



November 16, 2009

Ms. Kris Perry, Executive Director
First 5 California
2389 Gateway Oaks Drive, Room 260
Sacramento, CA 95833

Dear Ms. Perry:

Final Report—First 5 California, 2009 Financial Statement Audit of the Children and Families Trust Fund and Related Accounts

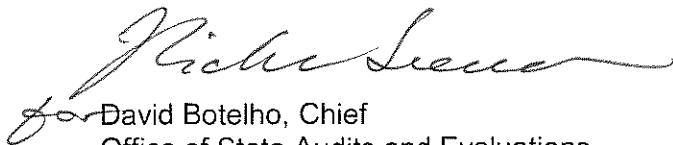
The Department of Finance, Office of State Audits and Evaluations (Finance), has completed its financial statement audit of the First 5 California's Children and Families Trust Fund and related accounts for the fiscal year ended June 30, 2009.

The enclosed report is for your information and use. The financial statements were fairly presented in accordance with generally accepted accounting principles. Because there were no audit findings or issues requiring a response, we are issuing the report as final.

In accordance with Finance's policy of increased transparency, this report will be placed on our website. Additionally, pursuant to Executive Order S-20-09, please post this report in its entirety to the Reporting Government Transparency website at <http://www.reportingtransparency.ca.gov/> within five working days of this transmittal.

We appreciate the assistance and cooperation of First 5 California, Department of General Services, and the California State Board of Equalization. If you have any questions regarding this report, please contact Cheryl Lyon, Manager, or James Kong, Supervisor, at (916) 322-2985.

Sincerely,



David Botelho, Chief
Office of State Audits and Evaluations

Enclosure

cc: Ms. Diane Levin, Chief Deputy Director, First 5 California
Ms. Kim Gauthier, Chief Counsel, First 5 California
Ms. Terry L. Miller, Chief, Administrative Services Division, First 5 California
Ms. Sandra Beck, Fiscal Operations Manager, First 5 California
State Controller's Office, Division of Audits, First 5 Oversight Unit

A F_{INANCIAL} S_{TATEMENT} A_{UDIT}

First 5 California
Children and Families Trust Fund
and Related Accounts
For the Fiscal Year Ended
June 30, 2009

Prepared By:
Office of State Audits and Evaluations
Department of Finance

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This report is also available on our website at <http://www.dof.ca.gov>

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EXECUTIVE SUMMARY

The Department of Finance, Office of State Audits and Evaluations (Finance), performed this audit in accordance with an interagency agreement with First 5 California. The objectives of our audit were to:

- Express an opinion on the *Balance Sheet and Statement of Revenue, Expenditures, and Changes in Fund Balance* of the Children and Families Trust Fund (Fund) and related accounts for the fiscal year ended June 30, 2009.
- Verify that the financial statements were prepared in conformity with generally accepted accounting principles for governmental funds.
- Report on internal control and compliance weaknesses, and provide recommendations for improving controls over operations of the Fund and related accounts.

Audit Results

- The aforementioned financial statements are fairly presented for the fiscal year ended June 30, 2009.
- The audit did not identify any reportable internal control or compliance weaknesses.

This report is intended solely for the information and use of First 5 California, those charged with governance, and the Legislature, and is not intended to be and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited.



INDEPENDENT AUDITOR'S REPORT

Ms. Kris Perry, Executive Director
First 5 California
2389 Gateway Oaks Drive, Room 260
Sacramento, CA 95833

We have audited the accompanying *Balance Sheet* as of June 30, 2009, and the related *Statement of Revenue, Expenditures, and Changes in Fund Balance* of the Children and Families Trust Fund (Fund) and related accounts, for the fiscal year then ended. These financial statements are the responsibility of First 5 California's management. Our responsibility is to express an opinion on these financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In connection with our audit, there are certain disclosures required by *Government Auditing Standards*. The Department of Finance (Finance) is not independent of the audited entity, as both are part of the State of California's Executive Branch. As required by various statutes within the California Government Code, Finance performs certain management and accounting functions. These activities impair independence. However, sufficient safeguards exist for readers of this report to rely on the information contained herein.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Fund and related accounts as of June 30, 2009, and the results of operations and changes in fund balance thereof for the fiscal year then ended, in conformity with accounting principles generally accepted in the United States of America.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the First 5 California, Department of General Services, and the California State Board of Equalization's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing our opinion on the effectiveness of the internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects management's or the employees' ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of First 5 California's financial statements that is more than inconsequential will not be prevented or detected by the internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

However, we noted other matters involving the internal control over financial reporting and its operation that we have reported to the management of the California State Board of Equalization in a separate letter dated November 2009.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether First 5 California's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of First 5 California management, those charged with governance, and the Legislature, and is not intended to be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

David Botelho, CPA
Chief, Office of State Audits and Evaluations
(916) 322-2985

November 16, 2009

**First 5 California
Children and Families Trust Fund and Related Accounts
Balance Sheet
At June 30, 2009**

	Children and Families Trust Fund (0623)	Counties Children and Families Account (0585)	Mass Media Communications Account (0631)	Education Account (0634)	Child Care Account (0636)	Research and Development Account (0637)	Administration Account (0638)	Unallocated Account (0639)
Assets								
Cash	\$ 36,350,247	\$ 330	\$ 684	\$ 938	\$ 883	\$ 606	\$ 43,701	\$ 58,766
Deposits in SMIF	7,920,000	901,000	96,073,000	118,657,000	58,112,000	75,681,000	24,459,000	13,932,000
Receivables	39,947,724	0	0	0	0	0	4,182	0
Due from Other Funds ¹	787,966	68,055,265	5,449,814	4,693,377	3,622,082	2,832,303	943,066	9,044,531
Due from Other Governments	0	0	0	0	0	0	0	7,466,434
Prepaid Expenses	0	0	0	0	0	0	73,508	0
Total Assets	\$ 85,005,937	\$ 68,956,595	\$101,523,498	\$123,351,315	\$61,734,965	\$78,513,909	\$25,523,457	\$30,501,731
Liabilities								
Accounts Payable	\$ 0	\$ 0	\$ 3,396,438	\$ 1,194,227	\$ 300,411	\$ 628,870	\$ 138,617	\$ 0
Due to Other Funds ¹	85,000,806	0	1,304,745	2,864,498	1,343,911	1,834,374	319,318	992,421
Due to Other Governments	0	68,956,595	0	13,439,189	3,938,435	432,127	645	6,532,145
Total Liabilities	85,000,806	68,956,595	4,701,183	17,497,914	5,582,757	2,895,371	458,580	7,524,566
Fund Balance								
Reserved for Encumbrances	0	0	233,801	519,558	220,812	324,724	0	0
Reserved for Unencumbered Balances of Continuing Appropriations	5,131	0	96,588,514	105,333,843	55,931,396	75,293,814	25,064,877	22,977,165
Total Fund Balance	5,131	0	96,822,315	105,853,401	56,152,208	75,618,538	25,064,877	22,977,165
Total Liabilities and Fund Balance	\$ 85,005,937	\$ 68,956,595	\$101,523,498	\$123,351,315	\$61,734,965	\$78,513,909	\$25,523,457	\$30,501,731

¹ - See Note 2

The accompanying notes are an integral part of the financial statements.

STATEMENT OF REVENUE, EXPENDITURES AND CHANGES IN FUND BALANCE

First 5 California Children and Families Trust Fund and Related Accounts Statement of Revenue, Expenditures, and Changes in Fund Balance For the Fiscal Year Ended June 30, 2009

	Children and Families Trust Fund (0623)	Counties Children and Families Account (0585)	Mass Media Communications Account (0631)	Education Account (0634)	Child Care Account (0636)	Research and Development Account (0637)	Administration Account (0638)	Unallocated Account (0639)
Revenue								
Cigarette Tax Revenue	\$ 555,404,306	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
SMIF Interest Revenue	792,126	414,573	1,843,497	2,748,882	1,341,339	1,669,417	549,629	359,668
Other Revenue	0	0	0	0	0	0	1,004	0
Total Revenue	556,196,432	414,573	1,843,497	2,748,882	1,341,339	1,669,417	550,633	359,668
Expenditures								
Appropriation Expenditures	11,722,619	420,656,961	15,212,819	55,134,790	22,366,876	17,087,347	6,924,572	15,149,695
Excess (Deficiency) of Revenue Over(Under) Expenditures	544,473,813	(420,242,388)	(13,369,322)	(52,385,908)	(21,025,537)	(15,417,930)	(6,373,939)	(14,790,027)
Other Financing Sources & Uses								
Operating Transfers In ²	0	420,242,388	31,518,179	26,265,149	15,759,089	15,759,089	5,253,030	10,506,060
Operating Transfers Out ²	546,502,986	0	0	0	0	0	0	0
Net Change in Fund Balance	(2,029,173)	0	18,148,857	(26,120,759)	(5,266,448)	341,159	(1,120,909)	(4,283,967)
Fund Balance July 1, 2008	2,034,304³	0	78,673,458	131,974,160	61,418,656	75,277,379	26,185,786	27,261,132
Fund Balance June 30, 2009	\$ 5,131	\$ 0	\$ 96,822,315	\$ 105,853,401	\$ 56,152,208	\$ 75,618,538	\$ 25,064,877	\$ 22,977,165

² - See Note 4

The accompanying notes are an integral part of the financial statements.

³ - Restated, See Note 3

NOTES TO FINANCIAL STATEMENTS

First 5 California Children and Families Trust Fund and Related Accounts For the Fiscal Year Ended June 30, 2009

NOTE 1 Summary of Significant Accounting Policies

A. Definition of Reporting Entity

The Children and Families Trust Fund (Fund) and its related accounts were created by the California Children and Families Act of 1998 (Act). Programmatic and fiscal oversight was placed with the California Children and Families Commission (State Commission). Subsequent to the Act, legislation was passed that provided for the State Commission to be known as First 5 California. The Act is intended to promote, support, and improve the early development of children from the prenatal stage to five years of age. The programs authorized by this Act are administered by First 5 California and by county children and families commissions.

Effective January 1, 1999, Section 30131.2 of the Revenue and Taxation Code authorized the California State Board of Equalization (Board) to collect 87 cents for each cigarette pack distributed, and a surtax on other tobacco products. Of the 87 cents collected, 50 cents is allocated and deposited into the Fund. The remainder funds the Proposition 99 and Breast Cancer programs.

While First 5 California has the full responsibility for the program and financial statements, the Board receives, accounts for, and deposits the Cigarette Tax revenue into the Fund. Furthermore, the Department of General Services performs accounting services for First 5 California.

The Fund was established to provide funding for research and development, education, training, and other functions specified in the Act. It primarily functions as a pass-through account which transfers funds to the related accounts according to allocation percentages established by the Act. The county commissions receive 80 percent of the funding and First 5 California receives 20 percent, which is allocated to seven separate accounts that implement specific functions of the Act, as illustrated in the following table.

Allocation of Cigarette Tax Revenue		
Account	Tax Revenue Allocation	Purpose
Counties Children and Families Account (0585)	80%	This account is established for 80 percent of the funds received in the California Children and Families Trust Fund (0623) to be allocated and appropriated to county commissions and expended for the purposes authorized in accordance with each county's strategic plan.
Mass Media Communications Account (0631)	6%	This account provides funding for communications to the general public utilizing television, radio, newspapers, and other mass media furthering the goals and purposes specified in the <i>California Children and Families Act of 1998</i> .
Education Account (0634)	5%	This account provides funding for education goals and purposes as specified in the <i>California Children and Families Act of 1998</i> .
Child Care Account (0636)	3%	This account provides funding for child care goals and purposes as specified in the <i>California Children and Families Act of 1998</i> .
Research and Development Account (0637)	3%	This account provides funding for research and development goals and purposes as specified in the <i>California Children and Families Act of 1998</i> .
Administration Account (0638)	1%	This account provides funding for administrative costs and other purposes as specified in the <i>California Children and Families Act of 1998</i> .
Unallocated Account (0639)	2%	This account provides funding for any other purposes of the <i>California Children and Families Act of 1998</i> , except for administrative costs.

Each county commission receives a portion of the funds equal to the percentage of the number of live births recorded in the relevant county for the most recent reporting period in proportion to the entire number of live births recorded in California for the same period. The live birth vital statistics are compiled by the California Department of Public Health. All expenditures must be incurred in accordance with the provisions of the Health and Safety Code Section 130105 (d).

In August 2009, Assembly Speaker Karen Bass appointed Sumi Sousa as Commissioner to the First 5 California Children and Families Commission (hereinafter referred to as "State Commission"), replacing Commissioner Don Attore.

In October 2009, Governor Arnold Schwarzenegger appointed Joe Munso as Chairperson to the State Commission, replacing Hector Ramirez; and appointed Patrick Duterte as Commissioner to the State Commission, replacing Commissioner David Kears.

Glen Thomas, Secretary of Education, is the ExOfficio Member of the State Commission, replacing David Long, former Secretary of Education.

B. Basis of Presentation—Fund Accounting

The Fund and related accounts are classified as *Other Governmental Cost Funds* for State of California financial reporting purposes. *Other Governmental Cost Funds* are special revenue funds used to account for revenues restricted by law for specified purposes. The financial statements are presented in accordance with generally accepted accounting principles.

C. Measurement Focus and Basis of Accounting

The accompanying financial statements have been prepared using a current financial resources measurement focus and the modified accrual basis of accounting. This measurement focus concentrates on transactions that increase or decrease resources available for spending in the near future. Under the modified accrual basis of accounting, revenues are recorded when they become measurable and available to finance expenditures of the current period. Expenditures are recorded when the related liability is incurred.

D. Budget and Budgetary Control

The accounting policies of First 5 California conform to the State Administrative Manual (SAM) based on the State's budgetary provisions. Program funds are continuously appropriated without regard to fiscal year. First 5 California management is responsible for exercising budgetary control to ensure that appropriations are not overspent at the Fund and related accounts level. The State Controller's Office is responsible for statewide appropriation control and does not allow expenditures in excess of authorized appropriations.

E. Deposits in Surplus Money Investment Fund

Investments consist of cash in excess of current needs on deposit in the Surplus Money Investment Fund (SMIF). The Fund and related accounts participate in the State of California's Pooled Money Investment Program, whereby cash on deposit in the State Treasury determined to be in excess of immediate needs are transferred to the SMIF for investment purposes. All earnings derived from investments of the SMIF are apportioned to the contributing fund as provided in the Government Code.

F. Revenue

Revenue consists of the cigarette taxes collected on sales of cigarette packs and other tobacco products, interest income earned on funds deposited in the SMIF, refunds from reverted appropriations, and unclaimed checks escheated to the issuing fund.

G. Compensated Absences

Liability for vested and unpaid vacation and annual leave is reported as a long-term liability on the government-wide financial statements. It is anticipated that compensated absences will generally not be used in excess of a normal year's accumulation. Unused sick leave balances are not included in compensated absences because they do not vest to employees. For further

information, refer to the *State of California Comprehensive Annual Financial Report*.

H. Retirement Plan

Regular employees of First 5 California are members of the California Public Employees' Retirement System (CalPERS), which is a defined benefit contributory retirement plan. Retirement contributions by employees are set by statute as a percentage of payroll (Tier I employees), or are zero (Tier II employees). Retirement contributions are actuarially determined under a program where total contributions plus CalPERS' investment earnings will provide the necessary funds to pay retirement benefits when incurred. The employer contributions are included in the cost of personal services. For further information, refer to the *State of California Comprehensive Annual Financial Report*, and to the *CalPERS Comprehensive Annual Financial Report*.

NOTE 2 Due From/To Other Funds

The Due From Other Funds for the Fund is the receivable for SMIF interest revenue and the receivable for the difference between the amount of funds transferred to the Board to cover expected administrative costs and the actual costs. The Due From Other Funds for the related accounts represents the receivable of the cigarette tax revenue allocation due from the Fund and SMIF interest revenue. The Unallocated Account 0639 also includes receivables from the School Readiness Program.

The balances of Due From Other Funds for the Fund and related accounts are as follows:

Due From Other Funds		
To	From	Amount
Fund 0623: (Trust Fund)	Surplus Money Investment Fund (0681)	\$ 115,348
	Board (of Equalization)	<u>672,618</u>
	Total	<u>\$ 787,966</u>
Account 0585: (Counties')	Children and Families Trust Fund (0623)	\$ 68,000,645
	Surplus Money Investment Fund (0681)	<u>54,620</u>
	Total	<u>\$ 68,055,265</u>
Account 0631: (Mass Media)	Children and Families Trust Fund (0623)	\$ 5,100,048
	Surplus Money Investment Fund (0681)	<u>349,766</u>
	Total	<u>\$ 5,449,814</u>
Account 0634: (Education)	Children and Families Trust Fund (0623)	\$ 4,250,040
	Surplus Money Investment Fund (0681)	<u>443,337</u>
	Total	<u>\$ 4,693,377</u>

Due From Other Funds		
To	From	Amount
Account 0636: (Child Care)	Children and Families Trust Fund (0623)	\$ 2,550,024
	Unallocated Account (0639)	850,891
	Surplus Money Investment Fund (0681)	<u>221,167</u>
	Total	<u>\$ 3,622,082</u>
Account 0637: (Research and Development)	Children and Families Trust Fund (0623)	\$ 2,550,024
	Surplus Money Investment Fund (0681)	<u>282,279</u>
	Total	<u>\$ 2,832,303</u>
Account 0638: (Administration)	Children and Families Trust Fund (0623)	\$ 850,008
	Surplus Money Investment Fund (0681)	<u>93,058</u>
	Total	<u>\$ 943,066</u>
Account 0639: (Unallocated)	Children and Families Trust Fund (0623)	\$ 1,700,016
	Mass Media Communications Account (0631)	1,304,745
	Education Account (0634)	2,864,498
	Child Care Account (0636)	1,303,879
	Research and Development Account (0637)	1,824,374
	Administration Account (0638)	155
	Surplus Money Investment Fund (0681)	<u>46,864</u>
	Total	<u>\$ 9,044,531</u>

The Due To Other Funds for the Fund represents the cigarette tax revenue due to the other related accounts as described in Note 1. Additionally, the Due To Other Funds includes the allocations from the Fund and related accounts to the Unallocated Account 0639 for the School Readiness Program administered by First 5 California. Under this Program, First 5 California distributes funds to eligible counties, in addition to the required 80 percent allocation of cigarette taxes as provided in Note 1, to assist with the development of children ages 0 through 5 to prepare them for school.

The balances of the Due To Other Funds for the Fund and related accounts are as follows:

Due To Other Funds		
From	To	Amount
Fund 0623: (Trust Fund)	Counties' Children and Families Account (0585)	\$ 68,000,646
	Mass Media Communications Account (0631)	5,100,048
	Education Account (0634)	4,250,040
	Child Care Account (0636)	2,550,024
	Research and Development Account (0637)	2,550,024
	Administration Account (0638)	850,008
	Unallocated Account (0639)	<u>1,700,016</u>
	Total	<u>\$ 85,000,806</u>

Due To Other Funds		
From	To	Amount
Account 0631: (Mass Media)	Unallocated Account (0639)	<u>\$ 1,304,745</u>
Account 0634: (Education)	Unallocated Account (0639)	<u>\$ 2,864,498</u>
Account 0636: (Child Care)	General Fund (0001)	\$ 40,032
	Unallocated Account (0639)	<u>1,303,879</u>
	Total	<u>\$ 1,343,911</u>
Account 0637: (Research and Development)	General Fund (0001)	\$ 10,000
	Unallocated Account (0639)	<u>1,824,374</u>
	Total	<u>\$ 1,834,374</u>
Account 0638: (Administration)	General Fund (0001)	\$ 259,690
	Compensation Insurance Fund (0512)	1,555
	Service Revolving Fund (0666)	54,530
	Department of Technology Services (9730)	1,105
	Prison Industry Authority (0678)	2,283
	Unallocated Account (0639)	<u>155</u>
	Total	<u>\$ 319,318</u>
Account 0639: (Unallocated)	General Fund (0001)	\$ 141,530
	Child Care Account (0636)	<u>850,891</u>
	Total	<u>\$ 992,421</u>

NOTE 3 Fund Balance

The term *fund balance* is defined as the excess of the assets of a fund over its liabilities. Part or all of the total fund balance may be reserved as a result of law or generally accepted accounting principles. Reserves represent those portions of the fund balance that are legally segregated for specific uses.

Reserved for Encumbrances

First 5 California utilizes encumbrance accounting to reserve funds for current year commitments. Although an expenditure or liability has not been incurred, the reservation recognizes that funds have been committed for a specified purpose that will be liquidated in the following fiscal year. Encumbrances include interagency agreements, program agreements, and other commitments. Encumbrances are reported as the *Reserved for Encumbrances* portion of the statutorily established accounts' fund balance.

First 5 California enters into multi-year agreements with vendors and county commissions, typically in periods of three-to-five years. However, encumbrances for

agreements only include the unpaid and remaining commitment for the current fiscal year (not the entire agreement), based on available estimates of expenditures for goods and services provided.

Reserved for Unencumbered Balances of Continuing Appropriations

The reserve represents the unencumbered balances of all appropriations for which the period of availability extends beyond the period covered by this report. These appropriations are legally segregated for a specific future use.

Restatement of Beginning Fund Balance

A prior year adjustment was made to Fund 0623's beginning fund balance for \$2,027,936 of tobacco tax revenue that was received or earned in the prior year, but recognized and recorded in FY 2008-09. The adjustment does not affect the ending fund balance.

Beginning Fund Balance Restatement	
Fund Balance, July 1, 2008	\$ 6,368
Prior Year Adjustment	<u>2,027,936</u>
Fund Balance July 1, 2008, Restated	<u>\$ 2,034,304</u>

NOTE 4 Operating Transfers

Legally authorized transfers between state funds are reported on the *Statement of Revenue, Expenditures, and Changes in Fund Balance* as Operating Transfers In or Operating Transfers Out, and are accounted for as increases or decreases in residual equity.

Operating Transfers Out represents the sum of the Operating Transfers In and the statutorily required backfill of \$21,200,000 for the Proposition 99 and Breast Cancer programs. The Operating Transfers In are calculated based on the applicable percentage of the Fund revenues, which include cigarette taxes and SMIF interest income. Balances are derived as follows:

Operating Transfers	
Cigarette Tax Revenue (Fund 0623):	
Current Year	\$ 555,404,306
Prior Year Adjustment (Note 3)	2,027,936
SMIF Interest Revenue	792,126
Board - State Operations	<u>(11,721,382)</u>
Total Operating Transfers Out	<u>546,502,986</u>
Backfill	<u>(21,200,000)</u>
Total Operating Transfers In	<u>\$ 525,302,986*</u>
*Operating Transfers In is allocated from Fund 0623 to the related accounts in accordance with the percentages specified in Note 1.	
<i>Note: An immaterial \$2 rounding error exists between this calculation and the amounts allocated to the related accounts in the Statement of Revenue, Expenditures and Changes in Fund Balance.</i>	

Section 130105 of the Health and Safety Code requires the backfill of lost funding for certain Proposition 99 and Breast Cancer Fund programs. Specifically, the Code provides that the Board shall determine within one year of the passage of this act the effect that additional taxes imposed on cigarettes and tobacco products has on the consumption of cigarettes and tobacco products in this state. To the extent that a decrease in consumption is determined by the Board to be the direct result of additional taxes imposed by this act, the Board shall determine the fiscal effect the decrease in consumption has on the funding of any Proposition 99 (the Tobacco Tax and Health Protection Act of 1988) state health-related education or research programs in effect as of November 1, 1998, and the Breast Cancer Fund programs that are funded by excise taxes on cigarettes and tobacco products. Funds shall be transferred from the Fund to those affected programs as necessary to offset the revenue decrease directly resulting from the imposition of additional taxes by this act. Such reimbursements shall occur, and at such times, as determined necessary to further the intent of this subdivision.

NOTE 5 Contingent Liability

A. Litigation

The Board is involved in legal proceedings that, if decided against the Board, may result in a loss of funds available for transfer to the various programs supported by tobacco taxes. No provision for the potential liability has been made in the financial statements.

Following are two significant lawsuits pending against the Board:

1. Taxpayers filed a refund lawsuit on December 5, 2007 for tobacco taxes paid. These taxpayers are the shareholders and officers of a corporation, who had continued distributing cigarettes and tobacco products after the corporation was suspended for failure to pay franchise taxes. The Board asserted controlling person liability against taxpayers under the Cigarette and Tobacco Products Tax Law. On February 23, 2009, the trial court entered judgment in favor of taxpayers in the amount of \$69,763 plus interest. Subsequently, the trial court awarded attorneys' fees to taxpayers under Code of Civil Procedure section 1021.5 in the amount of \$627,797. The Board has appealed both the judgment and the attorneys' fees award. Taxpayers are currently drafting a settlement offer. Risk of loss is determined to be probable, and the attorney's fees award could increase to \$1.3 million. The impact to the Fund is estimated at 36.36 percent of the total award, or \$498,046 (based on \$69,763 taxpayer judgment plus \$1.3 million attorney's fees award).
2. U.S. Smokeless Tobacco (UST) filed a refund lawsuit in 2007 for refund of \$725,978 in tobacco taxes paid. UST is a marketing subsidiary of the parent manufacturing company. UST, which obtained samples from its parent manufacturing company, owed excise tax on its distribution of samples to consumers based on the "wholesale" cost of the tobacco products. UST contends that the taxable wholesale cost is not the extended list price (i.e., the price at which it would regularly have sold the products) that it reported on its returns, but rather that it should pay tax on what it calls invoiced wholesale cost or manufacturer's cost. Tentative Decision after Non-Jury Trial entered

April 1, 2009. Post-trial briefs were filed in May and June, 2009. Post-trial oral argument was held in August 2009, and decision is pending. There is a probable risk of loss as assessed at this time. The impact to the Fund is estimated at 36.36 percent, or \$263,966. However, future years' losses or gains, as a result of the decision, cannot be estimated at this time.

NOTE 6 Subsequent Events

Healthy Families Program

On August 13, 2009, the State Commission approved up to \$81.4 million to pay the health care premiums and related enrollment expenses in FY 2009-10 for eligible children ages zero through five in the Healthy Families Program. The Managed Risk Medical Insurance Board (MRMIB) administers the Healthy Families Program. With health care as an essential element of children's readiness for school, the funding allocations set forth below are consistent with prior funding commitments made by First 5 California to fund its School Readiness Program, as well as language from the Act which authorizes expenditures to ensure children are ready to enter school.

Healthy Families Program Allocation	
Account	Amount Authorized
Mass Media Communications Account (0631)	\$ 30.0 million
Education Account (0634)	10.0 million
Child Care Account (0636)	20.0 million
Research & Development Account (0637)	<u>21.4 million</u>
Total	\$ 81.4 million

Statutory Changes

On September 22, 2009, the Governor signed AB 1422 (Chapter 157 of the Statutes of 2009). Titled *Health Care Programs: California Children and Families Act of 1998*, the bill makes changes to the California Children and Families Act to permit the transfer of funds from the Mass Media Communications Account, Education Account, Child Care Account and the Research and Development Account to the Unallocated Account. Such transfers of funds will be made upon approval of the State Commission for expenditure by the State Commission for any of the purposes specified in the California Children and Families Act.