
Independent Auditor's Report

THE GOVERNOR AND THE LEGISLATURE OF THE
STATE OF CALIFORNIA

Report on the Financial Statements

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, 2017, and the related notes to the financial statements, which collectively comprise the State of California's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of the following:

Government-wide Financial Statements

- Certain governmental funds that, in the aggregate, represent five percent of the assets and deferred outflows, and less than one percent of the revenues of the governmental activities.
- Certain enterprise funds that, in the aggregate, represent 82 percent of the assets and deferred outflows, and 53 percent of the revenues of the business-type activities.
- The University of California and the California Housing Finance Agency that represent 92 percent of the assets and deferred outflows, and 94 percent of the revenues of the discretely presented component units.

Fund Financial Statements

- The Safe Drinking Water State Revolving fund, that represents 12 percent of the assets and deferred outflows of the Environmental and Natural Resources fund, a major governmental fund.
- The following major enterprise funds: Electric Power fund, Water Resources fund, State Lottery fund, and California State University fund.
- The Golden State Tobacco Securitization Corporation, the Public Building Construction, the Public Employees' Retirement, the State Teachers' Retirement, the State Water Pollution Control, and the 1943 Veterans Farm and Home Building funds, that represent 84 percent of the assets and deferred outflows, and 51 percent of the additions, revenues and other financing sources of the aggregate remaining fund information.
- The discretely presented component units noted above.

The related 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, are based solely 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. The financial statements of the Golden State Tobacco Securitization Corporation, the Public Building Construction, the State Lottery, and the 1943 Veterans Farm and Home Building funds were not audited in accordance with *Government Auditing Standards*.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

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, 2017, and the respective changes in financial position and, where applicable, cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that management's discussion and analysis, and other required supplementary information as listed in the table of contents, be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We and the other auditors have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

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 introductory section, combining and individual nonmajor fund financial statements, and statistical section are presented for purposes of additional analysis and are not a required part of the basic financial statements.

The combining and individual nonmajor fund financial statements are the responsibility of management and were derived from and relate directly to the underlying accounting and other records used to prepare the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America by us and other auditors. In our opinion, based on our audit, the procedures performed as described above, and the reports of other auditors, the combining and individual nonmajor fund financial statements are fairly stated, in all material respects, in relation to the basic financial statements as a whole.

The introductory and statistical sections have not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on them.

Other Reporting Required by Government Auditing Standards

In accordance with Government Auditing Standards, we have also issued our report dated March 21, 2018 on our consideration of the State of California'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 in considering the State of California's internal control over financial reporting and compliance.

CALIFORNIA STATE AUDITOR

A handwritten signature in black ink that reads "John F. Collins II". The signature is written in a cursive style with a double underline at the end.

JOHN F. COLLINS II, CPA
Deputy State Auditor

March 21, 2018

NOTE 3: DEPOSITS AND INVESTMENTS

Cash balances not required for immediate use are invested by the State Treasurer. 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.

A. Primary Government

1. Control of State Funds

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 U. S. 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 and related organizations participate in the State Treasurer's Office pooled investment program. As of June 30, 2017, these discretely presented component units and related organizations account 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 earn income that compensates the banks for their services.

Demand and time deposits held by financial institutions as of June 30, 2017, totaling approximately \$6.4 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, 2017, the State Treasurer's Office had on deposit with a fiscal agent amounts totaling \$24 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.

Certain funds have elected to participate in the pooled investment program even though they have the authority to invest on their own. Others may be required by legislation to participate in the program; as a result, the deposits of these funds may be considered involuntary. However, these funds are part of the State's reporting entity. The remaining participant 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 assigned to the State's General Fund. Most of the \$88 million in interest revenue received by the General Fund from the pooled investment program in fiscal year 2016-17 was earned on balances in these funds.

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

2. Valuation of State Investments

The State Treasurer's Office reports its investments at fair value. The State Treasurer's Office performs a quarterly fair market valuation of the pooled investment program portfolio. The fair value of securities in the State Treasurer's pooled investment program is generally based on quoted market prices. In addition, the State Treasurer's Office performs a monthly fair market valuation of all securities held against carrying cost. These valuations can be obtained from the State Treasurer's Office website at www.treasurer.ca.gov.

Table 1 categorizes fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure the fair value of the assets and liabilities. Level 1 inputs are quoted prices for identical assets or liabilities in active markets at the date of measurement; Level 2 inputs are significant other directly or indirectly observable inputs other than quoted prices; and Level 3 inputs are significant unobservable inputs. The State has no investments measured at Level 3.

Table 1

Schedule of Investments – Primary Government – Investments by Fair Value Level

June 30, 2017

(amounts in thousands)

	June 30, 2017	Fair Value Measurements Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Pooled Investments			
U.S. Treasury bills and notes	\$ 33,297,173	\$ 33,297,173	\$ —
U.S. Agency bonds and discount notes	11,353,758	11,353,758	—
Supranational debentures and discount notes	1,594,981	1,594,981	—
Small Business Administration loans	872,312	872,312	—
Mortgage-backed securities	40,715	40,715	—
Certificates of deposit	15,294,086	—	15,294,086
Bank notes	599,802	—	599,802
Commercial paper	8,235,999	—	8,235,999
Total pooled investments at fair value	71,288,826	\$ 47,158,939	\$ 24,129,887
Other primary government investments			
U.S. Treasuries and agencies	2,866,955	\$ 1,381,784	\$ 1,485,171
Commercial paper	93,451	—	93,451
Corporate debt securities	1,017,548	135,868	881,680
Repurchase agreements	10,391	—	10,391
Other	932,386	638,750	293,636
Total other primary government investments at fair value	4,920,731	\$ 2,156,402	\$ 2,764,329
Investments measured at the net asset value (NAV)			
Money market funds/2a-7 money market funds	375,081		
Total investments measured at the NAV	375,081		
Other investment instruments			
Guaranteed investment contracts ¹	200,000		
Total other investment instruments	200,000		
Funds outside primary government included in pooled investments			
Less: investment trust funds	22,802,325		
Less: other trust and agency funds	2,050,572		
Less: discretely presented component units and related organizations ...	2,515,730		
Total primary government investments	\$ 49,416,011		

¹ Reported at carrying value.

As of June 30, 2017, the weighted average maturity of the securities in the pooled investment program administered by the State Treasurer's Office was approximately 203 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.

3. Oversight of Investing Activities

The Pooled Money Investment Board (PMIB) 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 PMIB 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, 2017, 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.

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, 2017, structured notes and medium-term asset-backed securities comprised approximately 2.4% of the pooled investments. A portion of the structured notes was callable agency securities which represented 0.2% of the pooled investments. The asset-backed securities consist of mortgage-backed securities, Small Business Administration (SBA) pools, and asset-backed commercial paper. The mortgage-backed securities, called *real estate mortgage investment conduits* (REMICs), 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 SBA 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 were short-term, asset-backed commercial paper (ABCP), which represented 0.7% of the pooled investments.

Table 2 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. Maturities are limited by the State Treasurer’s Office Investment Policy for the Pooled Money Investment Program. For commercial paper, the Investment Policy matches the Government Code. For corporate bonds and notes, the Government Code requires that a security falls within the top three ratings of a nationally recognized statistical ratings organization (NRSRO). Items reported as N/A have no limitation in either the Government Code or the State Treasurer’s Office Investment Policy.

Table 2

Authorized Investments

Authorized Investment Type	Maximum Maturity	Maximum Percentage of Portfolio	Maximum Investment in One Issuer	Credit Rating
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	270 days	30%	10% of issuer’s outstanding Commercial paper	A-3/P-3/F-3
Corporate bonds/notes	5 years	N/A	N/A	A-/A3/A-
Repurchase agreements	1 year	N/A	N/A	N/A
Reverse repurchase agreements	1 year	10%	N/A	N/A

4. Risk of Investments

The following types of risks are common in deposits and investments, including those of the State:

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. Interest Rate Risk

Table 3 presents the interest rate risk of the primary government's investments. In calculating SBA holdings' weighted average maturity, the State Treasurer's Office assumes that stated maturity is the quarterly reset date. Total pooled investments do not include \$5.6 billion of time deposits and \$646 million of internal loans to state funds. Repurchase agreements of the California State University system mature in three days. Most mortgage-backed securities are issued by U.S. government agencies, or government-sponsored enterprises such as the Federal National Mortgage Association, and entitle the purchaser to receive a share of the cash flows, such as principal and interest payments, from a pool of mortgages. Mortgage-backed securities are highly sensitive to interest rate changes because principal prepayments either increase (in a low interest rate environment) or decrease (in a high interest rate environment) the security yield. As of June 30, 2017, only \$41 million, or 0.1% of the total pooled investments, was invested in mortgage-backed securities.

Table 3**Schedule of Investments – Primary Government – Interest Rate Risk**

June 30, 2017

(amounts in thousands)

	Fair Value at Year End	Weighted Average Maturity (in years)
Pooled investments		
U.S. Treasury bills and notes.....	\$ 33,297,173	0.86
U.S. Agency bonds and discount notes.....	11,353,758	0.42
Supranational debentures and discount notes.....	1,594,981	0.62
Small Business Administration loans.....	872,312	0.25
Mortgage-backed securities.....	40,715	2.18
Certificates of deposit.....	15,294,086	0.25
Bank notes.....	599,802	0.27
Commercial paper.....	8,235,999	0.13
Total pooled investments.....	71,288,826	
Other primary government investments		
U.S. Treasuries and agencies.....	2,866,955	2.78
Commercial paper.....	93,451	1.36
Guaranteed investment contracts.....	200,000	4.83
Corporate debt securities.....	1,017,548	1.27
Repurchase agreements.....	10,391	0.01
Other.....	1,307,467	1.88
Total other primary government investments.....	5,495,812	
Funds outside primary government included in pooled investments		
Less: investment trust funds.....	22,802,325	
Less: other trust and agency funds.....	2,050,572	
Less: discretely presented component units and related organizations.....	2,515,730	
Total primary government investments.....	\$ 49,416,011	

b. Credit Risk

Table 4 presents the credit risk of the primary government’s debt securities. If a particular security has multiple ratings, the lowest rating of the three major NRSROs is used. Similar to interest rate risk shown in Table 3, time deposits and internal loans to state funds are not included.

Table 4

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

June 30, 2017

(amounts in thousands)

Credit Rating as of Year End		Fair Value
Short-term	Long-term	
Pooled investments		
A-1+/P-1/F-1+	AAA/Aaa/AAA	\$ 8,214,938
A-1/P-1/F-1	AA/Aa/AA	27,813,735
A-2/P-2/F-2	A/A/A	1,049,953
Not rated.....		40,715
Not applicable		34,169,485
Total pooled investments.....		\$ 71,288,826
Other primary government investments		
A-1+/P-1/F-1+	AAA/Aaa/AAA	\$ 949,401
A-1/P-1/F-1	AA/Aa/AA	2,809,982
A-2/P-2/F-2	A/A/A	1,031,024
A-3/P-3/F-3	BBB/Baa/BBB	20,892
B/NP/B	BB/Ba/BB	5,212
Not rated.....		679,301
Total other primary government investments		\$ 5,495,812

c. Custodial Credit Risk

The State has a deposit policy for custodial credit risk that requires deposits held by financial institutions to be insured by federal depository insurance or secured by collateral. As of June 30, 2017, one guaranteed investment contract of the Electric Power Fund in the amount of \$100 million was uninsured and uncollateralized.

d. 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. As of June 30, 2017, the State had investments in the Federal Home Loan Mortgage Corporation totaling 6.4% and the Federal Home Loan Bank totaling 6.5% of the total pooled investments and other primary government investments.