

First 5 Association of California



Financial Management Guide

Fifth Edition, 2015

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1 INTRODUCTION

The purpose of this First 5 Financial Management Guide is to help county commissions refine their financial management policies and practices. The First 5 Association contracted with the Government Finance Officers Association of the United States and Canada (GFOA) to prepare the initial guide. The revisions and additions to this edition were guided by extensive reviews by the First 5 Fiscal Workgroup and research by GFOA.

This guidance is provided as a resource to assist commissions in the development of financial policies and practices and is not intended to be mandatory. To the greatest extent possible, the guide relies on practices that are required by Proposition 10 enabling legislation or other sections of the state statutes governing First 5 commissions, and those that have been established by nationally recognized sources such as the Governmental Accounting Standards Board (GASB) and GFOA. The guide contains financial management policies and practices applicable to all commissions, whether small or large, independent or county-affiliated.

Many individuals and First 5 commissions participated in this effort to make the guide even more useful for commission staff. The contributing members of the First 5 Fiscal Workgroup are listed below:

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2 CONTRACTING

The purpose of this section is to set forth recommended contracting and contract administration guidelines for First 5 commissions. These guidelines are based on best practices in public procurement and reflect the flexibility necessary to accommodate independent commissions and county-agency commissions in small and large counties.

Best practice in governmental contracting requires a selection process that is based on the open and fair identification and selection of vendors qualified to render a particular service, taking into consideration both technical qualifications and price. Consequently, service contracting rules usually permit the use of a request for proposals (RFP) process rather than mandating selection of the lowest complying bidder. However, best practice also recognizes that conducting an RFP process is not the only way to assure open and fair selection of qualified service providers. Other procedures are available that can meet the best-practice requirements of fairness, openness, and thorough documentation.

Commissions should adopt a procurement policy to ensure that all contracting and procurement is consistent with state procurement laws and the commission's strategic plan.

2.1 PROVIDER SELECTION PRINCIPLES

The First 5 Association of California has identified a set of principles to help commissions award Proposition 10 funds to providers that are best qualified to support the purposes outlined in a Commission's strategic plan. Commissions should keep these principles in mind as they apply the procedures for selecting providers outlined in this section. The principles are:

1. Create strategic impact. Fund programs and activities that:
 - Support the goals in your strategic plan
 - Show evidence of effectiveness
 - Need Proposition 10 funding in order to meet your goals.
2. Promote inclusion. Fund programs and activities that:
 - Are responsive to the diverse needs of members of your community
 - Have been shaped by community input
3. Move toward service integration. Fund programs and activities that:
 - Reduce the fragmentation of existing services
 - Make services more accessible and comprehensive
 - Support shared decision making and shared resources among partners who need others to succeed
4. Build on strengths/build capacity. Fund programs and activities that:
 - Take advantage of organizational and neighborhood assets
 - Help participants to further develop their capacities

2.2 POLICY STATEMENT

The distribution of Proposition 10 funds shall be conducted economically and expeditiously, under fair, open, and well-documented procedures, and in accordance with best procurement practices. Commissions should enter into formal contracts with providers or vendors for purchases or agreements above a specific dollar threshold. The threshold should be determined by individual commissions. Contracts should link the performance of providers to the objectives of the strategic plan through the use of indicators of performance (outputs and/or outcomes), interagency linkages, or progress on sustainability to be achieved.

Commissions should take the necessary measures to ensure that providers comply with the terms of their contracts and deliver desired results.

The procedures in this chapter are written for local commissions. Where county ordinance or policy is inconsistent with these procedures, the ordinance or policy shall necessarily take precedence; however, if the county government agrees, commissions may be able to use the procedures in this chapter by waiver or formal amendment of county ordinance or policy.

2.2.1 Contracting and Procurement Policies

State code requires that commissions adopt contracting and procurement policies in a public hearing. The contracting and procurement policies must contain provisions to ensure that the grants and contracts are consistent with the county commission's strategic plan. [Health and Safety Code sections 130140(d)(4) and 130151(b)(1)].

With regard to contracting and procurement, the commission's policies shall be consistent with the following state laws:

- Article 7 (commencing with Section 54201) of Chapter 5 of Part 1 of Division 2 of Title 5 of the Government Code. Commissions are required to adopt policies and procedures governing purchases of supplies and equipment by written rule or regulations, and to make the rules available for public distribution. Commissions are also permitted to request the state Department of General Services to make purchases on their behalf.
- Chapter 2 (commencing with Section 2000) of Part 1 of Division 2 of the Public Contract Code. Commissions are permitted to award contracts that meet goals regarding minority-owned businesses, women-owned businesses, disabled veteran-owned businesses, and small businesses.
- Section 3410 of the Public Contracts Code. Commissions are required to give preference to United States-grown produce and United States-processed foods when there is a choice and it is economically feasible to do so. The public entity must make the determination of what is "economically feasible," considering the total cost, quantity, and quality of the food and the budget and policies of the entity.
- Chapter 3.5 (commencing with Section 22150) of Part 3 of Division 2 of the Public Contract Code. Commissions are required to purchase recycled products, instead of non-recycled products, whenever recycled products are available at the same or lesser total cost than non-recycled items. Commissions may give preference to suppliers of recycled products and may define the amount of this preference.

2.3 PROCEDURES

2.3.1 Provider Selection

There are essentially two ways to select providers: (1) conducting a request for proposals process and (2) selecting a "sole source" provider through an alternate process that is publicly disclosed. A request for qualifications and/or request for information can also be issued as a pre-contract step.

- *Procurement below Request for Proposals threshold* - For projects that fall below this threshold, the commission may choose to use an informal process for vendor selection. In this case, the commission should solicit at least three offers, preferably in writing. The commission may require documentation of three offers. If it is not possible to obtain three offers, the reasons should be documented in writing. If the solicitation is by phone, a written record must be created. The commission should maintain adequate records relating to all informal procurements. Such records and other documents related to informal vendor selection shall be subject to post-audit review.

- *Small Dollar Purchases* - Commissions may establish a level at which no competition is required, formal or informal. Purchasing cards are ideal for such transactions.

2.3.2 Request for Proposals (RFP)

- *RFP Process* - Commissions should use a formal process (such as the one outlined below) for awarding Proposition 10 funds to qualified providers in amounts exceeding a predetermined dollar threshold. This threshold shall be determined by each commission based on historical procurement patterns and level of control preferences.

Staff will develop the RFP, with general policy direction from the commission as needed. All RFPs should be approved by the executive director and/or the commission prior to release.

All RFPs should be appropriately advertised which might include sending to inquiring and relevant parties, posting on the commission Web site, and/or advertising in newspapers of general circulation in the county.

- *Pre-Proposal Conference* - A pre-proposal conference should be considered as it provides prospective vendors with an opportunity to ask questions and obtain a clearer understanding of the requirements in the RFP. This opportunity for clarification can help increase the quality of RFP responses.
- *Planning for RFP Evaluation* - Before releasing the RFP, the commission should develop and finalize an evaluation plan. The commission should evaluate proposals using some variation of the following process:

1. A proposal review committee is formed of persons with knowledge or expertise in the field. The proposal review committee can be comprised of internal staff, commissioners, community members, or some combination thereof. Smaller counties may not have “subject matter experts” within their communities to draw from and may elect to have an individual, rather than a committee, review the applications. This is acceptable but results in less transparency and/or depth of the evaluation process.
2. Some commissions may choose to pre-screen proposals and eliminate those that do not meet basic requirements for eligibility or failed to complete the proposal package.
3. All reviewers are asked to sign a standard conflict of interest form and to remove themselves from the committee if a conflict arises.
4. Staff develops a scoring matrix for each proposal that will provide consistency and guidance for rating responses (see model evaluation plan).
5. The Executive Director or other designated agent makes a final recommendation to the commission based on the results of the scoring matrix.
6. Final approval of the award rests with the commission.

For smaller commissions, a proposal review committee may not be feasible. If it is not, then the person or persons conducting the review should adhere to this process.

Conflicts of Interest

With regard to conflict of interest of commission members, commission staff, and outside reviewers, the county commission's policies shall be consistent with the following state laws:

1. Article 4 (commencing with Section 1090) of Chapter 1 of Division 4 of Title 1 of the Government Code. A commission is prohibited from entering into a contract if:

- a. The contract or grant directly relates to services to be provided by a commissioner or an entity the commissioner represents, or the contract or grant financially benefits a commissioner or the entity he or she represents, and
- b. The commissioner fails to recuse himself or herself from making, participating in making, or attempting to influence a decision on the grant or grants.

2. Article 4.7 (commencing with Section 1125) of Chapter 1 of Division 4 of Title 1 of the Government Code. Commissioners and staff are prohibited from engaging in employment of other compensated activities that are inconsistent, incompatible, or in conflict with their duties as commissioners or staff persons for the commission.

3. Chapter 7 (commencing with Section 87100) of Title 9 of the Government Code. Commissioners are prohibited from making, participating in making, or in any way attempting to use their official position to influence a governmental decision in which they have a financial interest. Commissioners are required to file disclosure statements upon becoming a commissioner and annually thereafter.

4. Conflicts of interest laws are complex and often contradictory. Commissions should consult with counsel when developing conflict of interest policies and procedures and when interpreting and applying these laws.

5. Conflicts of interest within the review committee are likely to occur during the review process. The commission may choose to deal with conflicts of interest by requiring commission members, commission staff, or reviewers to review a list of grant applicants and indicate those applicants for which they have a direct, indirect, or appearance of conflict of interest.

- *Direct conflicts* – Defined as having a current or previous relationship with the agency (e.g. employment, current/past board membership, child or an immediate family member receives services from the agency).
- *Indirect conflicts* – Defined as any family members or spouse/partner having a current or previous relationship with the agency (e.g. employment, current/past board membership).
- *Appearance of conflict of interest* – Defined as any situation that could be perceived that a conflict exists (e.g. a strong bias exists for or against the agency or a personal relationship exists between the committee member and the proposer).

- *RFP Content* - The RFP should include the following elements:

1. A statement of work that contains:

- Child outcomes and/or interagency linkages to be achieved and the performance measures to be used to evaluate progress toward those outcomes.
- Technological requirements or specifications, and legal limitations, if any.
- Required quality control standards to be met, if applicable.
- The format and number of copies of the completed progress reports and final report, if applicable.

- The extent and nature of the assistance and cooperation from the commission that will be available to the bidder.
 - A description of the system that will be used to evaluate the provider's performance.
 - Performance timelines and/or completion dates.
2. Selection criteria and process, including:
- Standards the commission will use in evaluating proposals.
 - Information on how the commission will select the winning proposal.
3. Time schedules, including:
- Date to submit questions or seek clarification of the RFP.
 - Date of Pre-Proposer's Conference, if applicable.
 - Date on which the proposals must be submitted.
 - Timetable the commission will follow in reviewing and evaluating proposals.
 - Anticipated date of award.
 - Anticipated contract term, including commencement and completion dates.
4. Notice of payment terms or restrictions, including:
- Whether and to what extent cash advances will be allowed.
 - Whether and to what extent progress payments will be allowed.
 - Penalties for late or inadequate performance.
 - Known or estimated budgetary limitations on the contract price, if applicable.
5. Requirements that prospective bidders must address or include in their proposal, such as the following:
- Specific questions to be answered or issues to be addressed.
 - An overall description of techniques, approaches, and methods to be used in performing the services.
 - Evidence of provider's capacity to perform the requested service, including:
 - A brief list of similar types of contracts that were successfully concluded, with a sample of such work.
 - A description of the lead personnel and anticipated supporting personnel to be employed during performance and their qualifications to perform the work.
 - Identification of a project coordinator.
 - Resumes for each major contract participant who will exercise a major policy, administrative, or consultative role in carrying out the services.
 - If subcontractors are contemplated, identification of those persons or firms, the portions and monetary percentages of the work to be done by the subcontractors, how they were selected and why, resumes of each major subcontract participant, and a description of how subcontracted work will be controlled, monitored, and evaluated.
 - A list of current or former references for which the bidder has performed similar work.
 - Proof that the bidder, if a corporation, is in good standing and qualified to conduct business in California or for bidders that are nonprofit organizations, proof of nonprofit status.
 - Copies of current business licenses, professional certifications, or other credentials.
 - Proof of financial solvency or stability, as deemed applicable.
 - The total cost of the project, with a detailed breakdown showing how the costs were determined, and the desired method of payment.
 - Identification of services provided on a flat fee, lump sum, or unit rate basis.

2.3.3 Request for Qualifications (RFQ)

An RFQ is used when a commission has specific requirements as to *how* services are to be delivered. In an RFQ, the applicant demonstrates their qualifications to provide those services according to the model that the commission has specified. In addition, the commission asks applicants to demonstrate their knowledge of, and commitment to, the specified model.

In contrast, an RFP is used when the specific service area is known and specified by the commission, but the specific methods for providing the services are determined by each applicant, in a proposal format. Each applicant proposes their own method/model of providing services, and the commission selects the one it feels will be most successful.

2.3.4 Sole Source Procurement

Sole source procurement should only be used when competitive procurement procedures are deemed infeasible for at least one of the following reasons:

- There is only one viable provider of the required service in the community.
- After solicitation of a number of sources, competition is determined to be inadequate.
- All local providers of a particular service will receive funding.
- The commission is contemplating an effort that has not previously been done in the community and is therefore unable to either develop an RFP with sufficient specificity or to identify potential providers.
- The contract is below a specified dollar threshold, as established by the commission.
- The contractor or vendor is familiar with the commission and is knowledgeable of its unique needs.

Whenever sole source procurement is used, the rationale must be fully justified in writing and approved by the commission or its designated agent (e.g., executive director) before a contract is signed. The documentation justifying sole source procurement should include the following:

- The effort made to solicit competitive bids or proposals, if any.
- A summary outlining the reason for the sole source, based on the allowable exceptions set forth above.
- Cost information in sufficient detail to support and justify the cost of the contract as reasonable and fair.
- Cost information for similar services and differences that should be noted and explained.
- Special factors affecting the cost under the contract.
- An explanation of why the commission believes the cost is appropriate.
- A description of the contractor or vendor's previous work with the commission and/or existing knowledge of the unique needs of the commission.

2.3.5 Intent to Negotiate

This is a form of procurement that has been used successfully by First 5 commissions to fulfill the unique mission of the Proposition 10 initiative. Commissions may select providers by engaging in community-based planning efforts in which stakeholders come together for the purpose of identifying specific needs and the providers best able to meet those needs. These meetings may result in an "intent to negotiate" with potential service providers. If this method of selecting sole-source providers is used, the dates and times of these meetings should be advertised well in advance and all potential providers must be invited to participate. Funds should not be awarded during these meetings. The natural bias toward competitive procurement should apply; any exceptions should adhere to the guidelines outlined in this procedure.

2.3.6 Request for Information (RFI)

For cases in which a new effort is initiated and no apparent service providers exist, or where a commission is not able to prepare an RFP, commissions may elect to issue an RFI. The RFI should contain a description of the need to be met and/or results to be achieved and invite responders to provide approaches to meeting needs or achieving results. The RFI may or may not request a price; if a price is not included, there are two methods for proceeding:

1. Once a recommended approach is selected, the commission may elect to proceed to negotiate a fair price with the selected provider. In this case, the process for sole source contracting described above should be used. If more than one provider has submitted substantially the same approach, parallel negotiations on price and other conditions may be used.
2. Once a recommended approach is selected, the commission may elect to proceed with an RFP process to select a provider. However, moving to an RFP process in this case may be problematic. Providers that have expended resources to develop a new approach are unlikely to be willing to provide this service if they know that their approach is to be used to select other providers. If a commission decides to use this two-stage process, providing a fee to the selected approach is advisable.

2.3.7 Contract Renewal

Contract renewal options differ depending on the type of award. Some contracts have time-limited terms and grantees must reapply for funds, which could happen through a Request for Application (RFA) or similar processes. In contrast, other contracts have time-limited terms, but are assumed to renew if the program continues in the commission's strategic plan and performance requirements are met.

Contracts that are assumed to renew still go through a performance requirement review, typically annually, prior to release of funds for following years. The contractor has to be delivering services and providing reports and be in compliance with the Scope of Work for contracts to be renewed. In some cases, multi-year contracts go through an annual review to ensure these criteria are met.

2.3.8 Evaluation of Proposals

Planning for the evaluation process is outlined in Section 2.3.2 and includes information about the Evaluation Committee selection, process, and conflict of interest concerns. In developing criteria for evaluating proposals, by whatever means a contract is awarded – RFP, sole source, or otherwise – the commission should use the principles outlined in Guidance to County Commissions on Allocating California Children and Family Act (Proposition 10) Funding:

- Does the program or activity fulfill the purposes of your strategic plan? Does it respond to the known needs of your community's Proposition 10 population, as established in your community assessment? Is it necessary to achieve the results you've identified in your strategic plan, especially for ethnic groups, language minorities, and special needs children and families?
- What is your evidence that the program is or will be effective in meeting your goals? Is the program based on current research? Has it been evaluated? If the program would be new to your community, has it been implemented in a community similar to yours, so that it's reasonable to assume that similar outcomes could be achieved in your setting?
- Does the program or activity target the particular group or groups you've identified as needing it the most?
- Does the program or activity improve the balance of services and activities in your community between prevention/asset development and intervention?

- If the program involves direct service, is it developmentally appropriate? Does it provide support for growth, or intervention in the case of difficulty, at the earliest and/or most appropriate time?
- Is Proposition 10 funding required in order for this program to be effective toward achieving your goals?
- Is the program sensitive to and respectful of different cultural beliefs and practices within your community?
- Would the program effectively serve special needs children and families?
- Have service recipients been involved in developing the program, its processes or products?
- Would inclusion of this program or activity in your Proposition 10 funding plan make the plan, as a whole, more responsive to diverse sectors of your community?
- Does the program fill a gap in existing resources within the county, or supplement and strengthen existing resources, as opposed to creating duplication or fragmentation?
- Does the program or activity support shared accountability among those responsible for the well-being of children in your community?
- Will the program or activity help to integrate existing services for young children in your community at the neighborhood level, making them more comprehensive and accessible?
- Does the program or activity support service providers and staffs to function in a more flexible and multidisciplinary way?
- Are there ways to maximize the advantage of Proposition 10 funding for this program or activity through blended funding or leverage of other funds?
- Does the program or activity identify and enhance existing community strengths?
- Will the program or activity help to build capacity in an underserved area by bringing in new providers or by working with providers already there to increase their effectiveness?

2.3.9 Notification and Appeals

Once a decision has been made, the commission should notify all proposers in writing of the intent to award the contract. As a courtesy, the notice should offer unsuccessful proposers the opportunity for a de-briefing after the contract has been awarded. In a de-briefing, commission officials should explain to the unsuccessful bidder the rationale for the decision. The de-briefing process can help minimize appeals and may lead to higher quality proposals in the future.

The notice may also outline the appeals procedure in cases where the commission has one. The following is a recommended appeals procedure:

1. The appeal must be filed within a timeframe to be determined by each commission based on local needs.
2. The appeal must be in writing and sent by certified or registered mail or delivered personally. If the appeal is hand-delivered, a receipt must be requested.
3. The appeal shall include the name, address, telephone, and facsimile numbers of the party appealing or its representative.
4. The title of the RFP under which the appeal is submitted shall be included.
5. A detailed description of the specific legal and factual grounds of appeal and any supporting documentation shall be included. The appeals process may only be used to contest a procedural aspect of the review process (i.e., fair and consistent application of rules and standards), not the merits of the proposal.
6. The specific ruling or relief requested must be stated.

The commission or its designee (e.g., the executive director), at its discretion, may make a decision regarding the appeal without requesting further documents. Therefore, the initial appeal must include all grounds for the appeal and all evidence available at the time the appeal is submitted. If the protestor later

raises new grounds or evidence that was not included in the initial protest but that could have been raised at that time, the new information will not be considered.

Upon receipt of a timely and proper appeal, the commission or its designee will investigate the appeal and provide a written response to the bidder within a reasonable time. If a response cannot be provided within a reasonable time, the vendor will be notified. If the appeal is upheld, the commission or its designee shall consider all circumstances surrounding the procurement in its decision for a fair and reasonable remedy. The commission or its designee may elect to take any of the following actions:

- Refer the results of the appeal back to the proposal review committee and direct it to review its decision and then make a selection.
- Conduct interviews with each of the bidders and then make a selection.
- Re-open the RFP process.

Providers whose contracts are ending and who apply for and are denied continued funding should use the same process for appealing those decisions.

2.3.10 Contracts

Every contract document should identify the contracting parties and include four major elements: (1) scope of work, (2) contract term, (3) contractor payment, and (4) terms and conditions. Each element must be clearly defined in every contract so that the commission's needs are met and the commission and the contractor understand their performance obligations.

Scope of Work

The contract should:

- Clearly define performance, outcomes, and/or interagency linkages to be achieved.
- Identify the performance measures to be used to evaluate contract compliance.
- Identify project milestones as well as any service deliverables or tasks for which the contractor is responsible.
- Address the possible conditions that may arise during performance of the contract that would trigger additions or deletions to the scope of work, schedule, or consideration.
- Address how the activities contained within each contract are consistent with the agency's strategic plan. This can be done via cross reference to the strategic plan. Some commissions cite the page number of the strategic plan where the relevant activities are described.

Additional descriptive information may be attached to the contract as an exhibit to help define the scope of work. This information often includes outcome measures and reporting guidelines. Define activities required to earn funding under and Federal or State grants that are leveraged using First 5 funds. Specific wording or charts may be required as per the funding source contract.

Terms and Conditions

Contract terms and conditions can be somewhat flexible to suit the needs of the commission and the specific contract circumstances. It is the responsibility of authorized commission staff to ensure that contract terms and conditions are appropriate given the type of contract being awarded. Examples of contract terms and conditions include, but are not limited to:

- Contract schedule, including when work shall be started and completed and identification of significant milestone dates, specifications, and quantities
- Restrictions on acceptance of tobacco funding
- Delivery or completion dates
- Contract type
- Independent contractor

- Payment terms and frequency
- Withholding of payments
- Availability of funds
- Supplantation
- Assignments and subcontracts
- Warranty
- Allowable vs. unallowable costs (including those covered under Federal and State guidelines)
- Fixed Asset restrictions or terms
- Any additional Federal or State charts to define the grants (i.e. CFDA chart)
- Any Federal or State fiscal leveraging requirements for program sustainability
- Requirements for bonds or letters of credit
- Program monitoring and evaluation
- Labor documentation
- Financial requirements
- Insurance requirements
- Indemnification
- Nondiscrimination
- Child abuse prevention and reporting
- Smoke free premises
- Liquidated damages
- Termination clauses
- Contract changes clause
- Audit rights
- Disputes and dispute resolution
- Contract suspension
- Remedies
- Confidentiality (HIPPA)
- Ownership of deliverables
- Notice
- Records retention requirements

Service providers should maintain and show proof of adequate insurance coverage before beginning work on any contract with the commission. Refer to the chapter on Risk Management in this Financial Management Guide for more information on insurance and indemnification. Certificates of insurance should be received from the contractor or be verified as current and on file with the commission prior to the beginning of any work, unless the executive director has approved a request for extension. Service providers should maintain insurance coverage that is appropriate to their business operations and the nature of the work. The commission should determine what kinds and levels of insurance are required. In general, insurance coverage should include:

- Workers' compensation and employer's liability
- General liability
- Commercial automobile liability
- Personal automobile liability
- Professional liability

Contracts should be executed by signature of the executive director or other designated agent of the commission. In addition, the provider should provide all applicable insurance and bonding documentation prior to beginning work. The commission's files should include an original, fully executed copy of every contract it enters into.

2.3.11 Performance Monitoring and Reporting

The commission should develop a system to ensure that the performance of providers meets the standards identified in the service contract and contributes to the achievement of outcomes identified in the strategic plan. This includes developing processes for collecting outcome data from providers and for reporting on such data to the communities they serve, the State Commission, and other stakeholders.

Traditionally, public sector compliance efforts have involved detecting and punishing violators in order to deter future instances of noncompliance. Such efforts assume the worst about people and assume that they must be forced into compliance. This can be effective, but it is also very expensive. Many public sector leaders now recognize that there are less expensive and more effective options. These options motivate through pride, peer pressure, rewards, and recognition—not fear. Such methods are characterized by such things as educating compliers, streamlining inspection processes, and providing resources to make it easier to comply. The commission should strive to win voluntary compliance from service providers rather than using heavy-handed enforcement approaches.

The methods to be used in monitoring a contract should be outlined in the contract itself and should include a combination of progress reports and site visits, depending on the provider’s risk profile.

To ensure that limited resources are being used in the most efficient manner, the commission may consider adopting a risk-based approach to monitoring and reporting. The essence of the risk-based approach is that some providers present less risk than others and thus warrant less scrutiny by the commission. Below are procedures for a basic risk- based monitoring system:

1. Develop reporting requirements that will apply to all providers regardless of the risk assessment. These requirements should contain information that is essential to the commission’s own information needs and no more. Additional reporting requirements will be placed on providers based on their risk profile.
2. Develop a standard scoring matrix for assessing provider risk. Criteria might include such things as the experience of the agency in successfully completing similar projects, number of years in operation, expertise of staff, financial solvency, etc.
3. Develop reporting requirements to correspond to various levels of risk (low, medium, or high, for example). Reporting requirements should increase as the level of risk increases. High-risk agencies should be subject to regular site visits in addition to meeting established reporting requirements.
4. Use the scoring matrix to assess the agency and assign a level of risk (low, medium, or high).
5. Communicate reporting requirements to the agency and provide assistance as needed.

The reporting system should provide the essential information needed—no more, no less—to determine whether Proposition 10 funds are being used appropriately and whether the provider is producing the results specified in the contract. Reporting requirements may vary from provider to provider, depending on the level of risk involved. The type, format, frequency, and substance of reports will depend on the needs and circumstances of each commission.

Interim progress reports should include the following basic information:

- Work progress to date, including progress toward measurable results
- Comparison of work progress to date with contract schedule and measures
- Expenditures to date
- Comparison of expenditures to date with contract budget
- Level of service provided
- Issues or barriers encountered and how they are being addressed
- Number of clients served

Progress reports should be reviewed by program and financial staff to ensure that both program and fiscal progress is on target. In addition, the commission may conduct on-site fiscal compliance audits of service providers if feasible. The purpose of such audits is to verify that progress reports are accurate and that proper documentation exists to support provider claims. The following are recommended procedures for conducting fiscal compliance audits:

1. Include a provision in the contract that gives the commission the right to enter the provider's premises and inspect any records pertaining to the services performed under the agreement.
2. Notify all providers at the time the contract is awarded that the commission will conduct random fiscal compliance audits.
3. Decide whether commission staff will perform the audits or whether the commission will use county resources or outside auditors.
4. Develop a method for selecting the sample of providers to audit. This method should correspond to the risk-based monitoring system described above; more high-risk providers should be audited than medium-risk providers, and more medium-risk providers should be audited than low-risk providers. At least one provider from each category should be subject to audit, so that all providers have a chance of being audited.
5. Determine the specific compliance items to be evaluated and develop a tool to be used in performing the evaluation (see model fiscal compliance audit form).
6. Schedule the audit and submit any requests for information or for interviews with provider staff.
7. Conduct the audit. Audits may include but should not be limited to the following:
 - Note location of financial records and verify that these documents are secure
 - Verify that copies of required licenses, certificates, and insurance policies are on file, as well as approved contracts/budgets for sub-contractors
 - Verify completion of financial audit; note any audit findings and whether recommended corrective action has been taken.
 - Verify that there is adequate separation of duties for authorizing, processing, recording, and reviewing contract transactions.
 - Test a sample of disbursements to ensure that they are supported by adequate documentation.
 - Test a sample of disbursements to verify that they are allowable under the contract.
 - Verify that actual disbursements match claims/reports submitted to the commission.
 - Verify that advance payments were expended prior to requests for release of additional funds. Cost reimbursement contracts requiring periodic invoicing and advance repayment from each invoice and where the advance is not more than 25% of the contract value will satisfy this requirement.
 - Verify adequacy of indirect cost calculations and legitimacy of such costs per contract.
 - Verify that there are adequate controls over sub-contractor payments.
 - Test a sample of payroll costs against personnel records.
8. The commission may also choose to conduct site visits as a monitoring tool.

2.3.12 Contractor Payments

The cost to the commission (or the price it will pay the contractor) for services under a contract should be clearly stated:

- The cost may be expressed as a lump sum (one-time payment), firm fixed price, unit price, labor rate, or other specific cost basis.
- The payment options should be specified in terms of advances permitted, reimbursement of actual expenses, and/or equal payments with year-end reconciliation.
- If the commission is contracting for labor, a schedule listing the hourly, daily, weekly, or monthly cost for each person or job classification should be incorporated into the contract. This includes firm fixed price or lump sum contracts, where the schedule may be used as the basis for establishing the cost of additional work authorized under the contract.

- Each party's responsibility for costs such as shipping, sales tax, permits, licenses, bonds, etc.
- With regard to payment, the contract should define how frequently the contractor may submit invoices and what the terms of payment will be.
- If the commission requires contractors to use special forms or formats in submitting invoices, those conditions should be stated in the contract. The commission may wish to consider developing a program handbook (see model program handbook) to help providers comply with the reporting requirements in the contract.
- The contract should define the conditions under which the commission may withhold payment, either as retention or in the event of a dispute with the contractor.
- The contract should clearly state when payment or partial payment is due and whether or not payment is tied to completion or acceptance of tasks, deliverables, and/or reports required to verify deliverables.

2.3.13 Advance Payments

Contracts should specify conditions under which advance payments may be provided. Advance payments should conform to contract terms.

- Any provider seeking the release of funds prior to the commencement of work under the contract should make such a request in writing, specifying the reason(s) advance funds are needed.
- All requests for advance funding should be subject to the approval of the executive director or other designated agent of the commission, based on the nature of each project and the needs of the provider.
- A cash advance should not exceed 50 percent of the maximum amount allowed under the contract. An identified proportion of the advance can be recovered each month.
- Additional funds should not be released until 75 percent of previously released funds have been expended.
- If at the end of the contract period (e.g., fiscal year), the provider has not utilized any portion of the funds advanced, the provider shall return that amount to the commission. If the amount is not returned, the commission can withhold funds from the subsequent year's contract (if there is one). The commission should make every attempt to negotiate a solution before pursuing litigation in the courts.

2.3.14 Progress Payments

The contract shall specify the procedures whereby providers may apply for and receive payment for services rendered to the commission. Every effort should be made to pay providers in a timely manner according to the terms of the contract.

- The program handbook (see procedure on performance monitoring and reporting) should provide detailed instructions on how to apply for payment, including instructions on how to complete any forms to be used in the application process.
- The commission should establish the intervals at which providers may request payment for services rendered (e.g., monthly, quarterly, tri- annually, annually, etc.).
- Providers should formally request reimbursement for services by submitting an invoice. Depending on the type of contract and the level of review desired by the commission, the provider may be required to include with the invoice an expenditure report comparing actual expenditures to the project budget.
- Payment of invoices should be contingent upon compliance with all contractual requirements, including the achievement of performance standards and the timely submission of interim program and fiscal reports.
- The release of funds to a provider should be approved by both program and financial staff. The program officer verifies that satisfactory progress has been made toward project objectives, as

determined by the commission's performance monitoring and reporting system. The finance officer verifies that all reported expenditures are allowable under the terms of the contract.

- An undisputed portion of an invoice should not be withheld pending the resolution of a disputed amount. If a portion of an invoice is in dispute, only the disputed portion should be withheld. The commission should pay the undisputed portions promptly.

3 INVESTMENT MANAGEMENT

The purpose of this chapter is to set forth general guidelines for the investment practices of First 5 commissions. Public fund investing includes short-term investments to meet daily cash flow requirements and long-term investments to meet future goals. These guidelines are based on current best practices in public investing and offer the flexibility necessary to accommodate different types and sizes of commissions.

In most cases, commissions will not be conducting day-to-day investment management, but will delegate this duty to investment professionals in the public or private sector. Most commissions currently delegate this duty to their county treasurer. However, in order to provide proper stewardship of public funds, it is important that commissions are familiar with fundamental investment concepts, and to the extent allowed by their County Treasurer, play an active role in setting the goals and policies of their investment program, and monitor and oversee professional portfolio managers.

The content of this chapter is primarily based on GFOA Best Practices and publications as well as the *Local Agency Investment Guideline* updated by the California Debt and Investment Advisory Commission (CDIAC).

3.1 POLICY STATEMENT

The primary objectives of the investment activities of First 5 commissions, in priority order, are legality, safety of principal, liquidity, and yield.

- *Legality* – The investment program must conform to federal laws, state statutes, local ordinances, and internal policies and procedures.
- *Safety of principal* – Commissions must take care to ensure the preservation of capital and the protection of investment principal.
- *Liquidity* – Commissions must maintain sufficient liquidity to meet operating requirements. Investment of operating funds in long-term maturities or illiquid instruments should be considered only if it is clearly demonstrated that these funds will not be required for operating needs.
- *Yield* – The investment portfolio should earn a market rate of return. Funds that may not be required for short-term liquidity should be invested to safely enhance yield. Investment officers should be encouraged to earn the highest yields possible consistent with safety of principal and liquidity requirements.

3.2 THE INVESTMENT POLICY

Commissions should have a written investment policy that, at a minimum, assigns responsibility for investment management. If a commission utilizes the county treasurer as an investment manager, the policy need go no further, since by doing so, the commission would be adopting the county's investment policies.

Some commissions utilizing the county treasurer as investment manager may choose to provide additional guidelines to the treasurer (for example, investing only in tobacco-free funds). A comprehensive investment policy should be adopted by commissions that manage their own investment portfolios.

3.2.1 Content of the Investment Policy

California law contains no provisions specifying what must be included in a local agency's investment policy. Commissions should adopt an investment policy that matches their investment strategy and method. For example, commissions that invest solely in their county's local government investment fund may not need to include a section on competitive bidding for investment securities. Commissions that choose to manage

their own investment portfolios are encouraged to use the policies developed by counties or cities as their models.

GFOA, the Association of Public Treasurers, and the California Debt and Investment Advisory Commission have each developed model investment policies for local governments. According to GFOA's Sample Investment Policy, an investment policy should cover the following topics:

- Governing authority of the investment program
- Scope of investment policy
- General objectives of investment activities (safety, liquidity, yield)
- Standards of care (prudence, ethics and conflicts of interest, delegation of authority)
- Authorized financial institutions, depositories, and broker/dealers
- Safekeeping, custody, and internal controls
- Suitable and authorized investments and collateralization
- Investment parameters (diversification, maximum maturities, competitive bids)
- Reporting (methods, performance standards, marking to market)
- Policy consideration
- Approval of investment policy

3.2.2 Responsibility for Investment Management

For commission funds invested in the county treasury, the county treasurer serves as a fiduciary and is subject to the prudent investor standard. Except as provided for in Government Code Section 27000.3, Section 53600.3 declares each person, treasurer, or governing body authorized to make investment decisions on behalf of local agencies to be a trustee and therefore a fiduciary subject to the prudent investor standard. These persons shall act with care, skill, prudence, and diligence under the circumstances then prevailing when investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing funds. Government Code Section 53686 requires that reports and/or audits concerning investments that are prepared by county treasurers must be provided to local agencies that have funds deposited in the county's investment pool.

Section 53600.5 stipulates that the primary objective of any person investing public funds is to safeguard principal; secondly, to meet liquidity needs of the depositor; and lastly, to achieve a return or yield on invested funds.

According to Section 53600.3, the commission can delegate *duties* to an external money manager via a principal-agent relationship, but they cannot delegate *fiduciary responsibility*. Further, to be consistent with best practice, contracts with external managers should allow them to make specific decisions within an established framework. Commission executive directors or their designated representatives should closely monitor the actions of these individuals to ensure they are consistent with the commission's investment policy and philosophy, and demand that external managers provide timely reports that comply with the requirements of state law.

The following list summarizes commissions' investment management responsibilities, whether the commission actively makes and manages its own investments or simply exercise oversight over investments held in an investment pool:

- Understand fundamental investment concepts (e.g., types of investment risk and the primary objectives of legality, safety of principal, liquidity, and yield).
- Develop an investment policy, including the commission's investment strategy and permissible types of investments. In some cases, a commission may adopt the county's policy, particularly when investments are not made or managed by the commission.

- Maintain effective internal controls for investment management.
- Select appropriate investment performance benchmarks that match the commission’s legally authorized investments, investment policy constraints, and cash flow requirements.
- Be aware of the interdependence of investment activity and Long Range Financial Plan, particularly in strategic spending of reserves. The Long Range Financial Plan provides guidance on long term liquidity needs, which affects the availability of funds to invest and the duration of investments. It important for commissions to prepare a cash flow analysis to determine the amount available for investment as well as the anticipated time that those funds will be needed. Closely monitor the actions of portfolio managers to ensure they are consistent with the commission’s investment policy and philosophy, and demand that external managers provide timely reports that comply with the requirements of state law.

3.2.3 Permissible Types of Investments

Model Allowable Investment Instruments and *Model Allowable Short-Term Investment Instruments* provide a synopsis of the permitted securities and conditions for using them (Sections 16429.1, 53601, 53601.6, 53601.7, 53635, 53635.2, and 53684). Commissions are encouraged to select investments among those allowed by the Models in order to make their own list of permissible investments based on their unique needs and risk tolerance. Commissions can consider the State of California’s Local Agency Investment Fund (LAIIF) for investing. Commissions should be aware of allowable institutions for deposits and of prohibited investments. The Model documents are a helpful reference concerning these issues.

3.2.4 Types of Investment Risks to be Considered

All investments contain an element of risk. Below are the major types of investment risk. Commissions should address these components of investment risk when developing investment policies.

- *Credit (default) risk.* Credit or default risk is the risk that some or the entire principal amount of the investment will not be available due to default by the issuer, securities broker or dealer, or financial institution. Default risk can be controlled by carefully screening and monitoring the credit quality of issuers, brokers, dealers, and financial institutions; by limiting investments to those of the highest credit quality; and by insisting on holding collateral against certain investments. National credit rating agencies can provide ratings on securities such as commercial paper and bankers’ acceptances. Bank rating agencies can provide ratings on financial institutions and savings and loan institutions. For more information, visit <http://www.fdic.gov/bank/individual/bank/>.
- *Liquidity risk.* Liquidity risk involves the ability to sell an investment before maturity. Some short-term investment instruments are fairly illiquid. For example, a non-negotiable certificate of deposit is an illiquid asset that carries an interest penalty for early redemption. Another example of an investment that is illiquid before its final maturity is commercial paper. The ability to sell commercial paper prior to maturity is dependent on the willingness of the issuer to repurchase the paper from investors since there is no secondary market (the market where securities are sold after their initial issuance) for short-term commercial paper.
- *Marketability.* Closely related to liquidity risk is the concept of marketability— the ability to sell an instrument on short notice without incurring a significant loss in price. An active secondary market will enhance an instrument’s marketability.
- *Market risk.* Market risk is the risk that changes in the financial market will reduce the value of a security. For example, as interest rates rise, bond prices will fall. In periods of rapidly rising interest rates, the market value of a debt instrument can fall below the principal amount invested. If a government sells the security before maturity, part of the principal will be lost. This was the case with mortgage-backed derivative products whose values plunged below the par value (face value) of the securities in the fall of 1994. Investors can reduce market risk by limiting the number of instruments in the portfolio that are subject to rapid market swings.

- *Interest rate risk.* Interest rate risk is the risk that investors will be holding an investment with a lower yield than the current market rate and hence incur an opportunity cost by underperforming the market. For example, if an investor held a one- year certificate of deposit earning 5 percent and interest rates rose to 7 percent, the investor would incur an opportunity cost of 2 percent. Investors can avoid interest rate risk by keeping maturities fairly short if interest rates are expected to rise.

3.2.5 Submitting the Investment Policy to the Commission

California law, Government Code Section 53646(a)(2) states that the treasurer or chief fiscal officer of any local agency may annually render to his/her legislative body an investment policy and, if applicable, his/her oversight committee, which the legislative body shall “consider” at a public meeting. The investment policy must be an agenda item at a public meeting of the agency’s legislative body at some time prior to or during the year it covers. More specifically, section 53646(b)(2) states “The quarterly report shall state compliance of the portfolio to the statement of investment policy...”, which implies that the investment policy must be an agenda item at a public meeting prior to completion of the first quarterly report of the year. The law does not place specific approval requirements on local agencies, nor does it specify when during the year that consideration or approval must occur.

Although California law does not require public agencies to submit an investment policy to their legislative body for annual review, those commissions which handle their own investment decisions are encouraged to conduct such an annual legislative review. This is consistent with guidance from the GFOA, the Association of Public Treasurers, and the California Debt and Investment Advisory Commission. Commissions which delegate investment authority to county treasurers are encouraged to conduct a legislative review of the investment policy every five years.

3.3 PROCEDURES

3.3.1 Deposit of Public Funds

California Government Code section 53646 gives the authority and defines the procedure for a commission treasurer to deposit local funds. Legally acceptable depositories include state or national banks, state or federal savings banks or savings and loan associations, state or federal credit unions and federally insured industrial loan companies.

3.3.2 Maturities of Investments

According to best practice, the commission should attempt to match its investments with its anticipated cash flow requirements. In other words, funds needed to meet cash flow requirements in the near future should be invested in more liquid, short-term investments, while reserve funds intended to be used in future years should be invested in longer-term investments that still preserve the safety of the principal and match cash flow requirements, but earn higher returns. For these reasons, commissions should consider completing periodic cash flow analyses and developing a cash flow document.

According to California law, there is a five-year maturity limit on permissible investments. However, local agencies may invest funds in securities with maturities exceeding five years if the local agency’s legislative body specifically approves the investment no less than three months prior to the purchase of the security (Government Code Section 53601). Part of that approval process involves assessing and disclosing the risk and possible volatility of longer-term investments.

According to best practice, reserve funds and other funds with longer-term investment horizons may be invested in securities exceeding five years if the maturities of such investments are made to coincide as nearly as practicable with the expected use of funds. Because of inherent difficulties in accurately

forecasting cash flow requirements, a portion of the commission's total investment portfolio should be continuously invested in readily available funds such as local government investment pools, money market funds, or overnight repurchase agreements to ensure that appropriate liquidity is maintained to meet ongoing obligations.

- *Ability of some commissions to invest funds in longer-term investments.* Commissions that are county agencies are controlled by their counties' investment policies and procedures. County governments typically make relatively short-term investments in order to meet cash flow requirements, and this approach is reflected in their policies and practices. However, based on some commissions' long-term plans for use of reserve funds and consequent lower liquidity requirements for the total amount available for investment, it may be possible to work with a county's investment managers and policy makers to implement changes in policy and procedure that maintain the safety of principal and meet commissions' liquidity requirements, but earn higher yields.

3.3.3 Internal Controls for Investment Management

An important step toward the prudent investment of public funds is to organize and formalize investment-related activities. Internal controls for the investment function are important to safeguard the commission's assets (cash and securities) and to ensure accurate and timely financial reporting. The commission's assets need to be protected not only from theft, fraud, and embezzlement, but also from inappropriate or poor decision-making.

To control the investment function, the local commission should rely on a combination of organization designs, systems and procedures. These can be summarized as follows:

- Written investment policy
- Formal written agreements
- Organizational design
- Segregation of duties
- Barriers to collusion
- Checks and balances
- Pre-employment screening
- Written procedures
- Training
- Reporting requirements
- External monitoring
- Paper systems
- Electronic funds transfer procedures and wire transfer agreements
- Internal loss controls
- Cost-benefit analysis

3.3.4 Safekeeping

According to California law (Sections 53601 and 53608), as long as the securities for safekeeping are in the name of or under the control of the agency and kept in a legally separate trust department, they can be held by the same firm from which they were purchased. However, best practice is to use a safekeeping service that is not related in any way to the company that sold the securities.

Agencies should strive to "perfect" the delivery of securities purchased by avoiding situations in which a relationship exists between the broker-dealer and safekeeping provider. Even in situations when the safekeeping function is in a subsidiary or trust department that is legally independent of its parent company, strong ties between the two may remain. In the event that the parent company fails, local

agencies may have some difficulty in regaining possession of their securities from the subsidiary or trust department.

3.3.5 Investment Performance Benchmarks

The commission's appointed treasurer will select investment performance benchmarks. The primary selection criteria of the appropriate benchmark are compliance with policy and statutes, risk tolerances, and growth objectives. Additional criteria to be considered are allowable types of securities, time horizon of portfolio, and maturity constraints.

It may be appropriate to segregate the commission's total investment portfolio into more homogenous types of investments. For example, the commission might have one benchmark for its short-term cash investments and a separate benchmark for its long-term investments.

Below are two sources of investment rate of return data and an assessment of California local government investment pools:

- State Treasurer Local Agency Investment Fund
- Historical Interest Rate Data
- Assessment of Local Government Investment Pools: A Survey of California County Pools, California Debt and Investment Advisory Commission.

3.3.6 Investment Reporting to the Commission

An investment report is not required if all of the commission's funds are deposited in one or more of the following types of investments:

- The county treasury
- The Local Agency Investment Fund (LAIF) maintained by the State Treasurer
- FDIC-insured bank deposits
- National Credit Union Shared Insurance Fund-insured accounts in a credit union
- Accounts insured or guaranteed pursuant to California Financial Code Section 14858
- Some combination of the above

If all of the commission's funds are deposited in the above types of investments, in place of an investment report, the following information must be submitted to the legislative body, internal auditor, and chief executive officer:

- The most recent account statement for the investment.
- A statement of compliance with the investment policy or an explanation for noncompliance.
- A statement of the ability or inability to meet expenditure requirements for six months, as well as an explanation of why money will not be available if that is the case.

Government Code Section 53646 states that all local agencies may file investment reports on the status of their investment portfolios with their respective legislative body, internal auditor, and chief executive officer.

The investment report should be submitted timely and regularly. The report should include the following information:

- Investment type, issuer, date of maturity, par value, and dollar amount invested in all securities, investments, and monies held by the commission.
- A description of the funds, investments, and programs (including lending programs) managed by contracted parties.
- A market value of the overall portfolio as of the date of the report and the source of the valuation.
- A statement of compliance with the investment policy or an explanation for noncompliance.

- A statement of the ability or inability to meet expenditure requirements for six months, as well as an explanation of why money will not be available if that is the case.
- Any other additional information that the commission elects to receive.

3.3.7 Selection of Investment Advisors

The services of investment advisors range from advice-only consultation to fully discretionary management. GFOA recommends that state and local governments exercise caution and prudence in their selection of investment advisors, particularly because the responsibility for safety and liquidity of governmental funds cannot be delegated to an investment advisor. (GFOA's *An Introduction to Investment Advisers for State and Local Governments* provides a resource on selecting and evaluating investment advisers.)

GFOA urges state and local governments considering or retaining an investment adviser to develop policies regarding the periodic procurement and selection of investment advisory services. In accordance with state and local law or other requirements, these policies should address the following:

1. The responsible public official or the governing board should appoint a consultant and/or review committee to conduct the search process. Such consultant and/or review committee members should be independent and free of any special interests in any investment advisory firm under consideration.
2. A competitive, merit-based procurement process for selection should be employed.
3. Responsibilities of the investment adviser and/or investment manager should be stated.
4. The consultant and/or review committee should determine the criteria to be used in the selection.

Criteria should include but are not limited to:

- Investment style
 - Years in business
 - Assets under management
 - Investment performance versus appropriate benchmarks over an agreed upon period of time
 - Delivery of SEC Form ADV Part I and Part II (including Schedule I) prior to contract execution
5. The consultant and/or review committee should determine the sources for candidates to be considered, including but not limited to:
 - Consultants database(s) on investment advisory firms
 - Industry reports and articles
 - Marketing materials
 - References from other jurisdictions
 - Special research and reports in order to ensure diversity in candidate pool
 - Other governmental entity resources and information
 6. The consultant and/or review committee should perform due diligence on candidates, including but not limited to:
 - Quantitative information (financial stability and performance review)
 - Organizational structure of firm
 - Experience and depth of personnel in firm, including turnover
 - Firm-specific investment philosophy and portfolio management strategies
 - Trading process
 - Management fees
 - Ability to communicate investment information clearly to lay people
 - References from other clients
 - Interviews with finalists
 - Use of a request for proposal (RFP) process

After the consultant and/or review committee has made a recommendation regarding the selection of an investment advisor, the contract process should include the following:

- Establishment of account responsibility
- Assignment of management and fiduciary responsibility
- Determination of professional liability insurance for crime, errors, and omissions
- Establishment of fee and terms of invoicing and payment
- Procedure for termination of contract by either party
- Specifications related to nondiscrimination in contracting and ethics rules
- Certification that the investment adviser has read and understood the investment policy
- Compliance with appropriate laws and regulations at both the state and local levels

The finance officer managing the investment advisor contract should comply with the following ethical considerations:

- Adherence to all of the jurisdiction's ethics laws, rules, and regulations related to procurement and involvement with contractors, including those related to political contributions
- Disclosure to jurisdiction of any inherent or potential conflicts of interest in dealing with specific investment advisors prior to taking any official action
- Adherence to the GFOA Code of Professional Ethics

The commission should develop and implement an ongoing risk control program, including:

- Ongoing compliance reviews
- Delivery versus payment
- Third-party custody
- Prohibitions against self-dealing
- Independent audits
- Timely reconciliations
- Maintaining current documentation of the investment advisor's internal controls audit
- Other appropriate internal control measures

3.3.8 Financial Reporting of Investments

Commissions should properly apply GASB standards as it pertains to accounting and financial reporting of investments at fair value. Commissions are only required to make adjustments annually for such purposes. Commissions investing with the local county treasurer or local government investment pool (LGIP) should request required GASB reporting amounts for use in financial statement purposes.

4 PLANNING AND BUDGETING

OVERVIEW - LINKING THE STRATEGIC PLAN, LONG-TERM FINANCIAL PLAN, AND THE BUDGET

In its strategic plan, a commission sets goals and objectives, and develops strategies for achieving them. In its long-term financial plan (some commissions call this a “sustainability plan”), a commission takes a long-term view of its financial situation and makes tentative plans for allocating future resources to attain the objectives identified in the strategic plan. In its budget, a commission makes a commitment for how resources will be used in the short term, typically the upcoming one or two fiscal years. The budget is a short-term spending and operational plan shaped by the goals and objectives in the strategic plan and the financial direction set in the long-term financial plan.

This chapter is divided into three sections: strategic plan, long-term financial plan, and budget. Financial results are addressed in the chapter on financial reporting.

4.1 STRATEGIC PLAN

A commission develops the strategic plan through a collaborative process that includes input from stakeholders and an assessment of needs, trends, and the current environment. A strategic plan includes goals, objectives, and strategies for achieving those objectives. The California Children and Families Act of 1998 includes requirements for developing a strategic plan.

4.1.1 Policy Statement

As required by state law, commissions will develop and adopt an adequate and complete strategic plan for the support and improvement of early childhood development within the county, using a collaborative process.

4.1.2 Procedures

The procedures presented below are based on directives enumerated in the California Health and Safety Code (Sections 130100-130155) and State Commission guidelines for implementing the California Children and Families Act (September 1999).

- A commission must conduct at least one public hearing on its proposed county strategic plan before the plan is adopted. (Section 130140(a)(1)(D)). When the plan is amended, a public hearing must be held and a copy must be sent to the state. (Section 130140(a)(1)(E and F)).
- A commission’s strategic plan must be consistent with and in furtherance of the purposes of the Act (Proposition 10) and any guidelines adopted by the State Commission at the time the plan is adopted. (Section 130140(a)(1)(C)(i))
- A commission’s strategic plan must recognize that revenue allocations from the State Commission will be used only to supplement existing levels of service and not to fund existing levels of service. The strategic plan must recognize that no moneys in the California Children and Families Trust Fund will be used to supplant state or local general fund money. (Section 130131.4)
- The strategic plan must be formally adopted by the commission. The adopted strategic plan must be an adequate and complete plan for the support and improvement of early childhood education within the county. (Section 130140(a)(1)(C))
- A commission must submit its adopted county strategic plan and any subsequent revisions to the State Commission. (Section 130140(a)(1)(F))
- Strategic plans are to be reviewed annually and revised as necessary and appropriate. (Section 130140(a)(1)(C)(iii))

The following are the required components of a strategic plan (Section 130140(a)(1)(C)(ii)):

- A description of the goals and objectives proposed to be attained.
- A description of the programs, services, and projects proposed to be provided, sponsored, or facilitated.
- A description of how measurable outcomes of such programs, services, and projects will be determined by the commission using appropriate and reliable indicators.
- A description of how programs, services, and projects relating to early childhood development within the county will be integrated into a consumer-oriented and easily accessible system.
- A budget that shows estimated allocations to the various program components that support the commission's goals for early childhood development.

4.1.3 Community Input Session(s)

A commission should hold one or more community input sessions to obtain stakeholder input on priorities. Some commissions may choose to have separate meetings for strategic planning and financial planning (budgeting or long range financial planning). Other commissions may provide opportunities for community input on both strategic planning and resource allocation at the same time.

4.1.4 Commission Planning Session

The commission should have a planning session to make tentative long-term financial plans and to set priorities for the upcoming budget period. The inputs of this session should be the proposed long-term financial plan, the summary of the commission's most recent financial and performance information, and the summary of stakeholder input. This could be a part of a Commission general strategic planning process. Staff should prepare background information for a commission planning session. This background information should include:

- A summary of the stakeholder input from the community input session.
- A summary of the commission's most recent financial and performance information.
- Staff recommendations for long-term plans for meeting the objectives in the strategic plan.
- A proposed long-term financial plan (or an update to an existing plan).

4.2 LONG-TERM FINANCIAL PLAN

A commission's long-term financial plan, which is developed for a minimum of five years, illustrates the likely financial outcomes of particular courses of action or factors affecting the environment in which it operates. Such a financial plan is not a statement of what is certain to happen but rather a projection, including potential future significant financial and operational issues or problems may affect goals to be achieved. Long-term financial planning expands a government's awareness of options, potential problems, and opportunities. It helps decision makers to see the long-term implications of expanding or reducing existing programs, and helps decision makers to take corrective action before potential problems become more severe. Decision makers should use the plan as a resource when making budget decisions.

Policy Statement

Commissions must develop a long-term financial plan. The plan should assess the long-term financial implications of current and proposed policies, programs, and assumptions. It should provide a long-term view of how resources will be allocated to attain the objectives in the strategic plan.

4.2.1 Procedures

The following procedures provide commissions a recommended approach to long-term financial planning, including components, content, and commission-specific activity. The financial plan, though not a binding commitment like the budget, must be adopted by the commission to show its intent to allocate funds in future budget periods. The plan is to be adopted after a public hearing. (Section 130151(b)(5)). Specific procedures:

1. Develop a plan that includes the following components:
 - An analysis of past financial trends.
 - An assessment of needs, trends, opportunities, and potential shortfalls the commission will face in the future and actions needed to address these issues. Many methods are available for generating these projections. Model documents are available to illustrate the various ways individual commissions complete their projections.
 - Long-term forecasts of future revenues and expenditures that use alternative economic, planning, and policy assumptions. In certain circumstances, commissions may decide to develop and adopt multiple forecasts to describe possible futures. It is important that assumptions are clear when multiple forecasts are created under varying scenarios.
 - A plan for total revenue and expenditure levels for the planning period.
 - A plan for allocating resources among the objectives in the strategic plan. Commissions may also want to allocate resources to specific programs.
2. The financial plan should include forecasts of future revenues, expenditures, and reserves for a period of at least five years.
3. The financial plan should include future revenue and expenditure levels in a likely scenario. In this plan, expenditures should not exceed available revenues and reserves during the planning period.
4. The financial plan should include a thorough assessment of the “revenue risk” attached to the Proposition 10 tobacco tax funding stream. Such attention is warranted as state level revenue modeling and analysis projects a decline of tobacco tax revenue in future years.
5. The financial plan should be updated every year in concert with budget preparation.
6. Some commissions may choose to incorporate a community input process into the development of financial plans.

4.3 BUDGET

The budget is a commitment for the allocation of available resources for a specific budget period, usually a fiscal year. The budget is shaped by the goals and objectives contained in the strategic plan and the financial direction set in the long-term financial plan. The budgeting policies and procedures presented here cover both the written budget document and the decision-making process for developing the budget. The purpose of this section is to set forth general guidelines for the allocation of Proposition 10 funds—guidelines grounded in best practices in budgeting but reflecting the flexibility necessary to accommodate different types and sizes of commissions.

4.3.1 Policy Statement

The budget must tie directly and explicitly to the commission’s long-term financial plan. All program allocations are to be consistent with the long term financial plan.

The budget must be within the parameters of the commission’s strategic plan and must be in alignment with all strategic plan decisions.

These policies are in line with the essential features of a good budget process as identified by the National Advisory Council on State and Local Budgeting:

- Incorporate a long-term perspective
- Establish linkages to broad organizational goals
- Focus budget decisions on results and outcomes
- Involve stakeholders and promote effective communication with them

4.3.2 Procedures

Establish a Process for Preparing and Adopting a Budget

- *Annual and Multi-year Budgeting.* The commission should consider adjusting the time period of the budget to a period (e.g., 12 months, 24 months, 36 months, etc.) that best fits its needs within the constraints imposed by its commission policies, county government, or state law. An annual budget authorizes a commission’s planned revenues and expenditures for one year. A multi-year budget authorizes a commission’s planned revenues and expenditures for two or more consecutive budgetary years.

Multi-year budgets tend to be more beneficial for organizations with predictable revenues and expenditures, such as First 5 commissions. Thus, if a commission is limited in its ability to adopt multi-year budgets by policies or laws, it might still produce detailed projections of revenue and expenditures over multiple years for planning purposes, but only adopt the first year as the formal budget. Commissions should consider the advantages and disadvantages of multi-year budgeting and select a time period that best fits their needs.

- *Budget Calendar* - The commission’s budget process should be guided by a written budget calendar. The budget calendar is a schedule that lists the dates of key budget events and deadlines. It specifies the key tasks in the budget process, when they must be completed, and who is responsible for each task. The budget calendar describes the procedure for preparing, reviewing, and adopting the budget. The calendar should be distributed to budget stakeholders early in the budget process.
- *Budget Process.* Although small and large commissions have different processes for developing budgets, the commission’s budget process should generally follow these key steps:
 1. In a planning session, the commission sets priorities for the upcoming budget period and adopts a long-term financial plan.
 2. Staff prepares a proposed budget based on priorities established in the commission’s strategic plan.
 3. Commission reviews the proposed budget. This may be done in one or two meetings, depending on the size of the commission or policies of the commission.
 - a. Commission approves the budget.
 4. Adopted budget is communicated to stakeholders using a popular budget document.
 - a. Staff administers and monitors the budget.
 5. Commission or its delegate amends the adopted budget as necessary.
- *Preparation of Proposed Budget* - Staff should prepare a proposed budget based on the priorities set in the local commission planning session and established in the commission’s strategic plan. Commission management’s responsibility generally is to present the proposed budget in a way that best facilitates effective resource allocation decisions by the commission. It should show anticipated resources and how these resources will be used to implement the objectives in the strategic plan. In other words, it should present financial information in a format that helps decision makers to ensure that their funding decisions will support the purposes they have outlined in their strategic plan.

4.3.3 Budget Document

The budget document should include the following sections:

- *Budget Summary* – The beginning of the budget document should include a budget summary that gives the “big picture” and highlights key information in the budget such as important changes in revenues, expenditures, and reserves as well as past budgetary performance.
- *Tables* – Tables should present financial data in a format that shows how resources will be used to carry out the objectives in the strategic plan. Tables should include at least three years of financial data (prior year actual, current year estimated, next year proposed budget).
- *Budget Narratives* – The budget document should include budget narratives that provide the assumptions behind the budget estimates, explain significant changes in budget line items, explain how the resource allocation in the budget relates to the goals and objectives in the strategic plan, and “tell the story behind the budget numbers.”

4.3.4 Commission Review of Proposed Budget

The commission reviews the proposed budget prior to adoption. The commission should use the strategic plan and the long-term financial plan as the framework for its review.

4.3.5 Budget Adoption

The commission should adopt the proposed budget at least one month prior to the beginning of the next budget period. In the adopted budget, the operating expenditures must not exceed the operating resources (forecasted revenues and reserves). Commissions may review and adopt budgets at different levels: fund, cost center, program, or line item depending on commission policies.

4.3.6 Communicate Budget to the Public through a Popular Budget

The commission should prepare a “popular budget” document that meets the following objectives:

- Provides a “big picture” view of the budget and highlights the most important budgetary information.
- Effectively communicates budgetary information in a clear, user-friendly format using charts, tables, and/or narrative when appropriate.
- Clearly shows how the funding decisions in the budget will be used to carry out the objectives in the strategic plan.
- Presents a long-term financial view.
- Explains the need for reserves or fund balance.

4.3.7 Budget Administration

Staff should administer and monitor the adopted budget. Staff should use the budget document as a guide for expenditures throughout the budget period so that actual expenditures do not exceed the total adopted budget, resources are used for the appropriate purposes, and resources are not expended too quickly.

4.3.8 Budget Amendments

Depending on individual commission policies and procedures, the commission may make amendments to the adopted budget as necessary. Any changes to the total amount of the budget must be approved in writing by the commission prior to recording the change. Unless otherwise authorized, the commission or its delegate approves budget amendments.

5 ACCOUNTING

The law establishing the state and local commissions requires a high level of accountability. All Proposition 10 expenditures made by a commission must be for the purposes for which the commission was created, and in accordance with the approved commission strategic plan. As a recipient of federal, state, and other grant funds, program accounting is needed. In addition, the California Children and Families First Act requires outcome- based accountability.

Generally accepted accounting principles (GAAP) ensure the credibility and reliability of information that is critical to public support. GAAP for local governments have been established and maintained by the Governmental Accounting Standards Board (GASB). The Government Finance Officers Association (GFOA) plays a significant role in interpreting and teaching GAAP. GAAP and accounting best practices, as well as legal requirements, underlie the following policies and procedures.

5.1 POLICY STATEMENT

Accounting policies provide high-level guidance and focus attention on critical executive responsibilities associated with accounting. Accounting policies create the environment and culture in which commissions, management, and staff members make numerous decisions and take action on a daily basis. Following are the key accounting policies suggested for First 5 commissions:

- Accounting is conducted in accordance with GAAP as promulgated by the GASB, and in accordance with the guidance in *Governmental Accounting, Auditing, and Financial Reporting (GAAFR)* published by GFOA.
- Accounting transactions are recorded in a manner that facilitates outcome-based accountability.
- Accounting procedures and records should be used to ensure expenditures are made only for the purposes authorized by the California Children and Families Act of 1998 (as amended), and in accordance with the commissions' approved strategic plans.
- Accounting procedures are adopted and followed to safeguard financial resources.

5.2 GENERAL ACCOUNTING PROCEDURES

Every commission should adopt a set of general accounting procedures to account for commission financial resources and record revenues and expenditures. The following general accounting procedures comprise the major elements that define and drive the accounting system:

- Generally accepted accounting principles
- Fund accounting
- Modified accrual basis of accounting
- Account classification
- Program accounting
- Cost allocation
- Budgetary control
- Internal control

Commissions that adopt these general accounting procedures will be well positioned to implement the accounting policies discussed above and meet the reporting criteria presented in the financial reporting chapter. Accounting guidance for asset, liability, revenue, and expenditure/expense accounts is presented in Section 5.7 of this chapter.

Generally Accepted Accounting Principles (GAAP)

Commission accounting policies, practices, and systems should conform to generally accepted accounting principles in order to maintain public trust in commission operations and reporting. When new accounts are created or changes in accounting practices are made, commissions need to ensure that they continue to comply with GAAP.

The primary source of GAAP for the public sector is the Governmental Accounting Standards Board (GASB), an independent standard-setting body operating under the auspices of the Financial Accounting Foundation. GAAP for the public sector is not the same as GAAP for the private sector. GASB issues accounting standards that ensure governmental accounting and reporting is conducted effectively and in the public interest.

The GASB is aided in its work by the Governmental Accounting Standards Advisory Council (GASAC), a consultative body made up of representatives of major groups interested in governmental accounting and financial reporting, such as GFOA and the American Institute of Certified Public Accountants (AICPA).

5.2.1 Fund Accounting

Government accounting systems are organized and operated on a fund basis to provide strong accountability for the use of public funds. GASB defines the term “fund” as follows:

- A fund is defined as a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulation, restriction, or limitations.

Fund accounting focuses on the inflow and use of current financial resources, whereas private sector accounting focuses on profit and net worth. Commissions are government entities that are required to use fund accounting.

Fund accounting includes three broad classifications of funds:

- Governmental funds typically are used to account for tax- supported activities (commissions’ activities are generally tax- supported, therefore commissions would use a governmental fund.)
- Proprietary funds are used to account for a government’s business-type activities like a water department or an airport.
- Fiduciary funds are used to account for resources that are held by the government as a trustee or agent for parties outside the government. Fiduciary funds cannot be used to support the government’s own programs.

One type of governmental fund is the **general fund**. The general fund is the chief operating fund of most governments and can be used by First 5 commissions. Another type of governmental fund used by commissions is the special revenue fund. A special revenue fund accounts for the proceeds of a specific revenue source that is restricted by law or administrative action to be expended only on a specified purpose(s). Special revenue fund accounting is commonly used when revenue sources are exclusively designated for a specific purpose. Independent commissions are more likely to use a general fund, while county commissions use a special revenue fund.

Given the legal and administrative requirements associated with Proposition 10 monies, it is advised that commissions designated as county departments establish their accounts using the special revenue fund designation. For both county and independent commissions, the state is required to transfer Proposition 10 funds into the commission trust funds. Trust funds are separate from the commissions’ general funds or special revenue funds, which are accounting entities only.

5.2.2 Modified Accrual Basis of Accounting

There are three bases of accounting: cash accounting, accrual accounting, and modified accrual accounting. Commissions should use the modified accrual method of accounting because it more effectively recognizes increases and decreases in financial resources. A conversion to the accrual basis is necessary at year-end for reporting purposes as described in Chapter 5.

The modified accrual basis of accounting is a method of accounting in which expenditures are recorded at the time liabilities are incurred and revenues are recorded when earned so long as they are both measurable and available to finance expenditures of the current period. For example, under the modified accrual basis of accounting, local commissions would:

- Record tobacco tax allocations when they are listed on the monthly distribution schedule per the First 5 California website (measurable) and determined to be collectible within the current period (available).
- Record payments to providers for services provided under a contract at either the time an invoice is approved or at the time a check for services is disbursed.

The budget document should include a clear definition of the basis of accounting used for budgetary purposes. If the budgetary basis of accounting and the GAAP basis of accounting are the same, this fact should be clearly stated. If the budgetary basis of accounting and the GAAP basis of accounting are different, major differences and similarities between the two bases of accounting should be noted. Disparities may include basis differences, timing differences, fund structure differences, and entity differences.

5.3 ACCOUNT CLASSIFICATION

5.3.1 Chart of Accounts

Commissions engage in a wide range of financial activities. An account classification system called a chart of accounts is used to record and organize this financial activity. A well-organized chart of accounts provides the organizing framework for budgeting, and substantially enhances reporting capabilities. Each commission should utilize a standard chart of accounts along with an accompanying definition of each account.

A chart of accounts can be tailored to an organization's specific needs. In order to decide what to include in a chart of accounts, each of the following questions should be considered:

- What reports do you want to prepare?
- What financial decisions, evaluations, and assessments do you need to make on a regular basis?
- What level of detail do you require?
- What is your capacity for tracking financial information?

The chart of accounts includes all accounts in the general ledger—assets, liabilities, fund balance, revenues, and expenditures. Asset, liability, and fund balance accounts reflect the financial resources of the commission and are referred to as balance sheet accounts. An excellent source for developing balance sheet accounts is Appendix E in GFOA's *GAAFR*.

Revenue and expenditure accounts reflect the operations of the commission and need to meet management's reporting needs. Below is a suggested list of revenue and expenditure accounts.

General-Purpose Revenue Examples:

- Tobacco Tax Revenue – The amount of revenue received is based on birth-rate information and the commission's rules of distribution. Guidelines are derived from Proposition 10 legislation. (Section 130105(d)(1 and 2)).

- Interest Earnings – Revenue received from use of money over a period of time.
- State Surplus Monetary Investment Fund (SMIF) – Apportioned interest earned on tobacco tax revenue by the state prior to disbursement.
- Miscellaneous Revenue – Revenue not associated with specific state/county/city sources, such as registration fees for a conference held by a commission.

Special Purpose Revenue Examples:

- AmeriCorps Reimbursement Revenue – Revenue received from the federal government to reimburse AmeriCorps workers assigned to commission.
- Child Signature Program – Funds allocated from the State Commission.
- Other Grants – Commissions may be awarded other grants from the state or other government or private agencies. Each grant’s revenue should be reported separately.

Periodically, revenues are transferred to fund program activities from other financing sources. Below are examples of accounts used to make these transfers. Chapter 6, Financial Reporting, will provide more information on transferring funds.

Program Expenditure Examples:

The outcome categories listed below identify program areas in which the State First 5 Commission has targeted funding and under which they categorize funding expenditures of each County Commission in their annual report. County Commissions may or may not align their Strategic Plan with the State categories. However, annually they report their expenditures under these categories. Program accounting can take many forms and some of these are reflected in section 5.3.3. Aligning their accounting system with these reporting requirements would facilitate the reporting requirements; however, it may or may not be feasible depending upon how each Commission has aligned their programs with the State.

- Improved Family Functioning: Strong Families
- Improved Child Development: Children Learning and Ready for School
- Improved Child Health: Healthy Children
- Improved Systems of Care: System Integration and Capacity Building
- Other long-range outcomes identified by local commissions

Commissions will need to add to and delete from their chart of accounts based on their strategic plans, funding strategies, business plans, and external/internal reporting requirements. (Note: Refer to Appendix E in GFOA’s GAAFR for examples.)

5.3.2 Object of Expenditures

In addition to developing a chart of accounts, government entities often code expenditure information to identify the “character” or “object” of the expenditure. It is recommended that each commission use eight major object classifications for services or commodities, with subcategories as needed (e.g., travel and meetings). Potential subcategories are provided in Appendix E in GFOA’s GAAFR.

- Salaries and wages
- Employee benefits
- Purchased professional and technical services
- Purchased property services
- Other purchased services
- Supplies
- Property
- Other goods and services

5.3.3 Program Accounting

Account classification creates a structure to account for assets, liabilities, fund balance, revenues, and expenditures. In addition, commissions often need information on programs. A program is a set of specific activities funded or provided by the commission to accomplish a particular purpose. Program activities may have more than one revenue source, and may require expenses from multiple organizational units. The crosscutting nature of program revenues and expenditures requires commissions to take added steps to collect and store information by program.

To establish program accounting, some organizations create transaction codes to capture program activity, while others create additional accounts. In cases where county accounting services are used, the county may have transaction codes or accounts to collect program (or project) information. In other cases, commissions may have to develop program accounting information in their internal accounting systems. For example, School Readiness Initiative program costs could be paid partly out of the county share of tobacco tax revenues and partly from State Commission matching funds, so the same program code (SRIPRO) could be set up for use in each of two different organizational units. Pure administrative costs, not directly attributable to a program, could be charged to program code ADM. Funds that have not yet been committed through commission decision to any specific purpose could be coded to program code UNCOO.

Because of the commission’s legal mandate for outcome-based accountability, and the program evaluation requirements associated with the grant funds, commissions are encouraged to employ program accounting.

5.4 COST (EXPENSE) ALLOCATION

Most of the accounting for commission activities is accomplished by charging directly to programs. However, certain situations require special allocation of administrative and indirect costs to accurately account and report the cost of commission activities.

Cost items that meet the commission’s definition of administrative costs are charged directly to an administrative area in the accounting system. During the year, however, it may be necessary to apply these administrative costs to specific programs to determine “total” program costs. These indirect costs are allocated to individual programs or to general program categories. During the year some costs will occur that have both a program and an administrative component, and other costs may involve more than one program. Cost allocation is used when costs need to be estimated and apportioned among different programs or organizational units. Examples of costs that may need to be allocated include office rent, telephone, and personnel costs.

Once it is determined that costs need to be allocated or apportioned, an allocation formula is created to obtain a reasonable estimate. For example, assume a three-person administrative staff had annual rental costs of \$12,000, personnel and benefit costs of \$150,000, commodity costs of \$8,000, and telephone costs of \$10,000. During the year the three-person staff maintained time records that showed administrative services were provided to five separate programs. Total administrative costs of \$180,000 would be allocated to each program by percentage as shown below:

Program	Total Admin Hours	% of Time	Allocated Costs
1	1,000	20%	\$36,000
2	2,000	40%	72,000
3	500	10%	18,000
4	500	10%	18,000
5	1,000	20%	36,000
Total	5,000	100%	\$180,000

State and local governments receiving large federal grants generally are required to maintain formal cost allocation plans. Specific guidance on cost allocation plans can be found in OMB Circular A-87. However, the cost of maintaining a formal cost allocation plan is prohibitive for smaller government entities. It is recommended that local commissions use the cost categories described in the Cost Allocation section.

Where a commission does not use an ongoing time system, time studies can be conducted. For example, a commission may conduct a time study of all staff positions in order to properly compute expenses that can be submitted for reimbursement under the Medi-Cal Administrative Activities (MAA) federal entitlement program. The time study would show the percentage of each staff person's time spent on each commission program and on internal administrative activities. The results of this time study can be also used for internal allocation of costs across program codes.

Cost allocation may differ among commissions, and some commissions allocate indirect and administrative costs only at year end. Commissions are advised to develop and follow a procedure for cost allocation that establishes a consistent and transparent process with an auditable trail. A sample cost allocation methodology and sample forms are included in the model documents at the end of this chapter.

5.5 BUDGETARY CONTROL

The adopted budget approved by the commission (including amendments) creates a formal revenue and expenditure plan. As described in Chapter 4, *Planning and Budgeting*, staff members administer and monitor the adopted budget during the year to establish budgetary control. Specific steps need to be taken to establish that control.

Initially, the budget needs to be aligned with the accounting system. The budget includes estimated allocations to the various program components that support the commission's goals for early childhood development. The program accounting structure needs to be aligned with the programs in the budget. Also, the revenue and expenditure items in the budget need to be aligned with the chart of accounts to effectively compare "actual" revenues and expenditures with "budgeted" revenues and expenditures.

Second, a formal or informal encumbrance system can be used to control the expenditure side of the budget. Encumbrances are financial commitments representing the estimated amount to be paid when open contracts are completed. Essentially the encumbrance reserves a portion of a budget. When the contract is performed, an expenditure will be recorded in the accounting system (and the encumbrance will be reversed). Until the expenditure is recorded encumbrances are used so the commission does not over commit funds. Following are examples of where encumbrances are used:

- When a purchase order, contract, or other commitment is made and the goods or services have not been received.
- Funds may be encumbered for estimated expenditures, such as utilities, for which no purchase document is issued.
- Having a method to track encumbrances is important for financial reporting purposes, especially for proper representation and recording of fund balance.

Third, a monthly reporting system is used to identify budgeted and actual amounts and the fund balance, ensure resources are used for the appropriate purposes, and ensure resources are not expended too quickly. Chapter 5, *Financial Reporting*, discusses the monthly reporting system.

Fourth, during the year amendments are made to the original budget as circumstances change. Records of the original budget and all amendments need to be maintained. At year-end both the "original" budget and "final amended" budget amounts will be needed for financial reporting purposes.

5.6 INTERNAL CONTROLS

Internal control refers to procedures or systems designed to promote efficiency, assure the implementation of a policy, safeguard assets, and/or avoid fraud and error. More detailed information about internal controls can be found below and in chapter six of this guide.

5.7 SPECIFIC ACCOUNTING PROCEDURES

The following accounting procedures provide guidance for particular asset, liability, revenue, and expenditure/expense accounts. In many cases, the guidance presented focuses on procedures to safeguard financial resources. The examples of procedures provided illustrate steps that can be taken to establish internal control. In practice commissions may use other procedures to establish internal control.

5.7.1 Cash

Part of the overall maintenance of adequate accounting procedures is the ability to control cash collections and disbursements. Account procedures for cash should emphasize timely processing and recording. Specific procedures include:

- Segregation of duties in the cash collection and disbursements process, to the greatest extent possible. Ideally, the duties of authorization, custody, record keeping, and reconciliation should be segregated. In those instances where these duties cannot be fully segregated, mitigating controls should be established;
- Review by check signers and approvers of supporting documentation for all disbursements;
- All cash collections, whether in the form of checks or currency, deposited in a timely manner, safeguarded until properly deposited, and accurately recorded in the accounting records;
- Restrictive endorsement of checks upon receipt;
- Bank reconciliations performed on a timely basis and reviewed on a timely basis by individuals not involved in the cash collection or disbursement process;
- Investigation of variances between bank statements and commission records; cash and checkbooks secured with as limited access as possible;
- Disbursements, whether in the form of checks, electronic transfers, or other means, approved, adequately documented, and accurately recorded in the accounting records; maintenance of a process for retaining and retrieving supporting disbursements documentation;
- Authorization and recording of account transfers required for wire transfers.

5.7.2 Petty Cash

Petty cash funds facilitate the purchase of goods and services under limited circumstances. Commissions are not required to maintain petty cash funds. However, if a commission chooses to maintain a petty cash fund, detailed procedures are needed to account for and safeguard petty cash, such as:

- Dollar limits established for petty cash funds;
- Funds kept in a locked location;
- Receipts required for all disbursements;
- Periodic surprise cash counts performed by supervisors;
- Petty cash custodian independent of the approval and accounting functions;
- Identification of allowable and unallowable use of the petty cash fund;
- Establishment of reconciliation procedures, with reconciliation performed by someone other than the custodian;
- Replenishment of fund as needed by processing a request for payment form with attached paid receipts.

5.7.3 Purchasing Cards

Purchasing cards include both credit cards issued by national credit agencies such as VISA and MasterCard and store cards. Purchasing cards are not required for use by commissions but may be used to facilitate small purchases and employee travel. Purchasing cards are preferable to the use of petty cash due to the tracking features available. If used, commissions should have detailed policies and procedures regarding the issuance, use, and reporting of card transactions. Commissions should have appropriate safeguards in place while being careful not to restrict the ability to benefit from the advantages of purchasing cards through the implementation of overly tight controls. Items for consideration include:

- Authorization requirements for issuance of a card
- Policies governing sharing of cards amongst employees
- Dollar and transaction limits for cards including daily limits and monthly limits
- Security for cards while not in use
- Identification of allowable and unallowable use of cards
- Policies articulating whether purchase orders are required to correspond with card use
- Prohibition of certain commodity types such as alcohol and cash
- Receipts required for all transactions
- Procedures for submission of monthly card statements and supporting invoices including approval requirements by an individual other than card holder
- Procedures for recording transactions to accounting records
- Procedures for reconciliation of statement balances and payment of statement amount
- Identification of actions which lead to discontinuation of allowed card use by employees

5.7.4 Accounts Receivable

An accounts receivables process will be maintained that identifies and bills all amounts due on a timely basis. The process will identify overdue receivables and provide timely collection notices. The primary receivable of most commissions is the state disbursement of tobacco revenues.

Specific procedures include:

- Creation of procedures to prepare and send billings in a timely manner;
- Approval of billing information, including rates and amounts;
- Daily deposit of collections;
- Billing, collection, and cash application performed by different people;
- Effective steps take to collect past due accounts, with uncollectible accounts written off after a defined period of time;
- Approvals required to write-off accounts.

5.7.5 Investments

Financial information on effective managing of commission investments can be found in Chapter 3, Investment Management. From an accounting and internal control standpoint:

- Investments should be properly authorized and accurately recorded;
- Investments should be properly safeguarded;
- Sales of investments should be properly authorized and accurately recorded;

5.7.6 Capital Assets

Capital assets include such items as land, structures and improvements, furniture, and equipment owned by the commission. Under the modified accrual basis of accounting, commissions charge capital asset purchases as expenditures.

Most commissions have few capital assets, although some have purchased assets such as buildings and other facilities. The 80 percent of the Proposition 10 tobacco revenue that is distributed to local commissions per Section 130105(d)(2) of the state code can be used to purchase capital assets. However, the 20 percent allocated to accounts of the state commission, which may be distributed to local commissions for various purposes, cannot be used for purchase of capital assets.

Procedures to safeguard and control capital assets are as follows:

- All capital assets having a value of more than a specified dollar amount and a useful life of one year or more monitored through inventory controls;
- Management and commissioner approval of all capital asset purchases, depending on dollar amount;
- Pertinent data on capital assets (including description, cost, source of funds, and data acquired) recorded as soon as capital assets are acquired and data is available;
- All items tagged with a pre-numbered identification sticker;
- Performance of periodic physical inventories;
- Maintenance of a listing of expendable equipment (assets that do not meet the specified dollar amount to be classified as a capital asset, but require control) that could easily be misappropriated, as well as a periodic inventory of this equipment;
- Recording of donated capital assets at fair market value as of date of donation.

Construction Costs

Construction projects may be funded based on the completed contract method and invoices submitted by the contractor. An initial advance payment may be issued.

5.7.7 Purchasing and Payables

A purchasing process shall provide for the efficient purchasing of commission needs, prevent unnecessary purchase of materials and supplies, and provide compliance with budgetary requirements. Chapter 1 of this financial management guide includes more detailed information about procurement and contracting.

The authorization to purchase supplies and services should be reflected in the accounting records and should include the following:

- Compliance with requirements for formal or informal bids;
- Approval of purchase orders based on available budget;
- Expenditures consistent with the purpose of the organization and the approved strategic plan (California Codes, Health and Safety Code, Section 130100-130155);
- Establishment of purchase prices, terms, and commitments;
- Requisitioning of supplies and services;
- Recording of purchases in the correct time period and amount with sufficient documentation.

All expenditures made should be reflected in the accounting records—including the payment amount and allocation—in the correct time period, to the appropriate fund or account, and with sufficient information to identify the payee.

A complete accounts payable ledger should be maintained that shows liabilities to be paid in the future, when each one is due, and whether it has been paid. The following safeguards should be put in place:

- Review of invoices for calculation accuracy and payment approval;
- Comparison of invoice quantities, prices, and terms with purchase orders;
- Comparison of invoice quantities with receiving report.

5.7.8 Payroll

The payroll accounting procedure needs to ensure that paychecks/direct deposit advices are issued to employees on time and that payroll is accurate. All payroll liabilities should be reflected in the accounting records, including:

- The amount of the liability and
- Allocation to the appropriate fund, program, or expenditure account and time period.

All recorded liabilities should be supported by appropriate evidence showing that the liability is for authorized work actually performed by authorized employees, temporaries, or consultants. Procedures to ensure reliable payroll accounting include:

- Time cards prepared and signed by employees and approval by the supervisor and executive director prior to payroll preparation;
- Proper documentation of changes in salaries and wages in the personnel file;
- Payroll and benefit calculations and eligibility for benefits verified periodically.

5.7.9 Compensated Absences

Compensated absences are absences for which employees will be paid, such as vacation and sick leave. A liability for compensated absences for services already rendered and that are not contingent on a specific event should be accrued as employees earn the rights to the benefits. The compensated absence liability should be calculated based on the pay or salary rates in effect at the balance sheet date. See GASB Statement No. 16 for further guidance.

5.7.10 Leases

Leases entered into by the commission are classified as capital leases or operating leases. Leases that meet the reporting criteria of capital leases (with benefits and risks similar to ownership of the property) should be treated as such with both the asset capitalized and depreciated and the present value of future lease payments treated as a long term liability. Other types of leases should be reported as operating leases.

5.7.11 Travel and Business Expense

Commissioners and staff are authorized to receive reimbursement for travel and business expenses incurred while attending official functions, as long as the expenses are reasonable, prudent, and appropriate. Reimbursement for expenses associated with other related training, seminars, or meetings must have prior approval from the executive director, in the case of commission staff, or the commission chair, in the case of commissioners.

5.8 RESTRICTED FUNDS ACCOUNTING

Most commission funds come from distributions of the tobacco tax revenues collected by the state. However, commissions also may receive funds from the State of Commission, other state departments, the federal government, private foundations, or other sources. These funds normally are restricted in how they may be used, and require special accounting information to be collected and reported periodically. Funds from the State Commission cannot be used for the purchase of capital assets.

Procedures needed to record and safeguard restricted funds include:

- A budget or plan is prepared when a grant or funding agreement is established, including restrictions and parameters of the funding agreement. Account numbers are created to track funding and expenses in accordance with the agreement.
- Procedures are established for receipts to be recorded accurately, deposited in a timely manner, and where appropriate, allocated to the correct account.
- Projects with matching fund requirements are tracked in a manner that allows verification that the matching fund requirements have been met. Certain State Commission funds carry restrictions requiring the local commission to match the state funds with local funds according to a pre-defined ratio, such as one local dollar for every state dollar or three local dollars for every state dollar.

Matching fund requirements also occur with federal grants, and can also be found in grant agreements with private foundations.

Commissions should use the accounting procedure that works best for tracking matching funds. For example, if three local dollars must be used for every state dollar, the transaction would be coded to allocate 75 percent of the expense amount to the cost center corresponding to the source(s) of local funding being used as the match and 25 percent of the expense amount to the cost center holding the funds with the matching fund requirement.

- A review procedure is used to review expenditures to ensure they meet the requirements, in addition to meeting the purposes of the commission as expressed in the strategic plan.
- A review procedure is used to ensure payroll costs charged to a restricted fund are based on only the time spent working on grant programs. Periodic reviews are conducted to determine that audit requirements are met and follow-up is performed on audit recommendations.
- Periodic management reports are generated to analyze compliance with funding agreements and matching fun requirements.

6 FINANCIAL REPORTING

This chapter provides First 5 commissions with recommended policies and procedures for reporting financial information. It should be read and applied in conjunction with the chapter on accounting in order to ensure consistency between these two related areas. This chapter focuses primarily on financial information; however, it also includes information on reporting on achievement of program or strategic goals, including output and outcome information because of the important link between financial reporting and goal achievement.

First 5 commissions are responsible for two kinds of reporting: external and internal. While independent commissions will prepare financial statements in accordance with Generally Accepted Accounting Principles (GAAP) at the end of the fiscal year, commissions that are agencies of county governments will be part of the county's GAAP financial statements at the end of the year. However, for management purposes, commissions' finance staff should provide internal reports on a regular basis to program managers and other staff.

Legal Requirements

California law requires that the state and local commissions adhere to specific reporting requirements (California Codes Health and Safety Code Sections 130100-130155). The following are statutory requirements for financial reporting:

- Counties are to have a process to track and monitor administrative costs with periodic reports to the commission (quarterly in many counties). (Section 130140(d)(5)) and 130151(b)(2).
- Policies are needed to assess and communicate the financial condition of the commission. (Section 130151(b)(6))
- Commissions are to track evaluation expenditures and document results of expenditures. (Section 130151(b)(7))

6.1 COUNTY COMMISSION REPORTING

On or before October 15 of each year, the State Commission and each county commission shall conduct an audit of, and issue a written report on, the implementation and performance of their respective functions during the preceding fiscal year. At a minimum, this report should include which funds were expended, the progress toward and the achievement of program goals and objectives, and the measurement of specific outcomes through appropriate indicators (Section 130150). The audits and reports of each county commission shall be transmitted to the State Commission and the State Controller's Office by November 1 (Section 130150 (a)).

The county commission shall conduct at least one public hearing prior to adopting any annual audit and report (Section 130140 (G)).

Each county commission shall make copies of its annual audits and reports available to members of the general public on request and at no cost (Section 130150 (d)).

6.1.1 County Commission Reporting of State Commission Information

The State Commission shall make copies of each of its annual audits and reports available to members of the general public on request and at no cost. The State Commission shall furnish each county commission with copies of those documents in a number sufficient for local distribution by the county commission to members of the general public on request and at no cost (Section 130150 (c)).

The county commission conducts at least one public hearing on each annual report by the State Commission prepared pursuant to subdivision (b) of Section 130150 (Section 130140 (H)).

6.1.2 Best Practices

Best practices in financial reporting for local government have been established and maintained by the Governmental Accounting Standards Board (GASB) and the Government Finance Officers Association (GFOA). The GASB provides a formal standard setting process for annual financial reports, using statements and other technical pronouncements to continually improve reporting practices. As part of the annual planning and financial reporting process, commissions should review all GASB pronouncements and consider the impact on the organization and its financial statements. While some GASB pronouncements may have little or no impact to First 5 organizations, others may entail significant implementation efforts and at times may require additional reports either internally or externally (such as from actuaries). Adequate planning is necessary in order to ensure the proper implementation of applicable GASB statements. The GFOA provides guidelines for reporting excellence and administers an awards program to recognize effective financial reporting by state and local governments. The criteria used in this program have become the benchmark for government reporting. The GFOA and the GASB can be consulted for implementation guidelines pertaining to new GASB statements.

6.2 POLICY STATEMENT

Commissions will report financial information to supply the appropriate individuals the right information, at the proper time, and in the correct format. Specifically, management will take steps to achieve the following goals identified by GFOA for external and internal reports:

- *Content* – financial reports balance competing demands for completeness and conciseness.
- *Timeliness* – information is received soon enough to take effective action.
- *Currency* – the information communicated is current.
- *Accuracy* – the information is reliable (not necessarily precise).
- *Access* – the information is accessible to those who need it.

Annual financial statements will be prepared in accordance with generally accepted accounting principles (GAAP). Likewise, annual financial statements will be independently audited in accordance with generally accepted government auditing standards (GAGAS).

Independent commissions may issue comprehensive annual financial reports (CAFRs) that include the required financial statements and appropriate introductory, supplemental, and statistical information. Although all commissions are required to conduct an annual audit, those that are county government agencies or component units are not required to issue CAFRs as such detailed financial information is reported in the county government's comprehensive report. However commissions are encouraged to prepare CAFRs if they are able to do so.

6.3 PROCEDURES

6.3.1 External Reporting

External reporting refers to the annual public distribution of “general-purpose” financial statements designed to meet the basic financial information needs of a variety of potential users, including taxpayers and citizens, oversight and legislative bodies, and investors and creditors. The goal of external reporting is to provide the information needed by interested parties to gain a fair understanding of the government’s financial position and results of operations. External reports are developed in conformity with GAAP. GAAP requirements are designed to provide all primary users of general-purpose external financial reports with the reliable information needed to assess an entity’s finances.

External reporting is a fundamental responsibility of all governments. This section describes two types of external reports local commissions need to provide—the comprehensive annual financial report, or CAFR, and the popular report. Independent commissions typically prepare both a CAFR and a popular report, while county agency commissions often prepare just the popular report. However, some independent commissions do not prepare CAFRs.

The CAFR is an extensive financial disclosure of the commission’s use of funds for the year, financial performance, and the financial position at year-end. Budget information, government fund information, and government-wide information is presented. The comprehensive nature of the CAFR has evolved over time as the dimension of public disclosure has increased. Credit rating agencies, government financial analysts, and other government officials are the principal users of the CAFR. The popular report is an external report that summarizes the information in the CAFR and provides more subjective information about the governmental entity and the surrounding region. It has been crafted to better communicate with the citizenry.

6.3.2 Comprehensive Annual Financial Report (CAFR)

Commissions that produce a CAFR shall do so in accordance with applicable requirements and best practice standards in order to meet the expectations of their stakeholders. The CAFR opens with an Introductory Section to orient the user to the document as well as the governmental entity. The Financial Section provides the basic financial statements and detailed supplemental data. The Statistical Section provides relevant statistical data. Following is a discussion of each section, including examples of significant documentation requirements. Checklists helpful in the completion of a CAFR can be found on GFOA’s website under the Awards Program tab and the section entitled Certificate of Achievement for Excellence in Financial Reporting Program (<http://www.gfoa.org/coa>).

Introductory Section

This section of the CAFR, generally excluded from the independent audit, orients and guides the reader through the report. The introductory section generally includes:

- *Cover, Table of Contents, and Formatting.* General information about the name of the government, preparers’ names, a description of the three sections of the CAFR (Introductory, Financial, Statistical), the table of contents, and other explanatory information.
- *Letter of Transmittal.* This is a very important document designed to communicate the CAFR to the users. The letter is a chance to bring the reader’s attention to key topics included in CAFR, including legal requirements, management’s framework of internal control, independent audit, and single audit. It also directs attention to Management’s Discussion and Analysis (MD&A) in the Financial Section. The letter of transmittal is often used to provide information useful for assessing the commission’s financial position, as well as information about the commission itself.
- *Other material deemed appropriate by management.* GFOA’s Certificate of Achievement for Excellence in Financial Reporting Program specifies the following *other material* for inclusion in the introductory section of a CAFR:
 - Organizational chart;
 - List of principal officials; and
 - Reproduction of the prior year’s Certificate of Achievement for Excellence in Financial Reporting (if applicable).

Financial Section

The financial section of the CAFR presents the basic financial statements of the commission, preceded by the independent auditors’ report and the MD&A. Basic financial statements include the government-wide financial statements, fund financial statements, and the related note disclosures. In addition to the basic

financial statements, note disclosures, and the MD&A, the financial section includes detailed financial data and other applicable required supplementary information (RSI).

- *Independent Auditors' Report.* This is the first document presented in the Financial Section. The Independent Auditors' Report needs to express an opinion on fair presentation of the basic financial statements in conformity with GAAP, and indicate that the audit was conducted in conformity with generally accepted government auditing standards.
- *Management's Discussion and Analysis (MD&A).* The MD&A precedes the basic financial statements and provides a brief, objective, and clear introduction to these financial statements, including an analysis of financial performance for the year and the financial position at the end of the year. The analysis is based on facts, decisions, and conditions and addresses whether the government's overall financial position has improved or deteriorated during the reporting period. The government should disclose any other "currently known facts, conditions, or decisions" that are expected to have a significant effect on financial position (net position) or results of operations (revenues, expenses, and other changes in net position).

For commissions, the MD&A is an opportunity to add information that may be more accessible to the general public than the financial statements alone. The MD&A can include such issues as whether the tobacco revenue is in line with projections, links between the financial picture and the strategic plan, the impact of the market on investment return and projections, and status of commission reserves.

If economic factors significantly affected the operating results of the current period, they should be discussed as part of this analysis. Significant budgetary variations (both original budget versus final amended budget and final amended budget versus actual) for the general fund are also discussed.

Restrictions, commitments, or other limitations significantly affecting the availability of fund resources for future use are also included. Discussion of "possible" future events should not be included in the MD&A, but rather is appropriate for the Letter of Transmittal.

The MD&A describes the basic government-wide financial statements and the basic fund financial statements, as well as the difference in the kinds of information provided by each. Condensed financial data, extracted from the government-wide financial statements, is included in the MD&A:

- Total assets (distinguishing between capital and other assets)
- Total liabilities (distinguishing between long-term liabilities and other liabilities)
- Total net position (distinguishing net investment in capital assets [net of related debt]; restricted net position; and unrestricted net position)
- Program revenues (by major source)
- General revenues (by major source)
- Total revenues
- Program expenses (at least by function)
- Total expenses
- Excess (deficiency) before contributions, special and extraordinary items, and transfers
- Contributions (to term endowments or permanent fund principal)
- Special and extraordinary items
- Transfers
- Change in net position
- Ending net position

Financial Statements

The financial statements of the commission include fund (general fund, special revenue) financial statements and government-wide financial statements prepared in accordance with GAAP, and notes to the financial statements. The fund financial statements are prepared on the modified accrual basis, the

basis of accounting recommended in Chapter 4, *Accounting*. That information will need to be converted to a full accrual basis to prepare government-wide financial statements.

There are two financial statements required for government funds (including special revenue funds established for county- agency commissions):

- Balance sheet and
- Statement of revenues, expenditures, and changes in fund balance.

There are two financial statements required for government- wide reporting (the reporting used by independent commissions):

- Statement of net position and
- Statement of activities.

Required Supplementary Information (RSI). RSI is required information that is reported in addition to the basic financial statements. RSI includes the MD&A which was discussed earlier. The other major RSI that commissions need to provide is the budgetary comparison schedule, and defined benefit schedules.

Budgetary comparison schedules are needed for the General Fund and major Special Revenue Funds. The schedule needs to include the adopted budget, the final budget, and the actual results. Actual results need to be presented on the same accounting basis as the budget. If the budget is not based on modified accrual accounting, the commission will need to reconcile the two different accounting bases in a separate schedule or note to the RSI.

Much, if not all, of a commission's internal reporting will be consistent with the budgetary basis which is not in accordance with GAAP. Reporting in accordance with GAAP is primarily for the benefit of outside users of the financial statements, whereas internal reporting focuses its attention on management, elected officials and others primarily interested in the flow of financial resources and compliance reporting. It is recommended that commissions place equal emphasis on external and internal reporting.

For the fiscal year ending June 30, 2015, GASB Statement No. 68 defined recognition and disclosure requirements for state and local government employers providing defined benefit pensions to employees. Defined benefit schedules for single or agent employer plans need to be presented covering the past 10 years regarding:

- Sources of changes in the components of the net pension liability
- Ratios that assist in assessing the magnitude of the net pension liability
- Comparisons of actual employer contributions to the pension plan with actuarially determined contribution requirements, if an employer has determined contributions.

Commissions participating in a cost-sharing multiple employer retirement system must disclose additional pension information in the notes to the financial statements as well as additional RSI. While some reporting requirements differ for single employer and agent plans, the general RSI requirement includes the following ten-year (prospective only) disclosures:

- Annual money-weighted return on plan investments
- Total Pension Liability, Net Pension Liability, funded status and related ratios
- Schedule of proportionate share and changes in Net Pension Liability
- Contribution schedules

Commissions should request the required information from their retirement system. Commissions may be required to reimburse the retirement system for the additional actuarial studies and staff time necessary to prepare the disclosures.

As part of a contractual agreement, the State Commission may impose additional reporting requirements that must be fulfilled by commissions before state funds are disbursed. For example, the State Commission could amend the annual report guidelines to request a supplemental report that would show state funds received and local funds committed to meet the state match.

Statistical Section

The statistical section provides financial and statistical data that better informs the user about the commission's activities. Trend data is provided, where available, for 10-year periods. Following are the required statistical section categories generally related to commission activities. Commissions can provide other historical trend data as they deem appropriate.

- Financial trends information
- Revenue capacity information (primary revenue sources)
- Demographic and economic information
- Operating information

Public Participation

The commission is required to have an annual audit pursuant to Section 130150 of the Health and Safety Code. A public hearing must be held to receive citizen input on the annual audit report to First 5 California. The annual audit must be submitted to the State Commission by November 1 of each year. The State Commission prepares a written report that summarizes and consolidates the annual audits of all the county commissions for the preceding year. This report is submitted to the governor, the legislature, and each county commission.

Popular Report

Many governments also issue financial reports that more effectively communicate financial information to the public. This summary report, referred to as a popular report, is less technical and less complex, but provides reliable information. Popular reports use the audited information from the CAFR, as well as other relevant data about the commission.

All commissions are encouraged to issue popular reports. The greatest benefit of issuing a popular report is the ability to communicate effectively with stakeholders concerning the performance of the commission. Many stakeholders who do not have extensive government finance experience will find the popular report format more useful than the CAFR.

6.4 AUDIT

6.4.1 Audit Requirements

All commissions are required to conduct an independent audit of the basic financial statements. For commissions receiving federal financial assistance, possibly from several different federal grantor agencies, the Single Audit Act allows a single audit to meet the needs of all federal grantor agencies. This single audit can be performed by the commission's external financial auditor, if contracted for, or by another third-party auditor (see Single Audit discussion below).

The audit requirements refer to an external review required by an independent audit firm to determine that the financial statements fairly present the financial position of the agency being audited in accordance with GAAP. Auditors make this determination based on a review and testing of financial data maintained by the commission. In general, there are two types of opinions that auditors can make after review of the financial information:

- An unmodified or "clean" opinion is one in which the auditor can state without reservation that the financial statements are fairly presented in conformity with GAAP.

- A modified opinion is one in which the auditor expresses reservations about the fair presentation of the financial statements in conformity with GAAP. A common reason for a modified opinion may be that the data provided is insufficient to support the information provided in the financial statements.

Particular audit requirements include:

- *Auditor Rotation.* Government Code Section 12410.6(b) requires Commissions to rotate, after six consecutive years, lead or coordinating audit partners who either have primary responsibility or reviewing responsibility over the audit. Audit services provided before fiscal year 2013-14 should not be used in calculating consecutive years. The State Controller may waive this requirement if another eligible public accounting firm is not available to perform the audit.
- *Internal Controls.* It is a common practice for auditors to issue a report on the internal controls tested as part of the financial statement audit. Auditors will consider issues such as segregation of duties, existence of regular reporting processes, and internal mechanisms to prevent and detect instances of noncompliance or, in extreme cases, negligence or fraud. As instances are identified, these issues should be brought to the attention of management and the commission.
- *Management Letter.* The most common forum for auditors to communicate all reportable conditions is known as the management letter. The management letter provides a vehicle for the auditor to share concerns or other issues identified and to recommend appropriate management corrective action. Auditors may express concerns in the management letter that are not materially significant enough to result in a change in the opinion. Commissions and the fiscal officer/director should document and monitor the actions that will be taken during the next fiscal year in response to the concerns/comments outlined in the management letter. The management letter may also indicate that the auditors have no concerns.
- *Acceptance of Annual Financial Audit.* The commission reviews the annual independent audit report, including discussion of reportable conditions, internal controls and management points. After review, the commission approves and accepts the independent audit, identifying specific appropriate corrective actions to any financial or management risks noted in the audit.
- *External Auditor Involvement in Preparing Financial Statements. Communicating Internal Control Related Matters Identified in an Audit.* Each commission must produce its financial statements and footnote disclosures accurately. Current auditing standards restrict the types of non-audit work that an auditor may perform without sacrificing independence. Under AICPA interpretations, auditors may draft statements if they are placing the financial information into correct form without making management decisions or making entries into the accounting records of the commission. For example, auditors may prepare draft statements from the commission's balanced trial balance, prepare draft disclosures from information provided and approved by management, and the auditor may suggest adjustments if they are understood and approved by the commission. The critical issue is that auditors cannot be part of a commission's internal control structure because, in addition to performing traditional audit functions, the auditor is also required to evaluate internal control deficiencies during the audit process. If identified deficiencies are considered significant or material weaknesses, the auditor must communicate them to management or other officials.

6.4.2 Expanded Audit

In addition to the standard financial audit, commissions are now required to go through an expanded audit per state code section 130151 (1 through 8). Commissions hire the same auditor to complete the financial and expanded audits, and both are presented and submitted as one package. Commissions can view the expanded and financial audit as one audit with two components: 1) the financial audit, which is monitored by First 5 California, and 2) the compliance audit, which is monitored by the State Controller's Office (SCO).

The expanded audit covers the following items:

- Contracting and procurement policies: a policy consistent with state law and adopted in a public meeting and a legal representation letter should be in place. A new legal representation letter is required annually even in the policy did not change.
- Administrative costs: administrative costs should be defined and a cap should be established at a public meeting. Costs should be monitored.
- County ordinance creating county commission: policies and procedures should ensure compliance with the county ordinance. The auditor will review the commission’s strategic plan.
- Long-range financial plan: the plan should be adopted at a public meeting.
- Financial condition of commission: policies and practices for reporting financial condition should be in place.
- Amount spent on program evaluation and related results: a policy regarding evaluation costs should be in place. The auditor will verify that the amount spend on evaluation complies with the policy and that evaluation data were collected.
- Salaries and benefits: policies and procedures for establishing employee salaries and benefits should be in place.
- When audit findings have been reported in prior years, the current audit report must include a schedule of prior audit findings and the disposition of such findings.

Per expanded audit requirements, commissions must adopt conflict of interest policies for commission members that are consistent with applicable state law. These policies must ensure that the commission complies with all applicable state and local conflict of interest statutes and regulations. Commission staff members are advised to do the following to achieve compliance:

- Adopt a conflict of interest policy in a public meeting. Ensure that minutes of this meeting are available for auditors.
- Obtain a letter from legal representative that states that commission’s policy is consistent with applicable state and local laws and regulations.
- Make conflict-of-interest policy available to auditors.
- Have minutes documenting appropriate abstentions for contract award actions available.
- Review Form 700 (Economic Interest) filings.

The SCO has produced an Expanded Audit Guide, Standards and Procedures for Audits of Local Entities Administering the California and Families Act (First 5). The Expanded Audit Guide along with Frequently Asked Questions can both be accessed in the resources section at the end of this chapter. It is important to oversee the audit process and ensure that the auditors are complying with the requirements of the Expanded Audit Guide.

In addition, it is important for commission staff and auditors to check the State Controller’s website regularly for advisories and revisions to expanded audit guidelines to assure continued compliance.

6.4.3 Single Audit

The fundamental standards of financial audits in the public and private sectors are provided by *generally accepted auditing standards* (GAAS) established by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA). The ASB has issued a formal Statement of Auditing Standards (SAS) that establishes basic auditing standards. In the public sector, there is a second set of standards that commonly guides financial audits. These standards are set by the Comptroller General of the United States and are found in the General Accountability Office (GAO) publication, *Government Auditing Standards*, or the Yellow Book as it is commonly known. The terms *generally accepted government auditing standards* (GAGAS) or *government auditing standards* (GAS) are commonly used to describe these standards.

The Office of Management and Budget published the *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* in December 2013. The “Super Circular” supersedes OMB

Circulars A-21, A-87, A-89, A-102, A-110, A-122, A-133, and the guidance in Circular A-50 on Single Audit Act follow-up. Commissions expending less than \$750,000 in federal awards during the fiscal year are exempt from Federal audit requirements for that year. Commissions exempt from the single audit requirement must continue to maintain records for review or audit by appropriate officials for the Federal agency, pass-through entity and US Government Accountability Office (GAO). Commissions expending \$750,000 or more per fiscal year in federal awards will be subject to the provisions of the Single Audit Act with expenditures tested accordingly. Expenditures include expenditure/expense transactions associated with grants, cost reimbursement contracts, and cooperative agreements and direct appropriations. They also include amounts disbursed to sub-recipients (pass-through grants), the use of loan proceeds under loan and loan-guarantee programs, the receipt of property, the receipt of surplus property, the receipt or use of program income, the distribution or consumption of food commodities, the disbursement of amounts entitling an entity to an interest subsidy, and insurance (during the award period). The circular became effective on December 26, 2013 with full implementation for all non-Federal entities no later than December 26, 2014.

6.4.4 The Role of the Audit Committee

A strong and responsible audit committee can improve the effectiveness of the audit process and assist in maintaining the integrity of internal control and financial reporting. Not all commissions have a formal audit committee, but other committees may perform this function. If the audit and audit review process are conducted by staff only, the services of a financial advisor should be made available.

Written documentation should outline the scope of the Committee's responsibilities, as well as structure, process, and membership requirements. All members of the audit committee should possess or obtain a basic understanding of financial reporting and auditing. In addition, the audit committee should have access to the services of a financial expert -- either a committee member or an outside party engaged for this purpose. Typical audit committee responsibilities include:

- Selection of the external auditor
- Review of material findings
- Oversight of internal control and financial reports/statements
- Set up procedures for filing complaints about financial controls, processes, and related complaints.
- Serve as communication link between commission, auditor, and management

The audit committee should present annually to the full commission a written report of how it has fulfilled its duties and met its responsibilities. The report should also specifically document that it has discussed the financial statements with management, with the independent auditors in private and privately among Committee members, and believes that they are fairly presented, to the extent that the determination can be made based solely on conversations.

6.5 INTERNAL REPORTING

This section provides recommendations for an internal reporting framework. This section does not represent reporting in accordance with GAAP, but rather reporting in accordance with budgeting processes. As was noted earlier, external financial reports that follow GAAP generally have a different look and focus than internal reports. Internal reporting typically is designed to accomplish two goals:

- allows management to monitor compliance with legal and contractual provisions applicable to the management of public funds; and
- provides management with the information on current performance that it needs to make future financial plans.

Because internal reports are designed to serve the needs of management, management is free to select the format and content it believes is most relevant, with timeliness being a key consideration for their use as monitoring or planning documents. It is recommended that commissions place equal emphasis on external and internal financial reports and recognize that each has a different user base.

Internal reports should be regularly issued to each commission's management team for review and approval and with sufficient time for commissioners to review prior to presentation at commission meetings.

6.5.1 Balance Sheet

Public sector entities typically produce balance sheets only at year-end, with the exception of reporting for enterprise funds and other business-type operations. However, commissions may choose to produce monthly or quarterly balance sheets. If commissions decide to include balance sheets as part of their internal reporting, they should include the following:

- *Assets.* Assets should include cash, receivables, and amounts due from other funds or county agencies.
- *Liabilities.* Liabilities should include accounts payable, accrued liabilities, and amounts due to other funds or county agencies.
- *Fund balance.* The fund balance category is of particular importance for First 5 commissions given the long-term perspective under which they operate. Fund balance includes funds committed for multi-year initiatives and programs. Proper reporting for fund balance provides an opportunity for commissions to report on how they have committed funds over a period of years. Effectively accounting for fund balances involves recognizing major organizational decisions concerning the future use of funds, with varying levels of obligation. A consistent application of the methods for committing funds is essential.

A commission may report on fund balance during the fiscal year or only at year-end. Consistent with GAAP reporting, fund balance is reported within the balance sheet in *governmental funds* financial statements – for example, general fund and special revenue funds -- in the Comprehensive Annual Financial Report.

6.5.2 Fund Balance

The term *fund balance* is commonly used to describe the difference between assets and liabilities. However, in governmental funds, fund balance is more of a measure of liquidity than of net position, because governmental funds report only financial assets, not illiquid assets such as the value of buildings. But it is not strictly a measure of liquidity, because some of the assets reported may be inherently non-spendable, such as supplies inventories. Consequently, a good definition of fund balance for governmental funds is: *all financial assets less liabilities normally expected to be liquidated with current financial resources.*

To be in conformance with generally accepted accounting standards, First 5 county commissions must report fund balance consist with Statement 54 of the Government Accounting Standards Board (GASB).

Financial Statements of First 5 Commissions may include up to five components of fund balance. Because each commission's circumstances are different, not all county commissions will have to show amounts in all of these components. The five possible components include:

- Nonspendable fund balance
- Restricted fund balance
- Committed fund balance
- Assigned fund balance
- Unassigned fund balance

Reporting encumbrances in fund balance. With the advent of GASB Statement No. 54, encumbrances are no longer reported in fund balance. Instead, material encumbrances would require footnote disclosure. Or, if the commission, or the county within which a commission operates as a county agency, has a policy of recording encumbrances at the time a purchase order is created, the value of all outstanding purchase orders and contracts (where no invoice has been received for payment) for future periods would be included in the footnote disclosure.

Materiality in auditing and accounting relates to the importance of an amount, transaction or discrepancy. It usually depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. In government, materiality has both a quantitative and a qualitative aspect, where materiality often concerns the nature rather than the size of an amount, such as illegal acts, bribery, corruption and related party transactions. Because of the importance of transparency in the public sector, commissions should discuss with and understand the level of materiality that will be chosen by the auditors of their financial statements.

Nonspendable Fund Balance

This category includes elements of the fund balance that cannot be spent because of their form, or because they must be maintained intact. For example:

- Assets that will never convert to cash, such as prepaid items and inventories of supplies;
- Assets that will not convert to cash soon enough to affect the current period, such as non-financial assets held for resale; or
- Resources that must be held intact pursuant to legal or contractual requirements, such as revolving loan fund capital or the principal of an endowment.

First 5 commissions that have assets such as prepaid items or supply inventories, or that manage endowments where the principle may not be spent, will report such assets in this component.

Restricted Fund Balance

This category includes resources that are subject to constraints that are externally enforceable legal restrictions. Examples include:

- Funding from the State Commission or foundations that are legally restricted to specific uses. For example, funds advanced by First 5 CA under specific agreements for services, such as Regional Technical Assistance funds or matching funds for specific initiatives.
- Funding that has been designated for legally enforceable contracts but not yet spent. This includes multi-year contracts.
- Funds legally restricted by County, state, or federal legislature, or a government's charter or constitution.
- Amounts collected from non-spendable items, such as the long term portion of loan outstanding, if those amounts are also subject to legal constraints.

Tobacco tax allocations to county commissions are not automatically categorized as restricted fund balance. This is because the purposes for which tobacco tax allocations may legally be used are no narrower than the purpose for which the commissions were created in Proposition 10 enabling legislation. Therefore, tobacco tax allocations remaining in fund balance must be reported in one or more of the components according to the guidelines provided in this Financial Management Guide and Statement 54.

Committed Fund Balance

Two criteria determine the Committed fund balance:

- Use of funds is constrained by limits imposed by the government's highest level of decision making (for First 5 county commission, this is the local commission).
- Removal or modification of use of funds can be accomplished only by formal action of the authority (i.e., local commission) that established the constraints.

Both commitments and modification or removal must occur prior to the end of reporting period; that is, the fiscal year being reported upon. For First 5 commissions, resources in this category would include:

- Resources committed for a future initiative as long as commission action is also required to remove this commitment.
- Resources that have been committed by a commission for specific agreements that have not yet been executed, where commission action is also required to remove this commitment.
- Resources committed as the local match for a State Commission initiative.

Assigned Fund Balance

The assigned portion of the fund balance reflects a commission’s intended use of resources, which is established either by the county First 5 Commission, a body created by the commission, such as a commission finance committee, or an official designated by the commission (e.g., an Executive Director).

The “assigned” component is similar to the “committed” component, with two essential differences, shown in the following table:

Key Differences Between Committed and Assigned Fund Balance		
	Committed	Assigned
A decision to use funds for a specific purpose requires action of First 5 Commission	Yes	No
Formal action of Commission is necessary to impose, remove or modify this constraint and formal action has taken place before end of reporting period	Yes	No

Another key difference is that the purpose of the assignment must be narrower than the fund itself. Consequently, tobacco tax revenues would not automatically be placed in the “committed” component. Resources that fit into this category include:

- Appropriation of a portion of existing fund balance sufficient to eliminate a projected deficit in the subsequent year’s budget, where the Executive Director may decide whether to use the entire amount.
- Resources assigned to a specific program or project or organization for which the commission has approved a plan or budget
- Resources approved by a commission for a long range financial plan where formal approval is not required to modify the amount.

Unassigned fund balance

Resources in the fund balance that cannot be classified into any of the other categories are included here.

6.5.3 Operating Statement

Each commission should prepare a regular statement of revenues and expenditures. Providing monthly operating statements to the commissioners is a best practice, but since some commissions do not meet monthly, the reports are given when needed, at least quarterly or at each commission meeting. At a minimum:

- Revenue should be classified by major sources: 1) general- purpose revenue, including tobacco tax revenue, interest earnings, and miscellaneous revenue; 2) special-purpose revenue (e.g., state school readiness program revenue); and 3) other sources (e.g., transfers from the long-term commitments account).

- Expenditure items should be classified by major category, such as personal services, supplies, and equipment. County- agency commissions are usually reliant on the county auditor- controller's office for financial reports. As long as these reports are presented in sufficient detail and in a format that enables commissioners and staff to understand their financial situation, the responsibility of the commission has been fulfilled. If standard county reporting formats are insufficient, commissions may need to request the creation of reports designed for their particular needs. Most modern automated financial systems are able to produce special reports.

7 INTERNAL CONTROL

Well-designed internal control elements allow for commissions to fulfill their purpose by promoting efficient operations, safeguarding against waste and fraud, ensuring adherence to regulations, and developing reliable financial and management data.

The purpose of this chapter is to relay the basics of an internal control framework and assist commission efforts in establishing one.

Appropriate internal control functions will allow commissions to mitigate financial risks, continually assess new risks and minimize operational distractions to achieve the key results established in a commission's strategic plan. The First 5 expanded annual audit addresses a particularly important element of an internal control framework: establishing a conflict of interest policy. The guidelines in this chapter are based on best practices and are designed for use by any size commission.¹

Effective internal controls create an environment where risk of abuse is reduced, but procedures are not so cumbersome as to slow day-to-day operations. Though commission management is ultimately responsible for creating this environment, staff at all levels play a crucial part in developing and maintaining it. When qualified staff are employed based on the required duties of the position, are adequately trained, and are kept apprised of commission internal control policies and procedures, they are best positioned to support a strong environment of internal controls.

7.1 POLICY STATEMENT

While the mission and impact of the First 5 initiative is achieved through various programs and activities, it is also the product of efficient and effective management and administration.

Commissions should clearly and consistently maintain an internal control framework by developing a control policy and accompanying procedures that establish a commitment to reducing risk of loss and preserving commission resources. This document should briefly explain the objectives/goals of the commission, the ethical standard expected from employees, and the policies/procedures it is committed to adhering to in order to meet those objectives.

7.2 INTERNAL CONTROL FRAMEWORK

A commission's internal control framework incorporates the organization's overall approach to internal control and explains how internal control is integrated into commission governance, management, and day-to-day activities.

The following are the basics of a good framework:

- *An effective control environment.* The success of any control measure is dependent upon an environment that fosters its success. A favorable control environment is one in which management is knowledgeable about internal controls, is committed to establishing and maintaining controls, and actively communicates support for those controls to the entire organization. Without establishing a control environment, control functions will likely fail.
- *Continual risk assessment.* In order to adequately address vulnerabilities, they first must be known. Risks can reside within the organization (improper cash handling process) or be external (changing client demographics). A sound framework will allow management to identify new risks and be prepared to respond to them.
- *Effective control-related policies and procedures.* Once risks have been identified, management needs to take steps to diminish them. There are a variety of tools and concepts

that are designed to achieve this goal, depending on the risk identified. For example, the creation of a document retention policy allows for a standard and agreed upon time within the commission that documents will be kept.

- *Effective communication of information.* All commissions need to capture relevant information and disseminate it in a timely manner. Commissions need to choose the appropriate format and medium for that communication, as well as identify the party and timing of delivery. Written documentation of policies and procedures is a primary means for communicating information about internal control to employees. Employees should be offered periodic training on internal control to facilitate their implementation.
- *Internal control monitoring.* Not only is it important to establish controls, but it's equally important to monitor their effectiveness and change policy if necessary. If a control does not seem to assist in alleviating potential risk issues, it should be changed. The cost of controls should be weighed against the benefit expected to be produced by the controls.

Although internal controls and responsibility involve everyone in the commission, it is important to stress that management sets the tone for a control environment. Once controls are established it is vital that managers follow those policies and “set the tone from the top.” The commission’s audit committee should provide independent review and oversight of the framework of internal control.

7.3 RISK ASSESSMENT STRATEGIES AND TOOLS

To begin implementing an effective internal control strategy, commissions must first identify areas of vulnerability to loss. This task requires that commissions first ensure that operational objectives have been identified. These objectives are the “who,” “what,” “where,” “how,” and “why” of the commission’s core mission, as well as the purpose of the individual units within the commission.

Once the commission’s objectives have been clearly defined, managers should begin a risk assessment, to determine the activities exposing the commission to the greatest risk of loss. Certain changes within a commission should be immediate “red-flags” for management that the commission is potentially at risk. These changes include:

- Changes in the operating environment, due to political pressures, regulation changes, legislative changes, funding cuts, etc.
- Changes in personnel, especially in high level or employees in sensitive positions
- Changes in technology or information systems
- New programs or services

The risks above are the less “day-to-day” type risks that a commission may face. Listed below are samples of areas where most commissions would need to focus their assessment activities for more routine operational activities.

- Cash receipt operations
- Contracted services
- Direct third-party beneficiaries - the closer a benefit is to cash (food stamps, public assistance) the more likely there is to be abuse
- Asset and supply management

7.4 CONTROL-RELATED POLICIES AND PROCEDURES

This section discusses the importance of the design, implementation, and maintenance of control-related policies and procedures. Written policies and procedures should be developed for internal controls, and these should be tailored based on the nature of transactions and activities of each commission.

Responsibility for development of internal control policies and procedures typically rests with the finance department which develops control-related policies and procedures for all departments to follow. Typical steps taken by finance officers include:

- Maintaining appropriate controls based on balances and activities of the commission
- Testing controls to ensure their effectiveness
- Reviewing and updating control procedures on a regular basis
- Weighing the cost of controls against the benefit provided
- Developing a written internal control policies and procedures

As a starting point in developing specific internal controls, commissions should assess their financial system. Each commission's system for recording and tracking financial data should either do or enable management to do the following:

- Assemble relevant information
 - The system should record all transactions relevant to finance
- Analyze the assembled data
 - The system should be able to relate one transaction to another
- Classify/assemble data
 - Financial information should be grouped logically in a chart of accounts
- Record assembled data
 - Journals are used to record individual transactions
 - Ledgers are used to record account balances
- Furnish data needed for internal and external financial reporting on a timely basis
 - Financial data is used for making decisions; therefore the value of the data decreases if it can't be accessed quickly.
- Maintain accountability over the commission's assets
 - System serves as a clearinghouse of all of the commission's assets.

The second step to controlling risk in financial reporting is to insure reports are accurate and that the assets and liabilities presented in the report actually exist, the accounting is accurate, and that the report is complete. Control-related policies and procedures for financial reporting are commonly categorized into the following areas:

- *Authorization.* A good step in controlling reporting is to ensure that the appropriate parties, in accordance with procedure, authorize all transactions. An extra level of control is to get transaction approval in writing. This provides both an audit trail, as well as documents that approval was given before the transaction took place.
- *Proper Design of Records.* Another important element of solid control procedures is to ensure that financial records are well designed. Characteristics of well-designed records include:
 - Sequential Numbering
 - Automatic Duplicates
 - Avoiding Unnecessary Information
- *Security of Assets and Records.* Accounting records can contain information often not appropriate to leave in the open. A system of securing assets and records should contain the following features:
 - Controlled Access:
 - Employees should only have access to records necessary for their job functions
 - Passwords to electronic files and software should be changed periodically
 - Physical Security
 - Protect against loss or theft by keeping supplies in locked cabinets
 - Deposit checks in a timely manner
 - Use a "check-out" system for files to keep track of who has what
 - Back up Computer Files
 - Disaster Recovery

- *Segregation of Incompatible Duties.* An incompatible duty is one that would put a single individual in the position of being able to commit a financial misdeed and also conceal it. In general, the person who authorizes a transaction should not then record that transaction and take possession of the goods acquired through the transaction. Also, for significant activities, one employee should prepare work with a separate employee reviewing and approving the work. Examples of work appropriate for supervisory review and approval may include cash and investment reconciliations and preparation of financial reports.

In a large commission, there may be separate departments responsible for these functions. In a smaller commission, it should be separate people. Commissions should consider utilizing staff or people who might not be in a finance role to achieve this segregation.

- *Periodic Reconciliation and Verification.* Accounting records should be compared periodically and data in the accounting records should be compared to what that data purports to represent such as a physical inventory of assets.
- *Analytical Review.* This type of review is conducted to assess what the financial reports can tell you about what is happening in the commission, such as fund balance irregularities and spending in certain accounts that are out of line with the norm.

7.5 EXAMPLE INTERNAL CONTROLS

Based on typical account balances of First 5 commissions, some example internal controls are as follows:

- *Cash and investments:* limitations on amounts of petty cash that may be maintained, careful controls over *petty* cash, monthly account reconciliation between bank account balances and general ledger, policies and procedures regarding investments, segregation of duties regarding cash receipt and disbursement.
- *Capital assets:* periodic reconciliation of subsidiary capital asset ledger with general ledger, periodic physical inventory/*inspection* of assets, use of asset coding mechanism such as bar code to control assets, policy regarding disposal of obsolete assets. Inventories of non-capitalized items that are susceptible to theft (such as computers and electronic devices) are also appropriate.
- *Liabilities:* proper *segregation* of duties between those approving invoices for payment and those processing the payments, vendor set up controls to limit the risk that a fictitious vendor is created.

For significant transaction activity of typical First 5 commissions, some example internal controls by major transaction type are as follows:

- *Revenue/receipts* – verification that amounts anticipated from the state are properly received, adequate segregation of duties related to receipt of cash, practice of receiving funds electronically where possible,
- *Disbursements* – segregation of duties between authorization for payment and payment processing, proper approvals in place prior to processing, use of encumbrance accounting for optimal budgetary control over disbursements, requirement that payments be made by central accounting office and not through any separately held accounts.
- *Purchasing/procurement* – adherence to procurement policies and procedures which conform to state requirements, use of standardized contract language, procedures for monitoring vendor performance in accordance with contract terms.
- *Payroll* - use of position control to ensure actual staffing is adequately budgeted, appropriate controls over time and attendance, employee leave, and other personnel policies. Segregation of duties for establishing new employees and for terminating employees from staff responsible for payment of employees. Proper supervisory approval for payroll transactions such as overtime, leave, time without pay, etc.

- *Financial reporting* – procedures for periodic closing of accounting records and preparation of financial reports, procedures to examine balances compared to prior year and budget with explanation of significant variances or unexpected results, review and approval by an individual other than the preparer, periodic reporting to commission, annual external audit by an independent certified public accountant.
- *Budgeting* – policies and procedures for development of annual budget and for amendment to the budget. Approval of budget modifications based on management policies. Periodic analytical review of activity in comparison to budget.

7.6 INFORMATION AND COMMUNICATION

Information and communication is the cornerstone of internal control. Staff at all levels should receive the information they need to achieve their goals, as well as information that communicates management's priorities. For information to be most useful to staff, it should be appropriate, accurate, timely, current, and accessible.

Channels of communication within a commission are very important. Not only should communication flow from top to bottom, but also, staff should be open to communicate up the chain of command as well. Most times, non-management employees can be in a better position than management to recognize a potential risk. It is also important to set up a system that would allow a path of communication for employees who believe that their supervisor is involved in inappropriate activities.

7.7 MONITORING

Once management has assessed its environment, identified its risks and has put communicated control policies in place, managers need to monitor these systems to ensure that they are functioning properly. Management uses many tools as controls. Reconciliations, verifications, and analytical reviews all assist in making financial decisions and in controlling potential risks to the commission. If a discrepancy should arise, it is management's responsibility to investigate and resolve the issue.

Two rules can be adhered to when following up on a potential control issue:

- Require some type of evidence for the discrepancy or problem, not an anecdotal explanation.
- Require that the resolution of all discrepancies be documented in writing and reviewed by a third party familiar with the event.

In accordance with AU-C Section 265, *Communicating Internal Control Related Matters Identified in an Audit*, auditors cannot be part of a commission's internal control structure because in addition to performing traditional audit functions, the auditor is also required to evaluate internal control deficiencies during the audit process. If identified deficiencies are considered significant deficiencies or material weaknesses, the auditor must communicate them to management or other officials.

8 ADMINISTRATIVE COSTS

Commissioners and other Proposition 10 stakeholders want to know not only that First 5 commissions are achieving results for California’s children, but also that funds allocated to commissions are spent wisely and efficiently. Health and Safety Code Sections 130140(d)(5) and 130151(b)(2) require that every county commission adopt a limit on the percentage of the county commission's operating budget that may be spent on administrative functions, pursuant to guidelines issued by the state commission that define administrative functions. As a best practice, the county commission’s policies and practices with respect to administrative costs should be periodically reviewed to ensure that the county commission's definitions comply with the state commission's guidelines. It is required by State law that the county commission has a regular process in place to monitor administrative costs.

Clearly defining administrative costs and establishing appropriate spending limits on such costs provide assurance to stakeholders that the maximum possible level of resources is spent on direct programs and services. This chapter establishes procedures for defining administrative costs and provides guidelines for commissions to use in setting spending limits on administrative activities.

It is important to understand the unique nature of First5 commissions and the purpose of Proposition10 in establishing administrative cost guidelines. A “one-size fits all” approach is not appropriate given the large variation in size, type (county agency or independent), and programming. Several factors, other than relative efficiency, affect the amount commissions spend on administrative functions. These factors are discussed below.

- *First 5's high level of contracting for services and emphasis on evaluation.* Enabling legislation and the structure of the First 5 initiative (for example, the level of contracting for services) distinguishes First 5 commissions from other governments, especially general-purpose governments. The level of effort devoted to planning, technical assistance, evaluation, and provider monitoring goes far beyond that of most general- purpose governments. While general-purpose governments provide most services themselves, most commissions contract for a majority of their program activities.
- *Allocation of support services.* Commissions may differ in the support services that are provided by their county government and how those costs are classified by commissions. For example, independent commissions do not have county support service charged to them unless they have decided to purchase services from their county governments. Another example of how county commissions differ is that county commissions may classify county services as program costs when direct client services are provided by county departments.
- *Economies of scale.* Smaller commissions typically have higher administrative cost percentages due to their inability to achieve the economies of scale available to larger commissions.

8.1 BEST PRACTICES AND STANDARDS

Costing Government Services

The full cost of a service encompasses all direct and indirect costs related to that service. Direct costs include the salaries, wages, and benefits of employees while they are exclusively working on the delivery of the service, as well as the materials and supplies, and other associated operating costs such as utilities and rent, training, and travel. Likewise, they include costs that may not be fully funded in the current period such as compensated absences, interest expense, depreciation or a use allowance, and retirement benefits. Indirect costs include shared administrative costs within the work unit and in one or more support functions outside the work unit (e.g., legal, finance, human resources, facilities, maintenance, technology). These shared costs should be apportioned by some systematic and rational allocation methodology and that methodology should be disclosed.

Departmental administrative costs are defined as expenses “...: which have been incurred for administrative and supporting services that benefit common and joint departmental activities. Departmental administrative costs are the costs of administrative and clerical salaries, office supplies, postage, local telephone costs, memberships, and other similar costs which support the basic missions of the university (instruction, research, and public services).”

United States Office of Management and Budget, Circular A-87 – *Cost Principles for State, Local, and Indian Tribal Governments*

Administrative costs are referred to as “central services.” Allocated central services refers to central services that benefit operating agencies but are not billed to the agencies on a fee- for-service or similar basis. These costs are allocated to benefitting agencies on some reasonable basis. Examples of such services might include general accounting, personnel administration, purchasing, etc.

8.2 POLICY STATEMENT

Consistent with the expanded audit requirements, each commission should adopt a written policy that defines administrative costs and sets an acceptable upper limit for administrative costs. Commissions should not only separate program costs from administrative costs, but also should establish a third category— evaluation costs.

Below are definitions for the three cost categories referred to above.

- *Administrative costs.* Costs incurred in support of the general management and administration of a First 5 commission, for a common or joint purpose that benefits more than one cost objective (other than evaluation activities), and/or those costs not readily assignable to a program or direct service.
- *Program costs.* Costs incurred by the commissions readily assignable to a program or service provider (other than for evaluation activities) and/or in the execution of direct service provision.
- *Evaluation costs.* Costs incurred by the commissions in the evaluation of funded programs based upon their accountability framework and data collection and evaluation for required reporting to state and local stakeholders.

Judgment and common sense must be used when applying these definitions to allocate costs to the three categories. For example, contract compliance costs may be appropriately classified in any of the categories. Time expended to ensure a contractor’s compliance with administrative contract requirements (determining if required insurances are in force and effect, for example) may be considered an administrative cost. Time expended to develop a contract for services or to review the contractor’s adherence to an adopted scope of work may be considered a program cost. Time expended to review contract outcome goals as compared actual contractor performance may be considered an evaluation cost. (The foregoing is applicable only if a commission decides to allocate costs to categories. In its discretion, a commission may decide to classify all contract compliance costs as administrative costs.)

Commissions should adopt a “principles-based” approach to defining administrative costs and setting limits on such costs that incorporates the following principles:

- Administrative costs are general in nature. This principle distinguishes between those costs that specifically and directly benefit a business unit, program, or evaluation activity from those that do not.
- Administrative costs support a commission’s basic mission rather than specific program goals. This principle distinguishes between the nature of costs that provide direct value to achieving specific program goals and objectives from those that do not.
- Evaluation costs pertain to those activities under taken to support the collection, production, and presentation of evaluation information to the state and local stakeholders.

8.3 PROCEDURES

Policy Adoption

Each commission should adopt a policy statement that:

- Defines administrative costs consistent with the above definition and requires adherence to this definition in its budgeting, accounting, and financial reporting processes.
- Establishes an upper limit on administrative costs as a percentage of budgeted total costs, based on an analysis of its administrative spending needs and best practice in government finance.
- Requires commission staff to report on administrative costs periodically during the year and as part of the commission's annual financial report.

Each commission will be responsible for ensuring compliance with the policy it sets. Procedures will be based on the following general parameters:

- All costs fall into one of three major categories: administrative, programmatic, or evaluation. Figure1 provides guidance on categorizing costs. Monitoring costs will be included in administrative costs unless those costs can be specifically associated with particular programs (for example, technical assistance to a service provider), in which case they may be included in program costs.
- Commissions will make their own determinations of where each of their cost elements fall, using the definitions provided for each category. However, any costs that a commission assigns to program costs that would typically be considered administrative in nature will require clear, auditable justification. Guidance for defining cost items may be found in GFOA's *Governmental Accounting, Auditing, and Financial Reporting*, which describes and defines "objects of expenditure" in Appendix E. Another point of reference is Figure1, which provides an example of how a commission may allocate costs.
- Staff costs may be assigned to program costs, as long as that time is limited to actual time spent on program-specific activities and appropriate records are maintained for audit and review purposes. One individual's time may be divided into more than one category, as long as accurate records are maintained. Staff salaries and benefits may be charged to each of the three categories, reflective of the proportion of work activity performed in each.
- Commission staff should use valid methodologies and tools for allocating costs. Valid methods include automated cost accounting systems, review of payroll records, cost-finding (a method for estimating costs based on observation, review of records, and interviews with employees), time studies, or other industry standards. While larger commissions may have the resources to establish automated cost accounting systems, smaller commissions will likely need to use a less formal and less precise (but no less legitimate) approach such as cost finding.

Organizational Procedures and Accountability Mechanisms

As part of the broader application of this administrative cost guidance, commission staff will play an integral role in adopting and executing this recommended practice. These procedures are provided below.

- Commission staff will be responsible for establishing cost elements for each of the three categories: administrative, program, and evaluation (seeFigure1).
- Commission staff will conduct an initial analysis to determine and document an upper percentage limit for administrative costs. Analysis should include a review of historical costs and benchmarking against other similar organizations (other First 5 commissions of similar size and demographics or non-profit agencies serving similar populations, for example).
- Commission staff will establish within the accounting and reporting system a methodology for

tracking and reporting on program, administrative, and evaluation costs.

- During budget preparation, commission staff will provide information on estimated costs to be included in the three categories of program, administrative, and evaluation.
- Commissions will maintain auditable records to ensure compliance with their administrative cost policy.
- Commissions should provide information on administrative and evaluation costs in reports that go to the public (budgets, annual financial reports, and community status reports) and use these reports to educate stakeholders, oversight bodies, and the public on the rationale for separating such costs from program costs, the appropriate level for such costs, and the way these costs support the commission's mission.

Figure1: Cost Category Delineation

<p>ADMINISTRATIVE COST* Costs incurred in support of the general management and administration of a First 5 commission for a common or joint purpose that benefits more than one cost objective (other than evaluation activities), and/or those costs not readily assignable to a specifically benefited cost objective.</p>	<p>PROGRAM COST Costs incurred by local First 5 commissions readily assignable to a program, grantee, contractor, or service provider (other than evaluation activities) and/or in the execution of direct service provision.</p>	<p>EVALUATION COST Costs incurred by local First 5 commissions in the evaluation of funded programs based upon their accountability framework and data collection and evaluation for required reporting to state and local stakeholders.</p>
General accounting/financial reporting	Direct services	Evaluation**
Local annual reporting activities	Program outreach and education	Evaluation technical assistance
Financial planning	Program planning	Evaluation database
Commission/association meetings and travel	Program grants and contracts	Travel and training related to evaluation
Payroll/benefits	Program/provider technical assistance and support (formerly Quality Assurance)	
Human resources services	Program Database management	
Legal services/consulting	Contract compliance	
Contract compliance		
Audit		
Strategic planning		
Procurement		
Rent		
Maintenance		
Utilities		
Insurance		
Cleaning/Janitorial		
<p>*These costs are typically administrative, but some may be allocated as appropriate to Program or Evaluation. For example, occupancy, utilities and indirect costs associated with the office space or salary of a program or evaluation staff person could be allocated to program or evaluation. In another example, an ED who attends a training on evaluation may charge this time and travel to evaluation.</p> <p>**Includes conduct of focus groups and case studies, state evaluation report production, and presentation.</p>		

9 RISK MANAGEMENT

Commissions should evaluate their need for insurance within the context of a broader risk management strategy. Insurance is merely one option for managing risks. Before considering insurance, a commission should first have a clear understanding of all of the risks that it faces. Then it should consider the best ways to reduce all of its risks. If this approach is not taken, a commission may overlook important risks or may miss the opportunity to reduce insurance costs by managing risks in another way. A risk management approach uses a comprehensive set of tools to manage risk (e.g., preventing risk through safety programs, transferring risk through contracts, insurance, etc.) and matches the most appropriate tools to each risk based on its potential impact and likelihood. This is important so that the most cost-effective tools are used to reduce risk.

The risk management process has three basic steps:

1. Identify risks
2. Assess risks
3. Manage risks

Step 1: Identify Risks

The first step in the risk management process is to systematically identify all of the risks that the commission faces. A risk can be defined as any event that could have an impact on the commission's mission and goals. Risks can come from inside or outside the organization. There are several different types of risk including:

- Physical risk (e.g., injuries, contagious diseases, adverse weather conditions, loss or damage to physical assets of the commission)
- Financial risk (e.g., loss of funding, theft of funds, financial fraud, investment loss)
- Operational risk (e.g., failure to achieve a program's objectives)
- Legal risk (e.g., lawsuits, noncompliance with state laws)
- Reputational risk (e.g., harm to the commission's reputation)

Step 2: Assess Risks

In this step, the commission evaluates each risk in terms of its likelihood of occurrence and potential impact. The intersection of the risk's likelihood and impact is the severity of the risk.

Step 3: Manage Risks

After identifying and assessing the commission's risks, the next step is to select the best tools to manage each risk. The appropriate tools will depend on the likelihood and potential impact of each risk. The goal is to select the most cost-effective tools for each risk. There are four primary ways of managing risks:

- Avoiding risk
- Preventing and reducing risk
- Transferring risk to other organizations
- Accepting risk

Avoiding Risk

In this option, a commission avoids risk by not performing the service or activity that creates the risk. This may not be a viable option if the service or activity is vital to the commission's mission and goals.

Preventing and Reducing Risk

An effective way of managing risks is to prevent and reduce risk by reducing the likelihood that the risk will occur and the impact of the risk if it does occur. Strategies to reduce the likelihood of a risk include:

- Policies and procedures
- Training and technical assistance
- Testing
- Inspection and process controls
- Preventative maintenance.

Strategies to reduce the consequences of a risk include:

- Planning for contingencies
- Minimizing exposure to sources of risk
- Putting physical barriers in place
- Locating an activity.

Transferring Risk to Other Organizations

Another option for managing risks is to transfer them to another organization. This may be done through several ways including: insurance, intergovernmental risk pools, and passing along the risk to another organization in a contract.

Using Contracts to Transfer Risk

Contracts are another tool that commissions can use to transfer risk to another organization. In a hold-harmless provision, a commission transfers risk under the terms of a contract. (This is a non-insurance risk transfer or contractual risk transfer.) One party agrees to indemnify and hold the other party harmless for all claims and legal expenses incurred under situations or scenarios anticipated in the contract. These agreements could impose different levels of responsibility, so that a contractor could indemnify a commission against:

- suits resulting from the contractors' negligence
- claims arising from joint negligence (i.e., if the commission were found by a court to be at fault, the contractor would assume those legal costs)
- all possible suits

However, indemnification and hold-harmless agreements are not the panacea to transferring risk. In some cases, the responsibility for a loss cannot be delegated and, therefore, the exposure to such a liability cannot be transferred through an agreement.

9.1 INSURANCE

There are three basic types of insurance coverage:

- *Property insurance* – protects against damage or loss of property
- *Liability insurance* – covers losses related to a commission being found negligent in the performance of operations
- *Workers' compensation* – provides employees with coverage for all medical bills resulting from job-related injuries or disabilities as well as lost income

Examples of supplementary products offered by insurance carriers include earthquake insurance and fidelity coverage. Fidelity bonds cover losses from embezzlement, fund misappropriation, and loss of money or property from dishonest acts committed by employees or volunteers. In addition, new insurance products are being developed to meet demand for new risk coverage, such as for technology-related risks.

Whereas property insurance protects an organization from a direct loss, liability insurance and worker's compensation protect organizations indirectly. In other words, the immediate "loser" in a liability or

workers' compensation situation might be the employee and only indirectly would the organization be affected (when that employee subsequently files a claim against the organization). Similarly, liability insurance protects elected officials or employees from financial loss (e.g., costly litigation), but ordinarily these costs are borne by the organization. Consequently, the organization must protect itself against these indirect losses as well.

Accepting Risk

It is important for commissions to determine their risk tolerance by actually quantifying how much dollar risk they can accept. This is basic step in selecting a level of insurance coverage that will meet the organization's needs. In some cases, the potential costs of a risk may be insufficient to justify the cost of risk transfer.

The contracting chapter within this Financial Management Guide offers guidance on entering into agreements with providers. Contracts should address exposure to significant sources of risk, and they should identify the responsibilities of both the commission and the provider.

Insurance Compliance

Contractor compliance with HIPAA (Health Insurance Portability and Accountability Act of 1996) and insurance requirements should be evaluated. The following are steps for establishing requirements and assessing compliance:

- Determine the level of insurance necessary for the services under contract.
- Include insurance and HIPAA requirements in the contract.
- Establish internal procedures for ensuring compliance with the requirements.
- Conduct file audits to ensure that proper insurance certificates, endorsements, and other documents are in place. Ensure that brokers provide new certificates when a contractor changes insurance.
- Identify circumstances in which all or part of the insurance requirement would be waived.

Contractors may need to add endorsements to their insurance policies to meet commission insurance requirements. An endorsement is a written document attached to an insurance policy that changes the coverage of the policy. An endorsement can add coverage that is not included as part of the original policy. This additional coverage can be added when the policy begins or during the term of the policy.

9.1.1 Contracting for Insurance

When deciding which insurance product and carrier to select, considerations beyond cost must be examined. Other important considerations include quality of service (e.g., ability to expeditiously process claims); scope of service; lines or breadth of coverage; and financial stability.

Lines or breadth of coverage refers to two factors. First, will the commission select a single insurance carrier for liability, workers' compensation, and property insurance, or will it select different companies that operate in each of those areas? Second, will the coverage from one carrier for a given line of coverage be as complete as another carrier's standard coverage, or will it have important gaps or exclusions?

Finally, financial stability is critical: the commission needs to be confident that the insurance company or pool has the financial wherewithal to make the commission whole in the event of a loss. Can the insurer respond to a claim that reaches the upper limit of coverage? An important resource for answering this question is insurance company ratings. (Weiss Ratings, Inc. examines several financial indices, such as the level of capital in relation to the risks it insures. A.M. Best performs similar analyses.)

It is important to note that the same criteria above can be applied to an intergovernmental risk pool. When commissions evaluate whether to join or leave a risk pool, they should take into account similar criteria, such as financial strength and stability.

9.2 INTERGOVERNMENTAL RISK POOLS

Initially, intergovernmental risk pools did exactly what their name implies: they provided a vehicle for local governments to pool their funds to provide for their insurance needs. Pools enabled governments to make a group purchase of insurance at a very affordable cost through economies of scale. Over the years, however, pools have evolved into entities that offer their members far more than just an affordable way to secure insurance. Most pools now incorporate the term risk into the name of their organization and are more often called risk management pools rather than simply insurance pools. Today, many pools function as a government's comprehensive risk manager. These pools provide services that include training and workshops, loss control audits, risk assessments, and onsite safety inspections.

Pools can be classified according to several factors, according to the Association of Governmental Risk Pools (AGRIP). Aside from the type of services offered (e.g., risk control, risk finance), pools vary by: lines of insurance coverage offered (e.g., workers' compensation); type of local government member (e.g., municipality, county, special district, region); "a la carte" options (allowing members to pick and choose services) versus a single package of services; degree of state regulation; financial resources available to the pool; extent of risk transference; and primary versus excess coverage.

Financial resources among pools differ for two reasons: (1) some pools can assess a mandatory charge upon members, and (2) some pools are well-capitalized and have a capital fund, whereas others follow a pay-as-you-go arrangement.

Regarding risk transfer, it is important to know that when joining a pool a commission may or may not transfer risks in the same way that it would when buying insurance. Some pools self-insure, meaning the pool must rely only on its own resources and those of its members to pay out claims. By contrast, other pools self-fund – they pass part of their collective risk to a reinsurer or insurance company providing excess coverage (or some other risk financing technique).

Finally, some pools provide what is known as primary coverage, wherein they assume the obligation to pay an entire claim. By contrast, pools that provide excess coverage act only on claims over a certain threshold (e.g., \$100,000).

10 RESOURCES

There are a number of helpful resources to accompany the material in this guide. This chapter provides numerous examples but does not represent an exhaustive list.

GASB Standards and Publications (gasb.org)

The Governmental Accounting Standards Board (GASB) is the independent organization that establishes standards of accounting and financial reporting for US state and local governments. First 5 organizations follow GASB standards for financial reporting. GASB statements, exposure drafts, implementation guides and other documents may be found on the GASB web site.

Selected GASB Statements:

GASB Statement	Guide Chapters
GASB 34 – Basic Financial Statements and Management’s Discussion and Analysis – for State and Local Governments	Accounting and Financial Reporting
GASB 54 – Fund Balance Reporting and Governmental Fund Type Definitions	Accounting and Financial Reporting

AICPA

The American Institute of Certified Public Accountants (AICPA) is the world’s largest member organization representing the accounting profession. It sets ethical standards for the profession and US auditing standards for private companies, nonprofit organizations, federal, state and local governments.

Description	Guide Chapter	Link
AU-C Section 265, <i>Communicating Internal Control Related Matters Identified in an Audit</i>	Internal Control	http://www.aicpa.org/research/standards/auditattest/downloadabledocuments/au-c-00265.pdf

GFOA (gfoa.org)

GFOA is the Government Finance Officers Association. The GFOA is a professional organization representing public finance officials throughout the US and Canada. GFOA has publications, best practices and other materials available as resources.

Selected GFOA Publications (<http://gfoa.org/publications>)

Publication	Guide Chapter(s)
<i>An Introduction to Investment Advisers for State and Local Governments</i>	Investment Management
<i>Investing Public Funds</i>	Investment Management
<i>Investment Procedures and Internal Controls</i>	Investment Management
<i>An Elected Official’s Guide to Multi-Year Budgeting</i>	Planning and Budgeting
<i>Budgeting Series</i>	Planning and Budgeting
<i>Governmental Accounting, Auditing, and Financial Reporting (GAAFR) and GAAFR Supplement</i>	Accounting and Financial Reporting
<i>Evaluating Internal Controls: A Local Government Manager’s Guide</i>	Internal Control
<i>An Elected Official’s Guide to Risk Management</i>	Risk Management

Selected GFOA Best Practices (<http://gfoa.org/best-practices>)

Best Practice	Guide Chapter
Creating an Investment Policy	Investment Management
Selection and Review of Investment Advisors	Investment Management
Diversifying the Investment Portfolio	Investment Management
Local Government Investment Pools	Investment Management
Governmental Relationships with Securities Dealers	Investment Management
Mutual Funds in Cash Management	Investment Management
Establishing a Policy for Repurchase Agreements	Investment Management
Managing Market Risk in Investment Portfolios	Investment Management
Collateralizing Public Deposits	Investment Management
Monitoring the Value of Securities in Repurchase Agreements	Investment Management
Mark-to-Market Reporting for Public Investment Portfolios	Investment Management
Providing a Concise Summary of the Budget	Planning and Budgeting
Measuring the Full Cost of Government Service	Planning and Budgeting
Using Fund Accounting Effectively	Accounting
Documenting Accounting Policies and Procedures	Accounting
Conforming to Governmental Accounting, Auditing and Financial Reporting Standards	Accounting
Establishing an Internal Audit Function	Internal Control
Measuring the Full Cost of Government Service	Administrative Costs

Other GFOA Resources

Description	Guide Chapter	Link
Sample Investment Policy	Investment Management	http://gfoa.org/sites/default/files/u2/SampleInvestmentPolicy.pdf
Financial Policies Supplement	Various Chapters	http://www.gfoa.org/financialpolicies

Other National Organizations

Organization	Guide Chapter	Link
National Association of State Procurement Officials	Contracting	http://www.naspo.org/
National Contract Management Association	Contracting	http://www.ncmahq.org/
National Institute of Governmental Purchasing	Contracting	http://www.nigp.org/eweb/StartPage.aspx
National Purchasing Institute	Contracting	https://www.npiconnection.org/home/index.asp
Recommended Practices of the National Advisory Council on State and Local Budgeting (NACSLB)	Planning and Budgeting	http://www.gfoa.org/services/nacslb

Organization	Guide Chapter	Link
Public Entity Risk Institute (PERI)	Risk Management	http://www.riskinstitute.org/peri/
Nonprofit Risk Management Center	Risk Management	http://www.nonprofitrisk.org/
Public Risk Management Association	Risk Management	http://www.primacentral.org/
Public Agency Risk Sharing Authority of California	Risk Management	http://www.parsac.org/

US Office of Management and Budget (OMB)

The Office of Management and Budget (OMB) is the largest office within the Executive Office of the President of the United States. The main function of the OMB is to assist the President in preparing the budget. The OMB also measures the quality and level of compliance of agency programs, policies, and procedures. Some useful OMB documents are shown below.

Description	Guide Chapter	Link
Circular A-21: <i>Cost Principles for Educational Institutions</i>	Administrative Costs	http://www.whitehouse.gov/omb/circulars_a021_2004
Circular A-87: <i>Cost Principles for State, Local, and Indian Tribal Governments</i>	Administrative Costs	http://www.whitehouse.gov/omb/circulars_a087_2004
Cost Accounting Standards Board (CASB), Title 48— <i>Federal Acquisition Regulations System</i> , Chapter 99— <i>Cost Accounting Standards Board, Office of Federal Procurement Policy</i> , Page 406	Administrative Costs	http://www.gpo.gov/fdsys/pkg/CFR-2002-title48-vol7/pdf/CFR-2002-title48-vol7-chap99.pdf

California State Code

Description	Guide Chapter	Link
California Public Contract Code	Contracting	http://www.leginfo.ca.gov/cgi-bin/calawquery?codesection=pcc&codebody=&hits=20

Other California State Publications and Websites

Description	Guide Chapter	Link
California State Contracting Manual	Contracting	http://www.dgs.ca.gov/ols/Resources/StateContractManual.aspx
California State Procurement Division	Contracting	http://www.dgs.ca.gov/pd/Home.aspx
California Association of Public Purchasing Officers	Contracting	http://www.cappo.org/
California Debt and Investment Advisory Commission (CDIAC)	Investment Management	http://www.treasurer.ca.gov/cdiac/
CDIAC Publications	Investment Management	http://www.treasurer.ca.gov/cdiac/publications.asp
Local Agency Investment Fund (LAIF)	Investment Management	http://www.treasurer.ca.gov/pmia-laif/laif-program.asp
Local Agency Investment Guidelines	Investment Management	http://www.treasurer.ca.gov/cdiac/LAIG/guideline.pdf
Understanding Public Investment Reporting: A Handbook for Local Elected Officials	Investment Management	http://www.treasurer.ca.gov/cdiac/invest/pubinvest.pdf
Investment Portfolio Reporting Practices: An Informational Guide	Investment Management	http://www.treasurer.ca.gov/cdiac/invest/invest_guide04-5.pdf
Preparing Requests for Proposals	Investment Management	http://www.treasurer.ca.gov/cdiac/issuebriefs/101994.pdf
Standards and Procedures for Audits of Local Entities Administering the California Children and Families Act	Financial Reporting	http://www.controller.ca.gov/Files-AUD/first5_auditguide_2013_14.pdf
First 5 California (Children and Families) Program Expanded Audit Guide – Frequently Asked Questions	Financial Reporting	http://www.sco.ca.gov/Files-AUD/ccfp_audit_guide_faqs.pdf
Public Agency Risk Sharing Authority of California	Risk Management	http://www.parsac.org/

11 GLOSSARY

accrual basis of accounting: Transactions are recorded when they occur regardless of when cash is paid or received. Commissions use a modified form of accrual accounting (see Modified Accrual Basis) for Governmental funds. However, the accrual basis of accounting is used for the preparation of annual government-wide financial statements where governmental activities are reported (governmental activities are defined later).

active investment management: Active management of an investment portfolio implies that the investing official may sell some securities in order to shift assets into other instruments. This may be done simply to rebalance a portfolio that has become over concentrated in one sector, or it may reflect an effort to enhance total returns by trading or swapping into securities that are expected to outperform the original holding. Active investment management requires expertise and frequent monitoring of financial markets.

administrative costs: Costs incurred for a common or joint purpose that benefits more than one cost objective, supports the general management and administration of a First 5 commission, and/or those costs not readily assignable to a specifically benefited cost objective.

advance payment: Any payment made to a contractor before work has been performed or goods have been delivered.

appropriation: Appropriations represent the maximum expenditures that are authorized by the governing body of the commission. They represent (by budget category) amounts that cannot be legally exceeded. Internal reporting must provide timely information so the Board of the commission can determine that the spending limits authorized have not been exceeded.

assigned fund balance: That portion of the fund balance that reflects a commission's intended use of resources, which is established either by the county First 5 Commission, a body created by the commission, such as a commission finance committee, or an official designated by the commission (e.g., an Executive Director).

balance sheet: The financial statement disclosing the assets, liabilities, and equity of the governmental funds (which includes general funds and special revenue funds). Governments are also required to disclose assets, liabilities and equity on a "government-wide entity" basis, using accrual accounting. This is known as the Statement of Net Position.

bankers' acceptance: A time draft drawn on and accepted by a bank to pay a specified amount of money on a specified date. Bankers' acceptances are short-term, non-interest bearing notes sold at a discount and redeemed at maturity at face value by the accepting bank. Bankers' acceptances are backed by the issuers' guarantee to pay, the underlying goods being financed, and the guarantee of the accepting bank.

broker: A person or firm that acts as an intermediary by purchasing and selling securities for others rather than for its own account.

budgetary basis of accounting: The form of accounting used to describe revenues and expenditures in the budget document. The term "basis of accounting" is used to describe the timing of recognition, that is, when the effects of transactions or events should be recognized. The basis of accounting used for purposes of financial reporting in accordance with generally accepted accounting principles (GAAP) is not necessarily the same basis used in preparing the budget document. For example, governmental funds are required to use the modified accrual basis of accounting in GAAP financial statements whereas the cash basis of accounting or the "cash plus

encumbrances" basis of accounting may be used in those same funds for budgetary purposes. Disparities between GAAP and the budgetary basis of accounting often occur because of regulations that govern budgeting (e.g., laws or ordinances of the state, county, city or some other jurisdiction) which differ from GAAP. There are four basic categories of difference between the budgetary basis of accounting and the basis of accounting that follows generally accepted accounting principles (GAAP) for state and local governments. They are:

- **basis of accounting** - "cash plus encumbrances" and "modified accrual" are two of the different ways to define revenues and expenditures;
- **timing** - the budget period may differ from the accounting reporting period, e.g., lapse periods for encumbrances;
- **perspective** - the budget and accounting reports may have different fund reporting structures, e.g., a budget may account for debt service in the general fund, while GAAP principles require that debt service be recorded in a separate fund;
- **entity** - the government's financial report may not include all of the same entities and funds as the budget document.

capital assets: Land, improvements to land, easements, buildings, building improvements, vehicles, machinery, equipment, works of art and historical treasures, infrastructure, and all other tangible or intangible assets that are used in operations and that have initial useful lives extending beyond a single reporting period. Capital assets historically were also referred to as fixed assets, but that terminology is no longer used in practice.

cash basis of accounting: Basis of accounting that recognizes transactions or events when related cash amounts are received or disbursed.

certificate of deposit: A time deposit in a financial institution documented by a certificate that bears a specified dollar amount of the deposit, a specified maturity date and a specified interest rate.

collateral: Underlying securities that are pledged to secure deposits of public funds. Also used in conjunction with repurchase agreements to protect the entity from default by the counter party.

collateralization: The process by which a borrower pledges securities, property, or other deposits for the purpose of securing the repayment of a loan and/or security.

CAFR (comprehensive annual financial report): An annual financial report that conforms to the requirements of the Governmental Accounting Standards Board.

commercial paper: An unsecured short-term promissory note issued by corporations, with maturities ranging from 2 to 270 days.

committed fund balance: That portion of fund balance that includes funds whose use is constrained by limits imposed by the government's highest level of decision making (for First 5 county organizations, the County First 5 Commission), and for which the removal or modification of use of funds can be accomplished only by formal action of the same level of decision making that established the constraints.

contract: A legally binding agreement between two parties for the provision of goods or services.

contract compliance: conformance and adherence to the terms of the contract. Contracts should be monitored by appropriate personnel to ensure that providers are complying with contract terms.

county pooled investment funds: The aggregate of all funds from public agencies placed in the custody of the county treasurer or chief finance officer for investment and reinvestment.

coupon: The annual rate of interest that a bond's issuer promises to pay the bondholder on the bond's face value; a certificate attached to a bond evidencing interest due on a payment date.

credit quality: The measurement of the financial strength of a bond issuer. This measurement helps an investor to understand an issuer's ability to make timely interest payments and repay the loan principal upon maturity. Generally, the higher the credit quality of a bond issuer, the lower the interest rate paid by the issuer because the risk of default is lower. Credit ratings are provided by nationally recognized rating agencies.

custodian: A bank or other financial institution that keeps custody of stock certificates and other assets.

dealer: Someone who acts as a principal in all transactions, including underwriting, buying, and selling securities, including from his/her own account.

derivative: Securities that are based on, or derived from, some underlying asset, reference date, or index.

disbursements: The payment of cash for expenditures. Such payments may precede the expenditures (an advance), coincide with the expenditures (a direct payment), or follow the expenditures (the payment of a liability).

discount securities: Securities that pay no interest. They are issued at a discount from their face value. An investor's return on investment is the difference between the discounted purchase price and the maturity (or sale) price. U.S. Treasury bills are an example of a discount security.

encumbrances: Contractual obligations to make future payments. Encumbrances represent the estimated amount of future expenditures that will result when, for example, purchase orders are placed and contracts are signed. Since the amount of an appropriation cannot be legally exceeded, the placing of purchase orders and the signing of contracts are critical events in controlling the commissions' funds. The financial resources of a fund are said to be encumbered when a transaction is executed that requires performance on the part of another party before the commission becomes liable to perform its part of the transaction (make payment to the entity). Consistent with the enactment of GASB Statement 54, encumbrances are no longer reported separately in the financial statements. For governments that use encumbrance accounting, significant encumbrances should be disclosed in the notes to the financial statements by major funds and non-major funds in the aggregate in conjunction with required disclosures about other significant commitments.

evaluation costs: Costs incurred by First 5 commissions in the evaluation of funded programs, in accordance with their accountability framework, and data collection and evaluation for required reporting to state and local stakeholders.

expenditures: Take place when a vendor or contractor performs on a contract or a purchase order, as well as when goods or services are received. An expenditure and a corresponding liability or cash disbursement will be recorded at the time goods or services are received or at the time funds are granted to an authorized recipient.

fiduciary funds: Funds used to report assets held in a trustee or agency capacity for others and which therefore cannot be used to support the government's own programs. The fiduciary fund

category includes pension (and other employee benefit) trust funds, investment trust funds, private-purpose trust funds, and agency funds.

fund balance: The value of the funds available to the commission. Fund balance is the difference between fund assets and fund liabilities of governmental funds.

GAAP: Abbreviation for "generally accepted accounting principles," which are conventions, rules, and procedures that serve as the norm for the fair presentation of financial statements. The Governmental Accounting Standards Board (GASB) is responsible for setting GAAP for state and local governments and political subdivisions thereof.

Governmental Accounting Standards Board (GASB): Ultimate authoritative accounting and financial reporting standard-setting body for state and local governments. The GASB was established in June 1984.

governmental activities: Governmental activities are basically all of the governmental funds reported together on an accrual basis. Also, governmental activities include all related capital assets and long-term liabilities and are reported at the government-wide level of reporting.

governmental funds: Funds generally used to account for tax-supported activities. There are five different types of governmental funds: the general fund, special revenue funds, debt service funds, capital projects funds, and permanent funds.

guaranteed investment contracts (GICs): An agreement acknowledging receipt of funds for deposit, specifying terms for withdrawal, and guaranteeing a rate of interest to be paid.

interest-only strips: The interest cash flow portion of a stripped mortgage-backed security or bond. The holder receives no principal payments. A significant loss in value can occur on interest only strips created from mortgage-backed securities when the underlying mortgage prepayments accelerate, typically in a falling interest-rate environment.

internal control (framework): Integrated set of policies and procedures designed to assist management to achieve its goals and objectives. To be comprehensive, the framework must: 1) prove a favorable control environment, 2) provide for the continuing assessment of risk, 3) provide for the design, implementation, and maintenance of effective control-related policies and procedures, 4) provide for the effective communication of information, and 5) provide for the ongoing monitoring of the effectiveness of control-related policies and procedures as well as the resolution of potential problems identified by controls.

inverse floaters: A security that reacts inversely to the direction of interest rates. These securities can be very volatile and can lose value in a rising interest-rate environment.

liquidity: The extent to which securities can be converted into cash on a short notice. Liquidity incorporates a security holder's ability to sell an instrument without significant loss, as well as other factors that might expedite quick exchange for cash. An example of an illiquid asset would be a nonnegotiable bank certificate of deposit, for which the holder must pay an interest penalty for premature redemption.

local agency investment fund (LAIF): A voluntary investment fund open to government entities and certain non-profit organizations in California that is managed by the State Treasurer's Office.

local government investment pool (LGIP): Investment pools that range from the State Treasurer's Office Local Agency Investment Fund (LAIF) to county pools, to Joint Powers Authorities (JPAs). These funds are not subject to the same SEC rules applicable to money market mutual funds.

long-term financial plan: A plan that assesses the long-term financial implications of current and proposed policies, programs, and assumptions and develops appropriate strategies to achieve its goals. A financial plan illustrates the likely financial outcomes of particular courses of action or factors affecting the environment in which the government operates. A financial plan is not a forecast of what is certain to happen but rather a device to highlight significant issues or problems that must be addressed if goals are to be achieved.

market value: The price at which a security is trading and presumably could be purchased or sold at a particular point in time.

materiality: Materiality in auditing and accounting relates to the importance of an amount, transaction or discrepancy. It usually depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. In government, materiality has both a quantitative and a qualitative aspect, where materiality often concerns the nature rather than the size of an amount, such as illegal acts, bribery, corruption and related party transactions. Because of the importance of transparency in the public sector, commissions should discuss with and understand the level of materiality that will be chosen by the auditors of their financial statements.

maturity: The date on which the principal or stated value of an investment becomes due and payable.

medium-term note: Corporate or depository institution debt securities that meet certain minimum quality standards (as specified in the California Government Code) with a remaining maturity of five years or less.

modified accrual basis of accounting: The basis of accounting adapted to government fund accounting where revenues are recognized when received in cash or when resources are considered available (except for material or available revenues which should be accrued to reflect properly the taxes levied and the revenues earned – not applicable to county commissions). Expenditures are recognized when the related fund liability is incurred.

multi-year budgeting: A multi-year budget is a document that authorizes a government's appropriations (i.e., planned expenditures) and anticipated revenues for two or more consecutive budgetary years. A multi-year budget also may consist of a biennial budget with one or two financial plans that serve as the tentative spending plans for the out-years (i.e., the first year appropriations are formally adopted, whereas the subsequent year "appropriations" are not).

National Advisory Council on State and Local Budgeting (NACSLB): A cooperative effort of eight state and local government associations to improve governmental budgeting. To this end, the NACSLB developed a comprehensive set of 59 recommended budgeting practices. These practices address all steps of the budgeting process including: the analysis and goal setting that occurs before the written budget document is produced, the items that should be included in the budget document, and the monitoring and evaluation that occurs after the document is adopted. The recommended practices are available on the Web at <http://www.gfoa.org/services/nacslb/>

nonspendable fund balance: Amounts in fund balance that cannot be spent because they are either not in spendable form (e.g., prepaid items and inventories) or legally/contractually required to be maintained intact (e.g., the reinvested principal provided by an endowment).

note: A written promise to pay a specified amount to a certain entity on demand or on a specified date.

object of expenditure: In the context of the classification of expenditures, the article purchased or the service obtained, rather than the purpose for which the article or service was purchased or obtained (e.g. personal services, contractual services, materials and supplies).

outcome: The end result that is sought. A service may have more than one outcome.

par: Face value or principal value of a bond, typically \$1,000 per bond.

passive investment management: An investment strategy in which securities are bought with the intention of holding them to maturity or investing in benchmark products designed to yield a market rate of return.

performance contract: A type of contract that specifies the end results desired rather than the specific details of how a product should be manufactured or how a service should be delivered.

performance measure: A particular value or characteristic designated to measure input, output, outcome, efficiency, or effectiveness.

portfolio: Combined holding of more than one stock, bond, commodity, real estate investment, cash equivalent, or other asset. The purpose of a portfolio is to reduce risk by diversification.

pre-proposal conference: A meeting with potential providers before the proposal submission date.

principal: The face value or par value of a debt instrument, or the amount of capital invested in a given security.

program costs: Costs incurred by local First 5 commissions readily assignable to a program, grantee, contractee, or service provider (other than post-contract program evaluation activities) and/or in the execution of direct service provision.

progress payments: Partial payments related to steps or phases toward the completion of the required services under a contract.

progress report: A report on contract performance or fiscal compliance made at specific intervals during the term of a contract.

proposal review committee: A committee or panel that convenes to evaluate the qualifications of bidders who respond to a request for proposals (RFP).

proprietary funds: Funds that focus on the determination of operating income, changes in net position (or cost recovery), financial position, and cash flows. There are two different types of proprietary funds: enterprise funds and internal service funds.

prudent investor standard: A statement, often included in laws and investment policies, that specifies the responsibility of government officials in their investment decisions with public funds. The prudent investor standard holds the investor to a higher standard of care than the average prudent person. The prudent investor standard states: "These persons shall act with care, skill, prudence, and diligence under the circumstances then prevailing when investing, reinvesting, purchasing, acquiring, exchanging, selling, and managing funds." The "prudent expert rule" holds an investor to an even higher standard and is often cited in contracts with investment advisors.

prudent person rule: A statement, often included in laws and investment policies, that specifies the responsibility of government officials in their investment decisions with public funds. The prudent person rule states: “Investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.”

repurchase agreements: An agreement of one party (for example, a financial institution) to sell securities to a second party (such as a local agency) and simultaneous agreement by the first party to repurchase the securities at a specified price from the second party on demand or at a specified date.

request for information (RFI): The document used to obtain information from potential providers before a solicitation document (RFP) is issued.

request for proposals (RFP): The solicitation document that is most appropriate in those situations in which it is necessary and appropriate to evaluate bidders on the basis of their qualifications as well as their price. The RFP describes the qualification requirements, performance specifications, time frames, and other requirements and asks bidders to describe how they would accomplish the services and at what price.

request for qualifications (RFQ): An RFQ is used when a commission has specific requirements as to *how* services are to be delivered. In an RFQ, the applicant demonstrates their qualifications to provide those services according to the model that the commission has specified. In addition, the commission asks applicants to demonstrate their knowledge of, and commitment to, the specified model.

restricted fund balance: Amounts in fund balance that have constraints imposed externally from creditors, grantors, contributors, laws or regulations of other governments, or imposed constitutionally by enabling legislation.

return on investment: Investors will face a multitude of securities and other instruments with varying quoted interest rates, coupons, prices, yields, and other numbers. The amount of income received from an investment, expressed as a percentage of its price, is the rate of return. A market rate of return is the yield that an investor can expect to receive in the current interest rate environment utilizing a buy-and-hold investment strategy. Total return is interest income plus capital gains (or minus losses) on an investment and is the most important measure of performance as it is the actual return on investment during a specific time interval. Many investors consider the holding period (from purchase until maturity or sale) the easiest interval to measure the return on investment. Others measure the investment return on a security or portfolio according to various time intervals (monthly, quarterly or annually).

reverse repurchase agreements: An agreement of one party (for example, a financial institution) to purchase securities at a specified price from a second party (such as a public agency) and a simultaneous agreement by the first party to resell the securities at a specified price to the second party on demand or at a specified date.

risk-based monitoring: An approach to contract monitoring in which reporting requirements are based on a given provider’s risk profile.

Rule G-37 of the Municipal Securities Rulemaking Board: Federal regulations to sever any connection between the making of political contributions and the awarding of municipal securities business.

safekeeping: A procedure where securities are held by a third party acting as custodian for a fee.

Securities and Exchange Commission (SEC): The federal agency responsible for supervising and regulating the securities industry.

securities lending agreement: An agreement of one party (for example, a local agency) to borrow securities at a specified price from a second party (for example, another local agency) with a simultaneous agreement by the first party to return the security at a specified price to the second party on demand or at a specified date. These agreements generally are collateralized and involve a third-party custodian to hold the securities and collateral. Economically similar to reverse repurchase agreement.

sole source procurement: A procurement awarded to a single provider following a process that determined that only that provider could practically fulfill the requirements of the procurement based on lack of other valid offers, unique qualifications to fulfill commission needs or other reasons.

secondary market: The market where securities are sold after their initial issuance.

stakeholder: The term "stakeholder" refers to anyone affected by or who has a stake in government. This term includes, but is not limited to: citizens, customers, elected officials, management, employees and their representatives (whether unions or other agents), businesses, other governments, and the media.

statement of activities: A government-wide presentation of its activities by function or program using the accrual basis of accounting. The statement presents revenues, expenditures, and a reconciliation of net position.

statement of net position: The government-wide presentation of assets, liabilities, and equity of governmental activities which includes all funds. It is the government-wide balance sheet. The Statement of Net Position is presented on an accrual basis.

statement of revenues, expenditures, and changes in fund balances: The governmental fund presentation of the revenues, expenditures, and other finance sources and uses of funds. This statement is presented on a modified accrual basis.

statement of work: A definition of the services to be delivered and/or the outcomes to be achieved.

supplantation: Occurs when new funds are used to fund existing programs. No funds provided by the commission should be used to supplant state or local general fund money for any purpose. In general terms, the word supplant means to take the place of, or take the place of something else.

trustee, trust company, or trust department of a bank: A financial institution with powers to act in a fiduciary capacity for the benefit of the bondholders in enforcing the terms of the bond contract.

U.S. Treasury obligations: Debt obligations of the U.S. government sold by the Treasury Department in the forms of bills, notes, and bonds. Bills are short-term obligations that mature in one year or less and are sold at a discount. Notes are obligations that mature between one year and 10 years. Bonds are long-term obligations that generally mature in 10 years or more.

unassigned fund balance: that portion of the fund balance portion that does not meet the requirements of the other classifications (assigned, committed, nonspendable, restricted).

weighted average maturity (WAM): The average maturity of all the securities that comprise a portfolio based on the relative size and maturity of each security, typically expressed in days or years.

yield: The income return on an investment based on the interest or dividends received. Yield is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value. There are several yield calculations that can be made, such as "yield to maturity" and "yield to call."

yield to maturity: the promised return assuming all interest and principal payments are made and reinvested at the same rate taking into account price appreciation (if priced below par) or depreciation (if priced above par).

yield to call: the yield an investor will receive if the security is called prior to maturity.

yield curve: A graphic representation that shows the relationship at a given point in time between yields and maturity for securities that are identical in every way except maturity.

zero-coupon bond (accrual bond): a security that does not pay interest but that is traded at a deep discount, yielding profit at maturity when the bond is redeemed at its face value.