Judicial Council of California · Administrative Office of the Courts

455 Golden Gate Avenue · San Francisco, California 94102-3688

www.courts.ca.gov

REPORT TO THE JUDICIAL COUNCIL

For business meeting on December 13, 2013

Title
Trial Courts: State Auditor Review of Bank Accounts

Agenda Item Type
Information Only

Date of Report
November 14, 2013

Submitted by
Administrative Office of the Courts
Fiscal Services Office
Zlatko Theodorovic, Director

Contact
Greg Keil, 415-865-7956
gregory.keil@jud.ca.gov

Executive Summary

In October 2013, the California State Auditor released a report, *Accounts Outside the State's Centralized Treasury System: Processes Exist to Safeguard Money, but Controls for These Accounts Need Strengthening.* The State Auditor discussed the bank accounts of the trial courts under California Penal Code section 1463.1 and California Government Code section 77009 that facilitate court operations and hold money in trust. There were no issues identified regarding the trial courts having these accounts.

Summary of Findings

The California State Auditor contacted Administrative Director of the Courts Steven Jahr's office on May 13, 2013, regarding an audit[1] of bank accounts held by state agencies outside the Centralized State Treasury System (CTS). The audit scope and objectives were to provide independently developed and verified information related to *state accounts* that exist outside the CTS, including:

1. Reviewing and evaluating relevant laws and regulations;

[1] The scope of the audit is in the "Analysis of Audit Request, 2013-107" (Attachment A), dated March 13, 2013.

2. Determining which agencies are involved in approving and monitoring accounts held outside the CTS and assessing each agency's processes and practices;
3. Determining balances maintained and the source and justification for placing these accounts outside the CTS;
4. Determining what controls are in place limiting deposits to accounts outside the CTS without following applicable laws and procedures;
5. Reviewing sample accounts that exist outside the CTS to determine:
    a. If accounts are established in compliance with laws, regulations, and the *State Administrative Manual*;
    b. Whether fiscal agents or third parties are maintaining these accounts;
    c. The controls in place to ensure that the moneys are properly accounted for and reported; and
    d. Benefits of maintaining accounts outside the CTS, and whether such costs are comparable to costs incurred by the CTS; and
6. Reviewing and assessing any other issues that are significant to the establishment of accounts outside the CTS.

Although the trial courts are not state agencies[2] or departments and accordingly are not subject to the *State Administrative Manual* or other state executive branch compliance requirements, the Administrative Office of the Courts (AOC) Treasury Services, on behalf of the trial courts, cooperated with the audit, responding to the State Auditor's questions and requests for information. Following the initial interview with the State Auditor on May 20, 2013, and subsequent discussions, details of the operation, practices, and legal authority for the trial courts' bank accounts held outside the CTS were provided. This information also included the most recent annual Report of Bank/Savings and Loan Association Accounts Outside the State Treasury System (Report No. 14), dated June 30, 2012, previously supplied to the State Treasurer's Office and State Controller's Office, listing the balances and legal authority for all trial court bank accounts.

In addition, at the request of the State Auditor, court contacts were supplied for the Superior Courts of Los Angeles and Napa Counties, which the auditors contacted directly regarding the operation of particular court bank accounts. The final audit report contained no findings for these two courts sampled.

The 55-page final audit report was released on October 15, 2013, containing five references to the trial courts, summarizing balances, describing samplings of accounts, cost savings realized from pooling of court bank accounts, and the frequency of court audits performed by the AOC's Internal Audit Services. The State Auditor's final report is attached (see Attachment C), with the

[2] Attachment B, the Legal Services Office letter, dated August 2, 2013, addressed to the California State Auditor, provides an analysis of the trial courts' legal entity status.

five trial court references described above appearing on pages 10, 11, 15, 18, and 26.[3] The final report is also available on the auditors' website at *www.bsa.ca.gov/reports/recent*, in addition to the report's Fact Sheet, Highlights, and Summary.

Also attached is the post-audit letter from the AOC to the State Auditor, dated September 13, 2013, emphasizing that the trial courts are not state agencies or departments and accordingly are not subject to the *State Administrative Manual* or other state executive branch compliance requirements.

Attachments

1. Attachment A: Analysis of Audit Request, 2013–107, dated March 13, 2013
2. Attachment B: Legal Services Office letter, dated August 2, 2013;
3. Attachment C: California State Auditor Report 2013-107, dated October 15, 2013
4. Attachment D: Post-audit letter from the AOC to the California State Auditor, dated September 13, 2013

[3] California State Auditor Report 2013-107, *Accounts Outside the State's Centralized Treasury System: Processes Exist to Safeguard Money, but Controls for These Accounts Need Strengthening* (October 2013), page 10, Figure 2, page 11, item 5 of table; page 15, Figure 3, page 18, second full paragraph, third sentence; and page 26, second paragraph, fifth and sixth sentences.

Elaine M. Howle State Auditor
Doug Cordiner Chief Deputy

ANALYSIS OF AUDIT REQUEST
2013-107
March 13, 2013

I. AUDIT REQUEST

Assemblymember Gray is requesting an audit to examine the extent to which state agencies have accounts that exist outside of the State Treasury and to assess the process for establishing and overseeing such accounts.

II. BACKGROUND

The Centralized State Treasury System (CTS) is a system, authorized by state law, where state moneys are deposited in specified local banks for credit to central accounts of the State Treasurer's Office (Treasurer). According to the *State Administrative Manual*, the purpose of the CTS is to maximize the earning of interest consistent with safe and prudent treasury management and to assure that depository banks provide adequate security for deposits of state money. Under this system, each depositing department notifies the Treasurer whenever a deposit is made. The State Controller's Office (Controller) maintains accountability for deposits by specific account.

Departments may be authorized either by state law or by approval from the director of the Department of Finance (Finance) to deposit moneys in banks outside of the CTS. Departments that wish to deposit money in an account outside of the CTS must apply to Finance and provide certain information as specified in the *State Administrative Manual* including: justification for the need for an account outside of the CTS; the name and location of the bank; the amount, source, and purpose of the funds to be deposited; and, the provisions for the withdrawal of the funds. Finance must notify the Controller and the Treasurer every time such a request is approved. In addition, departments that have the authority to deposit funds outside the CTS must submit an annual report to the Controller and the Treasurer that states the balance of these accounts at the end of every fiscal year. Agencies are responsible for ensuring that deposits of funds in accounts outside the CTS comply with applicable provisions of state law and required state procedures.

According to the Controller's *Budgetary/Legal Basis Annual Report*, there was more than $9.8 billion deposited in accounts outside of the CTS as of June 30, 2011. Recent media reports

have raised questions about the use of funds that are deposited outside of the CTS. These media reports have claimed that the California Department of Forestry and Fire Protection (CalFIRE) hid over $3.6 million generated from legal settlements in an account with the nonprofit California District Attorneys Association. News reports state that CalFIRE created the fund in 2005, but in 2009 its own auditors found that it had not received the required approval from Finance to keep the funds outside the state system. Assemblymember Gray is concerned there is public money that the Legislature has no knowledge of and believes that an audit is necessary to shed light on the extent to which these and any other accounts exist outside of the state system and whether they are justified.

III. AUDIT SCOPE AND OBJECTIVES

The audit by the California State Auditor will provide independently developed and verified information related to state accounts that exist outside of the Centralized State Treasury System (CTS) and their oversight and will include, but not be limited to, the following:

1. Review and evaluate the laws, rules, and regulations significant to the audit objectives.

2. Determine which agencies are involved in approving and monitoring accounts held outside of the CTS and assess each agency's processes and practices.

3. For the most recent five years, identify the accounts that exist outside of the CTS and determine how much money is in these accounts, including to the extent possible, the source and justification for placing these accounts outside the CTS.

4. To the extent possible, determine what controls are in place that limit agencies from depositing funds in repositories outside the CTS without following applicable laws and procedures.

5. For a sample of accounts including any for the California Department of Forestry and Fire Protection that exist outside the CTS:

   (a) Identify how amounts deposited are determined. Assess whether the accounts were appropriately established in compliance with laws, regulations, and the *State Administrative Manual*.

   (b) To the extent possible, determine whether fiscal agents or third parties are maintaining these accounts. Determine whether the fiscal agents or third parties comply with all applicable state laws, rules, regulations, and policies for managing and reporting state funds.

   (c) Identify and assess the controls in place to ensure that the moneys in these accounts are properly accounted for and properly reported, and verify whether these accounts are regularly audited.

(d) To the extent possible, determine the benefits of maintaining accounts outside of the CTS, such as costs and whether the fees and charges associated with these accounts are comparable to any charged on the accounts within the CTS.

6. Review and assess any other issues that are significant to the establishment of accounts outside of the CTS and the oversight of these accounts.

IV. OTHER WORK IN THE GENERAL AREA

None.

V. RESOURCE REQUIREMENTS

We estimate that this audit would require approximately 1,960 hours of audit work at a cost of approximately $209,720 plus travel and administrative expenses and the costs related to an outside consultant, if necessary. We will conduct this audit using our existing budget authority to the extent funding is available for audits approved by the Joint Legislative Audit Committee.

VI. REQUIRED DATE OF COMPLETION

Assemblymember Gray did not specify a completion date for this audit.

Elaine M. Howle

ELAINE M. HOWLE, CPA
State Auditor

ATTACHMENT A

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California Legislature

JOINT LEGISLATIVE AUDIT COMMITTEE
ADAM C. GRAY, CHAIR

STAFF
CAMERON VALDERRAMA
CHIEF CONSULTANT

KATARINA TARR
COMMITTEE SECRETARY

February 15, 2013

2013-107

Members
Joint Legislative Audit Committee
1020 N Street, Room 107
Sacramento, CA 95814

Dear Members of the Committee:

I respectfully request the Joint Legislative Audit Committee approve an audit that will examine the extent to which state agencies have accounts outside of the State Treasury, whether all such accounts were properly authorized and the monies properly administered and monitored. I am specifically concerned about the recent revelation that the Department of Forestry and Fire Protection (Cal Fire) deposited state money in an account administered by the nonprofit California District Attorneys Association (CDAA).

State law and administrative policies limit the circumstances under which state funds can be held outside the State Treasury. For instance, the California Government Code requires state funds be deposited in the custody of the state treasurer unless otherwise authorized by the director of finance or deposited directly in the State Treasury. Additionally, the law requires that all money belonging to the State under the control of anyone other than the state treasurer shall be deposited under conditions prescribed by the director of finance and any state employee who deposits money in any manner not prescribed by the director of finance may be terminated. State policies also limit the circumstances under which departments use fiscal agents.

Cal Fire made arrangements with the CDAA to manage settlement funds without authority and the approval of the Department of Finance. Though state law authorizes Cal Fire to recover fire suppression and investigation cost from responsible parties, it does not provide for the management of these monies by fiscal agents in accounts outside of the state system. In 2005, Cal Fire entered into a Memorandum of Agreement with CDAA to promote and improve training of as well as provide equipment for CDF's wildland fire investigators. The CDAA established the Wildland Fire Investigation Training and Equipment Fund to receive settlement monies, which according to the original Agreement can include charitable donations, court settlements, stipulated judgments, court approved settlement agreements, and judgments. In 2011, the original agreement was replaced with a Memorandum of Understanding signed by the two

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entities. In addition to provisions similar to those in the original Agreement, the MOU included a provision to enhance Cal Fire's civil cost recovery abilities. Both agreements specifically state that monies deposited into the fund are not state money. This raises serious concerns and questions about the management of these monies. Further, it's been reported that Cal Fire's regulations require the money to be in the state's general fund.

In December 2012, CDAA notified Cal Fire that it was terminating its performance as the fund manager effective February of this year. The obvious questions surrounding the severing of the arrangement is why terminate the MOU if there were no serious problems with it and what will happen to these settlement funds going forward?

Though I have serious concerns and questions surrounding Cal Fire's agreement with CDAA and settlement funds, state law does allow for the use of court-approved and administratively ordered contributions from environmental enforcement settlements for enforcement activities some of which are managed by CDAA. For example, the Environmental Enforcement and Training Act of 2002 created the Environmental Enforcement and Training Account Grant Program to provide a non-general fund source of financial assistance for environmental enforcement, education, and training to enhance statewide enforcement of environmental laws. CDAA receives 25 percent of these funds for environmental enforcement training.

However, similar to the Department of Parks' and Recreation's underreporting of account balances, Cal Fire did not follow state protocols, leaving the Legislature in the dark about their arrangement with CDAA and, therefore, unable to exercise its oversight responsibilities. Just as important, Cal Fire did not consider these monies state funds. These types of blunders prompt many questions about the proper management and safeguard of state assets.

This arrangement with Cal Fire and the CDAA is another example of state funds that the Legislature has no knowledge of. Coming on the heels of the revelations at the State Parks and Recreation, I believe an audit is necessary to shed light on the extent to which state money is held outside of the state system and whether the accounts are authorized, justified, and properly managed. At a minimum the audit should examine the following:

- What laws, rules and regulations govern the existence and administration of monies and accounts held outside of the State Treasury?
- How many accounts currently exist outside of the State Treasury and what circumstances were present to authorize and/or justify their existence?
- For the most recent 5-years, identify the amount of state money in these accounts and the source of these monies. How are the amounts deposited in these accounts determined?

For Cal Fire accounts held outside of the state system and a sample of other state agencies with accounts outside of the state system determine the following:

- Identify the state agencies involved in approving and monitoring these accounts. Do these agencies have adequate protocols in place to ensure that the monies are properly managed? Are these agencies following applicable laws, rules, and regulations?
- Identify the fiscal agents. To what extent are fiscal agents complying with any state laws, rules, and regulations governing the management and reporting of state monies? Do the fiscal agents have adequate controls in place to ensure the monies are used for only allowable activities at reasonable costs? Are these accounts audited and results publicly reported on a regular basis?
- What is the benefit to the State to have such accounts outside of the state system? Does it cost more to maintain these accounts outside of the state system? For example, how do the fees and charges compare to those charged by the State?

Thank you for your consideration. Should you have any questions do not hesitate to contact Debbie Meador, Chief Consultant to the Joint Legislative Audit Committee, at (916) 319-3300.

Sincerely,

ADAM C. GRAY
Assembly Member, 21ST District
Chair, Joint Legislative Audit Committee

ATTACHMENT B

Judicial Council of California

ADMINISTRATIVE OFFICE OF THE COURTS

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TANI G. CANTIL-SAKAUYE
Chief Justice of California
Chair of the Judicial Council

STEVEN JAHR
Administrative Director of the Courts

MARY M. ROBERTS
Chief Counsel

August 2, 2013

Brandon A. Clift
California State Auditor
555 Capitol Mall, Suite 300
Sacramento, California 95814

Dear Mr. Clift,

This letter responds to your e-mail to Greg Keil, Assistant Treasurer for the Administrative Office of the Courts, dated July 30, 2013. In that e-mail, you asked whether we agreed that courts are "departments" for purposes of section 19462 of the State Administrative Manual (SAM). We do not agree. Nor do we consider courts to be bound by the SAM generally.

Our position is not controversial. The Legislative Counsel of California, in 1977, concluded that courts are not required to follow the procedures of the SAM regarding disbursements of their funds and that SAM applies only to executive department agencies.[1] In 2008, the Court of Appeal endorsed both the legal reasoning and the conclusion of the Legislative Counsel.[2]

In a letter dated January 11, 1979, the Office of State Controller also affirmed that the SAM does not apply to judicial branch entities. The letter expressly stated that "the Judicial Council is not subject to the State Administrative Manual *which essentially pertains to the Executive Branch of State Government.*"[3]

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[1] See attached, Ops. Cal. Legis. Counsel, No. 16995 (Dec. 6, 1977) State Administrative Manual.

[2] *Los Angeles County Dependency Attorneys, Inc. v. Department of General Services* (2008) 161 Cal.App.4th 230, 239.

[3] See attached, Off. of State Controller, letter to Ray Croft, Jan. 11, 1979, italics added.

Finally, the recently-enacted California Judicial Branch Contact Law[4] reflects the Legislature's understanding that the SAM does not apply to judicial branch entities, such as courts. The law directed the Judicial Council to adopt a manual for judicial branch entities containing policies and procedures "*substantially similar*" to the procurement and contracting provisions of the SAM.[5] The law further directed that judicial branch entities would be governed by the procurement and contracting provisions of the SAM only until the council adopted such a manual. Because the council adopted the manual effective October 1, 2011—the operative date of the substantive provisions of the law— judicial branch entities were never governed by the SAM provisions.[6] As there would be no need for such a manual if the SAM itself already covered judicial branch entities, these provisions can only reflect legislative understanding that the SAM does not ordinarily apply to them.

We hope this clarifies the issue.

Sincerely,

Todd Torr
Attorney

TT/ND
Enclosures
cc: Ms. Angela Dickison, California State Auditor
Mr. Curt Soderlund, Chief Administrative Officer, AOC Judicial and Court Administrative Services Division
Ms. Mary Roberts, Chief Counsel, AOC Legal Services Office
Mr. Zlatko Theodorovic, Director and Chief Financial Officer, AOC Judicial and Court Administrative Services Division
Mr. John Judnick, Fiscal Services Senior Manager, AOC Judicial and Court Administrative Services Division
Mr. Greg Keil, Trial Court Trust & Treasury Services Manager, AOC Judicial and Court Administrative Services Division

---

[4] Pub. Contr. Code, § 19201 et seq.

[5] *Id.*, §19206, italics added.

[6] *Id.*, 19204(d).

ATTACHMENT B

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Sacramento, California

December 6, 1977

Honorable Mike Cullen
5144 State Capitol

Courts: State Administrative Manual - #16995

Dear Mr. Cullen:

QUESTION

You have asked whether the courts are required to follow the procedures of the State Administrative Manual regarding disbursement of their funds, which come from General Fund appropriations.

OPINION

The courts are not required to follow the procedures of the State Administrative Manual regarding disbursement of their funds.

ANALYSIS

The State Administrative Manual is a two-volume document published by the Department of General Services in conjunction with the Department of Finance, governing expenditure of public monies by state agencies. The State Administrative

ATTACHMENT B

Manual is published pursuant to the general supervisory powers of the Department of General Services over all matters concerning financial and business policies of the state in regard to the duties, powers, purposes, responsibilities, and jurisdiction specifically vested in the Department of General Services (Sec. 14650, Gov. C.) and the authority of the Department of General Services to approve most contracts entered into by state agencies (Sec. 14780, Gov. C.), together with the general supervisory powers of the Department of Finance over matters concerning the financial and business policies of the state (Sec. 13070, Gov. C.).

A "state agency," for such purposes, is defined as including every state office, officer, department, division, bureau, board, and commission (Sec. 11000, Gov. C.). However, in the landmark case of Millholen v. Riley, 211 Cal. 29, the California Supreme Court held that the expenditures of the courts were not subject to review by the Department of Finance under the statutes in operation at that time. Specifically, the statutes in operation at that time required the officers of the various departments, boards, commissions, and institutions for whose benefit and support appropriations were made in the budget to receive the consent of the State Department of Finance before making any expenditure in excess of such appropriations, gave the Department of Finance general supervision over financial and business policies of the state, and required all contracts entered into by any state officer, board, commission, department, or bureau for the purchase of supplies, materials, or services to be approved by the Department of Finance (see 211 Cal. 29, 31-32). Although the statutes were broadly worded, the court found that such provisions were limited in application to the executive department.

The court went on to note that while the Legislature may put reasonable restrictions upon constitutional functions of the courts, they may not defeat or materially impair the exercise of those functions. Thus, while the Legislature may provide for the appointment of court personnel by an executive department, if the Legislature or the Constitution should fail to provide for such persons the court vested with jurisdiction would have all the powers necessary to its convenient exercise and could appoint such personnel as may be required (Millholen v. Riley, supra, at p. 34, citing Nicholl v. Koster, 157 Cal. 416).

ATTACHMENT B

The authority of the courts to provide for their own disbursement of funds apart from regulation by any department of the executive branch has been reaffirmed in Hart Bros. Co. v. Co. of L. A., 31 Cal. App. 2d (Supp.) 766, 770, 771, upholding the expenditure of funds for the purchase of meals for jurors, and in Rivas v. County of Los Angeles, 195 Cal. App. 2d 406, 410, upholding court adopted regulations governing the compensation of court personnel and the related matters of vacations with pay, extended leave, and nonservice.

Accordingly, it is our opinion that the courts are not required to follow the procedures of the State Administrative Manual regarding disbursement of their funds.

Very truly yours,

Bion M. Gregory
Legislative Counsel

Clinton J. deWitt Legis. Counsel

By
Clinton J. deWitt
Deputy Legislative Counsel

CJdeW:co

OFFICE OF STATE CONTROLLER

ATTACHMENT B

PLACE:
DATE: January 11, 1979

TO: Ray Croft

FROM: L. E. Gercovich - SCO

RE: Claims of Judicial Council

Over the past months, a number of claim corrections were made on claims submitted by the Judicial Council on the basis that Department of General Services approval was lacking. Attached are copies of some of the corrections which cited provisions of the State Administrative Manual requiring General Services approval for various expenditures.

The Judicial Council is not a "state agency" as the term is defined in Government Code § 11000. Additionally, the Judicial Council is not subject to the State Administrative Manual which essentially pertains to the Executive Branch of State Government. (See attached copies of Legislative Counsel opinion #16995 dated 12/6/77, and Legislative Counsel opinion #6014 dated 4/4/78.)

Accordingly, the Judicial Council is not subject to the following code sections and SAM provisions requiring Department of Finance or General Services approval for various purposes:

Government Code Section	State Administrative Manual Section	Subject
11371(a) 11423	0530	Publication of regulation
13320		Budget submission
14669	1400.1	Space
14780	1203	Contracts
14780	3500	Purchasing
14850	2800	Printing

Attached for your information is a copy of a memorandum dated June 6, 1978, from the Director of General Services which confirms the Department's understanding that the Judicial Council is not subject to the State Administrative Manual.

If you have any questions on this matter, please let me know.

LEG:df
Attachments
cc: Chet Hancock
: John W. Robbins

ATTACHMENT C

California State Auditor

October 2013

Accounts Outside the State's Centralized Treasury System

Processes Exist to Safeguard Money, but Controls for These Accounts Need Strengthening

Report 2013-107

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621 Capitol Mall, Suite 1200
Sacramento, California 95814
916.445.0255 or TTY 916.445.0033

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ATTACHMENT C

California State Auditor

Elaine M. Howle State Auditor
Doug Cordiner Chief Deputy

October 15, 2013 2013-107

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 requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning state bank accounts that exist outside of the treasury system (outside accounts) and their oversight.

This report concludes that funds in outside accounts generally serve valid purposes, such as safeguarding money held in trust or allowing for certain benefits and efficiencies that are not available through California's Centralized Treasury System. As of June 30, 2012, the State's departments, agencies, and other entities (state agencies) had approximately $9.3 billion in nearly 1,400 outside accounts. For most of this money, state agencies have properly created and maintained the accounts. Also, the California Department of Finance (Finance), the Office of the State Treasurer (state treasurer), and the California State Controller's Office (state controller) each fulfilled its responsibility for authorizing and reporting on these outside accounts. Nonetheless, weaknesses in the control agencies' tracking of these outside accounts have created potential problems. These weaknesses include the state controller's failure to include all the state agencies that have outside accounts in its annual reporting on such agencies as well as the state treasurer's uncertainty about the existence of sufficient collateral—safeguards in the form of securities deposited at outside institutions—for all of the balances in outside accounts. The state agencies we reviewed, with the exception of the California Department of Forestry and Fire Protection (Cal Fire), properly created and generally have adequate controls related to their outside accounts. However, as discussed in the report, we found that it is still possible for an agency to bypass state rules and its own policies.

Cal Fire had $3.7 million in settlement payments for the cost of fire suppression and investigation (cost recovery revenues) deposited into an outside account—the Wildland Fire and Investigation Training and Equipment Fund (Wildland Fire Fund)—that was neither authorized by statute nor approved by Finance. Further, it did not subject the money in this outside account to its own internal controls, nor did it adequately track or monitor the account's revenues. As a result, this portion of Cal Fire's cost recovery revenue was not subject to Cal Fire's normal internal controls or to oversight by the control agencies or the Legislature, leaving Cal Fire open to possible misuse of these revenues.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA
State Auditor

621 Capitol Mall, Suite 1200 Sacramento, CA 95814 916.445.0255 916.327.0019 fax www.auditor.ca.gov

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ATTACHMENT C

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Summary

Results in Brief

As of the end of fiscal year 2011–12, the State's departments, agencies, and other entities (state agencies) kept about $9.3 billion in nearly 1,400 *outside accounts*, state bank accounts that are usually authorized by statute to hold money outside California's Centralized Treasury System (treasury system) or, less commonly, are approved by the California Department of Finance (Finance) for state agencies that request to separate certain funds from treasury system money. For most of this money, state agencies have properly created and maintained the accounts. Likewise, Finance, the Office of the State Treasurer (state treasurer), and the California State Controller's Office (state controller)—the *control agencies* tasked with overseeing the outside accounts—have generally fulfilled their respective responsibilities for authorizing and then reporting on these outside accounts. Nonetheless, weaknesses in the control agencies' tracking of these outside accounts have created potential problems. These weaknesses include the state controller's failure to include all the state agencies that have outside accounts in its annual reporting on such agencies as well as the state treasurer's uncertainty about the existence of sufficient collateral—safeguards in the form of securities deposited at outside institutions—for all of the balances in outside accounts. For example, for four of the last five fiscal years, the state controller failed to note that the California Public Employees' Retirement System did not submit required annual reports for its outside accounts, resulting in understatements of the amounts in outside accounts that averaged $4.7 million each year. Although the control agencies have recently taken steps to correct such problems by developing an action plan and improving reporting forms and instructions, they need to further strengthen their tracking of and reporting on state agencies holding these funds.

Funds in outside accounts generally serve valid purposes, such as safeguarding money held in trust. Of the reported $9.3 billion in outside accounts as of June 30, 2012, about $8.9 billion belonged to accounts authorized under state laws. In some outside accounts with significant balances, state agencies hold money to comply with specific provisions in bond contracts. For example, the California Housing Finance Agency (CalHFA) has outside accounts that fulfill the requirements of its bond funds' contracts by holding bondholders' money in trust and by investing that money to ensure that CalHFA can pay the bonds' interest. Other outside accounts serve as trust accounts for such funds as the ScholarShare Trust, which allows California families to save for college by making tax-advantaged contributions. Additionally, some statutorily authorized accounts are established to increase operational efficiency. Specifically, the California State University (CSU)

Audit Highlights . . .

Our audit of state accounts that exist outside of California's Centralized Treasury System (treasury system) and their oversight highlighted the following:

- » ***Weaknesses in the control agencies' tracking of these state bank accounts that exist outside the treasury system (outside accounts) have created potential problems.***
  - ***The California State Controller's Office failed to include all the State's departments, agencies, and other entities (state agencies) that have outside accounts in its annual reporting on such agencies.***
  - ***The Office of the State Treasurer has uncertainty about the existence of sufficient collateral—safeguards in the form of securities deposited at outside institutions—for all the balances in outside accounts.***
- » ***About $8.9 billion of the reported $9.3 billion in outside accounts as of June 30, 2012, belonged to accounts authorized under state laws and generally serve valid purposes.***
- » ***With the exception of the California Department of Forestry and Fire Protection (Cal Fire), the state agencies we tested segregated key accounting and reporting duties to safeguard collecting, recording, and reporting revenue.***
- » ***Although the state agencies we tested generally have adequate controls over outside accounts, an agency may still bypass state rules as well as its own policies such as Cal Fire did when it had $3.7 million deposited in an unauthorized outside account.***

ATTACHMENT C

system established its outside accounts to streamline its accounting processes, expedite its annual financial reporting, and obtain a better return on its investments. As of June 30, 2012, CSU's largest account, the Statewide Investment Fund Trust, held $1.8 billion.

Additionally, specific statutory authority allows state agencies to seek approval from Finance to open outside accounts that have benefits and efficiencies not available through the treasury system, such as the ability to process credit card receipts. Of California's nearly 1,400 outside accounts, about 225 received approval from Finance, including the California Raisin Marketing Board (raisin board), which had about $5.6 million in outside accounts as of June 30, 2012. The raisin board conducts fairs and other commodity-promoting activities, and the ability to pay its obligations promptly, afforded by outside accounts, allows it to obtain first-class services and rates and to pay temporary workers on their last day of work. On the other hand, the State must weigh the benefits of allowing state agencies to establish and use these accounts against the possibility of state agencies mismanaging them, for these funds are subject mainly to controls within the state agencies, with fewer statewide controls over them than over funds in the treasury system.

Fortunately, state agencies have generally complied with state requirements for establishing outside accounts. The state treasurer's staff recently reviewed the authorities that state agencies cited for establishing the various outside accounts they have created and found that it agreed with these authorities for most of the accounts. Furthermore, the agencies that established eight of the 11 accounts we tested cited appropriate statutory authority, and two others had received Finance approval. However, the remaining account, discussed later, was established without statutory authority or Finance approval. Also, the internal controls over the handling of revenue at the state agency level were generally adequate for 10 of the 11 accounts we tested. Specifically, with the exception of the California Department of Forestry and Fire Protection (Cal Fire), the state agencies we tested, such as the raisin board, segregated key accounting and reporting duties to safeguard collecting, recording, and reporting revenue.

Although the state agencies we tested during our audit generally have adequate controls over outside accounts, an agency may still bypass state rules as well as its own policies. For instance, Cal Fire had $3.7 million in settlement payments for the cost of fire suppression and investigation (cost recovery revenues) deposited into an outside account, the Wildland Fire and Investigation Training and Equipment Fund (Wildland Fire Fund), that was neither authorized by statute nor approved by Finance. Further,

it did not subject the money in this outside account to its own internal controls, nor did it track or monitor the account's revenues adequately. Specifically, the management of Cal Fire's law enforcement unit bypassed Cal Fire's accounting and budgeting processes by failing to submit a request to its accounting office to establish the account and by diverting and spending cost recovery revenues without submitting the appropriate request to increase its budget appropriations. As a result, this portion of Cal Fire's cost recovery revenue was not subject to Cal Fire's normal internal controls or to oversight by the control agencies or the Legislature, leaving Cal Fire open to possible misuse of these revenues. Additionally, we found that Cal Fire lacks adequate controls to safeguard cost recovery revenues. As the result of a decentralized process, staff at regional and local program offices collect these payments without adequate oversight; therefore, Cal Fire cannot ensure that these payments are deposited to the correct account. Finally, Cal Fire approved the purchase of equipment costing $1.7 million, but did not follow state policies for accounting for, or safeguarding the equipment. Specifically, Cal Fire did not maintain a list of equipment, tag equipment, or conduct periodic inventories. As a result, Cal Fire cannot be certain that the equipment has not been lost or stolen.

Recommendations

To improve the State's control over outside accounts, the control agencies should take the following steps:

- Within the next 60 days, Finance, the state treasurer, and the state controller should implement the policies and procedures they developed to ensure the receipt of outside account reports in each reporting period and to enhance monitoring efforts.

- Within the next six months, the state treasurer and the state controller should develop policies and procedures to each maintain a list of all outside accounts and should annually reconcile these lists with one another.

For the State to better monitor outside accounts, the Legislature should consider requiring the state controller to expand its reporting on outside accounts to include information on accounts opened during the last fiscal year. Reported details should include the authority, name, and balance of the new outside accounts.

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To safeguard cost recovery program revenue, Cal Fire should do the following within the next six months:

- Implement adequate segregation of duties for its cost recovery program revenues. For example, it should require that cost recovery payments be mailed to its accounting office, as are other payments.
- Develop policies and procedures requiring personnel not affiliated with the cost recovery program to reconcile expected cost recovery payments to deposits.
- Develop a process to track civil cost recovery cases statewide to monitor compliance with policies as well as to monitor collection status.

To ensure that state agencies do not misdirect cost recovery revenues in the future, the Legislature should specify that these revenues include any money received as a result of cost recovery efforts, and should require that these revenues be deposited in the state treasury.

To ensure that it possesses all equipment purchased with Wildland Fire Fund money, Cal Fire should:

- Compile a complete list of equipment purchased with the funds and reconcile it to accounting records.
- Tag all equipment purchased through the Wildland Fire Fund.
- Perform a periodic inventory of equipment.

Agency Comments

The agencies agreed with our recommendations and in some cases outlined steps to implement them.

Introduction

Background

Money in the possession or control of the State (state money) is held either in accounts in banks that have an agreement with the Office of the State Treasurer (state treasurer) to participate in the Centralized Treasury System (treasury system) or in bank accounts outside the treasury system (outside accounts). State money in the treasury system is safeguarded by a number of significant statewide controls, whereas state money in outside accounts is subject to few statewide controls and is protected primarily by department-level controls. The amount of state money in outside accounts has generally increased over the past five years and as of June 30, 2012, amounted to about $9.3 billion, or 14 percent of all state money, while roughly $55 billion was held in the treasury system.

The Legislature established the treasury system in 1949 to safeguard and maximize the return on state money. Before the establishment of the treasury system, state agencies—the State's departments, agencies, and other entities—managed their own cash and investments and kept the returns on their holdings. Presently, the investment earnings on state money in the treasury system are allocated among many different funds, including the State's General Fund. In fiscal year 2011–12, the General Fund received $25.8 million, or 10.6 percent, of the treasury system's $243 million in investment earnings.

Controls Over Funds in the Treasury System

The California Department of Finance (Finance), the California State Controller's Office (state controller), and the state treasurer make up the organizations with statewide oversight responsibilities (control agencies) affecting state money in the treasury system. The control agencies contribute to safeguarding the State's assets by performing a variety of activities, including overseeing revenue and disbursement cycles for funds in the treasury system. For example, Finance is responsible for establishing and maintaining the accounting system used by the majority of state agencies—the California State Accounting and Reporting System—and for providing instructions to state agencies on accounting procedures and reporting requirements through the *State Administrative Manual* (SAM). Finance also monitors and audits state agency expenditures to ensure that agencies comply with law, approved standards, and policies.

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The state controller's responsibilities include accounting for state funds, ensuring the accuracy and legitimacy of disbursements from the treasury system, and reporting on the State's financial condition. The state controller maintains central control accounts for all funds in the treasury system. Using its records, the state controller provides a monthly treasury system report to state agencies, which then reconcile the report to their own records. The state controller's disbursing responsibilities include paying claims through the treasury system and operating the State's payroll system. When paying claims, the state controller ensures that sufficient funds are available in specific appropriations to cover each disbursement. Finally, California law requires the state controller to submit a report to the governor, called the Budgetary/Legal Basis Annual Report, which contains a statement of the funds of the State, state revenues, and public expenditures of the preceding fiscal year. This report also includes a schedule listing those accounts held outside the treasury system.

The state treasurer is responsible for safeguarding and maximizing the return on investment of money in the treasury system consistent with safe and prudent treasury management. The state treasurer establishes agreements with depository banks, negotiates fees for the services the banks provide, manages banking services for the State, and implements controls over the banking activities of state agencies. Responsible for cash in the treasury system, the state controller also maintains central accounts related to each depository bank. The state treasurer downloads all the banking activity from the depository banks for accounts in the treasury system daily, and submits a record of all deposits to the state controller for posting to individual state agency accounts. Every month it compares its cash balances in the treasury system with the records of the state controller. The state treasurer also verifies daily that the depository banks protect the state deposits they hold. The Federal Deposit Insurance Corporation insures balances of up to $250,000 for each depositor in an insured bank should a bank fail, but for balances in excess of this amount, no such protection exists. As a result, the state treasurer ensures that depository banks holding state funds in excess of this insurance coverage place and maintain sufficient assets, such as securities, with another financial institution or custodian for safekeeping, as the banks are required to do by law. To ensure funds in the treasury system are properly accounted for, the state treasurer compares account information monthly with banks whereas the state controller compares account information monthly with state agencies.

Statewide Controls Over Outside Accounts

State agencies sometimes need to establish outside accounts because they must deal with funds held in trust for others. They may also establish outside accounts to gain operational efficiencies. In addition, because the treasury system cannot process all types of electronic fund transfers or efficiently process credit card receipts, some state agencies create outside accounts to handle such transactions.

To establish an outside account, a state agency must have express statutory authority or receive authorization from Finance. When a state agency needs Finance's approval, the SAM requires it to submit a request to Finance's Fiscal Systems and Consulting Unit and to include details about the proposed account, as shown in the text box. Finance reviews the agency's request and, as shown in Figure 1 on the following page, also consults the state treasurer, which focuses its review on the purpose and proposed type of account and expresses any concerns to Finance. If Finance approves the establishment of the account, it provides the agency, the state controller, and the state treasurer with a copy of the approval letter. State agencies cited Finance approval for about 225 of the nearly 1,400 outside accounts they reported as of June 30, 2012, and they cited authorization under state law for the remainder. A number of state agencies have express statutory authority to establish outside accounts, eliminating the need for Finance approval. For example, state law specifies that the Cotton Pest Control Board must use cotton grower assessment fees exclusively to pay costs directly related to the control of certain cotton pests and allows the board to determine how fees should be deposited and handled, thus allowing for the use of outside accounts for this purpose.

A request for a bank account outside the Centralized Treasury System (outside account) requiring the California Department of Finance's approval must include the following:

- Justification for the need to open the outside account.
- The name and location of the bank, savings and loan association, or credit union to be used.
- The legal name of the agency and the name of the account.
- Whether the proposed bank or savings and loan association is insured by the Federal Deposit Insurance Corporation or whether the proposed credit union is insured by the National Credit Union Administration.
- The amount, source, and purpose of the funds to be deposited as well as the type of deposit, length of deposit, and interest rate to be received.
- Provisions for the withdrawal of funds.

Source: *State Administrative Manual*, Section 8002.

After outside accounts are established, they are subject to certain monitoring and reporting requirements. The state agencies holding money in outside accounts are responsible for overseeing and safeguarding that money; the outside accounts are not subject to the statewide controls specific to the treasury system. However, as Figure 1 illustrates, the SAM requires state agencies to report the balance, authority, and purpose of all outside accounts to the state controller and state treasurer annually and to certify to the state treasurer that the accounts will have adequate collateral throughout the year according to law.

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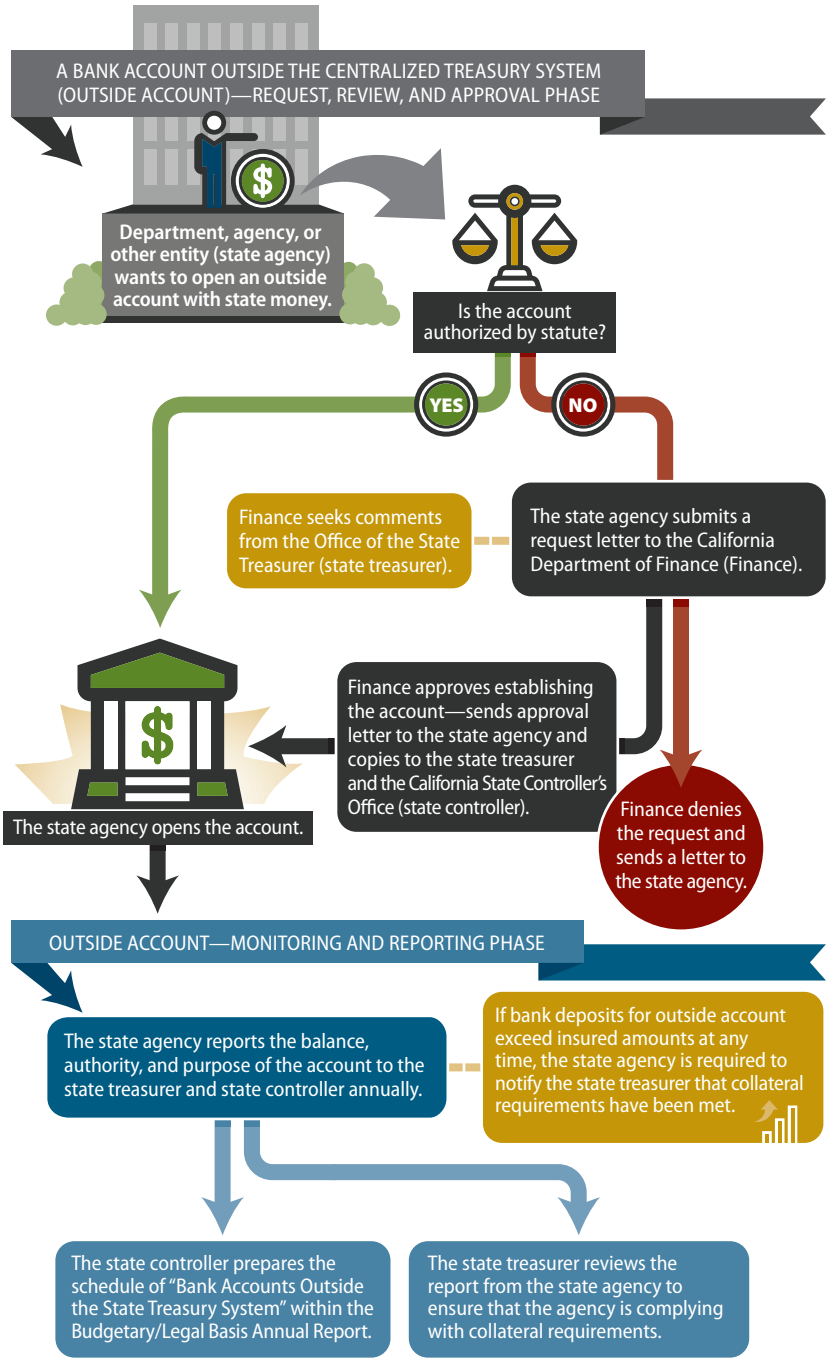
Figure 1
Statewide Process for Establishing, Monitoring, and Reporting an Account Outside the Centralized Treasury System



Sources: California Government Code, Section 16305.3; *State Administrative Manual*, sections 7975 and 8002; California State Auditor's analysis of policies and procedures; and other documents.

Trends in the Growth and Makeup of Outside Accounts

The amounts held in outside accounts have generally increased over the last five years, and two state agencies with statutory authority for establishing outside accounts have experienced large changes in the overall balances in their accounts. State agencies reported $9.3 billion in outside accounts as of June 30, 2012, whereas in fiscal year 2007–08, they reported $6.7 billion. As Figure 2 on the following page shows, most of the $2.5 billion increase occurred in fiscal year 2009–10. The California Housing Finance Agency (CalHFA) and California State University (CSU) accounts contributed to the majority of this increase. CalHFA's balance increased by about $1.5 billion in fiscal year 2009–10 when it issued $1.4 billion in bonds as part of the federal government's Housing Finance Agency Initiative. According to CalHFA's director of financing, the federal initiative offered a low borrowing rate, which financed CalHFA's single-family lending activities in 2010 and 2011. CSU's balance increased by nearly $682 million during fiscal year 2009–10. Most of this increase resulted from higher revenues generated by tuition increases and from lower spending caused by furloughs and layoffs.

A relatively small number of accounts at three agencies made up most of the state money outside the treasury system as of June 30, 2012, while more than half the accounts had a balance of less than $1,000. Two college savings plan accounts, with $4.5 billion, authorized by statute for the ScholarShare Investment Board made up about 48.6 percent of the total balance in outside accounts, and CSU's two investment accounts, with about $1.9 billion, made up about 20.3 percent of the total. CalHFA held $1.4 billion in 32 outside accounts, making up about another 15.5 percent of the total in outside accounts. As we discuss in the Audit Results section beginning on page 15, these agencies use the accounts to enable California families to save for college (ScholarShare), to gain increased operational efficiencies and implement an independent investment strategy (CSU), and to satisfy bond contract requirements (CalHFA). Most accounts with balances below $1,000 had balances of zero. The activity for most of these accounts is frequently swept into the treasury system, usually leaving no funds at the end of any given day.

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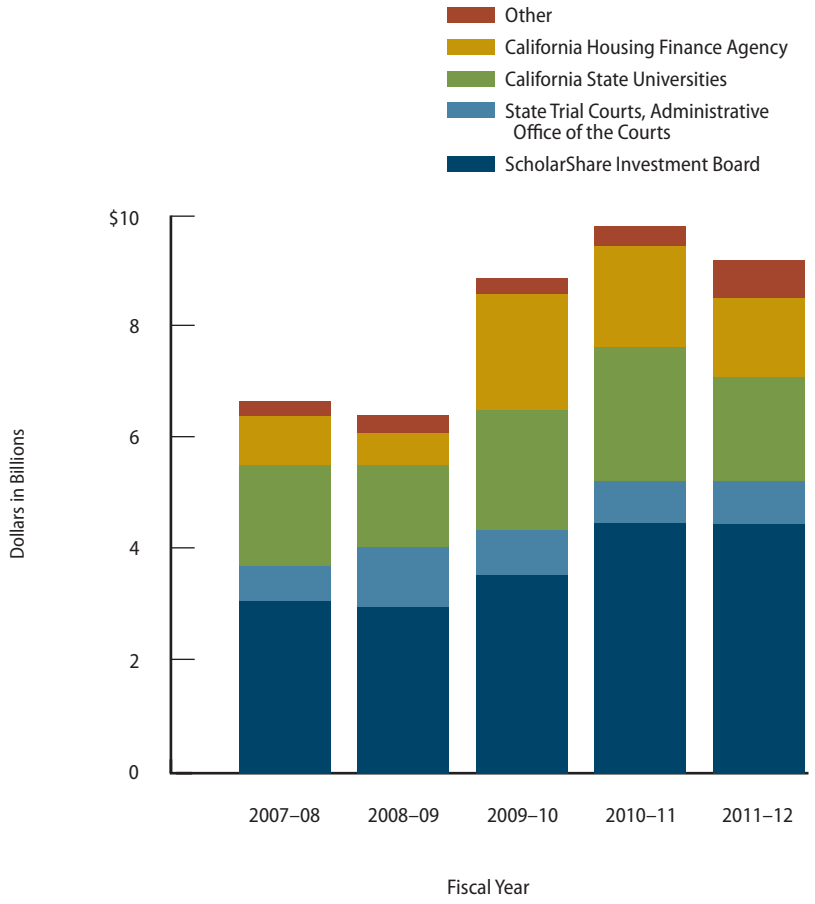
Figure 2
Money in Accounts Outside the State's Centralized Treasury System
Fiscal Years 2007–08 Through 2011–12



Sources: State of California Budgetary/Legal Basis Annual Report for fiscal years 2007–08 through 2011–12 (adjusted for reporting errors identified during the audit) and Wildland Fire Investigation Fund bank statements for June 30, 2008, June 30, 2009, June 30, 2010, June 30, 2011, and June 29, 2012.

Scope and Methodology

We conducted this audit at the direction of the Joint Legislative Audit Committee, which approved the audit objectives listed in the Table. Our fieldwork included reviewing controls at 11 state agencies and testing 11 outside accounts.

For one account, the California Department of Forestry and Fire Protection's Wildland Fire Investigation Training and Equipment Fund account, Finance's Office of State Audits and Evaluations conducted an audit and issued a report in August 2013. We relied on portions of its work related to expenditures and performed additional procedures to meet our objectives.

Table
Audit Objectives and the Methods Used to Address Them

	AUDIT OBJECTIVE	METHOD
1	Review and evaluate the laws, rules, and regulations significant to the audit objectives.	Reviewed relevant laws and regulations, and other requirements in the *State Administrative Manual* (SAM).
2	Determine which departments, agencies, and other entities (state agencies) are involved in approving and monitoring accounts held outside of the Centralized Treasury System (treasury system) and assess each agency's processes and practices.	• Interviewed staff at the California Department of Finance (Finance), Office of the State Treasurer (state treasurer), and California State Controller's Office (state controller)—control agencies—to determine each agency's role in approving, monitoring, and reporting bank accounts outside the treasury system (outside accounts). • Obtained and assessed the administrative policies and processes related to outside accounts for the control agencies.
3	For the most recent five years, identify outside accounts and determine how much money is in these accounts, including to the extent possible, the source and justification for placing these accounts outside the treasury system.	• To identify the dollar value of outside accounts we used the schedules of "Bank Accounts Outside of the State Treasury System" in the Budgetary/Legal Basis Annual Reports for fiscal years 2007–08 through 2011–12. We also tested the completeness and accuracy of the schedules. • To determine whether the state agencies' account balances remained consistent over the five-year period, we performed an analytical review of account balances by agency and identified and explained significant changes. • To identify the total number of outside accounts for fiscal year 2011–12, we reviewed and analyzed the state treasurer and state controller account listings of outside accounts. We counted each record as a single account although some records may represent more than one bank account. • To identify the primary source and justification for outside accounts, we analyzed the state treasurer account listings and the schedules of "Bank Accounts Outside of the State Treasury System" in the fiscal year 2011–12 Budgetary/Legal Basis Annual Report.
4	To the extent possible, determine what controls are in place that limit agencies from depositing funds in repositories outside the treasury system without following applicable laws and procedures.	• To determine the controls in place, we interviewed staff at Finance, the state treasurer, the state controller, and the eight agencies selected for review. • For the eight agencies selected, we assessed the controls over the collection and deposit of revenues in outside accounts.
5	For a sample of accounts that exist outside the treasury system:	Judgmentally selected 11 accounts to test. In selecting accounts, we considered agencies based on the size, purpose, and authority for their respective accounts. We further considered account type, balance, and authority in choosing the specific account to test within each agency. As a result of this selection process, we tested one or more accounts for each of the following agencies: • California Department of Food and Agriculture - Cotton Pest Control Program - California Raisin Marketing Board • Judicial Council of California, Administrative Office of the Courts - Los Angeles Superior Court - Napa Superior Court • California Housing Finance Agency • California Public Employees' Retirement System • California State University • California Energy Commission • Governer's Office of Business and Economic Development - California Infrastructure and Economic Development Bank - California Small Business Loan Guarantee program • California Department of Forestry and Fire Protection (Cal Fire) - Wildland Fire Investigation Training and Equipment Fund (Wildland Fire Fund)

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AUDIT OBJECTIVE	METHOD
a. Identify how amounts deposited are determined. Assess whether the accounts were appropriately established in compliance with laws, regulations, and the SAM.	For the 11 accounts selected: • Reviewed laws, regulations, and the SAM requirements related to the accounts, and determined whether accounts were appropriately established. • For accounts where agencies cited Finance approval: - Reviewed Finance's approval of the account. - Determined whether the state treasurer reviewed the account request. - Determined whether the state treasurer and the state controller received final notification of approved accounts. • If an agency did not cite Finance approval to establish its account, we obtained documentation from the agency to determine whether its cited statutory authority was accurate and sufficient. • Interviewed agencies to understand how amounts deposited are determined. We found that the source of the funds used to establish and maintain outside accounts varied, and likewise the methods used to determine the deposit amounts also varied. We did not find any reportable issues related to how deposits are determined. • For the Wildland Fire Fund, we selected eight receipts for fire cost recovery: - Interviewed Cal Fire personnel and obtained documentation to determine if deposited amounts were in excess of actual fire containment costs, and if Cal Fire consistently followed its parameters for allocating settlements to the Wildland Fire Fund. - Interviewed Cal Fire, the California District Attorneys Association (attorneys association), and the Office of the Attorney General (attorney general's office) to determine the role each played in determining amounts to deposit in the Wildland Fire Fund.
b. To the extent possible, determine whether fiscal agents or third parties are maintaining these accounts. Determine whether the fiscal agents or third parties comply with all applicable state laws, rules, regulations, and policies for managing and reporting state funds.	For the 11 selected accounts, we determined whether a fiscal agent or third party is maintaining the account and, if so, performed the following: • Identified laws, regulations, and policies for fiscal agents and for managing and reporting state funds. • Determined whether fiscal agent services were approved by Finance. • Reviewed fiscal agent contracts and determined whether the provisions conform with applicable legal and policy requirements identified and if there is a provision for audits. • Performed compliance testing on key legal and policy requirements. • Apart from Cal Fire, other accounts complied with fiscal agent requirements, as applicable.
c. Identify and assess the controls in place to ensure that the moneys in these accounts are properly accounted for and properly reported, and verify whether these accounts are regularly audited.	For the 11 selected accounts: • Interviewed the related state agencies and obtained supporting documentation to gain an understanding of the selected state agencies' controls over accounting and reporting for the accounts and assessed the adequacy of the controls. • Selected bank reconciliations for June 30, 2012, and one other month and assessed key controls over deposits and disbursements. We traced the account balances from the June 30, 2012, bank statements to the outside accounts report submitted to the state controller. - For the eight Wildland Fire Fund receipts selected, we assessed controls over deposits and traced deposits to the corresponding bank statements. - For the Wildland Fire Fund account, we selected one equipment item each from four of the expenditure projects tested by Finance's Office of State Audits and Evaluations and reviewed one additional equipment expenditure selected from the attorneys association's records and performed the following: — To determine the quantity authorized, we reviewed Cal Fire project files and Finance's workpapers. — To determine the quantity Cal Fire reported to hold in its regions and units, we reviewed Finance's workpapers. We also observed one item held by Cal Fire's Technical Services Section.

AUDIT OBJECTIVE	METHOD
	— To determine the quantity purchased, we reviewed project invoices. — To determine whether Cal Fire followed state procedures related to receiving and recording assets, we interviewed Cal Fire personnel responsible for each project and personnel responsible for receiving and distributing the equipment. We also reviewed Cal Fire project files for documentation of the receipt of equipment and Finance's workpapers for evidence of equipment tagging. - For the Wildland Fire Fund account, we reviewed Finance's workpapers and selected and reviewed two project expenditures from Cal Fire's project file to determine: — Whether projects were properly authorized. — Whether the expenditures were for training or equipment that aligned with the purpose of the fund. — Whether the expenditures were accurately recorded as training or equipment in the attorneys association's records. • We interviewed and obtained supporting documentation from state agencies to assess whether the agencies ensured that accounts had the proper collateral. • Interviewed the state agencies to determine whether accounts are regularly audited and, if not, determined the reason. We also obtained the most recent audit report for each account that received one.
d. To the extent possible, determine the benefits of maintaining accounts outside of the treasury system and whether the fees and charges associated with these accounts are comparable to those charged on the accounts within the treasury system.	For the 11 selected accounts: • Interviewed the related state agencies to obtain their perspective on the benefits of maintaining outside accounts and considered the quantitative and qualitative costs and benefits. • Obtained a listing of banking fees, costs, or billings to determine the costs of the accounts. • Analyzed fees to determine if they are comparable to those in the treasury system. • Interviewed and documented the state controller's, the state treasurer's, and Finance's perspective on the benefits and costs associated with outside accounts.
6 Review and assess any other issues that are significant to the establishment of outside accounts and the oversight of these accounts.	• Interviewed attorney general's office staff to determine the extent to which the attorney general's office is aware of state agencies that may have outside accounts. • Interviewed attorney general's office staff and obtained administrative policies to determine the role the attorney general's office plays in earmarking settlement money for private or local agencies or for deposit in outside accounts.

Source: California State Auditor's analysis of the Joint Legislative Audit Committee audit request number 2013-107, planning documents, and analysis of information and documentation identified in the column titled *Method*.

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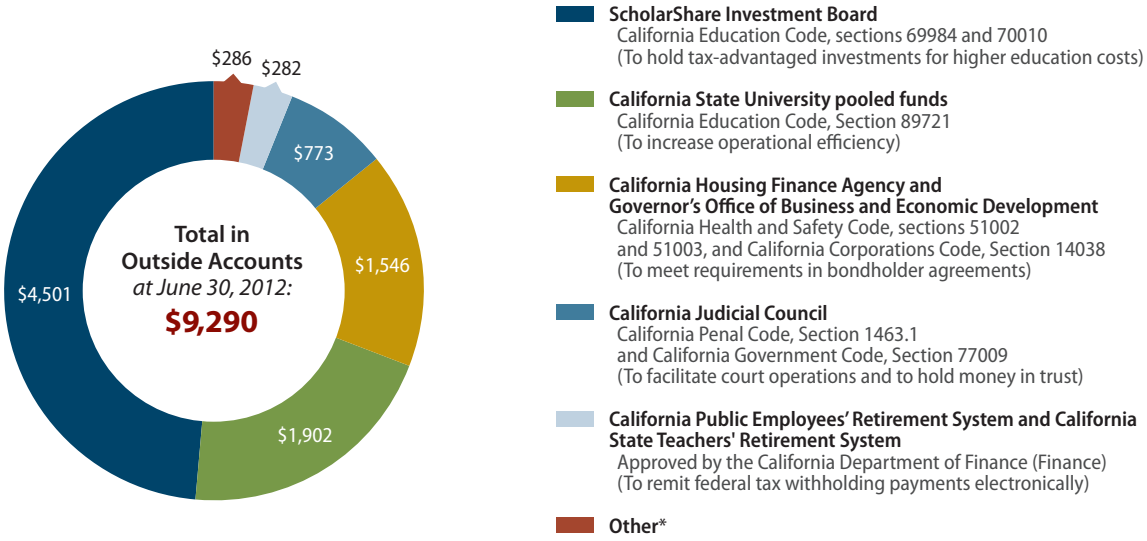
Audit Results

Funds in Accounts Held Outside the Centralized Treasury System Generally Serve Valid Purposes but May Present Some Risks

As described in the Introduction, a state department, agency, or other entity (state agency) must have either statutory authority or approval from the California Department of Finance (Finance) to establish an account outside the State's Centralized Treasury System (outside account). Most of the money in outside accounts is held in accounts authorized by statute, with a relatively small amount of money in outside accounts approved by Finance. Of the approximately $9.3 billion reported as held in outside accounts for the fiscal year ending June 30, 2012, about $8.9 billion was held in outside accounts authorized by statute. Similarly, state agencies cited statutory authority for about 1,200 of the nearly 1,400 outside accounts, while they cited Finance approval for the remaining outside accounts. Figure 3 shows the outside accounts and their authority and purpose.

Figure 3
Accounts Outside the Centralized Treasury System by Authority and Purpose as of June 30, 2012 (in Millions)



Source: Office of the State Treasurer's compilation and reconciliation of state agencies' Report of Bank/Savings and Loan Association Accounts Outside the State Treasury System as of June 30, 2012.

* State agencies cited statutory authority for $212 million of the other outside accounts, while Finance approved the remaining accounts totaling $74 million. Also, the responsible agency with the largest amount held in these other outside accounts is the California Department of Food and Agriculture with a balance of $86.7 million.

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A number of large outside accounts opened under statutory authority have been established to hold money in trust for others or to align with the provisions in bond contracts.

A number of large outside accounts opened under statutory authority have been established to hold money in trust for others or to align with the provisions in bond contracts. For example, the Legislature established the ScholarShare Trust, which allows California families (participants) to save for college on a tax-advantaged basis. State law specifies that all money deposited by participants must be promptly invested and accounted for separately and that this money and interest accumulates on behalf of the participants. State law further specifies that ScholarShare Trust money may be invested with an investment manager as determined by the ScholarShare board. According to the ScholarShare program investment policy, there are no restrictions on the types of investments that the ScholarShare Trust can make. The policy also specifies that participants bear the risk associated with the investment portfolio they select.

Similarly, for bond funds within the California Housing Finance Agency (CalHFA), contracts with bondholders stipulate that accounts and funds created under the contracts will be held in trust. The contracts also require that money in the funds be invested to ensure that sufficient money will be available to pay bond interest. According to CalHFA's director of financing, the contracts allow CalHFA the flexibility to invest bond proceeds to maximize investment income, within investment guidelines. The director explained that, in one case, bondholders even demanded that bond proceeds be placed in a specific investment.

Federal requirements may also dictate the need for an outside account. For example, the Internal Revenue Service (IRS) requires that large tax deposits be made by electronic funds transfers within 24 hours; to complete this transaction in the time allowed, an outside account is necessary. The Office of the State Treasurer (state treasurer) does have a contract for processing electronic funds transfers; however, this contract applies only to receiving money for items such as tax collections and does not cover situations in which a state agency wants to make a payment. Additionally, the California State Controller's Office (state controller) can process electronic funds transfers for payments. However, the assistant chief of the state controller's disbursements bureau explained that the state controller's standard turnaround on electronic funds transfers is three days and that an overnight process performed each day would be problematic. For similar reasons, the California Public Employees' Retirement System (CalPERS) and the California Teachers' Retirement System use outside accounts to submit taxes withheld from retirement checks to the IRS.

In addition to holding money in trust for others, specific statutory authority allows certain state agencies to open outside accounts to gain program efficiencies and other benefits not possible through

California's Centralized Treasury System (treasury system). For example, the Legislature granted the California State University (CSU) system the authority to hold funds outside of the treasury system. Funds in CSU's outside accounts amounted to $1.9 billion as of June 30, 2012. According to the assistant controller of the financial services division of CSU's chancellor's office, by using outside accounts, CSU has been able to streamline its accounting processes and complete its annual financial reports more quickly than by processing its revenues through the treasury system. Additionally, CSU is able to structure its investment portfolio to obtain a return that may exceed that of the State's Pooled Money Investment Account (pooled account), the treasury system's primary investment account. As of June 30, 2012, CSU held $1.8 billion in its Statewide Investment Fund Trust account, which provided an annual return of 0.76 percent, or twice the 0.38 percent return of the pooled account, in fiscal year 2011–12.

Likewise, the president of the California Department of Food and Agriculture's (food and agriculture) California Raisin Marketing Board (raisin board), which held about $5.6 million in Finance-approved outside accounts as of June 30, 2012, stated that the raisin board's revenues are from assessments on growers—industry participants—who have an interest in ensuring that the revenues benefit their industry. The raisin board's purpose is to advertise, promote, and conduct marketing and product research related to raisins, and it fulfills this purpose by conducting fairs and other commodity-promoting activities. The president asserted that the ability to pay promptly, afforded by outside accounts, allows the raisin board to obtain first-class services and rates. Additionally, he said that because of the nature of its business the raisin board hires temporary workers, and outside accounts allow it to meet requirements to pay the workers on their last day of work.

In addition to providing for timely electronic funds transfers, certain statutory- and Finance-approved outside accounts allow for the efficient collection of revenues through the processing of credit card transactions.

In addition to providing for timely electronic funds transfers, certain statutory- and Finance-approved outside accounts allow for the efficient collection of revenues through the processing of credit card transactions. According to the state treasurer's manager of banking operations, credit card receipts are difficult for the state treasurer to reconcile. Credit card companies deduct fees before remitting payments to state agencies, causing the deposits that the banks report to the state treasurer to differ from the deposits reported by state agencies. The state treasurer does not know the many fee structures administered by credit card companies and thus cannot practically perform reconciliations. The manager of banking operations said that zero-balance accounts, a type of outside account, resolve the reconciliation problem. The *State Administrative Manual* (SAM) now requires state agencies wanting to accept credit card payments to set up zero-balance accounts,

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whose balances are transferred daily to the treasury system. State agencies reported 473 zero-balance accounts to the state controller as of June 30, 2012.

Although factors exist that provide valid reasons for some state agencies to maintain outside accounts, the State has to consider the increased risk of mismanagement and the potential for higher costs related to these accounts, as well as its own inability to use excess money in the accounts for cash management purposes. State money in outside accounts, such as the California Department of Forestry and Fire Protection (Cal Fire) account discussed later in this report, is at greater risk of mismanagement than state money in the treasury system because outside accounts are subject to fewer statewide controls, as noted in the Introduction. However, with the exception of Cal Fire, the agencies we reviewed have sufficient controls over the money in their outside accounts. Additionally, banks holding state money in outside accounts with a balance that exceeds the federally insured amount must maintain a required level of collateral—securities deposited at another institution to safeguard the value of the outside account's balance. We found that 10 of the 11 accounts we reviewed had the required level of collateral, but without control agency oversight, there is a risk that a bank may not maintain the proper collateral to safeguard the account balance throughout the year.

A state agency with outside accounts may incur higher bank fees than necessary. Once the trial courts completed the consolidation of their outside accounts in 2011 and 2012, they were able to reduce banking service fees by approximately $700,000 annually, or approximately 50 percent.

While a state agency with outside accounts may incur higher bank fees than necessary, the bank fees for the outside accounts we reviewed were not excessive, amounting to less than half a percent of the account balance as of June 30, 2012, on an annualized basis. Nevertheless, the recent experience of two of these agencies suggests that other agencies might save money by reviewing the fees they pay on their outside accounts. In the first case, according to the Administrative Office of the Courts' assistant treasurer of trust and treasury services, once the trial courts completed the consolidation of their outside accounts in 2011 and 2012, they were able to reduce banking service fees by approximately $700,000 annually, or approximately 50 percent. In the second case, after we asked about its bank fees, the raisin board revisited its account services and fees in June 2013 and reduced monthly banking costs by approximately $290 a month, or approximately 37 percent.

In addition to the risks posed by outside accounts—those of mismanagement and higher bank fees—outside accounts can hamper the state treasury's flexibility in managing the State's cash. To increase potential investment earnings for all funds in the treasury system, the State pools the money it holds for its various funds. Because the funds have varying periods of high and low cash balances, which tend to complement each other, the State can use available cash to purchase more long-term, higher yielding investments than allowed

otherwise. Pooling also facilitates borrowing between funds in the state treasury. For example, to meet its short-term cash needs, the State's General Fund borrows from certain funds in the treasury system provided this borrowing does not interfere with the purposes of the funds or impede their day-to-day cash needs. As indicated in Figure 3 on page 15, however, much of the money in outside accounts is held in trust for others or as required by bond contracts and therefore is not available for borrowing.

Because new outside accounts could have a significant effect on the mix of account purposes and on the State's ability to manage its cash, we believe that additional reporting would help the Legislature better assess developments in outside accounts. To be useful, extra reporting would need to provide details on the authority, balance, and name of each new account, in addition to other characteristics already reported by the state controller. Because the state controller already collects and reports information on outside accounts in its Budgetary/Legal Basis Annual Report, it could provide additional information on new accounts with relative efficiency.

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The State's Control Agencies Have Generally Fulfilled Their Oversight Responsibilities but Have Not Always Adequately Tracked Outside Accounts

The State's control agencies fulfill their responsibilities for authorizing outside accounts by reviewing state agencies' requests for such accounts and either approving or denying them. However, the control agencies do not adequately track which state agencies have outside accounts nor do they adequately ensure that all state agencies report on these accounts. These failings have resulted in instances of incomplete and inaccurate reporting on outside accounts. Recent concerns regarding outside accounts have prompted the control agencies to implement procedures to improve their oversight of outside accounts, including creating lists of all outside accounts and requiring the related agencies to certify that their outside accounts will have adequate collateral throughout the year.

Control Agencies Authorize and Report on State Agencies' Outside Accounts

The State's control agencies have generally met their responsibilities for authorizing outside accounts and reporting on them. As described in the Introduction, Finance reviews and either approves or denies state agencies' requests to establish outside accounts. According to records provided by Finance, its Fiscal Systems and Consulting Unit (fiscal systems unit) has approved 95 of 104 outside account requests over the past five fiscal years with 72 of the

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approvals given for zero-balance accounts. The fiscal systems unit has a process in place to review each outside account request. It reviews the agency's justification for the outside account to determine whether the request substantiates a need and is consistent with law and regulations. It also reviews the justification to determine whether banking services outside the treasury system are needed to effectively manage the funds. As part of this process, the fiscal systems unit considers whether the benefits to the State of maintaining the money outside the treasury system outweigh the costs.

The state treasurer assists Finance in its evaluation by conducting an informal review of outside account requests. Finance sends the state treasurer an e-mail notification of each agency's request to establish an outside account. According to the state treasurer's manager of banking operations, the state treasurer focuses its review mainly on the purpose and type of the proposed account. For example, the state treasurer recently reviewed a request from a state agency to establish an account to receive patient funds through an automated clearinghouse. The state treasurer agreed with the reason for the account, but it provided comments related to the bank and location for the account. The requesting agency subsequently received Finance approval and opened the account with the bank recommended by the state treasurer.

Control Agencies' Tracking of Outside Accounts Is Inadequate

Control agencies do not adequately track which state agencies hold money in outside accounts. As a result, control agencies cannot be certain that all involved state agencies are reporting information on their outside accounts. This failure can result in inaccurate reporting by control agencies and in a lack of review of the collateral requirements for unreported balances in outside accounts. If a bank were to fail and had not posted adequate collateral, the State would lose all money in the account beyond the federally insured amount.

According to a supervisor in the state controller's budgetary/legal section, the state controller did not have any written procedures to ensure that all state agencies reported their outside account information for the period we reviewed.

The SAM requires that state agencies annually submit a Report of Bank/Savings and Loan Association Accounts Outside the Treasury System (outside accounts report), in which they disclose their outside accounts and the accounts' balances to both the state treasurer and the state controller. The state treasurer uses the outside accounts reports it receives to verify that the balances are protected through sufficient collateral, and the state controller summarizes the outside account balances it receives by agency and includes the information in a schedule of Bank Accounts Outside of the State Treasury System (outside accounts schedule) as part of its annual Budgetary/Legal Basis Annual Report. However, according to a supervisor in the state controller's budgetary/legal section, the state controller did not have any written procedures to ensure that

all state agencies reported their outside account information for the period we reviewed. The supervisor told us that the state controller has drafted and is finalizing such procedures. Additionally, the state treasurer had procedures to evaluate the collateral for amounts reported to it on outside account reports, but lacked any process to ensure that departments were consistently reporting such outside account information. As a result of these weaknesses, the state controller could not be sure that it included all outside accounts in its outside accounts schedule, and the state treasurer could not ensure that all outside accounts had proper collateral to secure their balances at year's end.

Because of the lack of sufficient procedures and systems for determining whether the state treasurer and state controller had received all required outside accounts reports, instances occurred in which reporting was incomplete and inaccurate. As part of our testing, we determined that for fiscal years 2007–08 through 2011–12, the state controller's outside accounts schedule generally conveyed accurate information for outside accounts that state agencies reported. However, because the state controller did not have sufficient procedures to reasonably ensure that state agencies holding money in outside accounts were consistently reporting them, it failed to identify some omissions. For example, as we discuss later, CalPERS did not submit its outside accounts report for four of the last five fiscal years, resulting in an average annual understatement of approximately $4.7 million. Additionally, for one year the state controller did not accurately calculate the total amount held in outside accounts, understating the amount by approximately $45 million.

Because the state controller did not have sufficient procedures to reasonably ensure that state agencies holding money in outside accounts were consistently reporting them, it failed to identify some omissions.

The state treasurer and state controller recently reconciled the outside accounts reports they had received for fiscal year 2011–12. They determined that some state agencies had reported approximately $1.75 billion more in total to the state controller than to the state treasurer. Conversely, data from the reconciliation indicate that other state agencies had reported approximately $400,000 more in outside account balances in total to the state treasurer than to the state controller.

The State's Control Agencies Have Taken Steps to Improve Their Oversight of Outside Accounts

Finance, the state controller, and the state treasurer met in March 2013 to discuss ways to improve compliance with state law and policies governing outside accounts. The director of the state treasurer's centralized treasury and securities management division stated that this meeting was in response to concerns expressed to the Joint Legislative Audit Committee regarding outside accounts. As a result of this meeting, Finance, the state controller, and the

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state treasurer have developed an action plan for ensuring that all state agencies comply with state law and the SAM requirements that relate to outside accounts. Since then, the control agencies have updated the outside accounts reporting form to include a signed certification from the state agency's head attesting that its reported outside accounts will have adequate collateral levels throughout the year and that its use of reported accounts is consistent with Finance approval or statutory authority. The updated form also requests information about account collateral. Finance updated the applicable sections of the SAM and related training materials to reflect the revisions to the outside accounts report and to educate state agencies about their responsibilities under the SAM.

Finance sent a letter to all state agencies in July 2013 that included a reminder about their obligations under state policies related to outside accounts.

Additionally, beginning with the fiscal year ending June 30, 2013, the SAM requires that state agencies submit their outside accounts reports to Finance's fiscal systems unit in addition to the state controller and state treasurer. According to its chief, the fiscal systems unit plans to review these reports to verify that it approved the accounts that state agencies claim it approved and to track closed accounts. Furthermore, Finance sent a letter to all state agencies in July 2013 that included a reminder about their obligations under state policies related to outside accounts.

Finally, as described in the previous section, the state controller and the state treasurer reconciled the fiscal year 2011–12 outside account information they received from state agencies, and from this reconciliation they created lists of all reported outside accounts. The chief of the state controller's state government reporting bureau said that her staff will use the list as a starting point for preparing the outside accounts schedule, beginning with the June 30, 2013, schedule. Further, she indicated that staff plan to use this list to identify closed or new accounts.

State Agencies Generally Complied With State Requirements for Establishing Outside Accounts but Did Not Always Completely or Accurately Report These Accounts

State agencies are generally complying with state requirements for establishing outside accounts. For instance, in our testing of outside accounts, we found that state agencies with statutory authority to establish outside accounts generally cited appropriate legal authority and those that required Finance approval to establish an outside account generally submitted the appropriate requests to Finance. The state treasurer also recently reviewed the laws and Finance approvals that state agencies reported as authorizing their outside accounts and agreed with most of them. However, state agencies have not always completely or accurately reported outside accounts as required.

State Agencies Have Generally Followed the State's Requirements for Establishing Outside Accounts

Although some agencies have statutory authority to establish outside accounts, those that do not generally submit the required requests to Finance before establishing an outside account. Of the 11 accounts we tested, state agencies cited appropriate statutory authority in establishing an outside account for eight cases and proper Finance authority in one case. However, one of the 11 accounts we tested, administered by Cal Fire, had neither statutory authority nor Finance approval. As discussed later in the report, we found problems with Cal Fire's establishment, management, and reporting of this account. Additionally we tested an account maintained by CalPERS, which cited neither Finance approval nor statutory authority, but instead cited an IRS mandate. We determined that this authority was not sufficient, and CalPERS subsequently requested Finance approval and received it retroactively in July 2013. In June 2013 CalPERS also developed and distributed a policy containing procedures for opening outside accounts.

Furthermore, as part of its outside accounts report reconciliation to the state controller, state treasurer staff reviewed the authorities that state agencies cited for their reported outside accounts and agreed with about 72 percent, or 996 accounts. For another 25 percent, or 346 accounts, staff found the citations vague or difficult to interpret, and they believed further evaluations in the form of legal opinions were required to reach a determination. However, for 42 outside accounts, state treasurer staff noted 27 instances in which state agencies cited no statutory authority or Finance approval for the accounts on the report and another 11 cases in which it disagreed with the statutory authority the state agency cited. In addition, the state treasurer compared its list of outside accounts to a list provided by Finance and determined that most of the accounts citing Finance approval had received such approval. However, in four cases the state treasurer confirmed with Finance that no record of Finance approval existed. The manager overseeing banking operations at the state treasurer told us that state treasurer staff followed up with state agencies in 37 of the 42 cases, referring them to Finance in some instances. He said that state treasurer staff did not follow up on five of the cases that were zero-balance accounts, instead focusing on accounts with balances and those requiring collateral.

For 42 of the nearly 1,400 outside accounts, state treasurer staff noted 27 instances in which state agencies cited no statutory authority or Finance approval for the accounts on the report, 11 cases in which it disagreed with the statutory authority the state agency cited, and four cases in which state agencies cited Finance approval when no such approval was granted.

A few of the 42 accounts questioned by the state treasurer have since been resolved. During our testing of 11 outside accounts, we confirmed that four of the 42 accounts questioned by the state treasurer had statutory authority or Finance approval. For two additional accounts, the state agencies that the state treasurer referred to Finance subsequently sought and received

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Finance's approval. This left the status of 36 of the 42 cases unresolved. Subsequently, the chief of Finance's fiscal systems unit told us that the unit has begun reviewing fiscal year 2012–13 outside accounts for the unresolved cases and has verified that it approved one of the cases. Since Finance is the control agency charged with approving outside accounts not established under statutory authority and since some of the unresolved instances may require its review and approval, we believe Finance is in the best position to pursue and resolve these outstanding cases.

State Agencies Have Not Always Completely or Accurately Reported Outside Accounts to Control Agencies

During our audit, we identified instances in which certain state agencies failed to report the balances of their outside accounts, as required, in one or more of the five most recent fiscal years.

While state agencies are generally complying with state requirements for establishing outside accounts, certain agencies have not annually reported their accounts as required, and other agencies have reported inaccurate account balances. As noted earlier, state agencies must annually report details on all of their outside accounts to the state controller and state treasurer. During our audit, we identified instances in which certain state agencies failed to report the balances of their outside accounts, as required, in one or more of the five most recent fiscal years.

As mentioned previously, CalPERS did not submit its outside accounts report to either the state treasurer or the state controller for four of the last five fiscal years. In addition, although CalPERS submitted its outside accounts report for fiscal year 2011–12 to the state controller, it did not submit the report to the state treasurer; further, about nine months after the filing deadline CalPERS filed a revised report with the state controller disclosing two additional outside accounts. In May 2013 CalPERS prepared the outside accounts reports for the years it did not submit them—fiscal years 2007–08 through 2010–11—and sent them to the state controller. As a result of CalPERS' failure to submit its outside accounts reports on time, the schedule of outside accounts in the Budgetary/Legal Basis Annual Report for those years was understated by between $4.5 million and $4.9 million in four of the past five fiscal years. According to the assistant division chief of CalPERS' fiscal services division, CalPERS did not submit its reports because it lost key staff and lacked written procedures for the reporting of outside accounts. CalPERS completed and distributed written procedures for reporting its outside accounts in August 2013.

Additionally, we found two instances in which state agencies inaccurately reported an outside account balance. In the most significant case, CSU overstated the balance of its Statewide

Investment Fund Trust (investment account) by $700 million as of June 30, 2012, because it included investments held in the State Agency Investment Fund—an account within the treasury system. The CSU Chancellor's Office (chancellor's office) allocates CSU's investments both inside and outside the state treasury and then reports the investments to its campuses as lump sums. Each campus subsequently reports its total investments on its outside accounts report to the state controller. When total investments include amounts in the treasury system, it results in an overreporting of the amount in outside accounts. Until the chancellor's office changes CSU's procedures for reporting the amount campuses hold in investments, it risks misreporting the balances in its outside accounts.

Until the chancellor's office changes CSU's procedures for reporting the amount campuses hold in investments, it risks misreporting the balances in its outside accounts.

State Agencies Generally Have Adequate Controls Over Outside Accounts

In general, the state agencies we tested have sufficient controls in place to deter the misdirection of revenue and to ensure proper accounting and reporting of outside account transactions. These controls include completing routine bank reconciliations, regularly reviewing account activity for compliance with program requirements, monitoring processes established to ensure that the agency safeguards and reports money in outside accounts, and ensuring segregation of duties so that staff who receive money are not performing other duties that would allow them to misdirect funds. For example, food and agriculture's raisin board has adequate segregation of duties over the money it receives. Specifically, a mail clerk receives payments and enters them into a tracking log, an accountant reviews the log and makes the deposits, and an accounting assistant updates the accounting records. The accountant also performs a monthly bank reconciliation, which is reviewed by both the vice president of finance and the president of the marketing board, and a compliance officer reviews the bank statements for anomalies.

Likewise, the CSU chancellor's office has multiple control processes in place to ensure that it properly safeguards assets in its investment account. The chancellor's office handles investment account deposits and withdrawals through electronic funds transfers and requires that two separate managers from its financing and treasury department prepare, review, and approve each transaction. The chancellor's office's accounting and payables department also reconciles CSU's accounting records with the investment account bank statements monthly. Additionally, the financing and treasury department reports quarterly on the investment account to the assistant vice chancellor/controller of the financial services division, and he reports investment activity to the Board of Trustees annually.

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Each of three other agencies we reviewed—the Governor's Office of Business and Economic Development's California Infrastructure and Economic Development Bank, the California Energy Commission, and the California Housing Finance Agency—has its outside accounts in the custody of a bond trustee. For these accounts, the agencies ensure that the bond trustee receives all deposits and disburses money according to the bond contract requirements. For example, under a 2005 bond contract for energy-efficiency revenue bonds, the California Energy Commission is required to ensure that loan repayments are deposited into a loan repayment account, and the trustee is required to transfer money from that account to a debt service account. Under this system, loan recipients send payments directly to the bond trustee, which then makes debt service payments; the California Energy Commission monitors loan and debt repayment activity.

About half the outside accounts we reviewed are audited by an outside entity.

About half the outside accounts we reviewed are audited by an outside entity. We found that external accounting firms perform annual financial statement audits covering six of the 11 outside accounts we reviewed. Additionally, the outside account we reviewed for the California Small Business Loan Guarantee Program, which is administered by the Governor's Office of Business and Economic Development, was recently audited by the federal Office of Inspector General. One of the objectives of this 2012 audit was to test compliance to identify reckless or intentional misuse. Although the two outside accounts we reviewed for the Administrative Office of the Courts are not subject to annual financial audits by external accounting firms, its internal audit services unit has a goal to perform audits of each court every four years. In fact, in March 2011 the unit conducted an internal audit of one of the courts we tested, while an external consulting firm under the direction of the internal audit services unit conducted a performance audit in February 2013 of the other court we tested. Similarly, Cal Fire's Office of Program Accountability conducted an internal audit of Cal Fire's outside account, referred to as the Wildland Fire Investigation Training and Equipment Fund (Wildland Fire Fund), in 2009. However, as discussed later, we found continuing problems related to Cal Fire's establishing the outside account, its tracking and reconciling of revenues, and its purchasing and safeguarding of equipment, issues raised by the 2009 internal audit as well as an August 2013 report issued by Finance's Office of State Audits and Evaluations. The last of the 11 outside accounts we reviewed, established for the Cotton Pest Control Program, is not required to have an audit.

Cal Fire Had $3.7 Million Deposited Into an Unauthorized Outside Account

Unlike the other state agencies we reviewed, Cal Fire established an outside account for which it had neither statutory authority nor Finance approval. Moreover, Cal Fire failed to follow its own

accounting and budgeting processes when it established the unauthorized account, and it failed to institute adequate controls over or sufficiently track the revenues of its Civil Cost Recovery Program (cost recovery program). Finally, Cal Fire did not follow state processes for receiving and safeguarding assets. Specifically, it did not retain receiving documents and reconcile them to invoices, or tag its equipment.

Cal Fire Established an Unauthorized Account Held Under the Name of a Non-State Entity

Between June 2005 and September 2012, Cal Fire arranged to have $3.7 million in settlement payments for the cost of fire suppression and investigation (cost recovery revenues) deposited to a bank account held under the name and tax identification number of the California District Attorneys Association[1] (attorneys association) to fund training and equipment projects. However, Cal Fire does not have statutory authority to establish an outside account, nor did it request and receive approval from Finance to establish the Wildland Fire Fund.

Cal Fire does not have statutory authority to establish an outside account, nor did it request and receive approval from Finance to establish the Wildland Fire Fund.

The California Health and Safety Code allows public agencies, such as Cal Fire, to recover the costs they incur, such as those for fire suppression and investigation activities (fire costs), related to a fire resulting from negligence or a violation of law. Through its cost recovery program, Cal Fire recovers fire costs from persons it determines are responsible for starting fires (responsible parties). The Office of the Attorney General (attorney general's office) also often plays a role in these cost recovery efforts because Cal Fire requests legal representation for cases exceeding $5,000. While the attorney general's office assists client agencies, such as Cal Fire, in obtaining revenues through cost recovery efforts, it performs little oversight of how agencies choose to direct these revenues.

A deputy attorney general who has represented Cal Fire stated that the attorney general's office does not have any policy to review a client's use of court case settlement money or to determine whether its clients have the authority to earmark this money for distribution to non-state entities, such as not-for-profit organizations. The chief assistant attorney general for the public rights division said that client agencies are responsible for determining their authority to earmark settlement money and so should consult their in-house legal counsel. Before May 2013 the attorney general's office had no formal policy in place for ensuring the authority of state agencies to distribute

[1] The attorneys association serves as the source of legal education for prosecutors and law enforcement personnel statewide and provides legislative advocacy for its members.

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settlements to non-state entities. However, in May 2013 it updated its policy to require the chief counsel of its client agencies to confirm that each state agency has the authority to direct payments according to the terms of each settlement made by the attorney general's office.

In May 2005 the deputy chief of Cal Fire's law enforcement unit (former deputy chief) executed a memorandum of agreement (agreement) with the attorneys association that required the association to establish and manage the Wildland Fire Fund. In exchange, the agreement stipulated that the attorneys association would receive administrative fees amounting to 3 percent of all cost recovery revenues deposited into the Wildland Fire Fund and 15 percent of all disbursements made from the fund. In October 2011 the administrative fee for disbursements was decreased to 5 percent. The attorneys association received $373,624 between 2005 and 2013 from the Wildland Fire Fund for its management services. While Cal Fire's agreement required the attorneys association to manage the Wildland Fire Fund, it did not require the attorneys association to ensure that the bank that held the Wildland Fire Fund money met the State's collateral requirements. State policy also requires agencies to obtain Finance approval for services provided by a fiscal agent, which is a third party that receives or disburses money on behalf of the State. However, Cal Fire did not request or receive Finance approval for the attorneys association to provide such services.

According to an internal audit report issued by Cal Fire's Office of Program Accountability in November 2009, Cal Fire included language in the agreement with the attorneys association to ensure that Wildland Fire Fund money would not revert to the State's General Fund.

The agreement also specified that money deposited in the Wildland Fire Fund would not be deemed state money within the meaning of California Government Code, Section 16305.2, which states that, with the exception of money in the Local Agency Investment Fund, all money in the possession of or collected by any state agency is state money. According to an internal audit report issued by Cal Fire's Office of Program Accountability in November 2009, Cal Fire included this language in the agreement to ensure that Wildland Fire Fund money would not revert to the State's General Fund. The 2009 internal audit also noted that it was not clear what authority allowed Cal Fire to keep Wildland Fire Fund money separate from state money and recommended that Cal Fire document its authority in its agreement with the attorneys association. In its 2009 internal control report—a report required every two years by the Financial Integrity and State Manager's Accountability Act—Cal Fire identified the Wildland Fire Fund as a potential area of risk, but it indicated only that it had identified weaknesses in its agreement with the attorneys association and did not discuss the internal audit's concern related to state money. The 2009 internal control report also indicated that Cal Fire was in the process of revising its agreement with the attorneys association to address the weaknesses in the agreement. However, in its revised 2011 agreement with the attorneys association, Cal Fire stated only that it believed money deposited into the Wildland Fire Fund was not state money as defined by the California Government Code, Section 16305.2, because Cal Fire did not possess or collect the money.

We disagree with Cal Fire's position that the settlement money deposited in the Wildland Fire Fund is not state money. Although the responsible parties wrote checks payable to the attorneys association, Cal Fire included the payment instructions in the settlement agreements or instructed the deputy attorney general to include the payment instructions. Cal Fire also collected the checks, delivered the checks to the attorneys association for deposit, and determined how the money was to be spent. As a result, Cal Fire collected and controlled the money in the Wildland Fire Fund and therefore was in possession of it, despite the fact that the money was deposited into a bank account that was opened by the attorneys association. In fact, the agreement stated that the attorneys association would not hold an interest in property acquired with Wildland Fire Fund money unless Cal Fire agreed to it, and in the revised agreement between Cal Fire and the attorneys association executed in October 2011, the attorneys association expressly disclaimed any ownership in the Wildland Fire Fund or any equipment or interest generated by it.

Furthermore, the California Health and Safety Code does not give Cal Fire authority to place recovered money in an outside account, and the California Government Code, Section 16303, requires that money withdrawn from the treasury system under an appropriation that is subsequently returned be credited back to the appropriation or fund from which it was drawn. Cal Fire receives reimbursements for the fire protection services it provides to other local, state, and federal agencies through cooperative agreements. Costs for these fire protection services are primarily paid for by the General Fund through a budget appropriation. Consequently, when Cal Fire recovers fire costs from government agencies, the money it recovers is credited back to the General Fund or other funds from which fire costs were paid. We would expect that recoveries from responsible parties would be treated similarly.

The California Health and Safety Code does not give Cal Fire authority to place recovered money in an outside account, and the California Government Code requires that money withdrawn from the treasury system under an appropriation that is subsequently returned be credited back to the appropriation or fund from which it was drawn.

Cal Fire's agreement with the attorneys association also specified that the purpose of the Wildland Fire Fund was to pay for training and equipment projects that benefit the efficacy and accuracy of Cal Fire personnel responding to wildland fire investigations, and that the fund was to receive settlement money from Cal Fire's cost recovery program. Cal Fire's northern and southern regional offices had policies allowing for deposits to the Wildland Fire Fund in cases when Cal Fire recovered more than 80 percent of its fire costs in a legal settlement.[2] However, the northern regional office limited deposits to the Wildland Fire Fund to 5 percent of a fire settlement, whereas, according to the deputy chief of fire prevention and law enforcement for the southern region, its deposits

[2] Cal Fire's policy changed over time, at one time it allowed for deposits to the Wildland Fire Fund when settlements were as low as 75 percent of fire costs.

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could be up to 20 percent of a settlement. We reviewed eight settlements that provided money to the Wildland Fire Fund and found that deposits ranged from 4.8 percent to 16.7 percent of each settlement.

According to Cal Fire's assistant deputy director of cooperative fire, training, and safety (assistant deputy director), who was deputy chief of the civil cost recovery office between March 2009 and December 2010, Cal Fire set up the Wildland Fire Fund to be used as a tool in negotiating cost recovery cases and to capture money that would not otherwise have been captured by the General Fund. However, in two cases we reviewed, the northern regional office demanded payment from responsible parties to the Wildland Fire Fund in its initial billing document. Cal Fire's demand that a portion of its fire cost be paid to the Wildland Fire Fund before the responsible party refused to pay for the cost of the fire demonstrates that the fund was not used as a negotiating tool. Further, the deputy chief of fire prevention and law enforcement for the southern regional office, as well as two case managers, stated that the Wildland Fire Fund was not used as a tool to negotiate settlements. They added that they determined the amount to include as a payment to the attorneys association for the Wildland Fire Fund only after a settlement amount was agreed upon. According to a deputy attorney general that represented Cal Fire, her role was to recover as much of Cal Fire's costs as possible, and she included payment instructions in the settlement agreements as directed by Cal Fire.

According to the attorneys association's former director of finance, she determined in 2010 that the Wildland Fire Fund bank account had been incorrectly set up under the attorneys association's tax identification number when she considered moving the account to another bank.

According to the attorneys association's former director of finance (attorneys association director), she determined in 2010 that the Wildland Fire Fund bank account had been incorrectly set up under the attorneys association's tax identification number when she considered moving the account to another bank. However, she said cost recovery program staff delayed providing her with Cal Fire's tax identification number when she requested it. After the attorneys association requested Cal Fire's tax identification number, Cal Fire approved a Wildland Fire Fund project to hire an attorney to research the possibility of creating a nonprofit foundation to be the holder of the Wildland Fire Fund. The project description noted that because ownership of the Wildland Fire Fund was required and neither the attorneys association nor Cal Fire desired ownership, research was needed to create clear ownership. However, we reviewed Cal Fire's project file and the attorneys association's accounting records and found no evidence that Wildland Fire Fund money was spent on the research project.

The attorneys association director said the account was never moved to a new bank because Cal Fire did not provide her with its tax identification number for the account. In February 2013 the

attorneys association withdrew as the Wildland Fire Fund manager. According to the assistant chief executive officer for the attorneys association, it did so because it no longer wanted the account under its tax identification number and because Cal Fire's expenditure requests were taking an increasing amount of time to process. Additionally, he said the attorneys association felt it was in its best interest to withdraw as Wildland Fire Fund manager after it was notified of litigation that Cal Fire is involved in related to the Wildland Fire Fund.

In April 2013 Cal Fire deposited the Wildland Fire Fund's final balance of $813,607 in a Special Deposit Fund account within the treasury system. According to a March 2013 letter from Finance that authorized Cal Fire to establish the Special Deposit Fund account, Cal Fire is required to obtain authorization from the Legislature or Finance before spending or transferring the money.

Cal Fire's Cost Recovery Program Management Circumvented Its Accounting and Budgeting Processes

Cal Fire's law enforcement unit circumvented accounting and budgeting processes for establishing accounts and obtaining program funding when it contracted with the attorneys association to establish the Wildland Fire Fund in 2005. As a result, expenditures of cost recovery revenues that Cal Fire directed into the Wildland Fire Fund were not subject to essential state fiscal controls and legislative oversight.

Cal Fire's accounting office is responsible for establishing and maintaining accounts and financial records. According to the chief of accounting (accounting chief), the accounting office follows the procedures in the SAM to establish accounts outside the treasury system. In fact, the accounting office complied with the SAM requirements and obtained Finance approval for a different outside account it uses to pay federal payroll taxes for temporary, seasonal, and emergency workers. However, the accounting chief stated that the accounting office does not have documentation showing that cost recovery program management ever asked the accounting office to establish the Wildland Fire Fund or request Finance's approval of it.

The accounting chief stated that the accounting office does not have documentation showing that the cost recovery program management ever asked the accounting office to establish the Wildland Fire Fund or request Finance's approval of it.

Similarly, Cal Fire's budget office is responsible for preparing and monitoring its budget and has a process for Cal Fire programs or organizational units (programs) to request funding for additional operating expenses and staff. To make a request, a program submits a concept paper to the budget office, including a justification for its request. According to Cal Fire's budget officer, once the budget office reviews the request and Cal Fire's director and

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the Natural Resources Agency[3] approve it, the program develops a budget change proposal, which the budget office submits to Finance. However, cost recovery program management did not use the required state process to seek funds for the kind of training and equipment it paid for through the Wildland Fire Fund. The budget officer could not find evidence that cost recovery program management had requested such funding through Cal Fire's normal budget process for fiscal year 2004–05, the year Cal Fire established the Wildland Fire Fund.

An e-mail dated January 2005 from the former deputy chief to a former cost recovery case manager suggests that cost recovery program management designed the Wildland Fire Fund, at least in part, to avoid state fiscal controls.

An e-mail dated January 2005 from the former deputy chief to a former cost recovery case manager suggests that cost recovery program management designed the Wildland Fire Fund, at least in part, to avoid state fiscal controls. Specifically, the former deputy chief discussed using the attorneys association or another third party to set up and manage a fund with the purpose of training and equipping Cal Fire's fire investigators. He said he would like to see an outside organization receive the money so it could be used in a more effective manner. He went on to say that if the State received the money, there would be a lot of limiting factors on how, when, and where it could be used, such as budgeting, purchasing, and contracting limitations, and spending freezes. However, such limitations are an essential part of the State's fiscal controls. Because Cal Fire did not follow its accounting and budgeting processes, expenditures of cost recovery revenues that Cal Fire directed from the Wildland Fire Fund were not subject to state fiscal controls and legislative oversight.

When asked why the cost recovery program did not follow the normal budget process to obtain additional training and equipment, the assistant deputy director said that the Wildland Fire Fund paid for training and equipment for attorney general's office staff as well as for non-state employees, such as district attorney investigators, contract county fire personnel, and local fire department personnel, and therefore it would have been improper to include the type of training and equipment provided by the Wildland Fire Fund in a budget proposal through the budget office. However, an August 2010 e-mail regarding a Wildland Fire Fund project to pay for a cost recovery program meeting indicates that involving these other staff was more a matter of appearance than substance. In the August e-mail, the assistant deputy director said Cal Fire should invite representatives from the attorney general's office and counties, even if only for a few hours, because it would be beneficial to include them in the process and would keep the project from looking like solely a Cal Fire project, which always raises an argument of subverting the state budget process. She also said in the e-mail that the more

[3] Cal Fire is a department under the Natural Resources Agency.

Cal Fire involves other agencies, the better it is for future audits of the Wildland Fire Fund. According to our legal counsel, however, state law does not prohibit the Legislature from appropriating money for these purposes. By directing and spending portions of cost recovery revenues through the Wildland Fire Fund account instead of following normal state processes, cost recovery program management prevented Finance and the Legislature from performing their role in deciding how state money should be spent, including whether some of it should be spent on non-state entities.

Cal Fire's Controls Over Cost Recovery Program Revenues Are Inadequate

Cal Fire does not have adequate controls over cost recovery settlement revenues. Unlike revenues that Cal Fire's accounting office processes, such as those related to cooperative agreements, cost recovery processes are decentralized and outside of the accounting office's control. When Cal Fire sends billing notices to local governments for the costs it incurs for fire protection, prevention, and investigation services under cooperative agreements, it instructs the local government to submit payment directly to the accounting office. However, program staff at regional offices and administrative units (units) across the State process cost recovery revenues, and because the program case managers who initiate and manage cost recovery cases also collect the payments, cost recovery revenues are not adequately safeguarded.

Specifically, case managers prepare cost recovery billing notices, participate in mediation and settlement meetings, provide the deputy attorney general with the payment instructions to include in settlement agreements, and receive the settlement checks. In some cases, a single case manager handles all aspects of the process. For three of the eight cases we reviewed, settlement agreements included instructions that a portion of the settlement be paid to the Wildland Fire Fund and sent to the case manager. Settlement payments for the remaining five cases were first sent to the deputy attorney general representing Cal Fire, then forwarded to either Cal Fire legal counsel or the case manager instead of to accounting. Without adequate segregation of duties for its cost recovery program receipts, Cal Fire continues to risk having these payments misdirected.

Without adequate segregation of duties for its cost recovery program receipts, Cal Fire continues to risk having these settlement payments misdirected.

The Civil Cost Recovery Program Does Not Sufficiently Track Program Revenues

Cal Fire does not have an adequate process to centrally monitor the progress of cost recovery cases and ensure accountability for program revenues. Currently, the civil cost recovery office in Sacramento (headquarters) does not receive information on

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all active cases at the regional offices and units; this information would allow statewide monitoring by headquarters. In its 2009 internal audit of the Wildland Fire Fund, the office of program accountability found no process for regional offices and units to report cost recoveries to headquarters and recommended revising Cal Fire procedures to require the reporting of all cost recoveries to headquarters. Cal Fire's cost recovery procedures currently state that regional offices and units should notify headquarters of new cases and provide it with updates. However, we found that headquarters' monitoring of active cases is informal and limited to case information reported by regional offices or specifically requested by headquarters.

According to the deputy chief of local government agreements, who was deputy chief of the civil cost recovery office between September 2012 and July 2013, regional offices and units do not consistently notify headquarters of new cases or provide updates. He said headquarters tracks active cases at the regional offices only when it specifically requests case information or when case managers voluntarily provide information. He also said that headquarters began tracking information on closed cases managed at the regional offices in 2009 and at the units in January 2013, but that it does not reconcile payment information to settlement documents to ensure a complete accounting for all payments. The 2009 internal audit also noted that no reconciliation was taking place to ensure that expected recoveries were placed into the Wildland Fire Fund.

In one instance that highlights Cal Fire's inability to track cost recovery settlement payments, a responsible party mailed a settlement check for $13,470 made out to the attorneys association to the former deputy chief of fire prevention and law enforcement for the northern regional office; however, the check was never deposited into the Wildland Fire Fund, and its whereabouts were not questioned for years. Specifically, the check was dated September 7, 2005, but it was not until August 2011 that a battalion chief at headquarters questioned whether the check had ever been deposited. According to a Cal Fire investigation report, Cal Fire subsequently contacted the bank where the check was processed in December 2005 but was unable to obtain any additional information. The investigation report stated that in its last contact with the bank in July 2013, Cal Fire learned that the bank no longer had the account records that would allow it to determine who cashed or deposited the check. As a result of not tracking expected payments and reconciling its records with those of the attorneys association, Cal Fire has not been able to recover the lost funding or determine who presented the check to the bank. Cal Fire indicated that it has not decided what further action to take regarding this issue.

As a result of not tracking expected payments and reconciling its records with those of the attorneys association, Cal Fire has not been able to recover the lost funding or determine who presented the check to the bank.

The deputy chief of the civil cost recovery office between September 2012 and July 2013 said that to improve program oversight, headquarters is currently in the process of developing procedures and a tracking system to monitor all civil cost recovery cases and reconcile payments with settlement documents. Although the Wildland Fire Fund no longer exists, Cal Fire's cost recovery payments still follow the same decentralized collection process as previously discussed, and headquarters does not adequately monitor cost recovery cases. Consequently, cost recovery revenues are still at risk of misdirection until headquarters implements better collection monitoring processes.

Cal Fire Did Not Follow State Accounting Policies for Equipment

Cal Fire approved the purchase of equipment costing $1.7 million, paid from the Wildland Fire Fund between 2005 and 2012, but did not follow state guidelines for accounting for or safeguarding the equipment.

Cal Fire approved the purchase of equipment costing $1.7 million, paid from the Wildland Fire Fund between 2005 and 2012, but did not follow state guidelines for accounting for or safeguarding the equipment. Cal Fire did not have procedures in place to document that it received all equipment purchased with Wildland Fire Fund money. Specifically, Cal Fire did not require staff to prepare receiving documents when accepting delivery of equipment, a process that would have allowed it to ensure that it received all authorized purchases. Further, Cal Fire infrequently placed inventory tags on the equipment it purchased with Wildland Fire Fund money, and did not maintain a complete list of purchased equipment, making it impossible to conduct periodic inventories of this equipment, as required by the SAM. As a result, Cal Fire cannot be certain that all equipment purchased was received, where the equipment is, or whether any of the equipment has been lost or stolen.

Cal Fire authorized the attorneys association to purchase equipment with Wildland Fire Fund money through a project proposal and approval process controlled by cost recovery program management. Cal Fire staff prepared project proposals that described the purpose and cost of each project, and provided details regarding how the project would be completed. A Wildland Fire Fund Committee (committee), comprising Cal Fire managers, evaluated each proposal and either approved the project as proposed or amended, or denied the proposal. Once the committee approved a project, the attorneys association purchased equipment and disbursed money according to the project's budget and specifications. For the five projects we reviewed, vendors shipped the equipment to Cal Fire regional offices or units located across the State, and in one instance to its technical services lands section in Sacramento.

While Cal Fire documented its process to authorize the attorneys association to purchase equipment, it did not document its actions to ensure the attorneys association disbursed the Wildland Fire Fund

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money as authorized. The attorneys association paid for equipment purchases by check or electronic funds transfers. According to Cal Fire desk procedures, cost recovery program staff were required to reconcile Cal Fire's records to the attorneys association's records for project expenditures. However, Cal Fire did not maintain a complete listing of expenditures or document the reconciliations it says it performed between it and the attorneys association. For this reason, Cal Fire cannot be sure that the attorneys association spent funds only for approved items and amounts. However, for about $641,000 in equipment purchases we reviewed—$425,000 from four projects Finance tested and $216,000 from one additional project we selected from the Wildland Fire Fund's general ledger—we found that the attorneys association properly recorded equipment expenditures in its records.

For about $641,000 in equipment purchases we reviewed, we found that the attorneys association properly recorded equipment expenditures in its records.

Cal Fire also lacked a formal process for receiving shipments paid for from the Wildland Fire Fund to ensure that it received all purchased equipment. According to the deputy chief of fire prevention and law enforcement for the northern regional office, the northern regional office did not have a formal policy or written procedures for receiving equipment. He said the practice for receiving equipment was to confirm that the entire order was received by comparing the packing list to the project request, which was usually provided. The regional office then contacted the units to pick up the equipment. Afterwards, it prepared and forwarded to headquarters transfer forms documenting which units received the equipment.

However, for most of the projects we reviewed, we found that Cal Fire's cost recovery program did not maintain documentation demonstrating that it received all of the equipment purchased by the attorneys association on its behalf, and in no case did it record the equipment in a property accounting or inventory system as required by the SAM. Although the project files contained invoices for the items purchased, Cal Fire usually could not provide documentation that it compared packing lists to project requests when it received the equipment shipments. Conversely for about half of the equipment, Cal Fire was able to provide us with transfer forms showing the units that received the equipment. However, it did not compile the transfer information, so it could be used to monitor the equipment. Specifically, Cal Fire did not maintain a complete list of the equipment purchased with Wildland Fire Fund money, or where it was located. Cost recovery staff provided us three different equipment lists, all of which were incomplete and included little information about specific pieces of equipment. The staff member responsible for producing the lists stated that she cannot ensure the completeness of the lists because she only has documentation for the equipment to the extent that the attorneys association and the regional offices maintained and provided it to her. As a result, Cal Fire cannot be certain that equipment

purchased with Wildland Fire Fund money was ever received or was not lost or stolen. For example, the attorneys association purchased 527 cameras and 88 terabyte hard drives, but Cal Fire's regional offices and units reported possessing only 480 cameras and 62 terabyte hard drives to Finance during its review.

Cal Fire also failed to follow another state policy related to safeguarding assets. Specifically, it failed to tag equipment purchased with Wildland Fire Fund money as state property as required by the SAM. Without proper tagging, Cal Fire is unable to conduct periodic inventory counts of the equipment as also required by the SAM. The testing performed by Finance showed that Cal Fire tagged less than 15 percent of the equipment sent to the regions and units. When we asked the deputy chief of fire prevention and law enforcement for the northern regional office why he did not tag the equipment, he said there was no instruction or policy to do so. According to the assistant chief of law enforcement at the southern regional office, he did not tag equipment because he was told that the equipment did not belong to Cal Fire; rather, he believed that the attorneys association owned it. However, as discussed earlier in this report, the agreement between Cal Fire and the attorneys association stipulated that the attorneys association would not hold an interest in or take ownership of the assets paid for by the Wildland Fire Fund. Without establishing processes such as properly receiving and recording equipment purchases, tagging equipment, and conducting periodic inventories, Cal Fire cannot effectively safeguard its assets.

Recommendations

To improve the State's control over outside accounts, the control agencies should take the following steps:

- Within the next 60 days, Finance, the state treasurer, and the state controller should implement the policies and procedures they developed to ensure the receipt of outside account reports in each reporting period and to enhance monitoring efforts.

- Within the next six months, the state treasurer and the state controller should develop policies and procedures to each maintain lists of all outside accounts and reconcile these lists annually.

To ensure that all outside accounts have proper authority, over the next six months, Finance should continue to pursue and resolve the 35 identified unresolved cases in which adequate authority could not be confirmed.

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For the State to better monitor outside accounts, the Legislature should consider requiring the state controller to expand its reporting on outside accounts to include information on accounts opened during the last fiscal year. Reported details should include the authority, name, and balance of the new outside accounts.

To ensure accurate reporting on its outside accounts in the future, within the next six months, CSU should develop procedures for excluding investments held by the treasury system from reported outside account balances.

To safeguard cost recovery program revenue, Cal Fire should do the following within the next six months:

- Implement adequate segregation of duties for its cost recovery program revenues. For example, it should require that cost recovery payments be mailed to its accounting office, as are other payments.
- Develop policies and procedures requiring personnel not affiliated with the cost recovery program to reconcile expected cost recovery payments to deposits.
- Develop a process to track civil cost recovery cases statewide to monitor compliance with policies as well as monitor collection status.

Cal Fire should continue its efforts to determine what happened to the $13,470 check that was not deposited in the Wildland Fire Fund.

To ensure that state agencies do not misdirect cost recovery revenues in the future, the Legislature should specify that these revenues include any money received as a result of cost recovery efforts, and should require that these revenues be deposited in the state treasury.

To ensure that it possesses all equipment purchased with Wildland Fire Fund money, Cal Fire should:

- Compile a complete list of equipment purchased with these funds and reconcile it to the attorneys association's accounting records.
- Tag all equipment purchased through the Wildland Fire Fund.
- Perform a periodic inventory of equipment.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the scope section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,

ELAINE M. HOWLE, CPA
State Auditor

Date:	October 15, 2013
Staff:	Jim Sandberg-Larsen, CPA, CPFO, Audit Principal Angela Dickison, CPA Brandon A. Clift, CFE Carol Hand Patrick B. McCasland, CPA
Legal Counsel:	Scott A. Baxter, JD

For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

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EDMUND G. BROWN JR. • GOVERNOR
STATE CAPITOL ■ ROOM 1145 ■ SACRAMENTO CA ■ 95814-4998 ■ WWW.DOF.CA.GOV

October 4, 2013

Ms. Elaine M. Howle, CPA
State Auditor
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento, CA 95814

Dear Ms. Howle:

Thank you for the opportunity to respond to the California State Auditor (CSA) draft report no. 2013-107. As part of this review, your staff evaluated the policies and procedures of the control agencies, including those of the Department of Finance (Finance), on accounts outside the state treasury system.

As mentioned in the report, Finance began working with the State Treasurer and State Controller in March 2013 to improve procedures for accounts outside of the state treasury system. The procedures to establish, report and monitor accounts outside of the state treasury were revised prior to the conclusion of this audit. We agree with the report's recommendations to continue to improve the State's control over the outside accounts and provide the following responses to the findings related to Finance:

1. Within the next 60 days, Finance, the State Treasurer, and the State Controller should implement the policies and procedures they developed to ensure the receipt of outside account reports in each reporting period and to enhance monitoring efforts.

   Finance has developed and implemented procedures to ensure the receipt of outside account reports and to enhance monitoring efforts. We are in the process of using the procedures as we receive the 2012-13 fiscal year-end reports from departments. We will continue to work closely with the State Treasurer and State Controller to ensure there is a comprehensive statewide list of accounts outside of the state treasury

2. To ensure that all outside accounts have proper authority, over the next six months Finance should continue to pursue and resolve the 36 identified unresolved cases in which adequate authority count not be confirmed.

   Finance is currently following-up on the 36 cases. As we receive the 2012-13 reports from departments, we are monitoring to ensure they provide proper authority. If we do not receive proper authority, we will follow-up with departments.

If you have any questions, please contact Larry Satter, Chief of Fiscal Systems and Consulting Unit at (916) 445-0211, extension 2802.

Sincerely,

MICHAEL COHEN
Director

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STATE OF CALIFORNIA
Bill Lockyer, Treasurer

OFFICE OF THE TREASURER
P. O. BOX 942809
SACRAMENTO, CA 94209-0001

October 4, 2013

Ms. Elaine Howle, CPA
State Auditor
621 Capitol Mall, Suite 1200
Sacramento, CA 95814
(916) 445-0255

Dear Ms. Howle:

Thank you for the opportunity to review and respond to your draft report titled "Accounts Outside the State Treasury System: Processes Exist to Safeguard Money, but Controls for These Accounts Need Strengthening." The State Treasurer's Office (STO) agrees with and fully supports the recommendations presented in the report. With respect to the specific recommendations:

1. *"Within the next 60 days the state treasurer should implement the policies and procedures they developed to ensure the receipt of outside account reports in each reporting period and to enhance the monitoring efforts."*

   STO has developed and implemented new or modified policies and procedures to ensure full compliance with mandated reporting requirements by every state department and agency.

2. *"Within the next six months the state treasurer and state controller should develop policies and procedures to each maintain lists of all accounts and to reconcile these lists annually."*

   STO has developed and implemented new or modified policies and procedures to build and maintain lists of all reported accounts. STO will annually reconcile its lists with those maintained by the State Controller's Office (SCO).

For a detailed list of the steps STO has taken, or will take, to implement the report's recommendations, please see the attached Appendix.

Your report accurately notes the control agencies met in March 2013 to *"discuss ways to improve compliance with state law and policies governing outside accounts."* We believe, however, it is important to add some context to the meeting, in the interest of providing a more complete accounting of actions STO took when it determined there were a number of unreported accounts outside the centralized treasury system. Four months prior, during the annual bank meetings that were held in November 2012, STO already had instructed all depository banks to provide our office a list of all known accounts they held for state agencies. The banks provided lists, and STO verified all accounts on the lists which required collateralization were adequately collateralized.

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Ms. Elaine Howle, CPA
October 4, 2013
Page 2

The lists provided by the depository banks, however, may not capture all accounts outside the treasury. Most agencies that establish outside accounts utilize their own Tax Identification Numbers (TIN). Privacy laws prohibit the depository banks from providing STO the TINs for the accounts they hold. Additionally, STO does not have the authority to require the IRS to provide us with a list of state government TINs. For these reasons, the state control agencies cannot have complete certainty their list includes all outside accounts.

So, in addition to the actions already undertaken, STO will pursue a revision to the State Administrative Manual (SAM) to require all state departments and agencies to provide our office with their TIN. This will facilitate the search for any and all state accounts held by depository and non-depository banks. We also will ask for a SAM revision requiring every department and agency with accounts outside the treasury to provide STO a copy of their monthly bank statements. This will help ensure that all outside accounts requiring collateralization are adequately collateralized.

We believe both these requirements are necessary to minimize the likelihood any unit of state government can establish accounts outside the centralized treasury system without the knowledge and approval of the state control agencies. We are confident these changes can be carried out administratively. If that does not prove possible, STO will sponsor legislation to mandate necessary accountability and reporting measures.

Additionally, when DOF approves outside accounts, it reminds the requesting agency in writing of the agency's obligation under SAM to report annually to DOF, STO and SCO to ensure the funds are collateralized as required by the Government Code. Consequently, STO will institute a new policy: If an agency fails to report to STO or adhere to the provisions of SAM and the Government Code, STO will report such non-compliance to DOF for enforcement action.

STO will continue to work closely with SCO and DOF to assure we at all times maintain and enforce strong measures and procedures to track and monitor accounts outside the treasury. To do a thorough job, STO will devote sufficient staff and data monitoring resources to these tasks.

Thank you for your thorough study, analysis and thoughtful conclusions. The report will help STO best carry out its responsibilities to maintain the safety, security and prudent use of the public funds entrusted to state government.

Sincerely,

Bill Lockyer

BILL LOCKYER
California State Treasurer

Attachment

APPENDIX

Policies and procedures pertaining to accounts that are outside the Centralized Treasury System have been developed and incorporated into the relevant procedures. Furthermore, the following steps have been or will be taken in an effort to protect state funds and to ensure that outside accounts are reported and adequately collateralized:

1. STD. 445 (Report 14) has been revised to include:
    a. A signature from the Department Head and the preparer under the penalty of perjury;
    b. Additional columns were added to require the reporting of collateral;
    c. Government Codes and FDIC regulations pertaining to collateral requirements.

2. The State Administrative Manual (SAM) has been revised to reflect the changes made to Report 14.

3. The Treasurer's website was updated to include information pertaining to Outside Accounts. The information discusses the approval process, reporting and collateral requirements. In addition, it provides references to the relevant Government Code and SAM sections.

4. The Treasurer has instructed all state depository banks not to establish an account outside the Treasury unless the request is accompanied by an approval letter from the Department of Finance or a proof that legislation authorizing such accounts has been granted by the legislature.

5. The Treasurer now requires all depository banks to submit a report listing all outside accounts with their respective balances as of the end of each fiscal year so that it can be compared with the Report 14's provided by state agencies.

6. When a bank requests from the Treasurer the release of collateral, the Treasurer now requires the bank to submit a statement listing the current balances to verify that there is sufficient collateral before authorizing the release.

7. The Treasurer and Controller will reconcile all Report 14's that are submitted by September 30th of each year. The reconciliation is already underway for this year. Both agencies are in constant communication during the reconciliation process and are working together to ensure the departments/agencies are in compliance with the reporting requirements.

8. The Treasurer is continually and systematically educating appropriate departments/agencies staff regarding the requirements for submitting the Report 14's.

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9. The Treasurer is following up with the departments/agencies that have not submitted a Report 14. Any agency that fails to report as required and does not respond to our requests will be referred to Finance for non-compliance.

10. The Treasurer will pursue another revision to SAM to require agencies with accounts outside the treasury to provide the Treasurer's Office with a copy of their monthly bank statements and TIN. This information will help facilitate the search for all state accounts held by depository and non-depository banks as well, and to help ensure that all outside accounts that require collateralization as indicated on the reports from the agencies are adequately collateralized.

11. The Treasurer implemented a new tracking system for all accounts approved by Finance to ensure that agencies report all new accounts on Report 14.

12. The Treasurer is will continue to update the procedures to include any new requirements.

JOHN CHIANG

California State Controller

October 7, 2013

Elaine M Howle, CPA, State Auditor
California State Auditor
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Re: Response to BSA Audit

Dear Ms. Howle:

Thank you for the opportunity to respond to the redacted draft copy of your audit report entitled, *Accounts Outside the State Treasury System: Processes Exist to Safeguard Money, but Controls for These Accounts Need Strengthening*, requested by the Joint Legislative Audit Committee. The response is on the attached CD you provided with your October 1, 2013 letter, reference number: 2013-107.

If you have any questions regarding this matter, please call me by phone at (916) 552-8080.

Sincerely,

GEORGE LOLAS
Acting Chief Operating Officer

Attachment

300 Capitol Mall, Suite 1850, Sacramento, CA 95814 ♦ P.O. Box 942850, Sacramento, CA 94250 ♦ (916) 445-2636 ♦ Fax: (916) 322-4404
777 S. Figueroa Street, Suite 4800, Los Angeles, CA 90017 ♦ (213) 833-6010 ♦ Fax: (213) 833-6011
www.sco.ca.gov

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- For the past three decades, the SCO has tracked state agencies with accounts outside the state treasury and reported them in its Budgetary / Legal Basis Annual Report. Your audit report concludes, "As part of our testing, we determined that for FYs 2007-08 through 2011-12, the state controller's outside accounts schedule generally conveyed accurate information for outside accounts that state agencies reported." While appreciating your finding that this report has generally been reliable, we also agree that the underlying tracking activities were completed using procedures stemming from informal long-time practices, rather than formal written policy. To ensure that procedures for this important task are available in writing, the SCO began by revisiting its historical practices in search of greater efficiencies and effectiveness. After this review, we developed written policies to track, monitor, and ensure the receipt of outside account reports. These formal written policies were officially implemented earlier this summer.

  Far in advance of the BSA audit, SCO met with the state treasurer and the Department of Finance to develop new additional reporting requirements. In July 2013, the SCO issued these additional reporting instructions reminding state agencies to report all accounts held outside the state treasury on their annual reports of accounts outside the state treasury and, importantly, to file their report even if they had no outside accounts. Previously, there was a presumption that if an agency does not file an annual report, it is declaring that it has no accounts outside of the state treasury. The SCO will also disclose, in the notes to the financial statements, the state agencies who fail to report accounts outside the state treasury beginning with the FY 2012-13 Budgetary/Legal Basis Annual Report. It is important to note that these new reporting instructions require the director to personally certify – under penalty of perjury – the accuracy of the report submitted by their agency. The latest SCO instructions also require state agencies which have accounts outside of the state treasury to provide a copy of the DOF authorization necessary to open such an account or, in the alternative, to cite the statute authorizing its establishment.

- SCO began working with the state treasurer in June 2013 to reconcile the FY 2011-12 outside accounts reports and will to continue to reconcile the reports annually. SCO has incorporated this reconciliation process in its formalized policies and procedures.

THE CALIFORNIA STATE UNIVERSITY

OFFICE OF THE CHANCELLOR

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SAN BERNARDINO
SAN DIEGO
SAN FRANCISCO
SAN JOSÉ
SAN LUIS OBISPO
SAN MARCOS
SONOMA
STANISLAUS

October 3, 2013

Ms. Elaine M. Howle
California State Auditor
Bureau of State Audits
621 Capitol Mall, Suite 1200
Sacramento, California 95814

Dear Ms. Howle:

The California State University (CSU) welcomes the opportunity to respond to the draft audit report "Accounts Outside the State Treasury System: Processes Exist to Safeguard Money, but Controls for These Accounts Need Strengthening." We appreciate the time and effort dedicated by the Bureau of State Audits in conducting this audit. Following is our response to the recommendation made by your office.

RECOMMENDATION: To ensure accurate reporting on its outside accounts in the future, within the next six months CSU should develop procedures for excluding investments held by the treasury system from reported outside account balances.

RESPONSE: We concur. Within the next six months, the CSU will develop procedures for excluding investments held by the treasury system from reported outside account balances.

Please do not hesitate to contact me if you have questions.

Sincerely,

Timothy P. White
Chancellor

401 GOLDEN SHORE • LONG BEACH, CALIFORNIA 90802-4210 • (562) 951-4700 • Fax (562) 951-4986

ATTACHMENT C

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STATE OF CALIFORNIA—NATURAL RESOURCES AGENCY

Edmund G. Brown Jr., Governor

DEPARTMENT OF FORESTRY AND FIRE PROTECTION
P.O. Box 944246
SACRAMENTO, CA 94244-2460
(916) 653-7772
Website: www.fire.ca.gov

October 4, 2013

John Laird, Secretary
California Natural Resources Agency
1416 Ninth Street, Suite 1311
Sacramento, California 95814

Re: Draft Report- Accounts Outside the State Treasury System: Processes Exist to Safeguard Money, but Controls for These Accounts Need Strengthening

Dear Secretary Laird:

The California Department of Forestry and Fire Protection (CAL FIRE) provides the following information and response to the September 30, 2013, Draft Audit Report from the California State Auditor regarding the audit of Accounts Outside the State Treasury System (Audit). CAL FIRE is currently engaged in litigation regarding the Wildland Fire Investigation Training and Equipment Fund (the Fund), which is the subject of the audit. When the Fund was established, management at the time believed that the legal authority existed to support the Department's ability to establish use of the Fund through civil cost recovery settlements so long as it was used for proper purposes and did not violate public policy. The Department will ensure that any future funds are established pursuant to Executive, Legislative, or Judicial authority.

CAL FIRE appreciates the thoroughness of the Audit and the constructive recommendations for improvements. Prior to the initiation of the Audit, CAL FIRE started taking important steps to address the internal control issues noted in the draft report's observations and recommendations. CAL FIRE's goal is to fully implement the necessary changes and procedures by the end of this calendar year.

Below, I will discuss the steps we are taking in connection with each of the audit's recommendations. We look forward to providing you with our detailed corrective action plan that sets forth our implementation milestones. In addition, we welcome any input that you or the State Auditor may have to ensure the steps CAL FIRE is taking properly address the Audit's recommendations.

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Recommendations to Safeguard Cost Recovery Program Revenue

Recommendation 1: Implement adequate separation of duties for its costs recovery program revenues.

Recommendation 2: Develop policies and procedures requiring personnel not affiliated with the cost recovery program to reconcile expected cost recovery payments to deposits.

Recommendation 3: Develop a process to track civil cost recovery cases statewide to monitor compliance with policies as well as monitor collection status.

CAL FIRE's Civil Cost Recovery Program (the Program) has grown significantly, and procedures once appropriate to manage the Program are no longer sufficient. Starting in July 2012, the Program identified two specific procedures/control systems and is currently working to implement them.

First, CAL FIRE is in the process of implementing procedures that will require payments for all civil cost recovery cases be made/delivered to a single point of remittance located within CAL FIRE's Departmental Accounting Office in Sacramento. The single point of remittance will be utilized for unit and region level cases. The Department has procured a new PO Box address to ensure that all incoming cost recovery program revenues are mailed directly to CAL FIRE's Accounting Office in Sacramento. At this time, the process is being tested at select administrative units to ensure adequate controls are in place. CAL FIRE anticipates implementation of this procedure with its two Regions and 21 Administrative Units by the end of this year. This revised procedure will ensure that the person sending out the Letter of Demand and settling cases is not involved in handling and/or processing the settlement payment. In short, there will be a separation of duties that will greatly reduce the risk of lost and/or stolen funds. In addition, CAL FIRE will require that a non-cost recovery program employee reconcile expected cost recovery settlements to actual deposits of cost recovery settlements on a monthly basis.

Second, CAL FIRE is creating a centralized database that will contain information regarding active and settled civil cost recovery actions. CAL FIRE staff is working to ensure that all necessary case-related information is captured by the database. The database will not only allow real-time tracking of what cases have been initiated, but it will also allow Program management and legal staff, at the Region and Sacramento level, to monitor all ongoing cases for compliance with policy. CAL FIRE believes the database will not only reduce the risk of lost and/or stolen funds, but will ensure that all cases are more efficiently managed.

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Recommendation to Continue Efforts to Determine What Happened to the $13,470 Check That Was Not Deposited in the Wildland Fire Investigation Training and Equipment Fund

CAL FIRE recently enlisted the services of the California Attorney General's Office to subpoena Bank of America's records to confirm that no documentation regarding the bank account in which the check was deposited exists. After receiving the bank's response to the subpoena, CAL FIRE will determine what additional steps, if any, should be taken to further investigate this matter.

Recommendations Regarding Equipment Purchased with Wildland Fire Investigation Training and Equipment Fund Money

Recommendation 1: Compile a complete list of equipment purchased with these funds and reconcile it to the attorney association's accounting records.

Recommendation 2: Tag all equipment purchased through the Wildland Fire Investigation Training and Equipment Fund.

Recommendation 3: Perform a periodic inventory of equipment.

CAL FIRE is creating a list of all equipment that was purchased with the WiFITER Fund. Once completed, CAL FIRE will reconcile its list with the California District Attorneys' Association's accounting records.

Capital assets will be inventoried and recorded in CAL FIRE's official accounting records in accordance with the requirements contained in section 8602 of the State Administrative Manual (SAM). CAL FIRE will ensure that this equipment will be included in future annual inventory processes. In addition, CAL FIRE is in the process of tagging all of the equipment that was purchased through the WiFITER Fund in accordance with section 8651 of SAM.

Sincerely,

Ken Pimlott

KEN PIMLOTT
Director

cc: Janet Barentson, Chief Deputy Director
Stephanie Shimazu, Chief Counsel
Windy Bouldin, Chief of Program Accountability

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bcc: Andy McMurry, Deputy Director
Clare Frank, Assistant Deputy Director
Tony Favro, Deputy Director

cc: Members of the Legislature
Office of the Lieutenant Governor
Little Hoover Commission
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press

ATTACHMENT D

Judicial Council of California

ADMINISTRATIVE OFFICE OF THE COURTS

JUDICIAL AND COURT ADMINISTRATIVE SERVICES DIVISION

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TANI G. CANTIL-SAKAUYE
Chief Justice of California
Chair of the Judicial Council

STEVEN JAHR
Administrative Director of the Courts

CURT SODERLUND
Chief Administrative Officer

September 13, 2013

Ms. Elaine M. Howle
State Auditor
California State Auditor
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Re: Audit 2013-107, State Treasury – Outside Accounts

Dear Ms. Howle:

As always, we welcome audits of the judicial branch and would like to thank you and your staff for the work performed on the above-referenced audit. We hope the information provided to you by the Administrative Office of the Courts on behalf of the trial courts helps your understanding of the trial courts and their bank accounts held outside the state treasury.

In addition, we appreciate your recent acceptance of our suggested changes to your audit report's specific comments concerning the trial courts. As reported to you in the letter dated August 2, 2013 from our Legal Services Office, the trial courts are not state agencies or departments, and accordingly are not subject to the State Administrative Manual or other State executive branch compliance requirements.

The judicial branch, however, has adopted certain state compliance practices that are appropriate for the branch, in support of sound public policy and management.

Please let us know if we can be of further assistance.

Sincerely,

Curt Soderlund
Chief Administrative Officer

CS/GK
cc: Zlatko Theodorovic, Director, AOC Fiscal Services Office
Gregory Keil, Manager, AOC Fiscal Services Office