior to fiscal year 2022–23. Consequently, State Parks did not report these expenditures in a timely manner. We identified similar instances for CARB and the California Department of Public Health, for which we issued a similar finding in fiscal year 2021–22 related to policies and procedures.

When grantees or contractors submit large invoices on an irregular basis, the preparation of estimates plays a critical role in financial reporting. For example, despite our reporting of a finding of this nature in the prior year audit, SWRCB limited its reporting of liabilities for fiscal year 2022–23 to invoices received by June 30, 2023. However, this approach did not account for all of the liabilities in need of reporting. Specifically, we identified in November 2023 through early 2024 that the SWRCB received invoices totaling $41 million for costs related to fiscal year 2022–23, as well as other invoices amounting to $120 million for costs related to fiscal year 2021–22, all from the same grantee. When we brought this matter to its attention, the SWRCB declined to correct this error, citing its desire for additional guidance from the State Controller.

The other department included in the prior year finding, HCD, is still in the process of updating its year-end accrual policies and procedures for the grant programs it administers related to the Federal Fund, General Fund, and other funds. Although HCD has made some progress in this area, it needs to make additional efforts in its preparation of estimates.

For fiscal year 2022–23, we identified additional departments with non-GAAP compliant policies and procedures of a similar nature. For example, the Department of Water Resources' policy is to report only liabilities associated with invoices received by August 10, so we performed additional procedures to mitigate this risk to its financial reports. In addition, the High Speed Rail Authority (HSRA) must estimate its accruals for construction contract expenditures when it incurs costs but has not yet received an invoice. However, we found that HSRA's year-end accrual procedures for the Transportation Fund and the Environmental and Natural Resources Fund do not have sufficient detail to ensure that HSRA prepares these accruals in compliance with GAAP. Specifically, HSRA does not have detailed procedures for estimating and accruing expenditures incurred but not yet invoiced during the fiscal year, such as specific directions for HSRA staff to obtain and verify the data upon which it bases its accrual estimates. The lack of such procedures resulted in the department having to submit corrections to the State Controller totaling $272 million.

The lack of GAAP-compliant policies and procedures also affected the financial reports of the Department of Transportation (Caltrans) for the Federal Fund. Specifically, Caltrans understated its transportation expenditure and intergovernmental revenue account balances in the Federal Fund by $1.6 billion when it incorrectly adjusted its budgetary-basis accounts to remove the impact of encumbrances. To comply with the GAAP-basis reporting instructions established by the State Controller, Caltrans submitted an adjusting entry to eliminate encumbrances from the balances being reported in the ACFR. However, this entry removed the impact of encumbrances that Caltrans already omitted from its budgetary-basis account balance for expenditures and revenues, thus resulting in an understatement to transportation expenditures and intergovernmental revenues of $1.6 billion.

Although Caltrans' existing procedures for preparing budgetary-basis accounts require the inclusion of encumbrances, it did not follow those procedures. The chief of the Caltrans Office of Financial Accounting and Analysis cited the department's use and misinterpretation of obsolete reporting guidance as the cause of her staff deviating from the existing procedures. However, Caltrans' procedures do not directly address how to properly adjust for encumbrances for year-end reporting. Similarly, Caltrans' procedures for developing its adjusting entry to properly accrue GAAP-compliant expenditures by eliminating encumbrances do not include detailed guidance to assist staff in fully understanding its process. A strong conceptual explanation of the reasons for the required calculations would have helped Caltrans staff better understand how to prepare balances for budgetary-basis and year-end reporting.

Despite the various attempts that the state departments discussed above have made to improve their practices for developing accruals for fiscal year 2022–23, they still lack formal policies and procedures to ensure that they are accurately identifying and reporting their expenditures and revenues. Departments have the responsibility for tracking material expenditures and properly recording them in the State's financial statements. Therefore, this issue continues to pose a significant risk of material misstatements persisting in the State's financial statements.

Criteria:

Departments are responsible for maintaining a system of controls over financial reporting. The design and operation of these controls should permit management and staff, in the normal course of performing their duties, to prevent, or detect and correct, misstatements to the financial reports, in a timely manner.

State Administrative Manual sections 8340 and 10608 require departments to accrue expenditures at fiscal year-end and record liabilities in accounts showing to whom amounts are due. SAM section 7981 requires departments to review their expenditure accruals periodically for material changes.

Codification of Governmental Accounting and Financial Reporting Standards section 1600 specifies the use of the modified accrual basis of accounting in governmental-fund financial statements. Under this basis, departments should recognize expenditures in the period they incur the liability, if measurable.

Codification of Governmental Accounting and Financial Reporting Standards section N50 states that for nonexchange transactions, recipients should recognize revenues, and providers should recognize expenditures, when all applicable eligibility requirements are met. This includes incurring an allowable cost under an expenditure-driven grant. For cash and other assets given in advance in nonexchange transactions, providers should report them as advances (assets), and recipients should report them as liabilities until they incur allowable costs and meet all eligibility requirements.

The *SCO's Procedure Manual for Budgetary-Basis Reporting* requires departments to submit a pre-closing trial balance. This report should include the year-end account balances, including cash, accruals, current year adjustments, and prior year accrual reversals. The manual also requires departments to include encumbrances, which recognize commitments related to unfulfilled purchase orders or outstanding contracts.

The *SCO's Procedure Manual for GAAP-Basis Reporting* instructs departments to prepare adjusting entries to eliminate the impact of encumbrances on their account balances to comply with the reporting standards established by the Governmental Accounting Standards Board.

Recommendations:

- To ensure the proper reporting of expenditures, departments should develop GAAP-compliant policies and procedures on how to prepare year-end accruals and train their staff to follow them.

- To ensure the proper reporting of expenditures, Caltrans should revise its procedures to include specific guidance for adhering to budgetary and GAAP reporting requirements in the context of its funds. Caltrans should train its accounting staff to ensure that they understand applicable reporting requirements and comply with department procedures.

Departments' Views and Corrective Actions:

Caltrans, HSRA, Energy, Public Health, State Parks, and SWRCB agreed with our recommendations and indicated they would implement them.

DWR stated that it is open to implementing our recommendations, but that it would be significantly valuable for the SCO to provide instructions and examples on how to address GAAP reporting. DWR stated that it relies on the SCO for guidance when establishing policies and procedures, and that it was not aware of existing guidance related to the expenditure accrual issues discussed in our finding.

CARB agreed with our recommendations and stated that it has already developed policies and procedures that comply with GAAP, conducted targeted training sessions, and reviewed prior fiscal year accruals to ensure the accurate reflection of costs.

HCD stated that it would make additional efforts towards finalizing its documentation for the preparation of estimates. However, HCD also stated that it does not agree that such estimates are currently missing from the year-end financial reports.

Comment:

To provide clarity and perspective, we are commenting on the responses from CARB and HCD:

Because CARB did not provide us with the policies and procedures mentioned above before we concluded our audit, we will request and review them during our upcoming fiscal year 2023–24 audit.

Although HCD was able to provide sufficient evidence supporting the existence of estimated advances to grantees, it did not provide similar evidence to support its claim that the financial reports include estimates for any amounts owed to grantees.

CALIFORNIA DEPARTMENT OF FORESTRY AND FIRE PROTECTION

Reference Number: 2023-7

Condition:

In prior fiscal years, we reported that the California Department of Forestry and Fire Protection (CalFire) did not reconcile its accounts to the State Controller's Office's (State Controller) records in a timely manner. During fiscal year 2022–23, CalFire continued to complete its reconciliations late. In particular, the department completed nine monthly reconciliations, ranging from August 2022 to May 2023, in August 2023. Consequently, the reconciliations for some months were extremely late—more than 300 days late for August 2022. These delayed reconciliations also contributed to CalFire's delay in submitting its year-end financial reports to the State Controller. The monthly account reconciliation serves as an important internal control because it enables departments to detect fraud and to identify and resolve errors or omissions in the financial information that is ultimately reported in the State's Annual Comprehensive Financial Report. We inquired of CalFire the reason why it continues to complete its monthly reconciliations late. CalFire's chief of accounting attributed its delays to needing to obtain information from the current year's approved budget before completing its required reconciliation tasks. As the need to obtain current budgetary information is a concern facing all departments, CalFire should discuss with its control agencies how it can obtain the needed information and still meet its reporting requirements.

Criteria:

State Administrative Manual (SAM) section 7901 requires that departments reconcile their accounts to those accounts maintained by the State Controller to disclose errors as they occur. Departments should analyze differences and make corrections to their accounts or request corrections to the State Controller's accounts so that information between both systems is complete and accurate. Corrections to errors must be made as soon as possible, and reconciling differences must be resolved before financial reports are prepared to ensure the accuracy of these reports. Reconciliations shall be prepared monthly within 30 days of the end of the preceding month.

SAM section 7930 requires that departments submit their year-end financial reports to the State Controller by August 31 for all funds.

Recommendations:

- CalFire should perform its monthly reconciliations to the accounts maintained by the State Controller in a timely manner, and it should do so before submitting timely financial reports to the State Controller.

- CalFire should redesign internal business processes that are affecting the timeliness of monthly reconciliations.

Department's View and Corrective Actions:

CalFire acknowledged the importance of reconciling and reporting financial data in a timely manner and noted that it had made progress in meeting the timelines required for financial reporting. It also noted that it has received approval to add positions to address its workload and has made internal enhancements to allow staff to more quickly and efficiently reconcile their budgets. However, CalFire stated that some of the obstacles preventing its timely reporting were outside of its control, such as delays in closing prior years' financial statements.

CALIFORNIA GOVERNOR'S OFFICE OF EMERGENCY SERVICES AND CALIFORNIA DEPARTMENT OF FORESTRY AND FIRE PROTECTION

Reference Number: 2023-8

Condition:

The California Governor's Office of Emergency Services (CalOES) and the California Department of Forestry and Fire Protection (CalFire) are responsible for recording amounts in the State's financial statements for reimbursements due from the federal government for disaster response work performed by CalFire. In fiscal year 2022–23, CalOES and CalFire recorded a $912 million restatement, reducing the amount due from the federal government in fiscal year 2021–22. However, when we initially requested documentation to support the restatement, each department informed us that it was the other department's responsibility to justify the amounts recorded.

Each year CalOES and CalFire must collaborate to record accurate amounts related to the disaster recovery work that CalFire performs that will be reimbursed by the Federal Emergency Management Agency (FEMA). CalFire engages in disaster recovery efforts and must provide estimated and actual costs of those efforts to CalOES to request federal reimbursement. CalOES is the Governor's designated representative to FEMA and, therefore, is the party responsible for managing the receipt of federal aid. Accordingly, CalOES and CalFire must partner to ensure the proper presentation in the State's financial statements of amounts related to costs that the State expects to be reimbursed by FEMA.

During fiscal year 2022–23, CalOES revised its accrual policy to comply with generally accepted accounting principles (GAAP). Specifically, it clarified when the State has entered into a grant agreement with FEMA and thus is eligible to seek reimbursement under the grant. It then applied the revised policy to the reporting of reimbursements for fiscal year 2021–22 and submitted entries to correct its accrual for that year from $962 million to $50 million. However, CalOES took responsibility for supporting only the $50 million it now believes it should accrue and stated that the $912 million adjustment was an estimate derived by CalFire. Conversely, when we spoke with CalFire, it stated that it was directed by CalOES to record the restatement.

The fiscal year 2021–22 accrual is now being restated because the two departments have not worked collaboratively in the past, and there is risk of misstatements in future years if the departments continue not to work together. To develop an accurate accrual, CalOES and CalFire will have to collaborate more effectively because each department has more readily available access to certain relevant information. Specifically, CalOES has direct access to information from FEMA regarding its review and approval of costs, including FEMA's approval of grants. Correspondingly, CalFire as the applicant has greater access to the details supporting the actual costs that form the basis of the federal reimbursement. Each department should share sufficient information with the other so that the collective group has a sufficient understanding of the annual accrual and is thus able to ensure its accuracy. However, if the departments continue their current isolated methods, their efforts will result in an increased risk of misstatements in future accruals.

Criteria:

Codification of Governmental Accounting and Financial Reporting Standards section N50 states that for nonexchange transactions, recipients should recognize revenues and providers should recognize expenditures when all applicable eligibility requirements are met. This accounting recognition includes incurring an allowable cost under an expenditure-driven grant for executed grants. In the absence of an executed grant agreement before the end of the reporting period and when incurred costs could be reimbursable once the grant agreement is executed, reimbursement revenue for allowable costs should be recognized only after the grant agreement is executed.

The *Code of Federal Regulations* Federal Emergency Agency subchapter for Disaster Assistance Part 206 section 202 identifies the State as the recipient of disaster funding. The recipient is designated as the grant administrator for all funds provided under the Public Assistance Program. The recipient approves subgrants based on FEMA's grant approval, and applicants submit subgrant requests.

Management is responsible for establishing and maintaining a system of internal controls designed to provide reasonable assurance of accurate financial reporting in accordance with GAAP and in compliance with applicable statutes and regulations.

Recommendation:

CalFire and CalOES should jointly develop guidelines that describe their annual process of identifying amounts due from the federal government. The guidelines should include the responsibilities of each entity, including an acknowledgment of the individual and shared responsibilities to submit accurate financial statements to the State Controller's Office.

Departments' Views and Corrective Actions:

CalOES agreed with the finding and stated that it has already addressed the recommendation by revising its existing policies and procedures to comply with GAAP. Further, CalOES agreed to continue meeting with CalFire to provide technical assistance and to support efforts to establish additional guidelines within CalFire's own accrual processes. In addition, CalOES plans to update its policies and procedures in more detail to expand on each department's shared and individual responsibilities for submitting accurate financial statements.

CalFire similarly agreed with our recommendation. CalFire agreed to collaborate with CalOES and establish comprehensive guidelines outlining the responsibilities of each department to submit accurate financial statements.

Comment:

Because CalOES did not provide us with its finalized policies and procedures before we concluded our audit, we will request and review them during our upcoming fiscal year 2023–24 audit.

CALIFORNIA ENERGY COMMISSION

Reference Number: 2023-9

Condition:

For fiscal year 2022–23, the California Energy Commission (Energy) did not complete its monthly reconciliation of its accounts to the State Controller's Office's (State Controller) records in a timely manner. In particular, Energy stated that it did not begin performing its fiscal year 2022–23 reconciliations until November 2022, which is five months into the fiscal year and beyond the state requirement of preparing reconciliations within 30 days of the preceding month. However, Energy was unable to determine specifically when it completed any of its reconciliations because it did not sign and date them upon completion. As a result of delayed reconciliations, Energy also submitted its year-end financial reports to the State Controller two-and-a-half months late. The monthly account reconciliation serves as an important internal control because it enables departments to detect fraud and to identify and resolve errors or omissions in the financial information that is ultimately reported in the State's Annual Comprehensive Financial Report.

Energy stated that it was unable to begin its monthly reconciliations until the State Controller had approved its cost allocation plan, which did not occur until November 2022. Energy also attributed its delays to the departure of a key member of its accounting department. Energy stated that it is in the process of developing a policy requiring that it perform monthly account reconciliations to the State Controller's records in compliance with the *State Administrative Manual*.

Criteria:

State Administrative Manual (SAM) section 7901 requires that departments reconcile their accounts to those accounts maintained by the State Controller to disclose errors as they occur. Departments should analyze differences and make corrections to their accounts or request corrections to the State Controller's accounts so that information between both systems is complete and accurate. Corrections to errors must be made as soon as possible, and reconciling differences must be resolved before financial reports are prepared to ensure the accuracy of these reports. Reconciliations shall be prepared monthly within 30 days of the preceding month.

SAM section 7930 requires that departments submit their year-end financial reports to the State Controller by August 31 for all funds.

Recommendations:

- Energy should perform its monthly reconciliations and submit its financial reports to the State Controller in a timely manner.

- Energy should proactively address its organization's succession planning to ensure that when key staff leave, the department can still perform reconciliations promptly. This effort may include conducting cross-training of other existing staff positions, requesting funding for additional positions, or exploring the possibility of contracting for external assistance to provide additional support.
- Energy should redesign internal business processes that are affecting the timeliness of monthly reconciliations.
- Energy should work with the Department of Finance and the State Controller to obtain any additional training for staff to ensure that they can properly perform monthly reconciliations and do so in a timely manner.

Department's View and Corrective Actions:

Energy agreed with our recommendation to perform monthly reconciliations and submit timely financial reports to the State Controller. It stated that it has begun implementing corrective actions to address the signing and dating of the monthly reconciliations and to engage in succession planning, including cross-training its staff.

DEPARTMENT OF PARKS AND RECREATION

Reference Number: 2023-10

Condition:

For fiscal year 2022–23, the Department of Parks and Recreation (State Parks) did not complete its monthly reconciliation of its accounts to the State Controller's Office's (State Controller) records in a timely manner or not at all. Specifically, State Parks did not prepare monthly reconciliations for nine months of the fiscal year and did not complete the reconciliations for the other three months until after the 30-day requirement. Consequently, State Parks submitted year-end financial reports to the State Controller two months late. The monthly account reconciliation serves as an important internal control because it enables departments to detect fraud and to identify and resolve errors or omissions in the financial information that is ultimately reported in the State's Annual Comprehensive Financial Report.

State Parks' chief of accounting stated that State Parks did not perform a reconciliation for each month because of errors it had discovered during the monthly reconciliation process that it could not resolve without the assistance of the Department of FISCal. Because of the amount of time it took to resolve these errors, the chief of accounting indicated that State Parks consolidated several months of reconciliations to finalize its year-end reporting tasks. The chief of accounting also noted that State Parks had initial vacancies in positions that were critical to completing the monthly reconciliations during fiscal year 2022–23 that were ultimately filled with new hires that the department needed to train, which further compounded the delays in completing the reconciliations. State Parks stated that it is in the process of developing a policy requiring that these reconciliations be performed monthly in compliance with the *State Administrative Manual.*

Criteria:

State Administrative Manual (SAM) section 7901 requires that departments reconcile their accounts to those accounts maintained by the State Controller to disclose errors as they occur. Departments should analyze differences and make corrections to their accounts or request corrections to the State Controller's accounts so that information between both systems is complete and accurate. Corrections to errors must be made as soon as possible, and reconciling differences must be resolved before financial reports are prepared to ensure the accuracy of these reports. Reconciliations shall be prepared monthly within 30 days of the preceding month.

SAM section 7930 requires that departments submit their year-end financial reports to the State Controller by August 31 for all funds.

Recommendations:

- State Parks should perform its monthly reconciliations to the accounts maintained by the State Controller and submit timely financial reports to the State Controller.

- State Parks should proactively address its organization's succession planning to ensure that when key staff leave, the department can still perform reconciliations promptly. This effort may include conducting cross-training of other existing staff positions, requesting funding for additional positions, or exploring the possibility of contracting for external assistance to provide additional support.

- State Parks should redesign internal business processes that are affecting the timeliness of monthly reconciliations.

- State Parks should work with the Department of Finance and the State Controller to obtain any additional training for staff to ensure that they can properly perform monthly reconciliations and do so in a timely manner.

Department's View and Corrective Actions:

State Parks stated that it agrees with the findings and acknowledges the recommendations. It indicated that it is in the process of refining its policies to ensure full compliance with SAM. State Parks also indicated that it will continue to participate in the Department of Finance's training on month-end and year-end closes.

DEPARTMENT OF PARKS AND RECREATION

Reference Number: 2023-11

Condition:

As we have reported in previous fiscal years, the Department of Parks and Recreation (State Parks) has not reconciled its capital asset account balances for buildings and related improvements to a subsidiary inventory ledger. Therefore, State Parks has not been reporting complete and accurate information to the State Controller's Office (State Controller) for inclusion in the State's Annual Comprehensive Financial Report (ACFR). During fiscal year 2022–23, we again found that State Parks lacked a comprehensive inventory of its capital assets and therefore continues to be unable to reconcile its account balances. As a result, for fiscal year 2022–23, State Parks reported the same capital assets to the State Controller that it reported in fiscal year 2017–18. Furthermore, we found that several of State Parks' policies describing how it will update its capital asset inventory do not ensure that its records will be in compliance with generally accepted accounting principles (GAAP). For example, its policies do not address the impairment or improvement of capital assets, and its policies on capitalizing work-in-progress costs are inconsistent with GAAP. Based on the historical level of funding made available to State Parks for capital assets, these issues do not pose a material risk of misstatement to the State's fiscal year 2022–23 ACFR. Nevertheless, it is important for State Parks to implement our recommendations to avoid a possible material misstatement in the future.

According to State Parks' chief of accounting, the department's more recent efforts to implement our recommendations were delayed because of its staff's ongoing efforts to resolve issues that they have detected within the asset listing.

Criteria:

Codification of Governmental Accounting and Financial Reporting Standards section 1400.102 states that capital assets should be reported at historical cost. The cost of a capital asset should include ancillary charges necessary to place the asset into its intended location and condition for use. Ancillary charges include costs that are directly attributable to asset acquisition, such as freight and transportation charges, site preparation costs, and professional fees. Interest cost incurred before the end of a construction period should not be capitalized as part of the asset's historical cost. Donated capital assets should be reported at their acquisition value plus ancillary charges, if any.

Codification of Governmental Accounting and Financial Reporting Standards section 1400.104 states that capital assets should be depreciated over their estimated useful lives unless they are inexhaustible, are intangible assets with indefinite useful lives, or are infrastructure assets reported using the modified approach.

State Administrative Manual (SAM) section 8650.1 states that to maintain accountability of capital assets, departments are required to maintain a record of all property, whether capitalized or not, in a property accounting or inventory system.

SAM section 8650.2 states that when capital assets are acquired, departments will record certain information in their systems including the date acquired, property description, owner fund, and historical cost or other basis of valuation.

SAM section 7924 directs departments to reconcile acquisitions and dispositions of capitalized assets and property with the amounts recorded in the property register. The reconciliation should be done monthly or at least quarterly, depending on the volume of transactions.

SAM section 8652 states that departments are to make a physical count of all property and reconcile the count with their accounting records at least once every three years.

Recommendations:

To ensure that it properly reports its capital assets in its year-end financial statements, State Parks should take the following actions:

- Develop policies and procedures for capital asset accounting and reporting that comply with GAAP.
- Conduct a comprehensive inventory of capital assets.
- Update its subsidiary capital asset records in the Financial Information System for California (FI$Cal) to reflect the results of the inventory and ensure that its year-end financial reports reflect any necessary restatements.
- In accordance with SAM section 8652, conduct a physical count of all property and reconcile the count with its accounting records at least once every three years.

Department's View and Corrective Actions:

State Parks agrees with the findings and stated that it will take the following actions:

- Enhance its policies and procedures to ensure compliance with GAAP.
- Complete a comprehensive inventory, which is currently underway, with all districts and divisions reviewing FI$Cal capital asset records.
- Update its FI$Cal capital asset records to reflect any necessary restatements from its comprehensive inventory.
- Conduct physical property inventories at least once every three years in accordance with SAM section 8652.

CALIFORNIA DEPARTMENT OF RESOURCES, RECYCLING AND RECOVERY

Reference Number: 2023-12

Condition:

In prior fiscal years, the California Department of Resources, Recycling and Recovery (CalRecycle) did not complete bank reconciliations or reconcile its accounts to the State Controller's Office's (State Controller) records in a timely manner. During fiscal year 2022–23, CalRecycle continued to struggle to perform these reconciliations on time. For example, all 12 monthly bank reconciliations for that fiscal year were late, and CalRecycle completed four of those reconciliations more than six months after the 30-day requirement. Both the bank reconciliation and the monthly account reconciliation serve as important internal controls because they enable departments to detect fraud and to identify and resolve errors or omissions in the financial information that is ultimately reported in the State's Annual Comprehensive Financial Report.

Similarly, CalRecycle continued to submit late year-end financial reports to the State Controller. Compounding the issues identified above, CalRecycle submitted its year-end financial reports for fiscal year 2022–23 in September 2023, one month before it completed its June 2023 bank reconciliation in October 2023. This sequence is concerning because the completion of bank reconciliations is a necessary control for ensuring that the information in the financial reports is accurate.

CalRecycle indicated that it did not complete its monthly reconciliations on time because it experienced significant turnover in accounting staff, and it had to focus on training newly hired staff. Additionally, CalRecycle noted that its late completion of fiscal year 2021–22 financial reports was a significant contributing factor to the delayed completion of reconciliations in fiscal year 2022–23.

Criteria:

State Administrative Manual (SAM) section 7901 requires that departments reconcile their accounts to those accounts maintained by the State Controller to disclose errors as they occur. Departments should analyze differences and make corrections to their accounts or request corrections to the State Controller's accounts so that information between both systems is complete and accurate. Corrections to errors must be made as soon as possible, and reconciling differences must be resolved before financial reports are prepared to ensure the accuracy of these reports. Reconciliations shall be prepared monthly within 30 days of the preceding month.

SAM section 7923 requires departments to reconcile their bank account balances with the like accounts maintained in the Centralized Treasury Trust System (CTS). Departments must reconcile their general cash, revolving fund cash, and agency trust fund cash accounts with their CTS Account Statement bank balance, and adjust for deposits in-transit, outstanding checks, and other reconciling items.

SAM section 7930 requires that departments submit their year-end financial reports to the State Controller by August 31 for all funds.

Recommendations:

- CalRecycle should perform its monthly bank reconciliations and reconciliations to the accounts maintained by the State Controller in a timely manner, and it should do so before submitting timely financial reports to the State Controller.
- CalRecycle should proactively address its organization's succession planning to ensure that when key staff leave, the department can still perform reconciliations promptly. This effort may include conducting cross-training of other existing staff positions, requesting funding for additional positions, or exploring the possibility of contracting for external assistance to provide additional support.
- CalRecycle should redesign internal business processes that are affecting the timeliness of monthly reconciliations.
- CalRecycle should work with the Department of Finance and the State Controller to obtain any additional training for staff to ensure that they can properly perform monthly reconciliations and do so in a timely manner.

Department's View and Corrective Actions:

CalRecycle agreed with our finding and indicated that it is committed to implementing our recommendations. It noted that it is reviewing its internal business processes to improve workflow. CalRecycle also said that it prioritizes the submission of all financial statements before completing the current year's reconciliations.

Comment:

To provide clarity and perspective, we are commenting on CalRecycle's response to our finding.

CalRecycle's statement that it prioritizes the submission of financial statements over the completion of reconciliations raises concerns about whether it adequately understands financial reporting requirements. When a department submits its financial statements to the State Controller, it certifies that the statements are accurate and complete. However, it would not be able to ensure the validity of that certification if it had not already completed its bank reconciliations. By submitting its financial statements before completing its reconciliations, CalRecycle increases the risk that the information it submits to the State Controller contains errors that could result in misstatements to the State's financial statements.

STATE WATER RESOURCES CONTROL BOARD

Reference Number: 2023-13

Condition:

In prior fiscal years, we reported that the State Water Resources Control Board (SWRCB) did not reconcile its accounts to the State Controller's Office's (State Controller) records in a timely manner. During fiscal year 2022–23, SWRCB continued to complete its reconciliations significantly late. For example, the department completed its September 2022 reconciliation in May 2023, more than 6 months after the deadline of October 2022. As a result of delayed reconciliations, SWRCB also submitted late year-end financial reports to the State Controller. The monthly account reconciliation serves as an important internal control because it enables departments to detect fraud and to identify and resolve errors or omissions in the financial information that is ultimately reported in the State's Annual Comprehensive Financial Report.

SWRCB cited a significant staff vacancy rate and difficulty recruiting and retaining accounting staff, and the delay in closing fiscal year 2021–22 monthly account reconciliations as contributing factors in its late completion of fiscal year 2022–23 reconciliations.

Criteria:

State Administrative Manual (SAM) section 7901 requires that departments reconcile their accounts to those accounts maintained by the State Controller to disclose errors as they occur. Departments should analyze differences and make corrections to their accounts or request corrections to the State Controller's accounts so that information between both systems is complete and accurate. Corrections to errors must be made as soon as possible, and reconciling differences must be resolved before financial reports are prepared to ensure the accuracy of these reports. Reconciliations shall be prepared monthly within 30 days of the preceding month.

SAM section 7930 requires that departments submit their year-end financial reports to the State Controller by August 31 for all funds.

Recommendations:

- SWRCB should perform its monthly reconciliations and submit its financial reports to the State Controller in a timely manner.

- SWRCB should proactively address its organization's succession planning to ensure that when key staff leave, the department can still perform reconciliations promptly. This effort may include conducting cross-training of other existing staff positions, requesting funding for additional positions, or exploring the possibility of contracting for external assistance to provide additional support.

- SWRCB should redesign internal business processes that are affecting the timeliness of monthly reconciliations.

- SWRCB should work with the Department of Finance and the State Controller to obtain any additional training for staff to ensure that they can properly perform monthly reconciliations and do so in a timely manner.

Department's View and Corrective Actions:

SWRCB acknowledges and understands the importance of performing timely reconciliations and having complete year-end procedures to fulfill internal control and reporting requirements. In particular, SWRCB agrees with our recommendations and has implemented some of them. Additionally, SWRCB will continue to develop plans and processes based on our recommendations to comply with year-end accrual reporting requirements and timely monthly reconciliations.

MULTIPLE DEPARTMENTS IMPLEMENTING GOVERNMENTAL ACCOUNTING STANDARDS BOARD STATEMENT NUMBER 87

Reference Number: 2023-14

Condition:

In fiscal year 2021–22, we reported that multiple departments were unable to ensure the reasonableness of the lease information they reported to the State Controller's Office (State Controller) for inclusion in the State's Annual Comprehensive Financial Report when implementing a new accounting standard. For fiscal year 2022–23, the California Highway Patrol (CHP) and the California Department of Transportation (Caltrans) continued to be unable to ensure the completeness of the lease information they reported to the State Controller. Specifically, Governmental Accounting Standards Board Statement Number 87 (GASB 87), *Leases*, establishes standards for accounting and financial reporting of leases, effective for fiscal year 2021–22. In response to the finding, CHP asserted that it would correct this deficiency by obtaining a master lease list from the Department of General Services and reconciling that information to CHP's list of leases to ensure completeness. However, CHP indicated that it has not yet performed this reconciliation because of staff turnover and changing priorities. Although Caltrans made a number of improvements to its GASB 87 procedures, those efforts did not include addressing our concerns about being able to ensure completeness of the lease information, which remains our key concern.

Criteria:

GASB 87 defines a lease as a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) as specified in the contract for a period of time in an exchange or exchange-like transaction. GASB requires governments to account for any contract that meets this definition under the GASB 87 lease guidance.

GASB Concepts Statement Number 1 establishes that information in financial reports must be reliable and comprehensive. GASB states that nothing material should be omitted from the information necessary to faithfully represent the underlying events and conditions.

Recommendation:

Departments should develop and implement procedures to ensure completeness of the leases they report. They should also ensure that they adequately train their staff on validating the completeness of their lease information.

Departments' Views and Corrective Actions:

CHP agrees with the finding and stated that it has developed and implemented procedures in accordance with the State Controller's GASB 87 reporting instructions and will continue to train staff on GASB 87 requirements. CHP is currently reassessing the workload assigned to the Asset Management/Lease Administrator desk. It may determine that redirecting some duties to another desk would facilitate regular reconciliations of the master lease lists, which would ensure that the information reported to the State Controller is reliable, comprehensive, and complete.

Caltrans stated that it appreciates our acknowledgement of its improvements and our recommendations for developing and implementing procedures to ensure completeness of leases. However, Caltrans asserted that its improvements address completeness, which includes but is not limited to clarifying roles and responsibilities, providing training and resources, cross-referencing lease contracts, and updating procedures. Caltrans' Office of Financial Accounting and Analysis (Accounting) and its districts and programs work together in partnership to address completeness. Accounting will continue to work with its partners and develop additional reporting tools and update its procedures to ensure that the universe of leases are identified and reported appropriately.

Comment:

To provide clarity and perspective, we are commenting on Caltrans' response to our finding.

Although Caltrans made some improvements to its policies, such as defining roles and responsibilities for certain accounting positions and district contacts, it did not include steps in those policies to ensure completeness. During our audit, Caltrans' accounting chief acknowledged that Accounting does not perform completeness procedures to ensure that it has not missed a contract. Caltrans stated that it would work with the districts to develop and update the procedures to address completeness.

Financial Audit Team for the *State of California: Financial Report for the Fiscal Year Ended June 30, 2023,* Report 2023-001, and the *State of California: Internal Control and Compliance Audit Report for the Fiscal Year Ended June 30, 2023*, Report 2023-001.1

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