PERFORMANCE AUDIT

OF

STATEWIDE CASH FLOW AND SHORT-TERM BORROWING

February 2000

27-700-99

EXECUTIVE DIGEST

STATEWIDE CASH FLOW AND SHORT-TERM BORROWING

INTRODUCTION

This report, issued in February 2000, contains the results of our performance audit* of Statewide Cash Flow and Short-Term Borrowing.

AUDIT PURPOSE

This performance audit was conducted as part of the constitutional responsibility of the Office of the Auditor General. Performance audits are conducted on a priority basis related to the potential for improving effectiveness* and efficiency*.

BACKGROUND

Pursuant to Article V, Section 3 of the State Constitution, the State Treasurer is responsible for collecting, investing, and disbursing State money. The State Treasurer manages the State's cash flow through the Common Cash Pool, which pools the combined cash balances of State money. This pooling of cash allows the State Treasurer to invest money not needed to pay immediate obligations so that investment earnings on available cash are maximized. Each quarter, the State Treasurer allocates earnings to the various funds comprising the Common Cash Pool based

** See glossary at end of report for definition.*

on each fund's average daily balance and the Common Cash investment earnings rate.

In order for the State to meet its obligations incurred pursuant to the appropriations for any fiscal year, Act 55, P.A. 1967, authorizes the State Treasurer to transfer cash on hand and on deposit among the various funds in the Common Cash Pool in such a manner as to best manage the available cash on hand. Those funds within the Common Cash Pool that have a net negative cash balance in any quarter of the fiscal year (internal borrowing*) are required to pay interest on such balances at a rate equal to the Common Cash investment earnings rate.

Further, Article IX, Section 14 of the State Constitution authorizes the State to issue short-term general obligation notes (external borrowing*). The State shall pledge undedicated revenues to be received within the same fiscal year for the repayment of the notes. Such indebtedness in any fiscal year shall not exceed 15% of undedicated revenues received by the State during the preceding fiscal year and shall be repaid at the time the pledged revenues are received, but not later than the end of the same fiscal year. For fiscal year 1998-99, the State's external borrowing limitation was $1,336,561,650. Short-term borrowing is often necessary because of differences in the timing of revenue collections and the payment of obligations within a fiscal year.

As of the fiscal year ended September 30, 1999, the total equity in Common Cash was approximately $3,987,806,000.

* *See glossary at end of report for definition.*

AUDIT OBJECTIVE, CONCLUSION, AND NOTEWORTHY ACCOMPLISHMENTS

Audit Objective: To assess the effectiveness and efficiency of the State's management of its cash flow.

Conclusion: We concluded that the State was generally effective and efficient in the management of its cash flow. However, despite the State's restructuring of payments as described in the following paragraph, it continues to have an imbalance in receipts and disbursements that will likely result in future cash flow deficits. The State could address these deficits within the constitutional short-term borrowing limitation. Our audit disclosed a reportable condition* relating to internal borrowing (Finding 1).

Noteworthy Accomplishments: The State recognized the need to make structural changes to its cash flow to help correct the imbalances between receipts and disbursements and to reduce the amount of short-term borrowing. Beginning in late fiscal year 1997-98, the State restructured school aid and colleges' and universities' payments. The payment restructuring had a favorable impact on the cash flow and the extent of short-term borrowing.

On September 27, 2000, subsequent to our audit fieldwork, Standard & Poor's upgraded the State's rating on the issuance of general obligation bonds to AAA (its highest quality rating). Also, Moody's upgraded the State's rating to Aaa (its highest quality rating) on October 5, 2000. Both rating services attributed the upgraded ratings, in part, to a significantly strengthened cash flow position, as a result of the restructuring of school

** See glossary at end of report for definition.*

aid payments and the accumulation of significant Counter-Cyclical Budget and Economic Stabilization Fund and General Fund cash reserves.

AUDIT SCOPE AND METHODOLOGY

Our audit scope was to examine the program and other records of the State's cash flow process. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Our audit procedures included the testing of records covering the period October 1, 1988 through September 30, 1999.

To accomplish our audit objective, we gained an understanding of and evaluated the State's procedures and methods to manage its cash flow, including its need to borrow on a short-term basis. We accumulated extensive data from the Department of Treasury relating to the Common Cash Pool. The data accumulated included, but was not limited to, fund balances, receipts, disbursements, cash flow projections, and short-term borrowing amounts and costs. We summarized and analyzed the data obtained to identify historic trends and relationships.

AGENCY RESPONSES

Our audit report includes 1 finding and 2 corresponding recommendations. The agency preliminary response indicated that the State Treasurer acknowledges the 2 recommendations.

February 12, 2001

Mr. Mark A. Murray
State Treasurer
Treasury Building
Lansing, Michigan

Dear Mr. Murray:

This is our report on the performance audit of Statewide Cash Flow and Short-Term Borrowing.

This report contains our executive digest; description of processes; audit objective, scope, and methodology and agency responses; background; comment, finding, recommendations, and agency preliminary response; and a glossary of acronyms and terms.

The agency preliminary response was taken from the agency's response subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that that audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General

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INTRODUCTION

COMMENT, FINDING, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSE

GLOSSARY

Description of Processes

Pursuant to Article V, Section 3 of the State Constitution, the State Treasurer is responsible for collecting, investing, and disbursing State money. The State Treasurer manages the State's cash flow through the Common Cash Pool, which pools the combined cash balances of State money. This pooling of cash allows the State Treasurer to invest money not needed to pay immediate obligations so that investment earnings on available cash are maximized. The fund groups that comprise the Common Cash Pool are:

1. General Fund

2. Special Revenue Funds*

    a. Counter-Cyclical Budget and Economic Stabilization Fund (BSF)

    b. School Aid Fund

    c. Other Special Revenue Funds*

3. Bond, Debt Service, and Capital Projects Funds

4. Enterprise Funds

5. Internal Service Funds

6. Retirement Funds

7. Trust and Agency Funds

In accordance with Act 105, P.A. 1855, the State Treasurer may invest surplus funds belonging to the State in bonds, notes, and other evidences of indebtedness of the United States government and its agencies; prime commercial paper; and certificates of deposit in financial institutions whose principal offices are located in the State of Michigan. Each quarter, the State Treasurer allocates earnings to the various funds

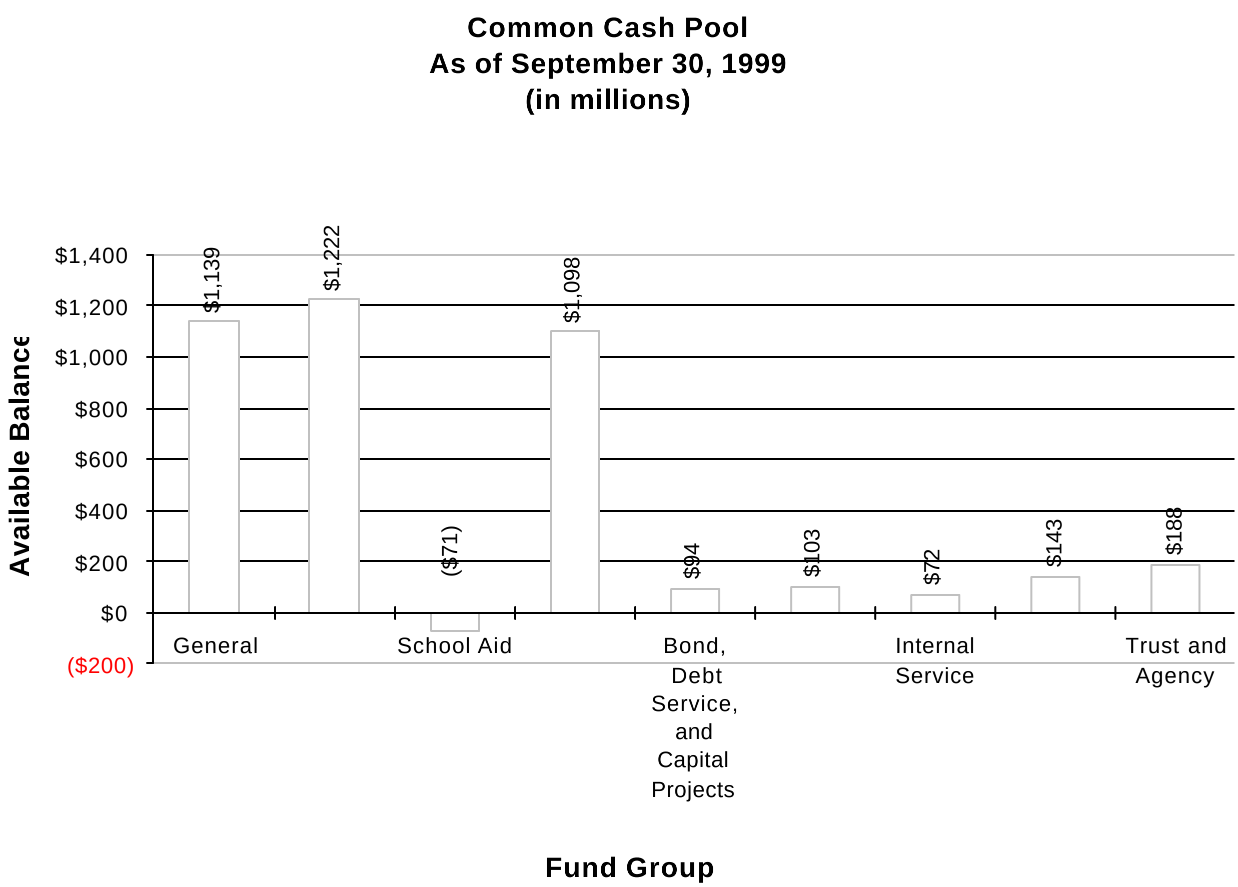
* *See glossary at end of report for definition.*

comprising the Common Cash Pool based on each fund's average daily balance and the Common Cash investment earnings rate. In addition to investing surplus funds, the State Constitution and State statute authorize the State Treasurer to invest retirement funds in a broad spectrum of investment types.

In order for the State to meet its obligations incurred pursuant to the appropriations for any fiscal year, Act 55, P.A. 1967, authorizes the State Treasurer to transfer cash on hand and on deposit among the various funds in the Common Cash Pool in such a manner as to best manage the available cash on hand. Those funds within the Common Cash Pool that have a net negative cash balance in any quarter of the fiscal year (internal borrowing) are required to pay interest on such balances at a rate equal to the Common Cash investment earnings rate.

Further, Article IX, Section 14 of the State Constitution authorizes the State to issue short-term general obligation notes (external borrowing). The State shall pledge undedicated revenues to be received within the same fiscal year for the repayment of the notes. Such indebtedness in any fiscal year shall not exceed 15% of undedicated revenues received by the State during the preceding fiscal year and shall be repaid at the time the pledged revenues are received, but not later than the end of the same fiscal year. For fiscal year 1998-99, the State's external borrowing limitation was $1,336,561,650. Short-term borrowing is often necessary because of differences in the timing of revenue collections and the payment of obligations within a fiscal year.

As of September 30, 1999, the total available balance* of the Common Cash Pool was approximately $3,987,806,000. The General Fund, BSF, School Aid Fund, and other special revenue funds comprised 85% of the total equity in Common Cash:



** See glossary at end of report for definition.*

Audit Objective, Scope, and Methodology and Agency Responses

Audit Objective

The objective of our performance audit of Statewide Cash Flow and Short-Term Borrowing was to assess the effectiveness and efficiency of the State's management of its cash flow.

Audit Scope

Our audit scope was to examine the program and other records of the State's cash flow process. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Audit Methodology

Our audit procedures were performed from June through September 1999 and included the testing of records covering the period October 1, 1988 through September 30, 1999. We conducted a preliminary review of the State's cash flow and short-term borrowing processes to gain an understanding of the processes and to form a basis for planning our audit. This included discussions with Department of Treasury staff, a review of related reports, and a review of relevant information and laws and regulations.

To accomplish our audit objective, we gained an understanding of and evaluated the State's procedures and methods to manage its cash flow, including its need to borrow on a short-term basis. We accumulated extensive data from the Department of Treasury relating to the Common Cash Pool. The data accumulated included, but was not limited to, fund balances, receipts, disbursements, cash flow projections, and short-term borrowing amounts and costs. We summarized and analyzed the data obtained to identify historic trends and relationships.

We reviewed two reports relating to the State's cash flow and short-term borrowing. The House Fiscal Agency performed a review, entitled "State Cash Flow and Borrowing Costs," dated June 30, 1997. The Senate Fiscal Agency also performed a review, entitled "State General Fund Cashflow, A Fiscal Area of Concern," dated September 7, 1993.

Agency Responses

Our audit report includes 1 finding and 2 corresponding recommendations. The agency preliminary response indicated that the State Treasurer acknowledges the 2 recommendations.

The agency preliminary response which follows the recommendations in our report was taken from the agency's written comments and oral discussion subsequent to our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and Department of Management and Budget Administrative Guide procedure 1280.02 require the agency to develop a formal response to our audit finding and recommendations within 60 days after release of the audit report.

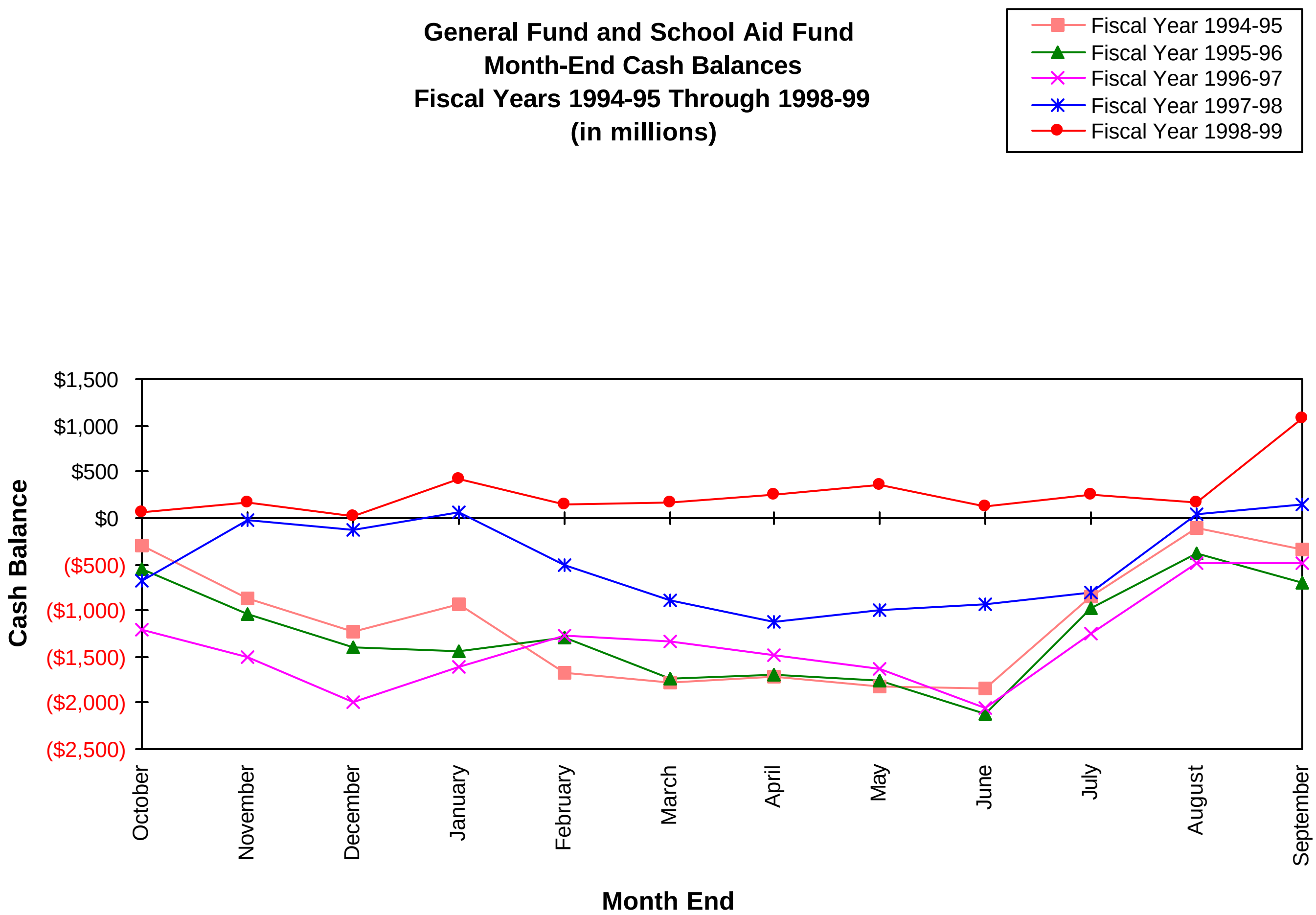
Background

The State manages its cash flow on a daily basis by monitoring the combined Common Cash Pool balances of the General Fund and the School Aid Fund. The General Fund is the State's primary operating fund. It is used to account for general purpose financial resources and those restricted resources which are not required to be accounted for in separate funds. The School Aid Fund's purpose is to aid in the support of the public schools and the intermediate school districts of the State. The Fund receives State revenues restricted to local school programs and appropriated transfers from the General Fund. The State considers these two funds in total when managing the cash flow because certain major sources of revenue flow into both and significant appropriations are satisfied from both. Cash flows in and out of funds other than the General Fund and School Aid Fund are much less volatile in nature and generally of less magnitude. This stability in cash flows allows the State to monitor cash activity in these other funds, while placing major emphasis on monitoring and forecasting cash activities in the General Fund and School Aid Fund.

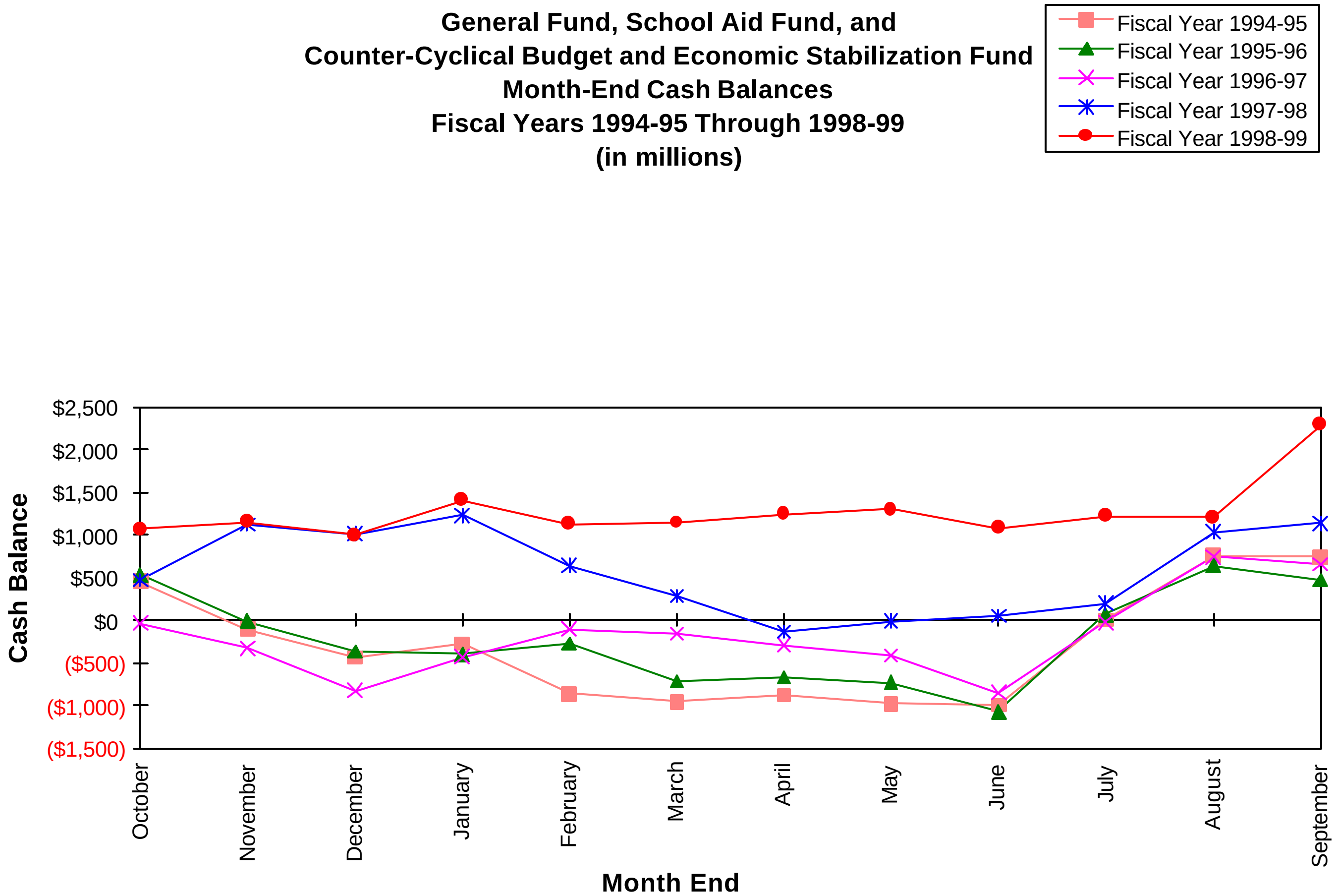
In managing the cash flow, the State also uses the Counter-Cyclical Budget and Economic Stabilization Fund (BSF) to meet its obligations. BSF, created by Act 76, P.A. 1977, was designed to accumulate balances during years of significant economic growth which may be utilized in years when the State's economy experiences cyclical downturns or unforeseen fiscal emergencies.

When the State uses the full extent of cash available from the General Fund, the School Aid Fund, and BSF and it needs further cash to meet its obligations, the State will borrow on a short-term basis. The amount and type of short-term borrowing will be a product of the State's cash position and its management of receipt and disbursement activities. Further, the condition of these three funds' cash balances has a direct impact on the State's budget. As cash balances decrease and the need to borrow increases, the interest costs and other costs associated with short-term borrowing become a direct budget expenditure and the State's revenues are impacted negatively because of the loss of interest earnings.

The following graphs illustrate the historical trend of the cash position within the General Fund, School Aid Fund, and BSF for the last 5 fiscal years. The General Fund balances reflect the proceeds and repayment of $500,000,000 in general obligation notes during fiscal year 1994-95 and $900,000,000 in general obligation notes in each of the fiscal years 1995-96 through 1997-98:



General Fund, School Aid Fund, and Counter-Cyclical Budget and Economic Stabilization Fund Month-End Cash Balances Fiscal Years 1994-95 Through 1998-99 (in millions)



The timing of the collection of receipts and the disbursement of State funds often develops imbalances in the cash flow, frequently creating the need for the State to borrow on a short-term basis to manage the cash flow. Each year, the State uses forecasting techniques to determine whether it will need to borrow on a short-term basis to meet its obligations. When the combined balances of the General Fund, the School Aid Fund, and BSF are zero or less, the State will estimate the amount of money needed to be borrowed to meet the obligations. Through an extensive managerial decision-making process, the State determines whether to borrow externally or internally from other funds within the Common Cash Pool, based on the consideration of numerous factors. The State Administrative Board must approve the decision to borrow externally. We reviewed the extent to which the State borrowed on a short-term basis to manage its cash flow for fiscal years 1990-91 through 1998-99:

Fiscal Year	Amount of External Borrowing	Amount of Internal Borrowing	Total Borrowing
1998-99	$ 0	$ 0	$ 0
1997-98	$900,000,000	$1,121,600,000	$2,021,600,000
1996-97	$900,000,000	$2,062,200,000	$2,962,200,000
1995-96	$900,000,000	$2,110,172,830	$3,010,172,830
1994-95	$500,000,000	$1,846,600,000	$2,346,600,000
1993-94	$ 0	$1,052,741,444	$1,052,741,444
1992-93	$900,000,000	$ 735,927,700	$1,635,927,700
1991-92	$700,000,000	$ 882,738,927	$1,582,738,927
1990-91	$500,000,000	$ 964,054,914	$1,464,054,914

The total borrowing amount is also recognized as the State's total cash flow deficit. The reason for the significant increase in total borrowing during fiscal year 1994-95 was because of the passage of Proposal A, a constitutional amendment approved by voters in 1994, which made structural changes in the method of financing local school districts. This created a significant increase in School Aid disbursements and the disbursements were paid in the first nine months of the fiscal year. The significant reduction in short-term borrowing during the last two years, 1997-98 and 1998-99, was because of the restructuring of school aid and colleges' and universities' payments and the collection of additional, unanticipated receipts, which is explained later in this report.

The amount that the State needed to borrow internally was determined by reviewing the State's actual cash flow for the General Fund and the School Aid Fund, by month, and determining the month during each fiscal year with the worst cash flow position (negative). The internal borrowing amount was the amount the State needed to bring the cash position of the funds back to zero, after considering the proceeds from any notes issued.

Also, we summarized the costs of borrowing:

Fiscal Year	Number of Days That General Obligation Notes Were Outstanding	Cost of External Borrowing	Cost of Internal Borrowing	Total Cost of Borrowing
1998-99	n/a	$ 0	$ 0	$ 0
1997-98	317	$30,415,332	$17,192,000	$47,607,332
1996-97	228	$20,250,125	$72,004,000	$92,254,125
1995-96	220	$16,821,436	$64,749,000	$81,570,436
1994-95	193	$11,185,743	$67,292,000	$78,477,743
1993-94	n/a	$ 0	$10,505,000	$10,505,000
1992-93	217	$14,566,828	$ 1,176,000	$15,742,828
1991-92	288	$22,324,623	$ 3,747,000	$26,071,623
1990-91	188	$13,736,772	$48,853,000	$62,589,772

The combination of the number of days that the general obligation notes were outstanding, the amount of the debt, and the interest rate at which it was borrowed determined the interest cost of short-term external borrowing. Also, there were other costs associated with the external borrowing, such as professional advisory services. The internal borrowing costs were determined based on the calculated Common Cash investment earnings rate.

The information presented indicates the history of the State's extent of short-term borrowing. As it illustrates, the State experienced a number of years in which it needed to borrow extensively on a short-term basis to manage its cash flow, resulting in substantial short-term borrowing costs. The State made structural changes to its cash flow to reduce the imbalances between receipts and disbursements and to reduce the amount of short-term borrowing. The State restructured school aid (Kindergarten - 12th grade) and colleges' and universities' payments because these payments constituted the largest portion of General Fund and School Aid Fund disbursements (36.5%, based on fiscal year 1997-98 disbursement data). The State restructured the payments from 9 monthly payments, beginning October 1 of the fiscal year, to 11 monthly payments (Act 142, P.A. 1997; Act 273, P.A. 1998; and Act 295, P.A. 1998, respectively). This change was partially implemented for school aid payments during fiscal year 1997-98, when the State made 10 monthly payments to school districts and was completely implemented during fiscal year 1998-99, when the State made 11 monthly payments. For colleges and universities, the change was entirely implemented during fiscal year 1998-99.

Any of a number of factors could adversely affect the State's cash flow in future years, including but not limited to: a slowdown in the economy or a recession (could reduce the balance of BSF, reduce receipts, and increase disbursements); changes in tax policy (including both the timing and amount of tax receipts collected); a general change in the timing of revenue collections; or changes in budget policy. The cash flow will also continue to be affected by timing differences between when money is appropriated and when subsequently expended, especially related to capital outlay projects. It will be important in future years for the State to monitor these and other events for their effect on the State's cash flow and on the amount of short-term borrowing. The State could also consider further changes to help improve future cash flow, such as further payment restructuring or acceleration of revenue collections.

COMMENT, FINDING, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSE

EFFECTIVENESS AND EFFICIENCY OF CASH FLOW MANAGEMENT

COMMENT

Audit Objective: To assess the effectiveness and efficiency of the State's management of its cash flow.

Conclusion: We concluded that the State was generally effective and efficient in the management of its cash flow. However, despite the State's restructuring of payments as described in the following paragraph, it continues to have an imbalance in receipts and disbursements that will likely result in future cash flow deficits. The State could address these deficits within the constitutional short-term borrowing limitation. Our audit disclosed a reportable condition relating to internal borrowing.

Noteworthy Accomplishments: The State recognized the need to make structural changes to its cash flow to help correct the imbalances between receipts and disbursements and to reduce the amount of short-term borrowing. Beginning in late fiscal year 1997-98, the State restructured school aid and colleges' and universities' payments. The payment restructuring had a favorable impact on the cash flow and the extent of short-term borrowing.

On September 27, 2000, subsequent to our audit fieldwork, Standard & Poor's upgraded the State's rating on the issuance of general obligation bonds to AAA (its highest quality rating). Also, Moody's upgraded the State's rating to Aaa (its highest quality rating) on October 5, 2000. Both rating services attributed the upgraded ratings, in part, to a significantly strengthened cash flow position, as a result of the restructuring of school aid payments and the accumulation of significant Counter-Cyclical Budget and Economic Stabilization Fund (BSF) and General Fund cash reserves.

FINDING

1. Internal Borrowing

The State used cash management practices emphasizing internal borrowing instead of external borrowing, thereby increasing borrowing costs and reducing investment returns for other special revenue funds within the Common Cash Pool.

The State borrowed both externally under its constitutional authority and internally from its other special revenue funds. In borrowing externally, the State had issued one series of general obligation notes in the maximum amount of borrowing desired for a fiscal year and, at the same time, used internal borrowing during those portions of the year when less than the maximum amount was needed from the bond issue.

We determined that it was less costly for the State to borrow externally than it was to borrow internally because the State can issue tax-free debt instruments, which have interest rates that are significantly lower than the rates of taxable debt instruments. The interest rate for internal borrowing is the short-term rate of return experienced by the State's Common Cash Pool. We compared the short-term general obligation note (external borrowing) rates to the internal borrowing rates for fiscal years 1994-95 through 1997-98:

Fiscal Year	External Borrowing Rate	Internal Borrowing Rate
1997-98	4.50%	5.71%
1996-97	4.50%	5.60%
1995-96	4.00%	5.57%
1994-95	5.00%	5.84%

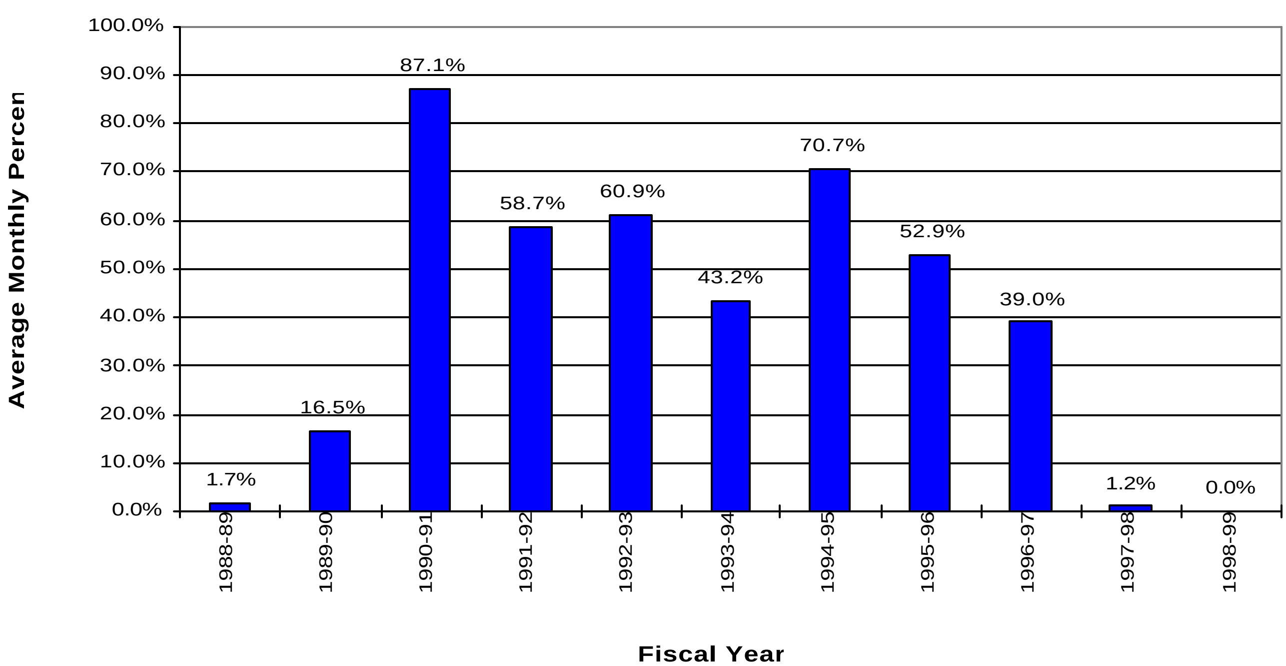
For the four years presented, the external borrowing rates were, on average, 1.18 percentage points (20.86%) lower than the internal borrowing rates. In addition, non-interest related costs, such as legal and advisory fees, were associated with external borrowing. For the four fiscal years presented, these additional costs averaged approximately $254,000, or an additional .03%, in related costs. Using a hypothetical scenario, if it is assumed that an annualized average of $500 million were borrowed, 1.15 percentage points of interest would represent $5,750,000 in interest cost annually.

To take full advantage of external borrowing, the State could establish a method to borrow the amount of cash it needs for the specific times that it needs it, such as through a line of credit with a financial institution. Department of Treasury staff informed us that they had considered more flexible methods of external borrowing in the past. However, they had not used any of these alternative methods.

At the same time, maintaining other special revenue funds for internal borrowing purposes reduces the ability to manage those funds' investments for the best rate of return for those individually. Although special revenue funds are paid at the taxable short-term interest rate, some of that cash could be invested on a longer term basis at generally higher rates of return.

When the State borrows internally, it first borrows from BSF (because of arbitrage* issues), then from the other special revenue funds, which is the fund group within the Common Cash Pool with the largest cash balance. We reviewed the State's cash flow for fiscal years 1988-89 through 1998-99 and determined the extent to which the State borrowed internally from the other special revenue funds to manage its cash flow:

Average Monthly Percentage of Other Special Revenue Funds Used to Manage the Cash Flow



* *See glossary at end of report for definition.*

We reviewed the makeup of the special revenue fund cash included as part of the Common Cash Pool. According to the *State of Michigan Comprehensive Annual Financial Report (SOMCAFR)*, nine of the special revenue funds have a portion of their fund balances reserved for permanent investment. Approximately 54% of the reserve amounts held for permanent investment are being held in the Common Cash Pool, which invests in short-term securities to maintain liquidity. However, it is not necessary to maintain liquidity for amounts held as permanent investments in these nine funds. The State Treasurer's Common Cash Pool earned an average of 5.6% over the last five completed fiscal years. In comparison, the five-year compounded rate of return for the Lehman Brothers U.S. Government market index was 7.6% (as of September 30, 1999), a difference of 2.0 percentage points (36% difference). If we assume an average investment amount of $200 million, 2.0 percentage points would result in $4.0 million in additional revenue annually.

The nine special revenue funds that have a portion of their fund balances reserved for permanent investment constitute 38% of the total fund balances of other special revenue funds. The remaining 62% of the fund balances of the special revenue funds did not have a portion reserved for permanent investment, but the State could consider investing a portion of those balances in longer term investments to yield greater investment returns. Alternative investment strategies could be considered for each individual fund, based on the intended use of each fund and the amount of risk the State is willing to assume.

Further, although holding the special revenue funds' cash in short-term investments increases the State's ability to borrow internally, it is contrary to the special revenue funds' purpose of earning income to fund specified activities. These special revenue funds were established to provide funding for specified purposes, not to accumulate a cash reserve to be borrowed by the General Fund and School Aid Fund. Most of these special revenue funds did not exist when the State Constitution established the State's short-term borrowing limits and, thus, were not contemplated as a source of borrowing.

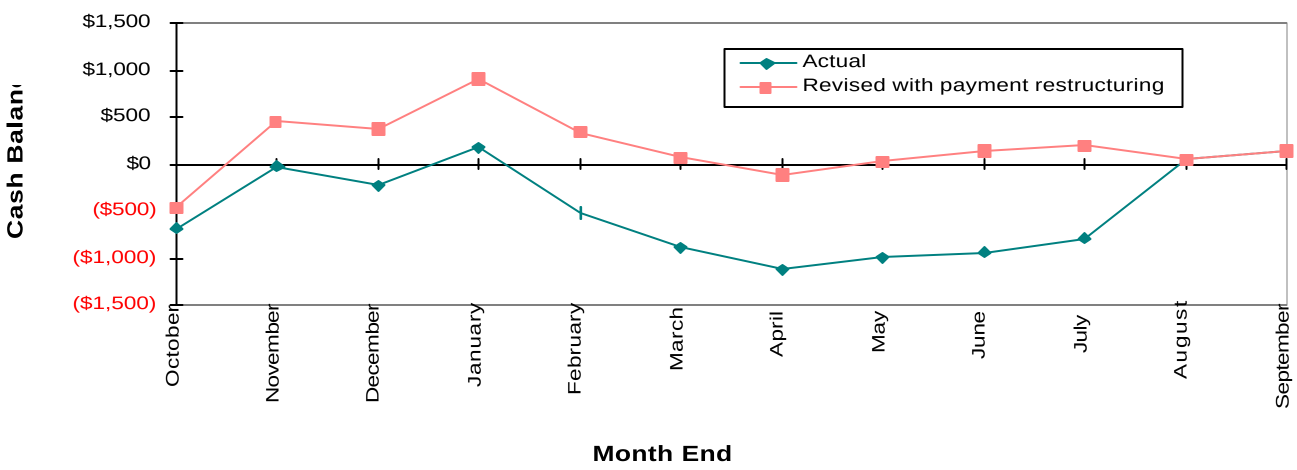
It is implicit that the investment strategy seek maximum benefit for each of those funds.

We analyzed the impact of special revenue fund alternative investment strategies on the States' likely borrowing needs. As noted in the table on page 16, the State needed to borrow extensively in fiscal years 1994-95 through 1997-98. However, the State's cash flow began to improve in fiscal year 1997-98 and no borrowing was needed in fiscal year 1998-99.

We identified two factors that were primarily responsible for the improvement. First, the State restructured school aid and colleges' and universities' payments partially in fiscal year 1997-98 and fully in fiscal year 1998-99. Second, the State collected unanticipated receipts of approximately $968,700,000 in fiscal year 1997-98 and of approximately $1,034,100,000 in fiscal year 1998-99. Total actual receipts were $29,908,100,000 and $31,197,500,000 in fiscal years 1997-98 and 1998-99, respectively.

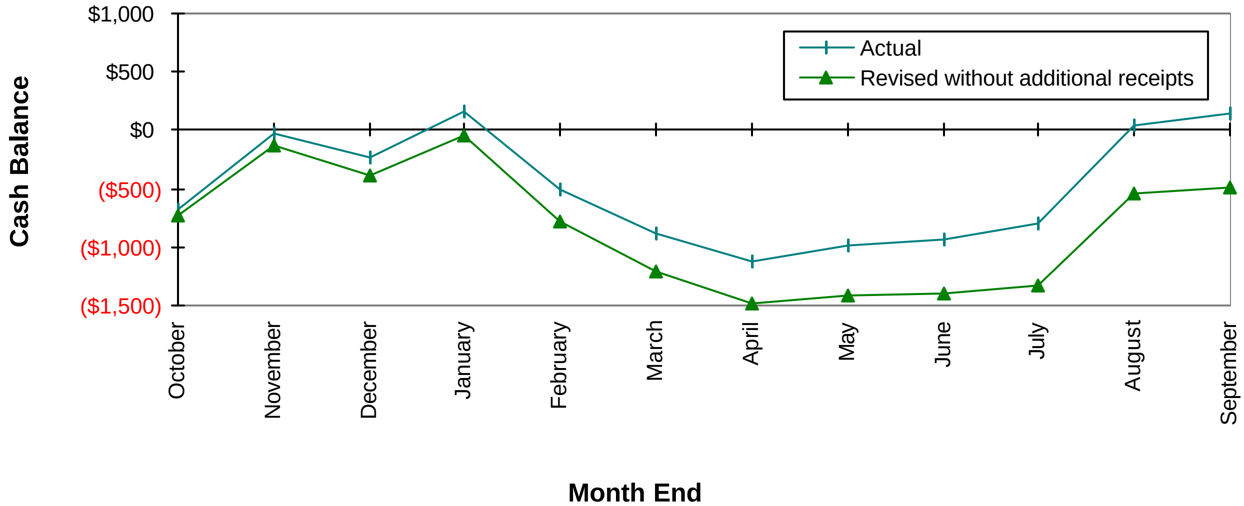
Because both the payment restructuring and the collection of additional receipts affected the cash flow during the same fiscal years, we performed an analysis to assess how much each of the two events improved the cash flow. Using fiscal year 1997-98 as our year of review, we first compared the actual cash flow with what the cash flow would have been if the State had fully restructured school aid and colleges' and universities' payments. The cash flow reflects the proceeds and repayment of $900,000,000 in general obligation notes issued in fiscal year 1997-98:

General Fund and School Aid Fund
Cash Flow
Fiscal Year 1997-98
(in millions)

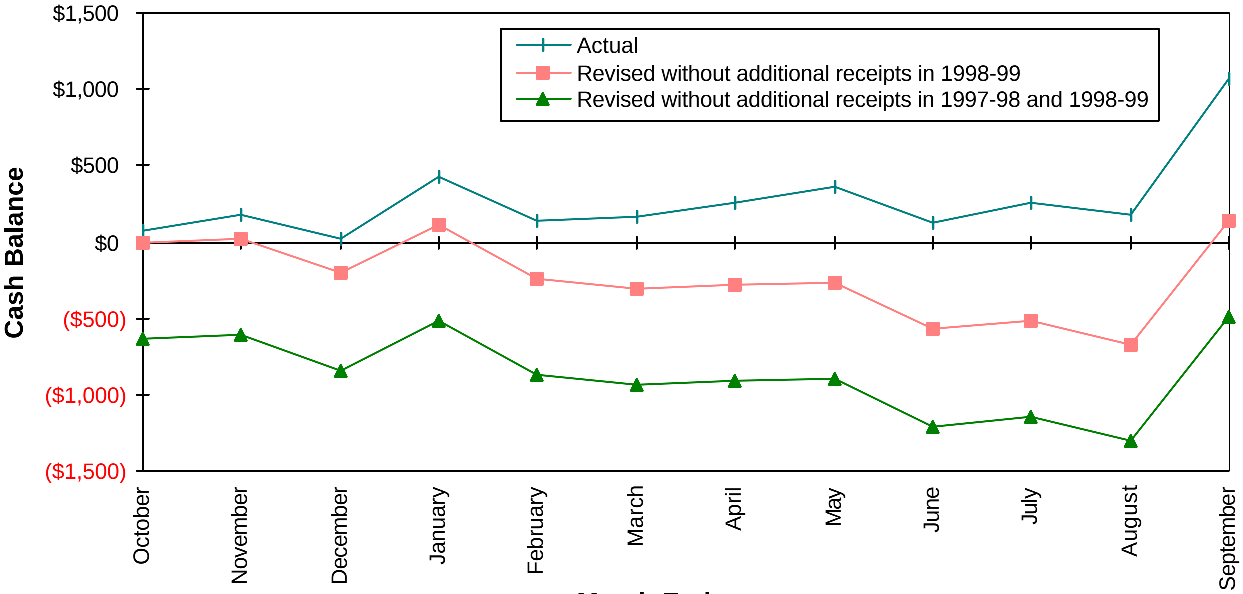


Next, we compared the actual cash flow to what the cash flow would have been if the State had not received the unanticipated receipts during fiscal years 1997-98 and 1998-99 (we made the assumption that the additional receipts were collected evenly throughout the fiscal year). The cash flow reflects the proceeds and repayment of $900,000,000 in general obligation notes issued in fiscal year 1997-98. As the graphs illustrate, the unanticipated receipts decreased the amount of cash flow deficit that would have been expected if total receipts had equaled total disbursements at fiscal year-end:

General Fund and School Aid Fund
Cash Flow
Fiscal Year 1997-98
(in millions)



General Fund and School Aid Fund
Cash Flow
Fiscal Year 1998-99
(in millions)

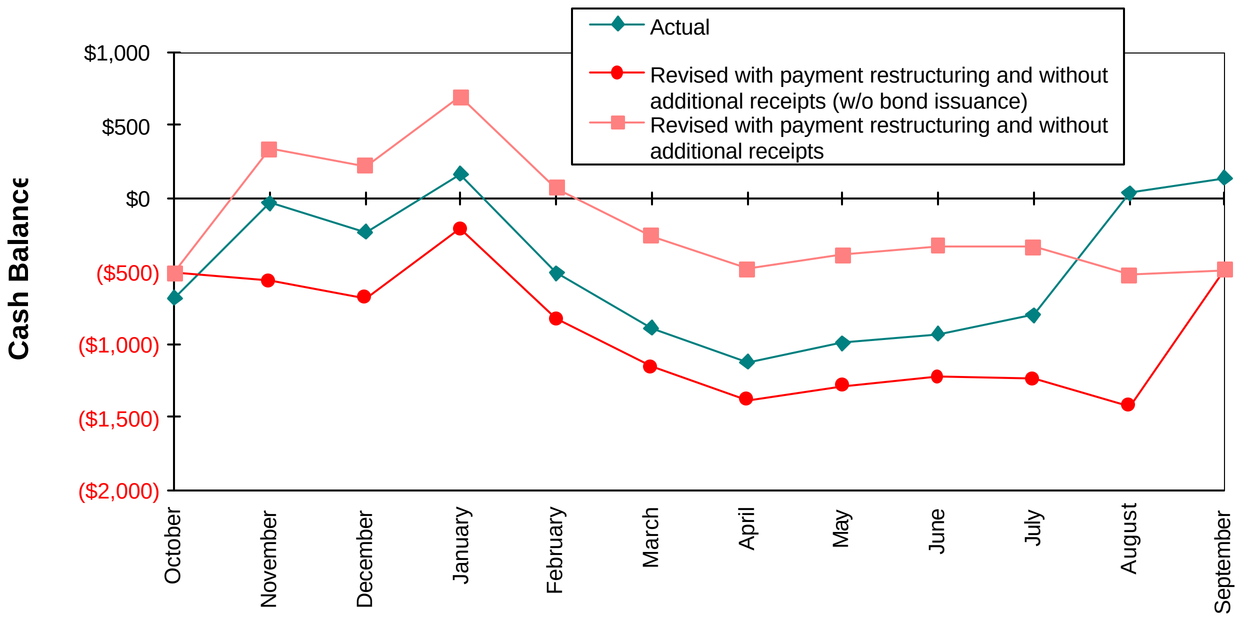


We were informed that the collection of the additional receipts was not anticipated by the State and was primarily because the economy performed better than expected in those fiscal years. Twice each year, the State holds the Consensus Revenue Estimating Conference in which representatives of the House Fiscal Agency, Senate Fiscal Agency, and Department of Management and Budget (or their designees) participate. The purpose of the conference is to produce a consensus revenue estimate for the General Fund and School Aid Fund that can be used by the Governor and the Legislature in preparing and approving the State budget. Because the State's budget (expenditures) is based on these revenue estimates, the collection of additional, unanticipated receipts has a positive effect on the cash flow.

Finally, we compared the actual cash flow with what the cash flow would have been, if the State had fully restructured school aid and colleges' and universities' payments but had not received the unanticipated receipts during fiscal year

1997-98. We also added to the graph the cash flow without the proceeds and repayment of $900,000,000 in general obligation notes issued in fiscal year 1997-98:

**General Fund and School Aid Fund
Cash Flow
Fiscal Year 1997-98
(in millions)**



The graphs illustrate the effects of the payment restructuring and the collection of the additional, unanticipated receipts on the cash flow. The following table further explains the effects on the amount of internal borrowing that would have been needed during the fiscal year under each scenario:

Scenario	Extent of Internal Borrowing Needed	Increase/(Decrease) in Internal Borrowing Needed
Actual cash flow	$1,121,600,000	n/a
Revised with payment restructuring	$ 461,400,000	($660,200,000)
Revised without additional receipts	$1,489,100,000	$367,500,000
Revised with payment restructuring without additional receipts	$ 523,900,000	($597,700,000)

We determined that just the implementation of payment restructuring would have reduced needed borrowing by $965,200,000 ($1,489,100,000 less $523,900,000) and that just the collection of additional, unanticipated receipts reduced needed borrowing by $367,500,000 ($1,489,100,000 less $1,121,600,000). Therefore, both events had a positive effect on the State's cash flow; however, the State's decision to restructure the payments had a greater effect than the collection of the additional receipts.

As the table and graphs illustrate, by adjusting the fiscal year 1997-98 cash flow for the impact of the restructuring of payments and the collection of the additional receipts, we determined that the State would have incurred a total cash flow deficit of approximately $1.4 billion ($523,900,000 internal borrowing needed and $900,000,000 in general obligation notes issued). Presuming that the unplanned receipts condition will not continue, but given the current fund balances in the General Fund and School Aid Fund (see background section), future cash deficits must be resolved by first borrowing from BSF (because of arbitrage issues), which had a September 30, 1999 fund balance of approximately $1.2 billion. If BSF's fund balance is significantly reduced or eliminated, the State's constitutional short-term borrowing authority, which was approximately $1.3 billion for fiscal year 1998-99, should be sufficient to address the cash flow deficit.

RECOMMENDATIONS

We recommend that the State implement a cash management strategy of maximizing the use of external borrowing to meet the State's cash flow needs.

We also recommend that the State implement an investment strategy for other special revenue funds to maximize the investment returns for those individual funds, while meeting the State's cash flow needs.

AGENCY PRELIMINARY RESPONSE

The State Treasurer acknowledges these recommendations and notes that decisions to borrow externally and/or to choose investments with potential for greater return must be considered within a comprehensive fiscal strategy for the State. These decisions and their timing have consequences. For instance, the State's action to improve its cash flow position in fiscal years 1997-98, 1998-99, and 1999-2000 was cited by Standard & Poor's and Moody's in their recent upgrades of the State's credit rating to the highest attainable. Specifically cited were prudent fiscal management practices, low debt levels, and the elimination of external borrowing for cash flow purposes.

External financing for cash flow deficits is affected by many factors. These factors include debt issuance impact, market perception of using external borrowing, credit rating agency evaluations, maintenance of a high credit rating, compliance with IRS regulations pertaining to issuing tax-exempt debt, other statutory requirements, and economic conditions subject to uncertainty.

While alternative investment strategies may result in greater earnings for the State's Common Cash Pool, the potential to obtain better investment returns will be associated with greater investment and liquidity risk. The State Treasurer has and will continue to evaluate short-term investment alternatives for individual funds while maintaining the State Treasurer's fiduciary responsibility to maintain appropriate cash balances and liquidity.

Glossary of Acronyms and Terms

arbitrage	Investment earnings representing the difference between the interest paid on bonds and the interest earned on securities in which bond proceeds are invested. The Internal Revenue Code regulates arbitrage on the investment of bond proceeds and the 1986 Tax Reform Act requires, with limited exceptions, that arbitrage from certain investments must be rebated to the federal government.
available balance	The cash balance less any warrants outstanding.
BSF	Counter-Cyclical Budget and Economic Stabilization Fund.
effectiveness	Program success in achieving mission and goals.
efficiency	Achieving the most outputs and outcomes practical for the amount of resources applied or minimizing the amount of resources required to attain a certain level of outputs or outcomes.
external borrowing	The issuance of general obligation notes in order to meet the State's obligations incurred pursuant to the appropriations for any fiscal year.
internal borrowing	The transfer of cash on deposit among the various funds in the Common Cash Pool in such a manner as to best manage the available cash on hand.
other special revenue funds	The special revenue fund group, excluding the Counter-Cyclical Budget and Economic Stabilization Fund and the School Aid Fund.

performance audit

A performance audit, which may be an economy and efficiency audit or a program audit, is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve public accountability and to facilitate decision making by parties responsible for overseeing or initiating corrective action.

reportable condition

A matter coming to the auditor's attention that, in the auditor's judgment, should be communicated because it represents either an opportunity for improvement or a significant deficiency in management's ability to operate a program in an effective and efficient manner.

special revenue funds

This fund group includes operating fund activities financed by specific revenue sources that are legally restricted for specified purposes. The Counter-Cyclical Budget and Economic Stabilization Fund and the School Aid Fund are considered special revenue funds.