

Issues Concerning the Accounting of California's Special Funds

LEGISLATIVE ANALYST'S OFFICE

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Hon. Mark Leno, Chair





What Are Special Funds?

- Governments Use “Fund Accounting.”** The state conducts financial affairs through hundreds of separate funds, including the General Fund (the state’s main operating account), nongovernmental cost funds, trust funds, federal funds, bond funds, and “special funds.” Fund accounting allows governments to monitor each fund’s performance and compliance with both legal and policy objectives.
- Over 500 Special Funds.** Special funds are governmental operations funds (excluding proprietary, or business-type, funds) that have *specific* funding sources and *specific* programmatic funding responsibilities in state law. (By contrast, the General Fund receives a broad variety of taxes available to fund *any* public purpose.) In California’s budgetary accounting system, over 500 special funds receive specified fee and tax revenues to support particular public programs.

 - **About \$38 Billion of Annual Special Fund Revenue.** The administration forecasts that special funds will generate about \$38 billion of revenue in 2012-13, averaging around \$70 million for each special fund.
 - **Special Funds Vary Significantly.** The state’s special funds range in size from very small funds with a few million dollars of annual revenue to very large, prominent funds with a few billion dollars of annual revenue.
- In General, Appropriated Through the Annual Budget Process.** In general, special funds—like the General Fund, most bond funds, and some other funds—are appropriated annually by the Legislature through the annual budget process. The *Governor’s Budget* (presented in January and revised in May) is the key decision making document for this process. The Department of Finance (DOF)—working with other state departments—prepares these documents, which include reports on prior-year, current-year, and proposed budget-year special fund revenues, expenditures, and fund balances.



Governmental Accounting: Much More Than Just “Cash on Hand”

- ☑ ***Different Accounting Methods Used.*** Different state and local funds are accounted for using differing methods of accrual (which determines the year in which revenues or expenditures are booked) and “measurement focus” (whether the financial statements consider just current or also long-term fund assets and liabilities).

- ☑ ***Different Financial Reports Prepared at Different Times, for Different Purposes.*** There are various financial reports prepared each year for the state’s funds—sometimes, with different accounting methods, as described above. Among these reports are:

 - ***Budgetary-Legal Basis Annual Report (Budgetary-Legal Report).*** Section 12460 of the Government Code defines the purpose of this report: to present funds’ financial results “on the same basis as that of the Governor’s Budget and the Budget Act.” The State Controller’s Office (SCO) prepares the budgetary-legal report with assistance from state departments. It is released several months after the end of each fiscal year.

 - ***Comprehensive Annual Financial Report (CAFR).*** In the CAFR, the SCO—working with departments—makes adjustments to the budgetary-legal report results in order to display financial results in compliance with generally accepted accounting principles (GAAP) for state and local governments. Differing accounting methods and measurement focuses are used for different funds, consistent with GAAP. The Bureau of State Audits (BSA) audits the CAFR. It is released several months after the end of each fiscal year.



Governmental Accounting: Much More Than Just “Cash on Hand”

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■ **Governor’s Budget *Fund Condition Statements*.**

Departments separately report information concerning special funds that they administer to DOF for inclusion in the January 10 and May Revision budget documents submitted to the Legislature. Information includes prior-year, current-year, and proposed budget-year fund balances, revenues, and expenditures. Different funds use different accounting methods depending on current law, historical practice, and administration policies. The fund condition statements in *Governor’s Budget* documents are used as decision making documents for the Legislature prior to the start of each fiscal year. (Thus, these documents are released on a completely different timeline from the SCO year-end financial reports described above.) Chapter 6400 of the *State Administrative Manual* requires departments to ensure that this budgetary data matches that presented to SCO, with rare exceptions.



What Are Fund Balances? The key issue in recent discussions has been the level of special funds’ reported fund balances. The fund balance is *not* the cash balance of a fund. Rather, the fund balance is the amount derived by subtracting total fund liabilities from total fund assets. For special funds and other governmental funds, both GAAP and state accounting practices are based on a method that essentially considers annual revenues and expenditures in determining changes in fund balances, such that the reported fund balances for these funds represent the cash and other resources available to fund programs on a current basis. (Thus, these fund balances exclude long-term assets and liabilities, including physical assets, pension liabilities, and other issues.)



Governmental Accounting: Much More Than Just “Cash on Hand”

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- ☑ ***Balances Differ Between SCO and DOF.*** Some recent press articles have suggested that SCO and DOF fund balance reports can be easily compared. This, however, is simply not the case. The SCO’s reported fund balances in the budgetary-legal report are higher due to this report’s inclusion of funds already committed for expenditure (encumbrances) and deferred payroll. By contrast, the DOF’s reported fund balances in *Governor’s Budget* documents omit these funds, which provides better information to the Legislature concerning the amount of funds available for appropriation in any given year. We have been told that the current treatment of special fund encumbrances in the budgetary-legal report derives from an administrative decision made by SCO and the Wilson Administration in 1991.



DOF's Recent Special Fund Review



In Aggregate, Potentially Less Fund Balances Than DOF Previously Reported. Following the discovery of higher balances in Department of Parks and Recreation (DPR) accounts and press speculation concerning balances in other funds, DOF conducted a review of special fund balances. On August 3, 2012, DOF reported that, in the aggregate, the state's special funds may have had \$415 million less in fund balances at the end of 2010-11, compared to figures included in the *2012-13 Governor's Budget* documents. The DOF's findings are summarized below.

- ***Have to Adjust SCO Fund Balances to Get a Useful Figure for Comparison.*** Because SCO's budgetary-legal report fund balances are systematically higher, as described on the previous page, the combined 2010-11 ending fund balance for 560 special funds had to be adjusted downward from \$12.5 billion to \$8.4 billion in order to make the figure useful for comparison to the figures included in *Governor's Budget* documents.
- ***Both Higher and Lower Fund Balances Than DOF Previously Reported.*** The review was prompted by the discovery that DPR fund balances were greater in the SCO's budgetary-legal report than those reported by DOF in *Governor's Budget* documents. The DOF did identify transactions totaling \$1.73 billion across all the state's special funds that contribute to higher fund balances being listed in SCO's budgetary-legal report. This figure, however, was offset by findings of \$2.14 billion of special fund transactions that contribute to lower fund balances being listed in SCO's report. In total, therefore, DOF identified about \$3.9 billion of accounting differences with SCO.



DOF's Recent Special Fund Review (*Continued*)

- **Potentially \$415 Million Less in Total Balances Than DOF Previously Reported.** As noted above, DOF found \$1.73 billion of transactions contributing to higher fund balances in SCO's report, which was offset by \$2.14 billion of transactions contributing to lower fund balances in SCO reports. Accordingly, on net, DOF found that SCO reported \$415 million less in special fund balances at the end of 2010-11 compared to those indicated by DOF in *Governor's Budget* documents. On net, some funds (such as DPR funds) had greater fund balances than DOF previously reported, while others (such as various Public Utilities Commission [PUC] funds) had less.



Reasons for Discrepancies. The reasons for the \$3.9 billion of discrepancies fall into four main categories, according to DOF. These are summarized below.

- **Methodology Differences Responsible for About 70 Percent of Discrepancies.** Differences in reporting methodology described by DOF were responsible for about 70 percent of the discrepancies noted above. These include large differences in various state transportation funds, Proposition 63 mental health funds, and economic recovery bond accounts, where it appears that the figures in the budgetary-legal report are not based on the same accounting methods as those in *Governor's Budget* documents and/or the annual *Budget Act*. In general, despite the requirements of Chapter 6400 of the *State Administrative Manual*, we understand that the applicable state departments used different accounting methods in their financial reporting documents submitted, respectively, to DOF and SCO.
- **Timing Differences Responsible for About 10 Percent of Discrepancies.** About 10 percent of the discrepancies were the result of the two sets of reports booking transactions in different fiscal years—apparently due to differing information provided by departments.



DOF's Recent Special Fund Review *(Continued)*

- ***Errors Responsible for About 7 Percent of Discrepancies.*** These discrepancies were the result of erroneous calculations by state departments, which resulted in incorrect figures being included in *Governor's Budget* documents.
- ***PUC and State Parks Discrepancies Account for 13 Percent of the Total.*** About 13 percent of the total discrepancies were attributable to PUC accounts (12 percent) and state parks accounts (1 percent). The reasons for these discrepancies are still under review by the administration.



LAO Comments—Issues Related to the DOF Special Funds Review

- DOF Plans to Implement Changes in Its Budget Review Processes.*** In the wake of its special funds review, DOF has announced plans to adopt additional policies and protocols to ensure regular reconciliations of accounting results with SCO. This is a useful development and should help prevent recurrences of these particular accounting problems in the future. Such reconciliations should help identify training needs for specific departments' financial staffs—such as those mentioned in yesterday's BSA report on the Oil Spill Prevention and Administration Fund—in a more timely fashion. We recommend that the Legislature direct DOF to report to the Legislature and the public by April 1, 2013, concerning any additional accounting differences it identifies in the coming months.
- Must Get to the Bottom of State Park Accounting Problems.*** The alleged multiyear misreporting of DPR fund balances in *Governor's Budget* documents is unacceptable. The Legislature must be able to rely on the accuracy of such budget documents, which are an important part of the annual decision making process. The expedited review of DPR accounting and management problems by BSA (as requested by the Joint Legislative Audit Committee) should prove to be helpful and informative.
- PUC and Other Accounting Discrepancies Are Also Significant.*** The DOF review indicated that various PUC telecommunications and related funds may have \$423 million less in fund balances than indicated in *Governor's Budget* documents. We recommend that the Legislature direct DOF to report to the Legislature and the public no later than January 10, 2013, concerning the reasons for such significant fund balance differences and any proposed changes to future PUC activities or spending. The Legislature may wish to institute similar reporting requirements for other funds with notable accounting differences, such as the Restitution Fund, the Corrections Training Fund, and breast cancer funds.



LAO Comments—Other Issues Concerning Special Funds and Accounting

- Relationship Between Special Funds and the General Fund.*** Special fund balances have been a critical element of the state's recent budgetary and cash flow planning. Multiyear loans of special fund balances to the General Fund—in order to help balance the state's annual General Fund budget—have grown from \$749 million at the end of 2007-08 to \$4.3 billion now (including additional loans in the 2012-13 state budget package). In addition, in 2012-13, up to \$16 billion of special fund and other funds' cash resources are likely to be used to ensure that the state can make General Fund payments on time.

 - ***Developing Multiyear Loan Repayment Strategy Is Advised.*** As the state continues to recover from the 2007-09 recession, we advise the Legislature to develop a multiyear plan to pay down special fund loans in the coming years and focus on rebuilding and preserving structural balance in the General Fund. This, in turn, should also reduce the need for special fund cash-flow assistance to the General Fund.

- Significant Special Fund Balances Merit Legislative Review.*** As special fund loans are repaid, the sometimes-significant fund balances of special funds will grow. We advise the Legislature to review these balances over the next several years and make changes to special fund programs on a case-by-case basis as needed.

 - ***Recommend Reporting Requirements to Facilitate These Reviews.*** We recommend that the Legislature pass a law requiring DOF—in conjunction with departments administering special funds—to provide reports over the next three fiscal years that disclose the magnitude of each major special fund's balances (as a percent of each fund's revenues and expenditures), the anticipated fund balances upon repayment of General Fund loans, and a list of various options for the Legislature to consider if it wishes to reduce special fund fees or taxes and/or increase special fund expenditures in response to these fund balance estimates. The DOF and



LAO Comments—Other Issues Concerning Special Funds and Accounting *(Continued)*

departments could be charged with recommending a targeted fund balance level for each major special fund and would need to consider not only fund balances, but the structural health (the special funds' ongoing surpluses or deficits) of each major fund. The administration could be given some flexibility to schedule these special fund reviews over the next several years. Required reviews could be limited to special funds with annual revenues over a given amount—for example, \$10 million per year.



Accounting Statutes Need Modernizing. The statutes describing the requirements for the state's budgetary-legal report and CAFR originated largely in 1984, when the Governmental Accounting Standards Board (a private, nonprofit organization) was just starting to standardize governmental GAAP throughout the U.S. These statutes are sometimes unclear or contradictory and require clean up in light of developments in recent decades.

- **Clarity Needed Concerning the Purpose of the Budgetary-Legal Report.** We observe that the budgetary-legal report has drifted away from its stated purpose—to account for fund balances and other transactions in a manner consistent to the treatment used in the *Governor's Budget* and *Budget Act*. We recommend passage of legislation that clarifies existing statutes and reiterates that the budgetary-legal report is to be based on the same accounting methods used by DOF and the Legislature in the most recent year's budget process in *all* applicable instances. Subsequent adjustments of prior-year fund balances and accounting methods should be clearly noted by the administration in *Governor's Budget* documents so as to ensure the closest possible comparability of these documents with past and future budgetary-legal reports. Revisions to DOF's *Manual of State Funds* and the *State Administrative Manual* may be required to clearly communicate accounting methods for each fund. The legislation could authorize SCO to provide information concerning encumbrances and deferred payroll for each fund



LAO Comments—Other Issues Concerning Special Funds and Accounting *(Continued)*

in an appendix to the budgetary-legal report or as a notation on the same pages that fund balances are listed. The GAAP reporting requirements relevant for the CAFR would not change. These changes could take effect with the publication of the 2013-14 budgetary-legal report.

These changes should prevent the inflation of fund balances in the budgetary-legal report that have contributed to needless confusion in recent weeks and promote somewhat easier comparison of SCO and DOF budgetary-legal financial data. Based on DOF's categorization of the accounting discrepancies, such changes might have prevented over 70 percent of the identified discrepancies between DOF and the budgetary-legal report.



Clarity Concerning Accounting of General Fund Revenues.

The recent discussions concerning state accounting have not focused on how the state accrues and reports its General Fund revenues. Revenue accounting and reporting practices, however, are becoming increasingly confusing and may make budgeting more difficult in the future by delaying final reports on a fiscal year's revenues for many months. (We discussed the key issues concerning a recently adopted change to revenue accounting in Section 35.50 of the *2012-13 Budget Act*—likely applicable only to revenues that would be received under Propositions 30, 38, and 39—in a 2011 report, *The 2011-12 Budget: The Administration's Revenue Accrual Approach*.)

We reiterate our recommendation in that report for a regularly updated public guide—prepared by DOF—describing the state's current revenue accrual methods and how they affect reported state revenues. Moreover, to prevent the monthly confusion concerning the different General Fund revenue reports of SCO and DOF, we recommend that the Legislature express its intent in statute that the two departments coordinate their releases in order to reduce confusion and focus on the most timely,



LAO Comments—Other Issues Concerning Special Funds and Accounting *(Continued)*

authoritative revenue data (“agency cash,” as reported by state tax agencies and DOF). The SCO’s “Controller’s cash” report remains useful as the only available information on the state’s borrowable cash resources (known as the “cash cushion”).