STATE OF CALIFORNIA
DEPARTMENT OF TECHNOLOGY SERVICES
INTERNAL SERVICE FUND

Independent Auditor's Reports
and Financial Statements

For the Year Ended June 30, 2006

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STATE OF CALIFORNIA
DEPARTMENT OF TECHNOLOGY SERVICES
INTERNAL SERVICE FUND

For the Year Ended June 30, 2006

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MACIAS GINI & O'CONNELL LLP
CERTIFIED PUBLIC ACCOUNTANTS & MANAGEMENT CONSULTANTS

3000 S Street, Suite 300
Sacramento, CA 95816
916.928.4600

2175 N. California Boulevard, Suite 645
Walnut Creek, CA 94596
925.274.0190

515 S. Figueroa Street, Suite 325
Los Angeles, CA 90071
213.286.6400

402 West Broadway, Suite 400
San Diego, CA 92101
619.573.1112

Board of Directors
State of California
Department of Technology Services
Rancho Cordova, California

Independent Auditor's Report

We have audited the accompanying financial statements of the State of California Department of Technology Services Internal Service Fund (Department), as of and for the year ended June 30, 2006, as listed in the table of contents. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Department and do not purport to, and do not, present fairly the financial position of the State of California as of June 30, 2006, and the changes in its financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department as of June 30, 2006, and the changes in its financial position and its cash flows for the year then ended conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 23, 2007, on our consideration of the State of California's internal control over financial reporting as it relates to the Department and 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 the 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.

Certified Public Accountants
Sacramento, California

January 23, 2007

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STATE OF CALIFORNIA
DEPARTMENT OF TECHNOLOGY SERVICES
INTERNAL SERVICES FUND

Statement of Net Assets
(Amounts expressed in thousands)

June 30, 2006

ASSETS:		
Current assets:		
Cash and investments	$	52,113
Accounts receivable		1,017
Travel advance paid to employees		126
Due from other funds		71,337
Due from other governments		122
Prepaid expenses		2,649
Total current assets		127,364
Noncurrent assets		
Capital assets, net of depreciation of $102,838		16,370
Intangible assets, net of amortization of $17,302		6,524
Total noncurrent assets		22,894
Total assets	$	150,258
LIABILITIES:		
Current liabilities:		
Accounts payable	$	25,463
Deferred revenue		96
Due to other funds		1,855
Notes payable		1,326
Other current liabilities		71
Total current liabilities		28,811
Noncurrent liabilities:		
Compensated absences payable		10,366
Notes payable		5,131
Other liabilities		736
Total noncurrent liabilities		16,233
Total liabilities		45,044
NET ASSETS:		
Invested in capital assets		22,894
Unrestricted		82,320
Total net assets		105,214
Total liabilities and net assets	$	150,258

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See accompanying notes to the financials statements.

STATE OF CALIFORNIA
DEPARTMENT OF TECHNOLOGY SERVICES
INTERNAL SERVICES FUND

Statement of Revenues, Expenses and Changes in Net Assets
(Amounts expressed in thousands)

For the Year Ended June 30, 2006

OPERATING REVENUE:		
Services and sales	$	207,672
OPERATING EXPENSES:		
Personal services		65,521
Services and supplies		121,834
Depreciation and amortization		13,349
Total operating expenses		200,704
Operating income		6,968
NONOPERATING REVENUE (EXPENSE):		
Investment and interest income		1,909
Interest expense		(373)
Total nonoperating revenue (expense)		1,536
Change in net assets		8,504
Net assets, at July 1, 2005		96,710
Net assets, at June 30, 2006	$	105,214

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See accompanying notes to the financials statements.

STATE OF CALIFORNIA
DEPARTMENT OF TECHNOLOGY SERVICES
INTERNAL SERVICES FUND

Statement of Cash Flows
(Amounts expressed in thousands)

For the Year Ended June 30, 2006

CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from customers/employers	$	186,905
Payments to suppliers		(144,546)
Payments to employees		(65,015)
Net cash used for operating activities		(22,656)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES :		
Acquisition of intangible assets		(5,257)
Acquisition of capital assets		(9,194)
Principal paid on notes payable		(2,027)
Interest paid		(373)
Net cash used for capital and related financing activities		(16,851)
CASH FLOWS FROM INVESTING ACTIVITIES :		
Earnings on investments		1,909
Net cash provided by investing activities		1,909
Net decrease in cash and cash equivalents		(37,598)
Cash and cash equivalents, beginning of year		89,711
Cash and cash equivalents, end of year	$	52,113
RECONCILIATION OF OPERATING INCOME TO NET CASH USED FOR OPERATING ACTIVITIES		
Operating income	$	6,968
Adjustments to reconcile operating income to net cash used for operating activities:		
Depreciation		7,356
Amortization		5,993
Change in assets and liabilities:		
Accounts receivables		379
Travel advance paid to employees		(8)
Due from other funds		34,476
Due from other governments		(26)
Prepaid expenses		(2,025)
Accounts payable		(22,532)
Deferred revenue		(55,718)
Due to other funds		1,845
Other current liabilities		34
Compensated absences payable		506
Other liabilities		96
Total adjustments		(29,624)
Net cash used for operating activities	$	(22,656)

See accompanying notes to the financials statements.

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STATE OF CALIFORNIA
DEPARTMENT OF TECHNOLOGY SERVICES
INTERNAL SERVICE FUND

Notes to the Financial Statements
(Amounts expressed in thousands)

For the Year Ended June 30, 2006

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements of the State of California Department of Technology Services Internal Service Fund (Department) have been prepared in conformity with United States generally accepted accounting principles (GAAP) as applicable to governmental units. The Governmental Accounting Standards Board (GASB) is the accepted standard setting body for establishing governmental accounting and financial reporting principles. These financial statements represent the initial financial statements of the Department. The accompanying financial statements are not intended to present fairly the financial position or changes in financial position of the State of California in conformity with the accounting principles generally accepted in the United States.

Reporting Entity

The Department was established on July 9, 2005 by the Governor's Reorganization Plan that consolidated the Stephen P. Teale Data Center, the California Health and Human Services Agency Data Center, and the Department of General Services' Office of Network Services and was included in the financial reporting entity of the State of California as an internal services fund.

The Department provides business telecommunications system and technological services, including, automated information handling, system design and analysis, conversion of date, computer programming, information storage and retrieval to public agencies. Public agencies include, but are not limited to, all state and local governmental agencies in the state, including cities, counties, other political subdivisions of the state, state departments, agencies, boards and commissions, and department agencies, board and commissions of other state and federal agencies.

The Department is governed by Technology Service Board as a self-sufficient internal service fund, and is administered by the California State and Consumer Services Agency and reports to the State Controller's Office and the Department of Finance. The purpose of the Department was established to improve and coordinate the use of technology and to coordinate and cooperate with all public agencies in the state in order to eliminate duplication and to bring about economies that could not otherwise be obtained.

Measurement focus and basis of accounting

The Department uses the flow of economic resources measurement focus applied on a full accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded when the related liability is incurred.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The Department distinguishes operating revenues from nonoperating revenues. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the Department operations. Principal operating revenues of the Department are customer service charges for data services. The principal operating expenses are personnel, maintenance, service and supplies. Nonoperating revenues and expenses consist of those revenues and expenses that are related to financing and investing.

The Department has elected under Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, to apply all applicable GASB pronouncements, as well as any applicable pronouncements of the Financial Accounting Standards Board, the Accounting Principles Board, or any Accounting Research Bulletins issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements.

Budgetary Process

The Department of Technology Services prepares an annual operating budget which is approved and adopted by the State Legislature and the Governor. The budget serves as an approved plan to facilitate financial control and operational evaluation.

Cash and Investments

Cash and investments are reported at amortized cost, which approximates fair value. The Department maintains its resources in the Surplus Money Investment Fund (SMIF) and operating accounts, which are part of the State Treasurer's pooled investment program. The resources of the SMIF are invested through the Treasurer's Pooled Money Investment Account (PMIA). Investments of the PMIA are restricted by State statutes and regulatory oversight is provided by the Pooled Money Investment Board. Investment income is distributed to the Department quarterly based on the Department's relative participation during the quarter. As of June 30, 2006, the weighted average maturity of the PMIA was approximately 152 days. Neither the SMIF or PMIA are rated. Additional information regarding investment risks, including interest rate risk, credit risk and foreign-currency risk of the PMIA can be found in the State's financial statements.

At June 30, 2006, $47.8 million was invested in SMIF and $4.3 million was held in the State Treasury.

For purposes of the statements of cash flows, the Department considers all amounts held in the State's investment pools to be cash and cash equivalents. Amounts held in the State's investment pools are available on demand; thus, they are considered highly liquid and cash equivalents for purposes of the statements of cash flows.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Capital Assets

Capital assets are stated at cost except for assets contributed to the Department, which are stated at their fair market value on the date contributed. When assets are retired or otherwise disposed of, the cost and related depreciation are removed from the accounts and any resulting gain or loss is reflected in net income for the period. Maintenance and repair costs are expensed as incurred. Significant renewals or betterments are capitalized and depreciated over their estimated useful lives.

Depreciation of capital assets is computed under the straight-line method over the following estimated useful lives:

Equipment	5 to 10 years
Structures and improvements	10 to 40 years

The Department's policy is to capitalize all capital assets with a cost greater than $5,000 and a useful life of more than one year.

Compensated Absences

Department statements report both the current and the noncurrent liabilities for compensated absences, which are vested unpaid vacation and annual leave. Unused sick-leave balances are not included in the compensated absences because they do not vest to employees.

Net Assets

The difference between assets and liabilities in the Statement of Net Assets is labeled as Net Assets and is subdivided into two categories as follows:

Invested in capital assets, net of related debt - This component of net assets consists of capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes or other borrowings that are attributable to the acquisition, construction or improvement of those assets.

Unrestricted - This component of net assets consists of net assets that do not meet the definition of "invested in capital assets, net of related debt

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Risk Management

The Department participates in the State of California's insurance program, which has elected, with few exceptions, to be self-insured against loss and liability. Generally, the exceptions are when a bond resolution or a contract requires the State to purchase commercial insurance for coverage against property loss or liability. There have been no significant reductions in insurance coverage from the prior year. In addition, there has been no insurance settlement in the last three years that has exceeded insurance coverage.

Use of Estimates

The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

NOTE 2 - DUE FROM OTHER FUNDS

Due from other funds generally represents receivables for from other state funds for services billed but not received. Due from other funds are owed by the following state funds:

Department of Social Services	$ 18,884
Department of Health Services	18,765
Department of Child Support Services	4,444
Department of Transportation	4,236
State Controller's Office	3,367
Employment Development Department	2,757
Board of Equalization	1,914
Department of Mental Health	1,767
Department of Rehabilitation	1,338
Department of Motor Vehicles	1,207
Department of Development Services	920
Other state customers	11,738
Total	$ 71,337

NOTE 2 - DUE FROM OTHER STATE FUNDS (Continued)

Of the total amount outstanding as of June 30, 2006, $28,881 was outstanding for over 90 days, and another $12,463 was outstanding between 61 and 90 days. The total aged receivables over the allowable 60 days as established by the Department represents $41,344 or 58% of the total amount of the receivable. Although, the aging of the receivables does not indicate an issue of collectability (since the amounts are due from other State of California funds), it does severely affect the Department management's ability to properly manage cash flow, including timely payment of expenses. The Department relies entirely on its revenue collections to maintain a 60 day working capital reserve.

NOTE 3 - CAPITAL ASSETS

The Department's capital assets consist of computer servers, central processing units, tape drives, front end processors, printers, and universal power supply. The activity for the year ended June 30, 2006 is as follows:

	Balance as of July 1, 2005	Additions	Deletions	Balance as of June 30, 2006
Equipment	$ 175,049	$ 9,194	$ (65,035)	$ 119,208
Accumulated depreciation	(160,517)	(7,356)	65,035	(102,838)
Total capital assets	$ 14,532	$ 1,838	$ -	$ 16,370

NOTE 4 - INTANGIBLE ASSETS

The Department's intangible assets consist of computer upgrades and software. The activity for the year ended June 30, 2006 is as follows:

	Balance as of July 1, 2005	Additions	Deletions	Balance as of June 30, 2006
Software	$ 38,503	$ 5,257	$ (19,934)	$ 23,826
Accumulated amortization	(31,243)	(5,993)	19,934	(17,302)
Total intangible assets	$ 7,260	$ (736)	$ -	$ 6,524

NOTE 5 - NOTES PAYABLE

The Department's notes payable activity for the year ended June 30, 2006 is as follows:

	Balance as of July 1, 2005	Additions	Deletions	Balance as of June 30, 2006	Due Within One Year
Koch Financial Corp.	$ 7,881	$ -	$ (1,540)	$ 6,341	$ 1,211
Comerica Leasing Corp.	581	-	(465)	116	115
Other	22	-	(22)	-	-
Total notes payable	$ 8,484	$ -	$ (2,027)	$ 6,457	$ 1,326

Note payable to the Koch Financial Corporation payable in monthly installments of $125,514 including interest at 5.1% per annum: due in April 1, 2011.	$ 6,341
Note payable to the Comerica Leasing Corp payable in monthly installments of $38,710 including interest at 3.6% per annum: due in October 1, 2006.	116
Total long term debt	6,457
Less current portion	1,326
Long term portion	$ 5,131

The annual debt service requirements to maturity for all notes payable are as follows:

Year Ending June 30,	Payments	Interest	Total
2007	$ 1,244	$ 296	$ 1,540
2008	1,247	232	1,479
2009	1,340	167	1,507
2010	1,410	95	1,505
2011	1,216	23	1,239
Totals	$ 6,457	$ 813	$ 7,270

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NOTE 6 - LONG TERM COMMITTMENTS

Long term contracts payable represent future commitments for maintenance on software, hardware and copiers, purchase of commodities, consulting services, and the purchase of the generator system. These commitments are not included as a liability on the statement of net assets because payments towards these contracts are contingent on the Department's maintenance needs.

Year ending June 30,		
2007	$	32,099
2008		8,143
2009		1,995
2010		1,506
2011		1,129
Total	$	44,872

NOTE 7 - OPERATING LEASES

The Department leases office space under an operating lease for office space and facilities. Total rental payments for all operating leases for the fiscal years ended June 30, 2006 were $4,929. The future minimum lease payments for this lease are as follows:

Year ending June 30,		
2007	$	4,377
2008		863
2009		908
2010		919
2011		937
Total	$	8,004

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NOTE 8 - PENSION PLAN

The Department participates in the California Public Employees' Retirement System (CalPERS) Employees who work half time or more are eligible to participate in CalPERS. CalPERS is an agent multiple-employer defined benefit retirement plan that acts as a common investment and administrative agent for various local and state governmental agencies within the State of California. CalPERS provides retirement, disability and death benefits based on the employees' years of service, age and final compensation. Employees vest after 5 years of service or after ten years for second-tier employees, and may receive retirement benefits at age 50. The payroll for Department employees covered by CalPERS for the fiscal year ended June 30, 2006 was $43,361, which represents all of the Department's payroll. These benefit provisions and all other requirements are established by State statute. Copies of CalPERS annual financial report may be obtained by writing to the California Public Employees' Retirement System, Fiscal Services Division, and P.O. Box 942703, Sacramento, California 94229 or by visiting the CalPERS website at www.CalPERS.ca.gov.

Member contribution rates are actuarially determined and are based on age of entry into the system. Department contributions are actuarially determined to provide for the balance of contributions needed. Contribution requirements are determined as part of the June 30, 2003 actuarial valuation using the entry age of normal actuarial cost method. The Department's contribution requirement for the year ended June 30, 2006 was $7,370, which represent 16.997 percent of covered payroll. The computation of percentages for the Department and the employee is based on various factors including bargaining contracts, membership tier, pay schedule (biweekly or monthly), and participation in social security and medicare. The authority for both benefit provisions and contribution obligations is derived from the State Employees Retirement Act of 1937, Section 31450 et seq. of the California Government Code.

The following table shows the Department's required contributions (annual pension cost) and the percentage contributed for the current year:

Fiscal Year	Annual Pension Cost (APC) (in thousands)	Percentage of APC Contributed
2005-06	$ 7,370	100%

MACIAS GINI & O'CONNELL LLP
CERTIFIED PUBLIC ACCOUNTANTS & MANAGEMENT CONSULTANTS

3000 S Street, Suite 300
Sacramento, CA 95816
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2175 N. California Boulevard, Suite 645
Walnut Creek, CA 94596
925.274.0190

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Board of Directors
State of California
Department of Technology Services
Rancho Cordova, California

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENTAL AUDITING STANDARDS*

We have audited the financial statements of the State of California Department of Technology Services Internal Service Fund (Department) as of and for the year ended June 30, 2006, and have issued our report thereon dated January 23, 2007, which contained an explanatory paragraph describing that the financial statements present only the Department and do not purport to, and do not, present fairly the financial position and changes in financial position of the Department or the State of California. 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.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the State of California's internal control over financial reporting relating to the Department in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting relating to the Department would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

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

This report is intended solely for the information and use of management of the State of California Department of Technology Services and is not intended to be and should not be used by anyone other than this specified party.

Certified Public Accountants

Sacramento, California
January 23, 2007

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