



AGENDA ITEM: 7

DATE OF MEETING: January 27, 2010

ACTION: _____

INFORMATION: _____X_____

Financial Plan Fiscal Year 2009-10 and 2008-09 Financial Audit

SUMMARY OF REQUEST

First 5 California staff will provide State Commissioners a report on three important fiscal issues: 1) the First 5 California FY 2008-09 financial audit, 2) Board of Equalization (BOE) administration cost detail, and 3) spending Plan for FY 2009-10 through 2012-13, including revenue, obligations, and trends.

AUDIT

The Department of Finance, Office of State Audits and Evaluations (DOF), performed First 5 California's FY 2008-09 financial audit. The report is titled, *A Financial Statement Audit, First 5 California Children and Families Trust Fund and Related Accounts for the Fiscal Year Ended June 30, 2009*. This report is available on First 5 California's Web site at <http://www.cafc.ca.gov/commission/fiscal.asp>.

DOF performed this audit in accordance with an interagency agreement with First 5 California. The objectives of the 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 ending 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 on the Fund and related accounts.

Audit Results:

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

Board of Equalization Administrative Costs

At the October 2009 State Commission meeting, Commissioners requested that a representative from the BOE come to the January State Commission meeting to speak to the Commission regarding the BOE's current and historical costs related to the administration of the California Children and Families Trust Fund (Fund). Unfortunately, the BOE's scheduled Board meeting coincides with First 5 California's Commission meeting, which precludes BOE from presenting at the January meeting.

In an effort to address the Commission's questions, BOE staff met with First 5 California staff and provided an overview of BOE programs and activities that affect the revenues and costs. The costs BOE presented were predominantly for program implementation and enforcement versus administration. The BOE provided the following documents with additional detail regarding BOE costs charged to the Fund:

- Attachment A: Letter from Liz Houser, Deputy Director, Administration, BOE to Kris Perry with the following two attachments: (1) Spreadsheet titled *2008-09 (Cigarette Tax and Cigarette Licensing Fee) Program Cost Break Downs*, and (2) Spreadsheet titled *California Children and Families First Trust Fund Revenues and Expenditures*.
- Attachment B: *Overview of the Tax and Licensing Programs – Excise Tax*
- Attachment C: *Program Fund Allocation*

BOE staff will be available to present at the April 2010 State Commission meeting upon the request of the Commission if additional information or explanation is required.

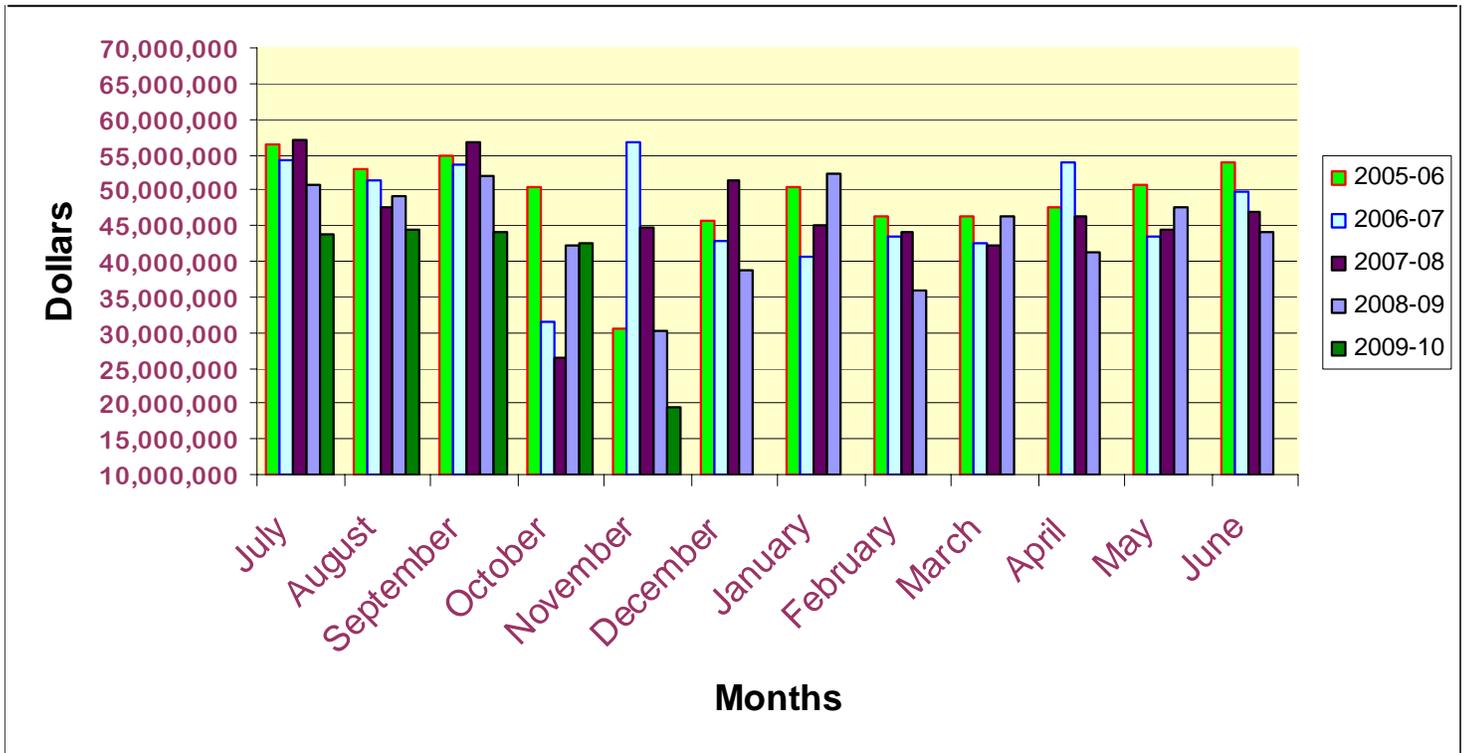
FISCAL HISTORY

First 5 California revenues consist of the cigarette taxes collected, interest income earned on funds deposited in the Surplus Money Investment Fund (SMIF), refunds from reverted appropriations, and unclaimed checks escheated to the issuing fund.

The chart on page 3 represents a historical depiction of tax revenues received in the Fund beginning with Fiscal Year 2005-06 through November 2009.

The amount of monthly revenue received varies each month, each year. During the first and fourth quarters of each year, revenues received are consistently higher than during the second and third quarters. The BOE calculated backfill typically occurs during the second quarter. Backfill funds are directed to Proposition 99 state health-related education or research programs in effect as of November 1, 1998, and Breast Cancer Fund programs impacted by the enactment of Proposition 10.

**Proposition 10
 California Children and Families Trust Fund (0623)**



First 5 California revenues are deposited monthly into six accounts according to statute (HSC Section 130105) as referenced below. The Distribution Conversion represents the distribution of actual percent-to-total for First 5 California revenue. The following table represents the statutory distribution of revenue by account type.

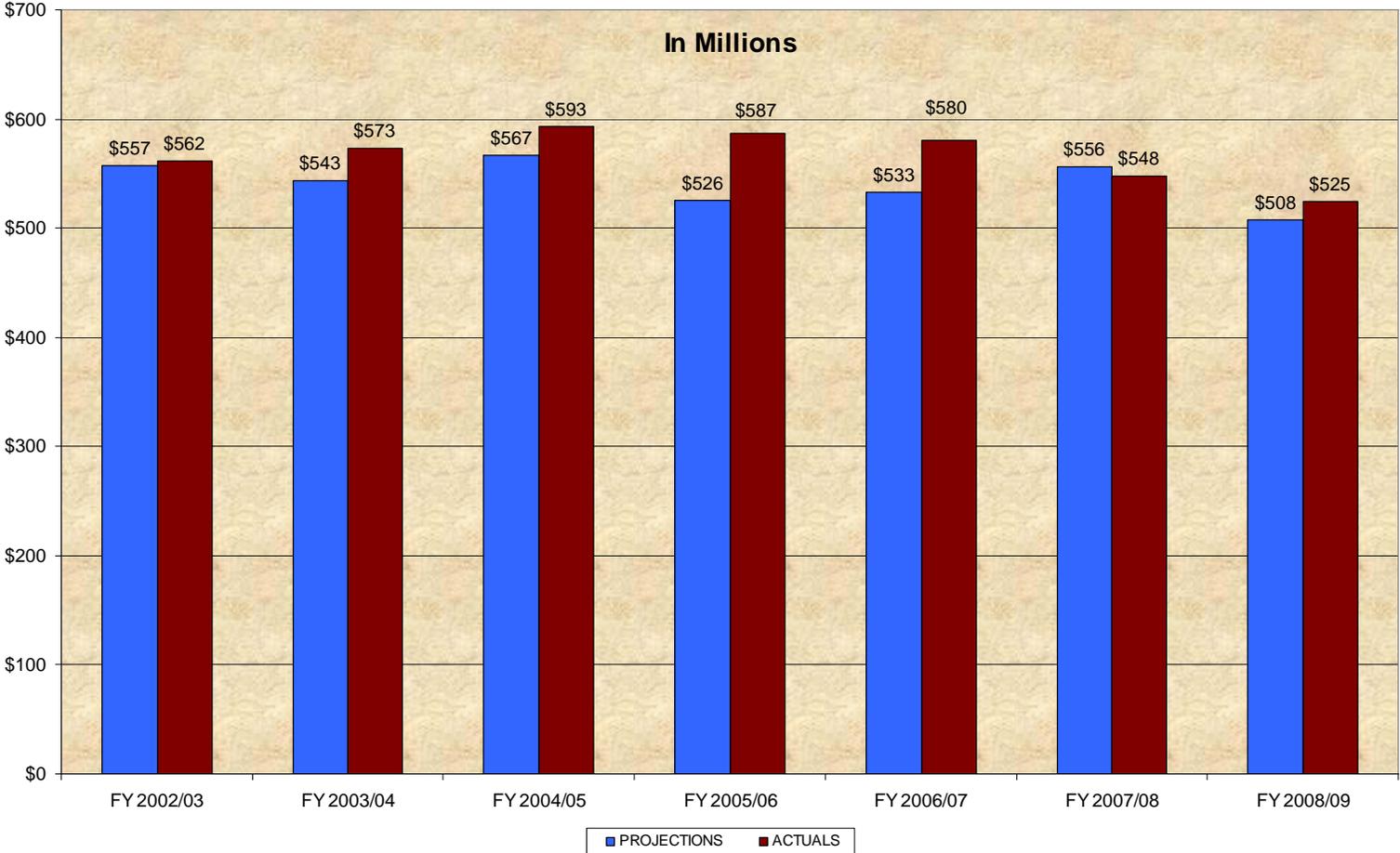
Account Type	Statutory Distribution	Distribution Conversion
Mass Media Communications	6%	30%
Education	5%	25%
Child Care	3%	15%
Research and Development	3%	15%
Unallocated	2%	10%
Administration	1%	5%
Total	20%	100%

Assembly Bill 1422 (Chapter 157, Statutes of 2009, Assemblymember Karen Bass) amended Health and Safety Code, section 130105 to authorize the Commission to redirect any funds not needed in the accounts to be transferred to the Unallocated account, for expenditure by the State Commission for any of the purposes described in Health and Safety Code Section 130100. However, funds in the Unallocated account cannot be expended for the administrative functions of the State Commission.

DOF releases cigarette tax revenue projections upon the release of the Governor's Budget in January of each year and updates its projections following the May Revise. Proposition 10 revenue is collected by the state and deposited in the California Children and Families Trust Fund (Fund) each month. After the revenue is deposited in the Fund, the BOE makes authorized adjustments. The BOE adjustments include, but are not limited to, BOE costs for administering the Fund, backfill to other state programs impacted by Proposition 10, and adjustments to cigarette and tobacco products tax paid by retailers and distributors. After the authorized adjustments are made, the revenue is transferred to the state and county commission accounts established in statute. The amounts transferred into these accounts are referred to as revenue "available to transfer" or "revenue received."

The following chart demonstrates that prior to FY 2007-08, the actual revenue received was consistently equal to or greater than the projected revenue. Beginning in FY 2007-08, the gap between the projected and actual revenue received was significantly narrowed. Fiscal Year 2007-08 was the only year that the actual revenue received was less than the projected revenue. In FY 2008-09, the actual revenue received exceeded DOF projections by approximately 3.35%.

**Comparison of Proposition 10 Revenue
 Projection and Actual Revenue Received**



DISCUSSION

Tax Revenue Projections

DOF projections confirm that tobacco tax revenue is declining. The rate of decline is caused by both intended and unintended factors, which include First 5 California's effective public outreach efforts and smoking cessation programs to reduce tobacco use, the impact of the federal legislation, H.R. 2, which funds the federal Children's Health Insurance Program (CHIP), and the impact of the state's sluggish economy.

In early February 2009, H.R. 2 was signed into law by the President. This bill funds the federal Children's Health Insurance Program (CHIP) with revenues from increases in federal excise tax rates on cigarettes and tobacco products. Under the law, the federal cigarette tax rate increased from \$.039 per pack to \$1.01 per pack on April 1, 2009. Federal tax rates for tobacco products also increased substantially; the increases varied greatly depending on the type of product.

In May 2009, the BOE released an analysis of the impact of CHIP on Proposition 10 funds. The BOE stated that FY 2009-10 will be the first complete year that all the provisions of the new federal legislation will be in effect. The BOE estimated that the CHIP revenue impact to Proposition 10 funds would result in a decrease of approximately \$43.60 million in FY 2009-10 and a decrease of approximately \$42.40 million in FY 2010-11, as detailed in the following chart.

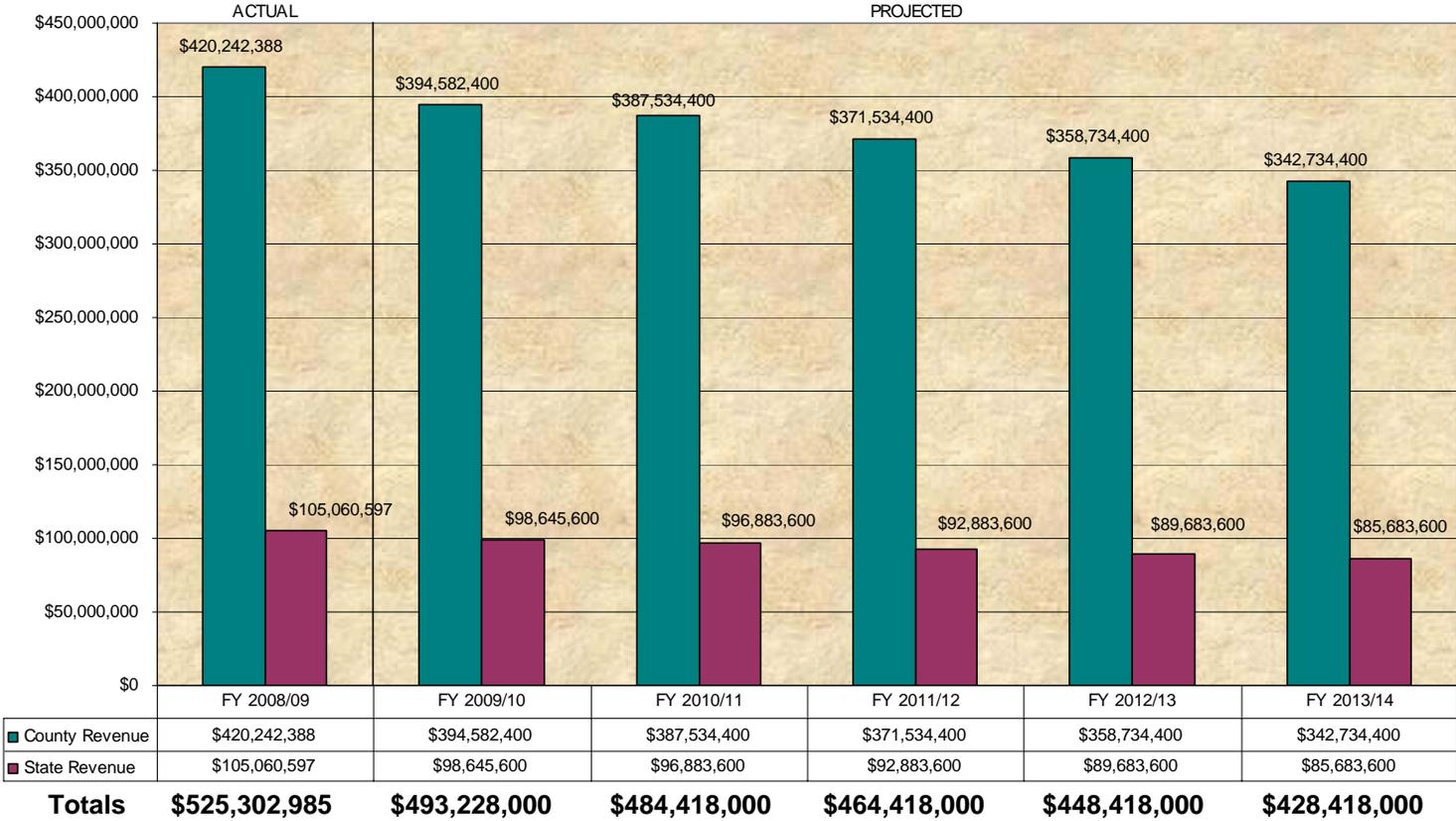
**BOE Revenue Impact Summary - Proposition 10 Fund Only
(\$ Millions)**

Category	Fiscal Year 2009-10		
	Total State Impact by Category	County Commissions 80 Percent	First 5 California 20 Percent
Cigarette Excise Tax Revenue	-40.00	-32.00	-8.00
Other Tobacco Products	-3.60	-2.88	-0.72
Total Projected Impact	-43.60	-34.88	-8.72

Category	Fiscal Year 2010-11		
	Total State Impact by Category	County Commissions 80 Percent Share	First 5 California 20 Percent Share
Cigarette Excise Tax Revenue	-38.80	-31.04	-7.76
Other Tobacco Products	-3.60	-2.88	-0.72
Total Projected Impact	-42.40	-33.92	-8.48

The following chart shows FY 2008-09 through FY 2013-14 actual and projected Proposition 10 tax revenue available to transfer to state and county commission accounts. The projected revenue is based on the DOF's cigarette tax revenue projections represented in the Governor's budget. The projected revenue for each fiscal year also includes the projected revenue decreases resulting from the federal CHIP legislation.

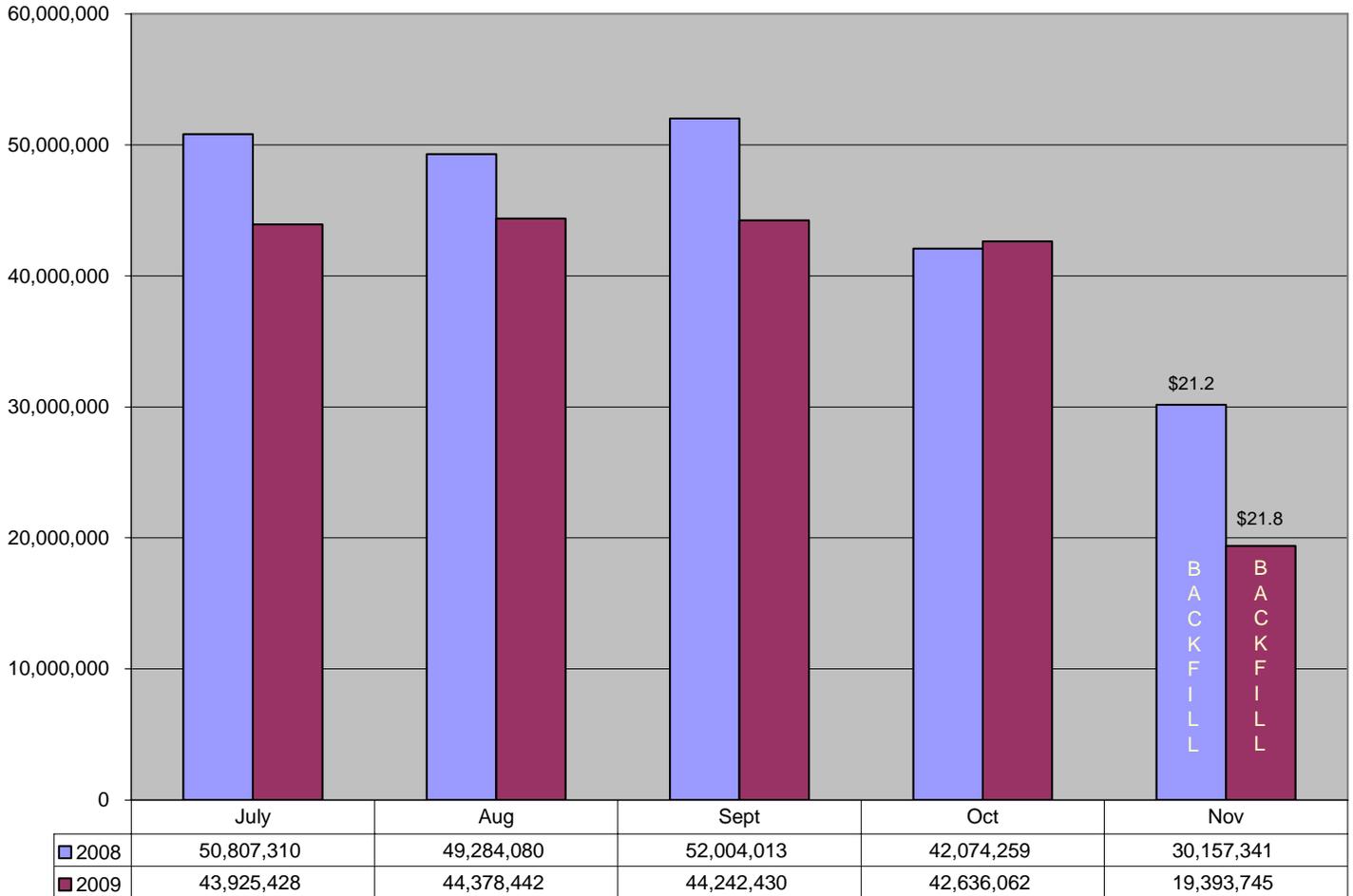
STATE AND COUNTY PROP 10 TAX REVENUE



- Between FY 2008-09 and FY 2009-10, Proposition 10 revenue is projected to decrease by approximately 6.11%.
- Proposition 10 revenue received in FY 2009-10 through November 2009 reflects a steeper decline as detailed in the chart on page 7.

Below is a comparison of FY 2008-09 and FY 2009-10 actual revenue received during the first five months of the current fiscal year, July through November.

Two Year Revenue Comparison by Month



The total state and county commission revenue received during the first five months in FY 2008-09 was \$224,327,003, or a monthly average of \$44,865,401. The total revenue received during the same five-month period in FY 2009-10 was \$194,576,107 for a monthly average of 38,915,221, a decrease of approximately 13% from the prior year.

DOF will update its tax revenue projections in May 2010, at which time First 5 California will revise its Revenue and Commitment plan to reflect the tax revenue projection adjustments.

Surplus Money Investment Fund

First 5 California 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 is 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.

The rate of interest earned on investment changes regularly and is posted to First 5 California’s accounts quarterly. The following chart shows the decline in interest rates by quarter for FY 2007-08 through the second quarter in FY 2009-10. The current interest rate of 0.594 represents the lowest rate since January of 1965.

SMIF Apportionment Yield Rates			
Fiscal Year	Period Ending	Interest Rate	Percent Change
07/08	9/30/2007	5.236	
	12/31/2007	4.955	-5.37
	3/31/2008	4.174	-15.76
	6/30/2008	3.108	-25.54
08/09	9/30/2008	2.769	-10.91
	12/31/2008	2.533	-8.52
	3/31/2009	1.903	-24.87
	6/30/2009	1.512	-20.55
09/10	9/30/2009	0.889	-41.20
	12/31/2009	0.594	-33.18

First 5 California’s Revenue and Commitment plan calculates projected SMIF revenue using 1.7% interest earnings annually. This yield rate was established at the time the revenue projection model was developed for First 5 California and is currently being reviewed. First 5 California’s interest revenue has steadily declined. Declines are due primarily to lower interest rates and large disbursements of funds from any particular account. First 5 California reconciles SMIF revenue quarterly and reports changes with each fiscal update.

Fund Condition

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 chart below represents First 5 California’s Fund Condition as of June 30, 2009, and the projected fund condition for FY 2009-10.

2008/09 Fund Condition 2009/10 Spending Plan		
<i>(Dollars in Millions)</i>		
	Actual 2008/09	Projected 2009/10
Prior-Year Fund Balance	\$373.1	\$381.4
Revenues and Transfers	\$113.6	\$105.1
Total Resources Available	\$486.7	\$486.5
Expenditures ¹	\$105.3	\$308.0
Ending Fund Balance ²	\$381.4	\$178.5

¹ Includes accruals/encumbrances
² Includes 15 percent operational reserve by account for FY 09/10

Prior-Year Fund Balance

- In October 2009, First 5 California’s reported actual expenditures for FY 2008-09 were \$121 million. This amount included program accruals and encumbrances which are reconciled in November through December of each year. The adjusted expenditure amount for FY 2008-09 is \$105.3 million. The decrease in the FY 2008-09 expenditure amount is the difference between the encumbered agreement amounts and actual contract or program expenditures reported.

Expenditure Summary:

- First 5 California’s Fund Condition shows a projected 53% decrease in ending fund balance from FY 2008-09 to FY 2009-10.
- In October 2009, First 5 California reported projected FY 2009-10 expenditures as \$275 million. The encumbrance of remaining School Readiness, Cycle 2, program obligations in FY 2009-10 was the primary reason for the increase in the projected expenditures from \$275 million to \$308 million.

- FY 2009-10 expenditures represent full program and infrastructure alignment within current State Commission authority.

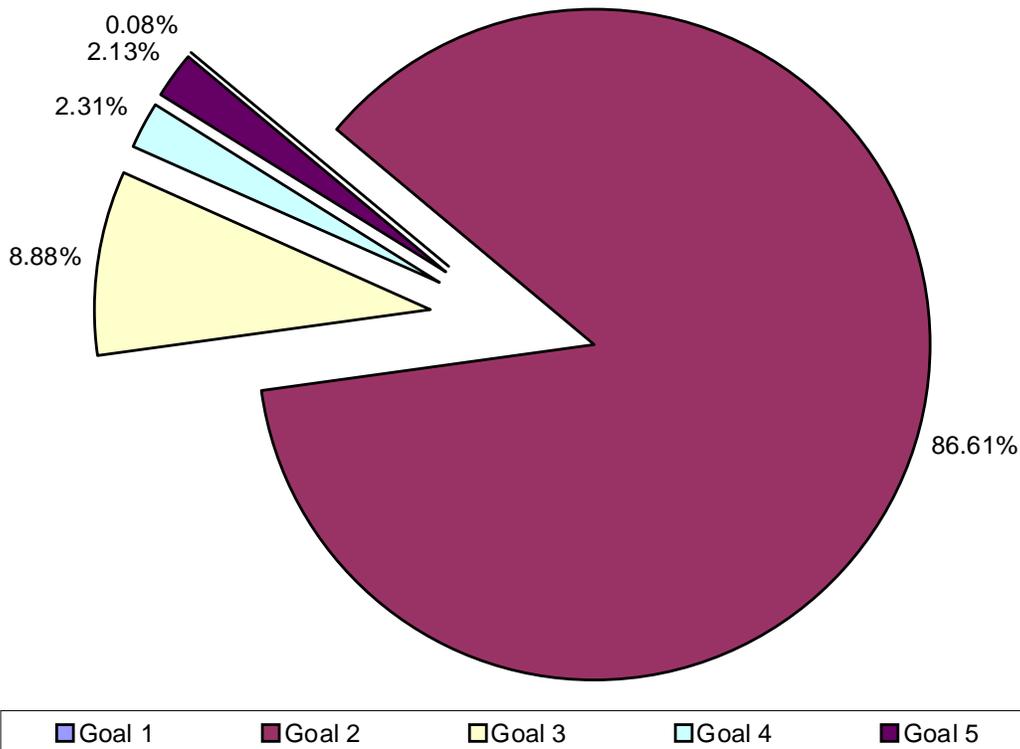
Prior Year Fund Balance:

- The change in FY 2008-09 reported expenditures resulted in an increased FY 2008-09 ending fund balance from \$364 million to \$381.4 million.

The following chart details the FY 2009-10 expenditure commitments by Strategic Goal areas.

Fiscal Year 2009-10 Expenditures by Strategic Goal Area		
<u>Goal Description</u>	<u>Amount Obligated</u>	<u>% of Total Obligations</u>
Goal 1: Focus on Policy Development	\$250,000	0.08%
Goal 2: Invest in Program Development	\$266,760,464	86.61%
Goal 3: Broaden Public Awareness	\$27,337,094	8.88%
Goal 4: Enhance Research and Evaluation	\$7,103,626	2.31%
Goal 5: Strengthen Organizational Operations and Systems	\$6,546,539	2.13%
Total	\$307,997,724	*100.00%

*Total Percent Adjusted for Rounding



General Observations

Revenue

- First 5 California's revenue received during the first five months of FY 2009-10 shows a significant decrease in revenue from prior years. Contributing factors for the decline include the impact of the federal CHIP tax and the ongoing economic challenges facing the State.
- The fiscal year-end fund balances reported in the annual audit do not fully represent current and future year encumbrances, obligations, and commitments.
- The Governor's 2010-11 proposed budget would have a severe and adverse impact on First 5 California's ability to meet current year and multi-year contract, program, and employment obligations and commitments.
- Individual county commissions may experience additional and sharper declines in tax revenue receipts if a county experiences both birth rate declines and revenue declines in the same fiscal year.

Expenditures

- The Revenue and Current Commitments for FY 2009-10 through FY 2012-13 include all approved State Commission Funding obligations and the funding commitments and proposed funding commitments detailed in Agenda Item 12.
- The funding proposals in Agenda Item 12 will result in a significant amount of leveraged funds to support First 5 California's mission.
- The BOE FY 2009-10 cost projections for administering the Fund, including enforcement activities to reduce cigarette tax evasion, total \$13,972,000, an increase of approximately 19% over FY 2008-09 costs.
- The FY 2009-10 Proposition 99 Backfill totaled \$21,800,000, an increase of 2.8% from FY 2008-09.
- First 5 California's Revenue and Current Commitments plan is a living document. During each year, several changes occur to the plan. These changes are generated by:
 - New funding obligations by the State Commission
 - Changes in DOF tax revenue projections

- Changes in state operations costs such as staffing, pro rata, State Controller's Office fees, and BOE's cost for administering the Fund
- Changes in contractors and county commission use of authorized funding
- New costs associated with statewide initiatives
- Changes in the federal legislation impacting cigarette and other tobacco product taxes.

The Revenue and Commitment plan includes a 15% revenue reserve on projected revenue to respond to unanticipated changes in revenue receipts.

As the State Commission creates its "Roadmap to the Future," the transition period between programs ending and new program development may result in temporary increased fund balances. Once the new programs have been developed and are implemented, First 5 California will experience a significant decline in the fund balances.

Terry Miller, Chief of the Administrative Services Division, will present additional detail related to Fiscal Year End figures and funding changes, and highlight spending commitments for Fiscal Year 2009-10 through Fiscal Year 2012-2013.

- Attachments:
- A. January 5, 2009 letter from Liz Houser, Deputy Director, Board of Equalization to Kris Perry with the following two attachments:
(1) *2008-09 (Cigarette Tax and Cigarette Licensing Fee) Program Cost Break Downs*, and (2) *BOE California Children and Families First Trust Fund Revenues and Expenditures*
 - B. *BOE Overview of the Tax and Licensing Programs – Excise Tax*
 - C. *BOE Program Fund Allocation*
 - D. *First 5 California, Revenue and Current Commitments FY 09/10 through FY 12/13*