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## *Independent Auditor's Report*

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### THE GOVERNOR AND THE LEGISLATURE OF THE STATE OF CALIFORNIA

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California, as of and for the year ended June 30, 2011, which collectively comprise the State of California's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the State of California's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the following significant amounts in the financial statements:

#### Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 86 percent and 36 percent, respectively, of the assets and revenues of the business-type activities.
- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, Public Employees' Benefits, and certain other funds that, in the aggregate, represent over 99 percent of the assets and revenues of the discretely presented component units.

#### Fund Financial Statements

- The following major enterprise funds: Electric Power fund, Water Resources fund, Public Building Construction fund, State Lottery fund, and California State University fund.
- Certain nonmajor enterprise funds that represent 92 percent and 66 percent, respectively, of the assets and revenues of the nonmajor enterprise funds.
- The funds of the Public Employees' Retirement System and the State Teachers' Retirement System, and certain other funds that, in the aggregate, represent 90 percent and 76 percent, respectively, of the assets and additions of the fiduciary funds and similar component units.
- The discretely presented component units noted above.

Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinions, insofar as they relate to the amounts included for those funds and entities, is based on the reports of the other auditors.

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 of America. 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 and the reports of other auditors provide a reasonable basis for our opinions.

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California, as of June 30, 2011, and the respective changes in financial position, and where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we will issue a separate report on our consideration of the State's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis, schedule of funding progress, infrastructure information, budgetary comparison information, reconciliation of budgetary and GAAP-basis fund balances, and related notes are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We and the other auditors have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the State of California's basic financial statements. The combining financial statements and schedules listed in the accompanying table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. The combining statements and schedules have been subjected to the auditing procedures applied by us and the other auditors in the audit of the basic financial statements and, in our opinion, based on our audit and the reports of other auditors, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The introductory and statistical sections of this report have not been subjected to the auditing procedures applied by us and the other auditors in the audit of the basic financial statements, and accordingly, we express no opinion on them.

CALIFORNIA STATE AUDITOR



JOHN F. COLLINS II, CPA  
Deputy State Auditor

February 24, 2012

## NOTE 3: DEPOSITS AND INVESTMENTS

The State Treasurer administers a single pooled investment program comprising both an internal investment pool and an external investment pool (the Local Agency Investment Fund). A single portfolio of investments exists, with all participants having an undivided interest in the portfolio. Both pools are administered in the same manner, as described below.

As required by generally accepted accounting principles, certain risk disclosures are included in this note to the extent that the risks exist at the date of the statement of net assets. Disclosure of the following risks is included:

*Interest Rate Risk* is the risk that the value of fixed-income securities will decline because of changing interest rates. The prices of fixed-income securities with longer time to maturity tend to be more sensitive to changes in interest rates than those with shorter durations.

*Credit Risk* is the risk that a debt issuer will fail to pay interest or principal in a timely manner, or that negative perceptions of the issuer's ability to make these payments will cause security prices to decline.

*Custodial Credit Risk* is the risk that, in the event a financial institution or counterparty fails, the investor will not be able to recover the value of deposits, investments, or collateral.

*Concentration of Credit Risk* is the risk of loss attributed to the magnitude of an investor's holdings in a single issuer.

*Foreign Currency Risk* is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit.

### A. Primary Government

The State's pooled investment program and certain funds of the primary government are allowed by state statutes, bond resolutions, and investment policy resolutions to invest in United States government securities, federal agency securities, negotiable certificates of deposit, bankers' acceptances, commercial paper, corporate bonds, bank notes, other debt securities, repurchase agreements, reverse repurchase agreements, and other investments.

Certain discretely presented component units participate in the State Treasurer's Office pooled investment program. As of June 30, 2011, the discretely presented component units accounted for approximately 3.5% of the State Treasurer's pooled investment portfolio. This program enables the State Treasurer's Office to combine available cash from all funds and to invest cash that exceeds current needs.

Both deposits and investments are included in the State's investment program. For certain banks, the State Treasurer's Office maintains cash deposits that cover uncleared checks deposited in the State's accounts and that earn income which compensates the banks for their services.

Demand and time deposits held by financial institutions as of June 30, 2011, totaling approximately \$5.9 billion, were insured by federal depository insurance or by collateral held by the State Treasurer's Office

or an agent of the State Treasurer's Office in the State's name. The California Government Code requires that collateral pledged for demand and time deposits be deposited with the State Treasurer.

As of June 30, 2011, the State Treasurer's Office had on deposit with a fiscal agent amounts totaling \$28.6 million related to principal and interest payments to bondholders. These deposits were insured by federal depository insurance or by collateral held by an agent of the State Treasurer's Office in the State's name.

The State Treasurer's Office reports its investments at fair value. The fair value of securities in the State Treasurer's pooled investment program generally is based on quoted market prices. The State Treasurer's Office performs a quarterly fair market valuation of the pooled investment program portfolio. In addition, the State Treasurer's Office performs a monthly fair market valuation of all securities held against carrying cost. These valuations are posted to the State Treasurer's Office website at [www.treasurer.ca.gov](http://www.treasurer.ca.gov). As of June 30, 2011, the weighted average maturity of the securities in the pooled investment program administered by the State Treasurer's Office was approximately 245 days. Weighted average maturity is the average number of days, given a dollar-weighted value of individual investments, that the securities in the portfolio have remaining from evaluation date to stated maturity.

The Pooled Money Investment Board provides oversight of the State Treasurer's pooled investment program. The purpose of the board is to design and administer an effective cash management and investment program, using all monies flowing through the State Treasurer's Office bank accounts and keeping all available funds invested in a manner consistent with the goals of safety, liquidity, and yield. The Pooled Money Investment Board is comprised of the State Treasurer as chair, the State Controller, and the Director of Finance. This board designates the amounts of money available for investment. The State Treasurer is charged with making the actual investment transactions for this program. This investment program is not registered with the Securities and Exchange Commission as an investment company.

The value of the deposits in the State Treasurer's pooled investment program, including the Local Agency Investment Fund, is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2011, this difference was immaterial to the valuation of the program. The pool is run with "dollar-in, dollar-out" participation. There are no share-value adjustments to reflect changes in fair value.

Certain funds have elected to participate in the pooled investment program even though they have the authority to make their own investments. Others may be required by legislation to participate in the program; as a result, the deposits of these funds or accounts may be considered involuntary. However, these funds or accounts are part of the State's reporting entity. The remaining participation in the pool, the Local Agency Investment Fund, is voluntary.

Certain funds that have deposits in the State Treasurer's pooled investment program do not receive the interest earnings on their deposits. Instead, by law, the earnings are to be assigned to the State's General Fund. Most of the \$37.1 million in interest revenue received by the General Fund from the pooled investment program in the 2010-11 fiscal year was earned on balances in these funds.

The State Treasurer's pooled investment program values participants' shares on an amortized cost basis. Specifically, the program distributes income to participants quarterly, based on their relative participation during the quarter. This participation is calculated based on (1) realized investment gains and losses calculated on an amortized cost basis, (2) interest income based on stated rates (both paid and accrued), (3) amortization of discounts and premiums on a straight-line basis, and (4) investment and administrative expenses. This amortized cost method differs from the fair value method used to value investments in these

financial statements; the amortized cost method is not designed to distribute to participants all unrealized gains and losses in the fair value of the pool's investments. Because the total difference between the fair value of the investments in the pool and the value distributed to pool participants using the amortized cost method described above is not material, no adjustment was made to the financial statements. The State Treasurer's Office also reports participant fair value as a ratio of amortized cost on a quarterly basis. The State Treasurer's Office has not provided or obtained a legally binding guarantee to support the principal invested in the investment program.

As of June 30, 2011, structured notes and medium-term asset-backed securities comprised approximately 3.19% of the pooled investments. A significant portion of the structured notes consisted of corporate floating-rate certificates of deposit. For the agency and corporate floating-rate securities held in the portfolio during the fiscal year, the interest received by the State Treasurer's pooled investment program rose or fell as the underlying index rate rose or fell. The portion representing the asset-backed securities consists of mortgage backed securities, Small Business Administration (SBA) pools, and asset-backed commercial paper. The mortgage-backed securities are called real estate mortgage investment conduits (REMICs), and are securities backed by pools of mortgages. The REMICs in the State's portfolio have a fixed principal payment schedule. A portion of the asset-backed securities consisted of floating-rate SBA notes. For floating-rate SBA notes held in the portfolio during the fiscal year, the interest received by the State Treasurer's pooled investment program rose or fell as the underlying index rate rose or fell. The structure of the floating-rate notes in the State Treasurer's pooled investment program portfolio provided a hedge against the risk of increasing interest rates. A portion of the asset-backed portfolio holdings was short-term, asset-backed commercial paper (ABCP), which represented 1.82% of pooled investments.

Enterprise funds and special revenue funds also make separate investments, which are presented at fair value.

Table 1 identifies the investment types that are authorized by the California Government Code and the State Treasurer's Office investment policy for the pooled investment program.

**Table 1****Authorized Investments**

<b>Authorized Investment Type</b>	<b>Maximum Maturity<sup>1</sup></b>	<b>Maximum Percentage of Portfolio</b>	<b>Maximum Investment in One Issuer</b>	<b>Credit Rating</b>
U.S. Treasury Securities	5 years	N/A	N/A	N/A
Federal Agency and Supranational Securities	5 years	N/A	N/A	N/A
Certificates of Deposit	5 years	N/A	N/A	N/A
Bankers Acceptances	180 days	N/A	N/A	N/A
Commercial Paper	180 days	30%	10% of issuer's outstanding Commercial Paper	A-2/P-2/F-2 <sup>2</sup>
Corporate Bonds/Notes	5 years	N/A	N/A	A-/A3/A- <sup>3</sup>
Repurchase Agreements	1 year	N/A	N/A	N/A
Reverse Repurchase Agreements	1 year	10% <sup>1</sup>	N/A	N/A

<sup>1</sup> Limitations are pursuant to the State Treasurer's Office Investment Policy for the Pooled Money Investment Account.

<sup>2</sup> The State Treasurer's Office Investment Policy for the Pooled Money Investment Account is more restrictive than the Government Code, which allows investments rated A-3/P-3/F-3.

<sup>3</sup> The Government Code requires that a security fall within the top three ratings of a nationally recognized rating service.

N/A Neither the Government Code nor the State Treasurer's Office Investment Policy for the Pooled Money Investment Account sets limits for this investment type.

## 1. Interest Rate Risk

Table 2 presents the interest rate risk of the primary government's investments.

**Table 2****Schedule of Investments – Primary Government – Interest Rate Risk**

June 30, 2011

(amounts in thousands)

	<u>Interest Rates<sup>1</sup></u>	<u>Maturity</u>	<u>Fair Value at Year End</u>	<u>Weighted Average Maturity (in years)</u>
<b>Pooled investments</b>				
U.S. Treasury bills and notes .....	0.15 - 1.63	28 days - 2.96 years	\$ 35,621,950	0.91
U.S. agency bonds and discount notes .....	0.20 - 1.18	5 days - 337 days	4,825,246	0.44
Supranational debentures and discount notes (IBRD) ..	1.32	299 days	300,552	0.82
Small Business Administration loans .....	0.53 - 1.38	0.25 year	544,255	0.25 <sup>2</sup>
Mortgage-backed securities <sup>3</sup> .....	3.92 - 14.25	154 days - 3.51 years	506,294	2.73
Certificates of deposit .....	0.11 - 0.55	1 day - 1.15 years	7,380,020	0.15
Commercial paper .....	0.10 - 0.37	1 day - 124 days	7,480,975	0.12
Corporate bonds and notes .....	0.13 - 0.30	27 days - 33 days	550,048	0.08
<b>Total pooled investments .....</b>			<b>57,209,340<sup>4</sup></b>	
<b>Other primary government investments</b>				
U.S. Treasuries and agencies .....			2,203,843	2.17
Commercial paper .....			339,831	0.04
Guaranteed investment contracts .....			225,597	11.14
Corporate debt securities .....			780,812	1.91
Repurchase agreements .....			5,439	0.00 <sup>5</sup>
Other .....			1,142,914	4.19
<b>Total other primary government investments<sup>6</sup> .....</b>			<b>4,698,436</b>	
<b>Funds outside primary government included in pooled investments</b>				
Less: investment trust funds .....			24,012,079	
Less: other trust and agency funds .....			3,286,091	
Less: discretely presented component units .....			2,295,603	
<b>Total primary government investments .....</b>			<b>\$ 32,314,003</b>	

<sup>1</sup> These numbers represent high and low interest rates for each investment type.

<sup>2</sup> In calculating SBA holdings' weighted average maturity, the State Treasurer's Office assumes that stated maturity is the quarterly reset date.

<sup>3</sup> These securities are issued by U.S. government agencies such as the Federal National Mortgage Association.

<sup>4</sup> Total pooled investments does not include certain assets of the State's pooled investment program. The other assets include \$4.0 billion of time deposits and \$4.8 billion of internal loans to state funds, primarily the General Fund.

<sup>5</sup> These repurchase agreements of the California State University mature in one day.

<sup>6</sup> Total other primary government investments include approximately \$9 million of cash equivalents that are included in cash and pooled investments.

Table 3 identifies the debt securities that are highly sensitive to interest rate fluctuations (to a greater degree than already indicated in the information provided previously).

**Table 3****Schedule of Highly Sensitive Investments in Debt Securities – Primary Government – Interest Rate Risk**

June 30, 2011

(amounts in thousands)

	<u>Fair Value at Year End</u>	<u>Percent of Total Pooled Investments</u>
<b>Pooled investments</b>		
Mortgage-backed		
Federal National Mortgage Association Collateralized Mortgage Obligations .....	\$ 506,247	0.885 %
Government National Mortgage Association Pools .....	47	0.000

These mortgage-backed securities entitle the purchaser to receive a share of the cash flows, such as principal and interest payments, from a pool of mortgages. Mortgage securities are sensitive to interest rate changes because principal prepayments either increase (in a low interest rate environment) or decrease (in a high interest rate environment). A change, up or down, in the payment rate will result in a change in the security yield.

2. Credit Risk

Table 4 presents the credit risk of the primary government's debt securities.

**Table 4**

**Schedule of Investments in Debt Securities – Primary Government – Credit Risk**

June 30, 2011

(amounts in thousands)

<b>Credit Rating as of Year End</b>		<b>Fair Value</b>
<b>Short-term</b>	<b>Long-term</b>	
<b>Pooled investments<sup>1</sup></b>		
A-1+/P-1/F-1+	AAA/Aaa/AAA	\$ 12,194,405
A-1/P-1/F-1	AA/Aa/AA	8,342,436
A-2/P-2/F-2	A/A/A	—
Not rated .....		506,247
Not applicable .....		36,166,252
<b>Total pooled investments .....</b>		<b>\$ 57,209,340<sup>2</sup></b>
<b>Other primary government investments</b>		
A-1+/P-1/F-1+	AAA/Aaa/AAA	\$ 1,872,515
A-1/P-1/F-1	AA/Aa/AA	1,001,183
A-2/P-2/F-2	A/A/A	1,146,134
A-3/P-3/F-3	BBB/Baa/BBB	4,661
Not rated .....		638,397
Not applicable .....		35,546
<b>Total other primary government investments ....</b>		<b>\$ 4,698,436</b>

<sup>1</sup> The State Treasurer's Office uses Standard & Poor's, Moody's, and Fitch ratings services. Securities are classified by the lowest rating of the three agencies.

<sup>2</sup> Total pooled investments does not include certain assets of the State's pooled investment program. The other assets include time deposits of \$4.0 billion, for which credit risk is mitigated by collateral that the State holds for them—as discussed earlier in this note—and \$4.8 billion in loans to state funds, primarily to the General Fund, for which external credit risk is not applicable because they are internal loans.

### 3. Concentration of Credit Risk

The investment policy of the State Treasurer's Office contains no limitations on the amount that can be invested in any one issuer beyond those limitations stipulated in the California Government Code. Table 5 identifies debt securities in any one issuer (other than U.S. Treasury securities) that represent 5% or more of the State Treasurer's investments, or of the separate investments of other primary government funds.

**Table 5**

**Schedule of Investments – Primary Government – Concentration of Credit Risk**

June 30, 2011

(amounts in thousands)

Issuer	Investment Type	Reported Amount	Percent of Total Agency Investments
<b>California State University</b>			
Federal Home Loan Bank	U.S. agency securities	\$ 274,299	11.39 %
Federal Home Loan Mortgage Corporation	U.S. agency securities	277,850	11.54
Federal National Mortgage Association	U.S. agency securities	158,806	6.59
<b>California State Lottery</b>			
State of California	Municipal securities	\$ 226,926	19.27 %
Commonwealth of Massachusetts	Municipal securities	62,772	5.33
<b>Golden State Tobacco Securitization Corporation</b>			
Abbey National North America LLC	Commercial paper	\$ 165,100	33.04 %
Federal Home Loan Mortgage Corporation	U.S. agency securities	203,934	40.81
Federal National Mortgage Association	U.S. agency securities	130,662	26.15
<b>Department of Water Resources</b>			
Federal National Mortgage Association	U.S. agency securities	\$ 75,313	89.10 %