DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Memorandum

Date AUG 11 1994

From June Gibbs Brown
Inspector General

Subject Follow-up Audit of Accumulated Surplus by the Department of General Services, State of California (A-09-93-00039)

To Kenneth S. Apfel
Assistant Secretary for
Management and Budget

This memorandum is to alert you to the issuance on August 15, 1994 of our final audit report. A copy is attached.

Our prior report resulted in a refund of $10.3 million by the State for the Federal share of the surplus accumulated by the Service Revolving Fund (SRF) through June 30, 1984. The SRF is an internal service fund administered by the Department of General Services to provide goods and services on a cost reimbursable basis to other agencies within the State. Internal service funds are required to operate on a break-even basis by charging users for allowable costs as established under Office of Management and Budget Circular A-87. We recommended that the State ensure that billing rates only recover allowable costs and are adjusted at least annually to eliminate any surplus.

However, we found that through June 30, 1991, the SRF accumulated a surplus of $76.9 million after the period covered by our prior audit. We estimate that $12.2 million represents the Federal share of billings claimed for reimbursement. We are again recommending that the State refund the Federal share and adjust billing rates to eliminate surpluses or deficits. The Department of Health and Human Services, Division of Cost Allocation, Western Office, has generally agreed with our findings.

The State Department of Finance (DOF) did not concur with the audit recommendations. The DOF commented that accumulated surpluses represent working capital which is needed to support operations and provided reasons for reducing the audited amount. However, Federal cost principles do not allow surpluses for billings above allowable costs. The DOF comments and our responses are summarized after the recommendations section in this report.

If you have any questions, please call me or have your staff contact John A. Ferris, Assistant Inspector General for Administrations of Children, Family, and Aging Audits, at (202) 619-1175.

Attachment

Department of Health and Human Services

OFFICE OF INSPECTOR GENERAL

FOLLOW-UP REVIEW ON AUDIT OF ACCUMULATED SURPLUS IN CALIFORNIA INTERNAL SERVICE FUNDS SERVICE REVOLVING FUND DEPARTMENT OF GENERAL SERVICES FOR THE PERIOD JULY 1, 1984 THROUGH JUNE 30, 1991

JUNE GIBBS BROWN
Inspector General

AUGUST 1994
A-09-93-00039

DEPARTMENT OF HEALTH & HUMAN SERVICES

Office of Inspector General

Region IX
Office of Audit Services
50 United Nations Plaza
San Francisco, CA 94102

CIN: A-09-93-00039

Russell Gould, Director
Department of Finance
State of California
State Capitol, Room 1145
Sacramento, California 95814-4998

Dear Mr. Gould:

This report provides you with the results of our follow-up audit of the accumulated surplus in the Service Revolving Fund (SRF) administered by the Department of General Services (DGS). The objectives of our audit were to determine if the recommendations in our prior audit of California's internal service funds were implemented, the amount of surplus accumulated by SRF and the Federal Government's share of the surplus. Our audit covered the period July 1, 1984 through June 30, 1991.

We found that the State had not implemented our previous recommendations. The SRF had accumulated a surplus of $76.9 million during the 7-year period included in this audit. The amount includes $35 million which the State transferred to the State General Fund and the Contingent Funds - Assembly and Senate without recognizing any Federal share. The Federal share of accumulated surplus and fund transfers totaled approximately $12.2 million.

We previously issued two other follow-up audit reports on accumulated surpluses in internal service funds for the Teale Data Center (TDC), issued under Common Identification Number (CIN) A-09-92-00105, and the Health and Welfare Data Center (HWDC), issued under CIN: A-09-92-00119. As agreed with the California Department of Finance (DOF), the response to those two audit reports would be included in the response to this report. The DOF provided its comments in a letter dated February 1, 1994, and in a supplemental letter dated March 14, 1994.

According to DOF, the amount in the retained earnings accounts is not cash and does not represent a refundable surplus. The accumulated surplus referred to in our audit is the accumulated net income of the internal service funds. The balance in the retained earnings accounts represents this accumulated net income. The DOF also stated that the retained earnings reflects working capital and undepreciated equipment. Specific comments were provided by DOF on our computation of the Federal share of the retained earnings. In addition, DOF provided several reasons for reducing the amount in the audited retained earnings accounts.

Based on DOF's supplemental letter and additional documentation, the Federal share of HWDC's reported surplus was reduced from $10.7 million to $9.4 million. In regards to the accumulated balance in the internal service funds, we used the June 30, 1991 retained earnings balance as reported by the Office of the Auditor General (currently the State Auditor, Bureau of State Audits) in the audited financial statements for the State of California. The State Auditor determined the amount of net income for the internal service funds in accordance with generally accepted accounting principles (GAAP). The DOF did not comment on our recommendations to make annual adjustments to the billing rates, avoid including unallowable interest costs in the billing rates and determine if any interest costs were claimed in prior years by clients of HWDC.

The DOF responses and our comments are summarized after the recommendation section. The DOF letters are included as Appendices A and B to this report.

INTRODUCTION

We performed a follow-up audit on accumulated surplus in SRF to determine if the recommendations in our prior audit of California internal service funds were implemented. In addition, the Single Audit report for the State of California for fiscal year (FY) 1991 reported a retained earnings balance of $102.2 million in SRF. The State Auditor agreed that SRF has a possible liability to the Federal Government for the surplus accumulated between July 1, 1984 and June 30, 1991. We performed supplemental audit work and determined the amount of SRF's accumulated surplus from July 1, 1984 through June 30, 1991, and calculated the Federal share that was improperly charged to the Federal program.

BACKGROUND

Internal service funds are used to account for the financing of goods and services provided on a cost reimbursable basis by service centers to other agencies. Federal cost principles require that such centers operate on a break-even basis by charging users for the allowable cost of goods and services provided. The SRF is an internal service fund administered by DGS that provides goods and services to about 200 State agencies (clients). The Federal Government shares in SRF billings when the clients claim reimbursement for these billings as costs under Federal programs.

The Office of Management and Budget (OMB) Circular A-87, Cost Principles for State and Local Governments, establishes principles for determining the cost of grants and contracts with State and local governments. The Circular states that no provision for profit or other increment above cost is intended to be included in charges to users (Attachment A, section A.1). Additional requirements for reimbursement of the costs of Federal programs are listed in the California Statewide Cost Allocation Plan (SWCAP). The SWCAP is an agreement between the State of California and the U.S. Department of Health and Human Services (HHS), Division of Cost Allocation, which establishes methods for reimbursement of the State's direct and indirect costs. Section III of the SWCAP for FY 1991 required that adjustments be made for variances between internal service fund billings and the allowable costs of providing services.

Our report (ACN 50451-09, dated February 28, 1985), identified accumulated surpluses in California internal service funds and concluded that such funds, including funds administered by DGS, were charging federally funded programs at rates which exceeded the costs of providing goods and services. We had recommended that California: (i) eliminate an accumulated surplus of about $138 million, (ii) review billing rates to ensure that they were calculated in accordance with OMB Circular A-87, and (iii) adjust billing rates at least annually to eliminate any surplus or deficit. California agreed to implement the recommendations and refunded $14.9 million to the Federal Government. The refund represented an estimate of the Federal share of the surplus accumulated as of June 30, 1984 by the State's internal service funds. The share of the refund relating to SRF was $10.3 million.

SCOPE

We performed our audit in accordance with generally accepted government auditing standards. The objectives of our audit were to determine if the State implemented the recommendations in our prior audit report, the amount of surplus accumulated from July 1, 1984 through June 30, 1991 by SRF, and the Federal Government's share of the surplus.

We relied on the work performed by the State Auditor during the single audit of the State of California for FY 1991 for the reasonableness of SRF's accumulated surplus and total billings, and for the reasonableness of the reported costs in the Governor's Budget. We performed our audit field work during the period December 1992 through September 1993 at DGS and other State offices located in Sacramento, California.

We estimated the Federal Government's share of SRF accumulated surplus for all clients. We estimated the amount of the accumulated surplus for each client by dividing the client's SRF billings by total billings. Except for the Office of State Printing (OSP), we used total SRF billings by client for the year ended March 31, 1991, based on records available. For OSP we calculated average yearly OSP billings by client based on available records for 6 years ended June 30, 1991. We applied the resulting percentages to total accumulated surplus to estimate each client's share of the surplus.

We calculated the Federal participation rates for each client agency by dividing total Federal funds expended by a client by total expenditures over the 7-year audit period. We applied the resulting percentages (which represent average Federal participation rates for the 7-year period) to the surplus allocated to each client. The total expenditures over the 7-year period were based on actual costs for FYs 1985 through 1991, as reported in the Governor's Budgets.

FINDINGS AND RECOMMENDATIONS

Except for the $10.3 million refund for the surplus accumulated before July 1, 1984, we found that the recommendations from our prior audit were not implemented. The SRF continued to bill its clients for more than the cost of providing services. We determined that the total amount of surplus accumulated since our prior audit was approximately $76.9 million. We estimate that $12.2 million of the increase relates to Federal reimbursement of SRF billings claimed by clients. We are recommending that the State of California refund the $12.2 million Federal share of the accumulated surplus and adjust billing rates at least annually to eliminate any surplus or deficit.

INCREASE IN ACCUMULATED SURPLUS

Our calculation of the surplus accumulated during the audit period is presented in the table on the following page.

We found that SRF did not adjust billing rates to eliminate the surplus accumulated in prior years. In addition, the increase in accumulated surplus occurred because SRF continued using billing rates based on cash needs rather than based on the recovery of costs which are allowable under OMB Circular A-87. Also, OSP added a markup of five percent to most of its billings. These conditions had been disclosed in our prior audit report.

INCREASE IN ACCUMULATED SURPLUS
FOR THE PERIOD JULY 1, 1984 THROUGH JUNE 30, 1991

Accumulated Surplus at June 30, 1991		$102,177,000
Less Adjustment for Beginning Balance:		
Accumulated Surplus at July 1, 1984	$70,699,000	
Adjustment for Prior Audit	(10,347,000)	
Adjusted Beginning Balance (see note)		60,352,000
Increase in Accumulated Surplus		$41,825,000
Transfers of Accumulated Surplus		35,035,722
Total Increase in Accumulated Surplus		$ 76,860,722

Note: The State resolved the recommended financial adjustment in our prior audit report (ACN: 50451-09). The State paid $10,347,000 for the Federal share of the surplus accumulated in SRF through June 30, 1984. Our adjustment eliminates the remainder of the surplus ($60,352,000) which represents the State's share.

TRANSFERS OF ACCUMULATED SURPLUS

We found that $35,035,722 was transferred out of SRF accumulated surplus for State use. The total consists of $34,661,899 which was transferred to the State General Fund during FYs 1989 through 1991, and an additional $373,823 which was transferred to the Contingent Funds - Assembly and Senate during FY 1985.

Our review of the accounting records shows that the transfers to the General Fund during FYs 1989 through 1991 were based on specific provisions in the State Budget Act. Generally, the Budget Act for those years included a provision that any accumulated surplus in SRF in excess of a specific amount will be transferred to the General Fund. Although similar provisions were part of the State Budget Act in prior years, we only identified actual transfers made to the State General Fund beginning in FY 1989. In addition, DGS was not able to provide documentation to support the transfer to the Contingent Funds. This transfer was similar to the inappropriate transfers made to the State General Fund and we included it in the total.

The transfers were used to reduce General Fund expenditures. Since the surplus was generated by billings that were reimbursed under Federal programs, the Federal Government should share in any credits. The OMB Circular A-87 (Attachment A, section C.3) states that any credits made to offset or reduce expenditure-type transactions should also offset or reduce the costs allocated directly or indirectly to Federal grants. We included the $35 million transfers in our calculation of the total amount of surplus in calculating the Federal share.

RECOMMENDATIONS

We recommend that the State:

1. Refund $12.2 million to the Federal Government for its share of accumulated surplus and transfers to the State General Fund and the Contingent Funds.

2. Adjust internal service fund billing rates annually based on allowable costs to eliminate any surplus or deficit.

In its letters dated February 1, 1994 and March 14, 1994, DOF did not agree with our recommendation that the State refund to the Federal Government its share of the accumulated surpluses at TDC ($1.8 million), HWDC ($10.7 million) and SRF ($12.2 million). Based on additional documentation provided by the State and discussions with DOF officials, we revised the Federal share for HWDC from $10.7 to $9.4 million. The Federal share for the other two internal service funds did not change.

The following are summaries of DOF's response on the issues that were not resolved and our comments. However, DOF did not respond to the other recommendations included in this audit report and the audit reports for TDC and HWDC.

DOF Response

According to DOF, the balances in the retained earnings accounts are not cash and cannot be refunded to the Federal Government. The response states that these balances represent undepreciated equipment, prepayments, expense advances and deferred charges. The DOF refers to the balances in the retained earnings accounts as "operating capital." Since the cash was used to purchase equipment, according to DOF, the internal service funds would have to sell the equipment in order to have cash available to refund the Federal Government its share. In addition, DOF states that a recent change to OMB Circular A-87 allows a 60-day working capital reserve. According to

DOF, the retained earnings accounts largely reflects this 60-day working capital reserve and the undepreciated cost of equipment. Therefore, in DOF's opinion, the amounts shown as balances in the retained earnings accounts are not surplus and are not available for refunds to the Federal Government.

Auditor Comments

We used the audited financial statements as of June 30, 1991 to determine the amount of retained earnings in each of the internal service funds. We reviewed the working papers of the State Auditor who performed the audit of the financial statements of the State of California. The State Auditor determined the amount of net income for the internal service funds in accordance with GAAP. The balance in the retained earnings accounts represents accumulated net income of the internal service funds. In our audit we refer to this accumulated net income as accumulated surplus.

Accumulated net income results from charging clients of the internal service funds an amount in excess of allowable expenditures. In determining the amount of net income, the State Auditor calculated the amount of revenues and deducted the related expenditures which include depreciation expense for equipment. Therefore, retained earnings is reduced by the cost of equipment through depreciation expense. The undepreciated equipment is part of the fixed asset account and is not, as stated by DOF, part of retained earnings. The DOF position that retained earnings be reduced by the amount of undepreciated equipment would allow the cost of the equipment to be reimbursed by the Federal Government when the equipment is purchased, instead of over the useful life of the equipment as depreciation. Similarly, prepaid expenses are not allowable for Federal reimbursement until they are recognized as an expense in computing the net income.

As stated in our audit reports, OMB Circular A-87 does not allow working capital. A proposed revision of OMB Circular A-87, issued for comments in August 1993, would allow working capital for up to 60 days of operating costs. However, this revision has not been finalized and the internal service funds would still have to demonstrate a need for working capital. Also, working capital as defined in the revision is cash expenditures for normal operating purposes and does not include equipment purchases.

DOF Response

The DOF stated that the ratios calculated by the auditors based on actual expenditures for the clients of TDC and HWDC should also have been used for the clients of SRF. According to DOF, these rates more accurately reflected Federal participation in internal service fund costs. For example, DOF states that the auditors used the Governor's Budget to compute the Federal participation rate of 20 percent to determine the Federal share of SRF's accumulated surplus related to Caltrans. However, the auditors used 8.5 percent to determine the Federal share of TDC's accumulated surplus related to Caltrans. This 8.5 percent was based on audit tests of TDC's billings at Caltrans to determine the actual Federal participation rate. The DOF stated that the 8.5 percent and other rates developed based on specific audit tests for TDC and HWDC clients should be used in the calculations related to SRF clients, instead of the rates developed from the Governor's Budget.

Auditor Comments

As stated in our audit report, we calculated the Federal participation rates for SRF clients by dividing total Federal funds expended by a client by total expenditures incurred over the 7-year audit period. These amounts were based on actual costs for FYs 1985 through 1991, as reported in the Governor's Budgets. We used this method because SRF provided services to over 200 clients and because SRF basically provided general administrative type services which would be allocated to all programs administered by the client.

For four clients at TDC and six clients at HWDC, we identified the programs that were billed to each client and used the Federal funds for those specific programs to compute the Federal participation rate. We used this method because these users represented the major clients at TDC and HWDC. In addition, we were able to identify the data processing services provided by these two data centers to specific programs and the amount of Federal reimbursement.

However, there is little relationship between programs directly charged for the billings from the data centers and the programs benefitting from the services provided by SRF. Therefore, the specific rates computed for the clients of the two data centers would not be the appropriate rates to compute the Federal share for SRF services to those clients.

DOF Response

The DOF stated that the auditors used 17.7 percent to compute the Federal share of TDC billings to the entire DGS. This was the Federal participation rate computed for SRF. Since SRF is only one component of DGS, it is unreasonable to use a rate computed for one component to determine the Federal share for the whole Department.

Auditor Comments

We used the 17.7 percent as the Federal participation rate for billings from TDC to SRF and not for the entire DGS. The 17.7 percent represents the average Federal share of all State agencies that SRF billed for its services weighted by the amount of the billings. Since SRF receives all of its funding from services it provides to other State agencies, we used this rate to estimate the Federal share of the funds used by SRF to pay for the billings from TDC.

DOF Response

The DOF stated that approximately $20 million of SRF's retained earnings had been transferred to the Architecture Revolving Fund. This $20 million includes capital outlay projects that were completed before June 30, 1991. This amount should be recognized as an expense and removed from retained earnings.

Auditor Comments

The DGS shows this $20 million as an advance to the Architecture Revolving Fund. According to DGS officials, they are in the process of documenting the cost of projects that were completed. The DGS plans to record these completed projects as an expense. Based on our review of the documentation available as of March 1994, we concluded that most of the projects relate to capital improvements. Examples of some projects were $1.1 million to renovate four public passenger elevators, $750,000 to modernize elevators and $125,000 to purchase and install a 5,000 gallon underground gasoline tank, two fuel dispensers and an overhang awning. Because these were capital improvements, the cost of these projects should be capitalized and depreciated over their useful lives.

DOF Response

According to DOF, payments are made to the State Compensation Insurance Fund for actual amounts paid to claimants of workers' compensation during the year. At the end of the year, an estimate of the total liability is determined for the internal service funds. The DOF states that the total amount of workers' compensation, which is estimated at about $16 million as of June 30, 1991, should be expensed and the accumulated surplus reduced by this amount. The DOF states that OMB Circular A-87 allows the cost of workmen's compensation insurance for Federal reimbursement.

Auditor Comments

The total liability which DOF believes should be expensed includes workers' claims covering several years. According to officials at the State Compensation Insurance Fund, some of these claims include future payments based on the life expectancy of permanently disabled claimants. The allowable portion for Federal reimbursement of these liabilities should be the amount actually paid during the year and not future payments.

Also, OMB Circular A-87 states that the allowable cost of a self-insurance program is the rates and premiums that would have been allowed had insurance been purchased. The amount paid to the State Compensation Insurance Fund does not represent insurance premiums. Instead, the amount represents the actual workers' compensation claims paid during the year and, therefore, would not qualify as allowable cost of a self-insurance program.

DOF Response

The DOF stated that the entire $13.6 million that should have been accrued for compensated absences for SRF should be expensed and, accordingly, the retained earnings balance should be reduced. In addition, DOF states that, because the auditors allowed the accrued liability for compensated absences for TDC and HWDC, the accrued liability for SRF should also be allowed.

Auditor Comments

The total liability which DOF believes should be expensed includes accrued annual leave and compensatory time-off which may not be taken for several years or may not be taken at all. The OMB Circular A-87 (Attachment B, section B.13.a) states that employee benefits in the form of regular compensation paid to employees during the periods of authorized absences from the job, such as for annual leave, are allowable. The allowable portion for Federal reimbursement of these liabilities should be the amount actually paid during the year and not the amount representing expenses that may occur in the future.

We did not make an adjustment for the accrued liability recorded for TDC and HWDC because the amounts were immaterial in relationship to the data centers' overall financial statements. Because of their immateriality, we did not determine whether the costs were allowable for Federal reimbursement.

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Final determination on these matters will be made by the HHS action official named below. We request that you respond to the HHS action official within 30 days from the date of this report. Your response should present any comments or additional information that you believe may have a bearing on the final determination of the matters presented in this audit report; as well as, the matters presented in the previously issued audit reports on TDC and HWDC.

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), Office of Inspector General, Office of Audit Services reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 CFR Part 5.)

Please refer to our CIN A-09-93-00039 in all correspondence related to this report.

Sincerely,

Lawrence Frelot

Lawrence Frelot
Regional Inspector General
for Audit Services

Direct Reply to HHS Action Official:

David S. Low, Director
Division of Cost Allocation, Region IX
50 United Nations Plaza, Room 304
San Francisco, CA 94102

APPENDICES

STATE OF CALIFORNIA PETE WILSON, Governor

DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR
STATE CAPITOL, ROOM 1145
SACRAMENTO, CA 95814-4998

February 1, 1994

Herbert Witt
Regional Inspector General
Department of Health and Human Services
50 United Nations Plaza
San Francisco, CA 94102

Dear Mr. Witt:

ACCUMULATED SURPLUS IN CALIFORNIA INTERNAL SERVICE FUNDS (ISF)

We have reviewed your three draft reports entitled "Follow-Up Review on Audit of Accumulated Surplus in California Internal Service Funds..." dated May 1993 for the Stephen P. Teale Data Center (TDC), and November 1993 for the Health and Welfare Data Center (HWDC) and the Service Revolving Fund (SRF). These reports recommend refunds of purported "accumulated surplus" as follows:

	"ACCUMULATED SURPLUS"	REFUND REQUIRED
TDC	$38,508,000	$ 1,800,000
HWDC	23,164,000	10,600,000
SRF	76,861,000	12,200,000

Based on our review of your audit work papers, the so-called "accumulated surplus" are the Retained Earnings balances reported by our ISF for the year ended June 30, 1991.

The identification of Retained Earnings with the notion of a "surplus" is a fundamental accounting misconception that prompted the accounting profession to eliminate use of the word "surplus" from its technical terminology. RETAINED EARNINGS is not a "surplus". It does not represent cash.

The attached schedule demonstrates that the Retained Earnings balances of our ISF, mostly reflect cash paid for NET ASSETS, i.e., the undepreciated equipment used in operations. The working capital that funds current operations and unexpensed operating outlays such as prepayments, expense advances, and deferred charges are also reflected in these Retained Earnings. Without equipmment and working capital (which constitute the OPERATING CAPITAL of these ISF) it will be impossible to provide any services. In a double entry accounting system, net assets are, of necessity, reflected in the equity accounts. Retained Earnings is the only equity account reported by our ISF. It is clearly an error to consider OPERATING CAPITAL a "surplus".

Equipment used in operations is by far the largest OPERATING CAPITAL item reflected in Retained Earnings. For example, for the year under review, FY ended June 30, 1991, the TDC ISF operated using equipment with a purchase price of $111 million. None of this equipment was purchased with federal moneys.

How was this equipment base funded? From earnings reinvested in operations i.e., Retained Earnings! The attached analysis clearly shows that far from being a "surplus", Retained Earnings are "earnings reinvested in the business". Note further that under Generally Accepted Accounting Principles (GAAP), one of the distinguishing features of the Proprietary Fund Type, which includes our ISF, is that these funds carry their own equipment in the balance sheet; and inevitably, their Retained Earnings reflect the net equipment balance to the extent that earnings from operations were used to purchase equipment.

To equate Retained Earnings with "surpluses" that can be refunded to customers is tantamount to requiring that equipment used in operations be liquidated and the proceeds refunded to customers who presumably were "over-charged" to make equipment purchases possible. In requesting refunds from the Retained Earnings of our ISF, federal auditors are, in effect, saying that revenues from operations may not be used to fund working capital or capital equipment. We are uncertain that you wish to assert such a position.

Recent changes in OMB Circular A-87 permit working capital reserves (60-day cash expenditures) in ISF. Further, since these ISF require massive amounts of state-of-the-art electronic equipment that are so susceptible to technological obsolescence, and since OMB Circular A-87 allows an equipment use allowance in Cost Allocation Plans, it is vital that ISF be allowed a reserve for equipment replacement that is commensurate with cost and useful life of these equipment. The audit failed to recognize that working capital and equipment are indispensable in our ISF operations.

Further, the audit work did not demonstrate that the billing rate structure include elements that are superflous to the cost of providing services. Furthermore, no attempt was made to examine the actual monetary resources in the ISF to determine the extent to which they include surplus or idle cash. The audit reports merely assert that the existence of Retained Earnings indicate "accumulated surpluses".

In our opinion, Retained Earnings is not cash and does not represent refundable "surpluses". Our analysis shows that it largely reflects working capital and undepreciated equipment. Therefore, to assume that the Retained Earnings balances recorded in our ISF are available for distribution to the federal government or any other customers is a fundamental accounting misconception.

Consequently, we urge you to reconsider the bases of these findings. We will be happy to meet with you in order to discuss the nature of our ISF Retained Earnings balances and why, under current United States GAAP, the Retained Earnings of proprietary funds, including our ISF, appropriately reflect working capital and undepreciated equipment.

If you have any questions regarding this memo, please contact Barry Rockwell at (916) 445-4638 or Wanda Kelley at (916) 445-4431.

Sincerely,

Latimer Stancil

for RUSSELL S. GOULD
Director

Attachment

ATTACHMENT I

STATE OF CALIFORNIA
ANALYSIS OF INTERNAL SERVICE FUNDS AT 6/30/91
TO DEMONSTRATE THAT RETAINED EARNINGS REFLECTS,
AT A MINIMUM, THE CASH INVESTED IN UNDEPRECIATED
EQUIPMENT AND WORKING CAPITAL

	STEPHEN P. TEALE DATA CENTER	HEALTH & WELFARE DATA CENTER	SERVICE REVOLVING FUND
EQUIPMENT (AT COST)	$110,928,000	$63,939,000	$111,336,000
LESS: ACCUMULATED DEPRECIATION	$ 61,117,000	$35,992,000	$ 53,948,000
NET (UNDEPRECIATED) EQUIPMENT	$ 49,811,000	$27,947,000	$ 57,388,000
LESS: INSTALLMENT CONTRACTS PAYABLE	$ 20,723,000	$16,860,000	$ 0
CASH INVESTED IN UNDEPRECIATED EQUIPMENT	$ 29,088,000	$11,087,000	$ 57,388,000
ADD: 60-DAY WORKING CAPITAL (1)	$ 13,029,000	$ 7,100,000	$ 80,633,000
EARNINGS INVESTED IN OPERATIONS (2)	$ 42,117,000	$18,187,000	$138,021,000
"ACCUMULATED SURPLUS" (PER DHHS)	$ 38,508,000	$23,164,000	$ 76,861,000
"ACCUMULATED SURPLUS" AFTER ADJUSTMENT FOR EARNINGS INVESTED IN OPERATIONS	$(3,609,000)	$ 4,977,000	$(61,160,000)

(1) = DEFINED AS 60 DAYS CASH EXPENDITURES IN ACCORDANCE WITH PROPOSED A-87 GUIDELINES
(2) = DOES NOT INCLUDE PROVISION FOR OUTLAYS SUCH AS PREPAYMENTS, EXPENSE ADVANCES, AND DEFERRED CHARGES.

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STATE OF CALIFORNIA PETE WILSON, Governor

DEPARTMENT OF FINANCE
OFFICE OF THE DIRECTOR
STATE CAPITOL, ROOM 1145
SACRAMENTO, CA 95814-4998

March 14, 1994

Mr. Lawrence Frelot
Regional Inspector General
Department of Health and Human Services
50 United Nations Plaza
San Francisco, CA 94102

Dear Mr. Frelot:

CIN A-09-92-00105, TEALE DATA CENTER
CIN A-09-92-00119, HEALTH AND WELFARE DATA CENTER
CIN A-09-93-00039, SERVICE REVOLVING FUND

Thank you for the opportunity to respond to the three referenced draft audit reports. The first recommendation of each report requests that the State of California refund a total of $24.7 million to the Federal Government. The $24.7 million comprises $1.8 million from the Teale Data Center (TDC), $10.7 million from the Health and Welfare Data Center (HWDC), and $12.2 million from the Service Revolving Fund (SRF).

We disagree that the State of California should refund the amounts recommended. Our response is based on a review of the reports and workpapers of the Office of the Inspector General's (OIG) reports and work papers, and discussions with OIG staff; and a review of the workpapers of the Bureau of State Audits (formerly the Auditor General), and discussions with its staff. As a result of our review, we identified issues that we feel affect the amount of the refund that your office has calculated. These issues include:

- an inconsistent application of federal participating ratios
- items that should have been used to reduce the accumulated surplus
- consideration of the working capital reserve

1. <u>AN INCONSISTENT APPLICATION OF FEDERAL PARTICIPATING RATIOS</u>

The OIG determined the federal participation ratios for user agencies of the internal service funds (ISF) either by estimating the ratios based on expenditures reported in the Governor's Budget or by determining an actual ratio based on audit tests. We feel that the ratios calculated based on audit tests of actual expenditures more accurately reflect federal participation in the ISF costs. For example, while the federal participating ratio for Caltrans based on the Governor's Budget was estimated to be 20%, the ratio for TDC based on audit tests was actually only 8.5%. Although in this case the 8.5% was appropriately used, this example shows how major the differences can be. The difference in the ratios calculated for the TDC is due to the fact that while Caltrans uses the TDC primarily for administrative functions, the federal government reimbursement for administrative costs is very small. Likewise, we found that for other than the four large TDC users and six large HWDC users, the OIG also used the estimated ratio based on the Governor's budget rather than the more accurate ratio derived from audit tests. For the ten users cited above, we did not determine the differences that would have resulted in using the calculated percentage rather than the estimated percentage. However, for Caltrans we calculated that the difference would result in a $600,000 reduction in the requested refund. Potential Impact: Amount of federal refund in question - approximately $600,000.

In addition to an inconsistent use of ratios, the OIG used participating ratios that were not applicable. For example, the OIG used the 17.7 % federal participation rate developed during their audit of the TDC to calculate their share of the SRF, and then applied this rate to the entire Department of General Services (DGS). We do not agree with the use of this ratio because the SRF is only one portion of the DGS; it is unreasonable to assess the whole department with an amount based on only one component, especially since the DGS receives no federal funding directly. Using a federal participation ratio for DGS computed in the same manner as for other entities would result in a $200,000 reduction in the requested refund. Potential Impact: Amount of federal refund in question - Approximately $200,000.

2. <u>ITEMS THAT SHOULD HAVE BEEN USED TO REDUCE THE ACCUMULATED SURPLUS</u>

We found three items that we believe should have been used to reduce the accumulated surplus balance.

a. <u>Reserve for Prepaid Items</u>. Included in the retained earnings balance for the SRF is approximately $20 million that represents SRF capital outlay projects for which funds had been transferred to the Architecture Revolving Fund. This $20 million includes projects that were completed before June 30, 1991, and should have been removed from the fund balance. The accumulated surplus shown in the OIG's draft audit report should be reduced by the amount of the completed projects at June 30, 1991. Potential Impact: Amount of federal refund in question - approximately $3.2 million.

b. <u>Worker's Compensation</u>. None of the retained earnings balances for the three ISFs was adjusted for the accrual of liabilities for worker's compensation costs. During the fiscal year, agencies make payments to the State Compensation Insurance Fund (SCIF) for actual amounts owed. At year end, SCIF computes an estimate of the outstanding liability for enterprise and internal service funds; this amount was calculated and available to the OIG auditors for the 1990/91 fiscal year. Moreover, beginning with the 1992/93 fiscal year, the Bureau of State Audits will reduce the fund balance for the worker's compensation liability at year

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end. This liability is accrued in accordance with generally accepted accounting principles to recognize the expense within the period in which it was incurred.

In addition, OMB Circular A-87, Attachment B, Section B.13.b, states that costs of employee benefits in the form of employers' contribution or expenses for workmen's compensation insurance are allowable if they are granted under approved plans and are distributed equitably to grant programs and to other activities. Attachment A, Section B.3, defines cost as that determined on a cash, accrual, or other basis. Attachment A, Section C.1.e. establishes the basic guideline that allowable costs be accorded consistent treatment through application of generally accepted accounting principles. Potential Impact: Amount of federal refund in question - approximately $3.0 million.

c. Compensated Absences. The retained earnings balances for the three ISFs were not consistently adjusted for the accrual of liabilities for compensated absences.

During the annual audit of the State's financial statements, the Bureau of State Audits makes adjusting entries to specific funds or in the aggregate for a group of funds depending on the lowest level of audit effort. This is done to meet their objective to express an opinion on the financial statements as a whole, not on specific funds.

One such adjustment is for compensated absences. The Bureau of State Audits made fund specific adjustments to the balances at HWDC and TDC and an aggregate entry that included $13.6 million for the SRF in the 1990/91 fiscal year. Although the OIG allowed the adjustments to the retained earnings balance at HWDC and TDC it did not allow the adjustment at the SRF. Potential Impact: Amount of federal refund in question - approximately $2.2 million.

3. CONSIDERATION OF THE WORKING CAPITAL RESERVE

The State has formally requested, in a letter dated January 26, 1994 to David Low at DHHS, that the ISFs be allowed to operate with a working capital reserve of at least 60 days. Because OMB Circular A-87 was in revision at the time of the OIG audit and the revisions had been open for comment during the audit period, consideration should be given to allow the ISFs to operate with a 60-day working capital reserve while the request is being evaluated. As discussed in our earlier letter, we estimate this need to be approximately $100 million for the three ISFs. Potential Impact: Amount of federal refund in question - approximately $16.0 million.

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We have not calculated a total for all of the above issues because they are not necessarily cumulative. The issues affect different points within the OIG calculation. Some of the issues lower the amount of accumulated surplus (the base amount of the calculation) while others result in changes to the federal participating ratios.

We previously sent you a letter in response to the draft audit reports regarding our concerns over the definitions of surplus and retained earnings. We hope that this second letter further clarifies our specific concerns. On March 1, 1994, my staff discussed these concerns with Bob Kimoto of your office.

If you have any questions, please call Enrique Farias, Chief, Office of State Audits and Evaluations at (916) 322-2917.

Sincerely,

for RUSSELL S. GOULD
Director