NEW ISSUES AND REMARKETING

BOOK ENTRY ONLY

RATINGS:	***Series BQ and Series BR***	***Series BJ Bonds***
Moody's:	**Aa3**	**Aa3/VMIG1**
S&P:	**AA-**	**AA-/A-1+**
Fitch:	**AA-**	**AA-/F1+**

(See "RATINGS" herein)

In the opinion of The Honorable Bill Lockyer, Attorney General of the State of California (the"Attorney General"), and Orrick, Herrington & Sutcliffe LLP ("Bond Counsel"), based upon an analysis of existing laws, regulations, rulings and court decisions and assuming (among other matters) compliance with certain covenants, interest on the Series BQ Bonds and Series BR Bonds is excluded from gross income for federal income tax purposes and is exempt from State of California personal income taxes. In the opinion of the Attorney General and Bond Counsel, interest on the Series BQ Bonds is not a specific preference item for purposes of calculating the federal individual and corporate alternative minimum taxes, although such counsel observe that such interest is included in adjusted current earnings in calculating federal corporate alternative minimum taxable income. In the opinion of the Attorney General and Bond Counsel, interest on the Series BR Bonds is a specific preference item for purposes of calculating the federal individual and corporate alternative minimum taxes. The Attorney General and Bond Counsel express no opinion regarding any other tax consequence related to the ownership or disposition of, or the accrual or receipt of interest on, the Series BQ Bonds and Series BR Bonds. See "TAX MATTERS" herein.

The Honorable Daniel E. Lungren, then-Attorney General of the State of California, and Bond Counsel delivered an opinion in connection with the issuance of the Series BJ Bonds, dated the date of such issuance, stating that, based upon an analysis of then-existing laws, regulations, rulings and court decisions and assuming (among other matters) compliance with certain covenants, interest on the Series BJ Bonds was excluded from gross income for federal income tax purposes, was exempt from State of California personal income taxes and was a specific preference item for purposes of calculating the federal individual and corporate alternative minimum taxes. It is a condition to the remarketing of the Series BJ Bonds that the Attorney General and Bond Counsel deliver their opinion stating that such remarketing will not, in and of itself, adversely affect the exclusion of interest on the Series BJ Bonds from gross income for federal income tax purposes. See "TAX MATTERS" herein.

$351,500,000
STATE OF CALIFORNIA
VETERANS GENERAL OBLIGATION BONDS

Fixed Rate New Issues
$8,500,000 Series BQ (Non-AMT)
$71,500,000 Series BR (AMT)

Short-Term Remarketing
$100,000,000 Series BJ 3/4 (AMT)
$171,500,000 Series BJ 5/6 (AMT)

Dated: As shown on inside front cover page

Due or subject to mandatory tender: As shown on the inside front cover page

This offering consists of veterans general obligation bonds listed above (the "Offered Veterans G.O. Bonds") authorized by the voters of the State of California (the "State").

The Offered Veterans G.O. Bonds have been or will be issued as fully-registered bonds in denominations of $5,000 or any integral multiple thereof in book-entry form.

Interest is payable on June 1 and December 1 of each year, commencing as shown on the inside front cover page. **The Offered Veterans G.O. Bonds are subject to redemption prior to maturity, including redemption at par. See "THE OFFERED VETERANS G.O. BONDS."**

The remarketed Series BJ Bonds will be subject to mandatory tender (with no right to retain) on the applicable Mandatory Tender Date, as shown on the inside front cover page. **The Official Statement is not intended to provide any information with respect to any Series BJ Bond after its applicable Mandatory Tender Date. See "THE OFFERED VETERANS G.O. BONDS—Mandatory Tender and Redemption of Series BJ Bonds."**

MATURITIES, MANDATORY TENDER DATES, PRINCIPAL AMOUNTS, INTEREST RATES AND PRICES OR YIELDS
[see inside front cover page]

The Offered Veterans G.O. Bonds are general obligations of the State to which the full faith and credit of the State are pledged. Principal of, premium, if any, and interest on the Offered Veterans G.O. Bonds are payable from any moneys in the General Fund of the State, subject only to the prior application of such moneys to the support of the public school system and public institutions of higher education. In addition, State law requires funds for the payment of debt service on the Offered Veterans G.O. Bonds to be transferred to the General Fund from the Veterans Farm and Home Building Fund of 1943. See "AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS—Security and Payment of Veterans G.O. Bonds."

The Treasurer will apply to list the Series BR Bonds due December 1, 2029 on the New York Stock Exchange.

This cover page contains certain information for quick reference only. It is not a summary of this issue. Investors must read the entire Official Statement to obtain information essential to the making of an informed investment decision.

The Series BQ Bonds and Series BR Bonds are offered when, as and if issued and received by the Underwriters set forth below, subject to the approval of legality by The Honorable Bill Lockyer, Attorney General, and by Orrick, Herrington & Sutcliffe LLP, Bond Counsel. Certain legal matters will be passed upon for the Underwriters by Hawkins, Delafield & Wood, Underwriters' Counsel. Public Resources Advisory Group has served as Financial Advisor in connection with the issuance of the Offered Veterans G.O. Bonds. The remarketing of the Series BJ Bonds by the Underwriters is subject to certain conditions, including receipt of the opinion of the Attorney General and Bond Counsel described above. The Offered Veterans G.O. Bonds will be available for delivery on or about April 28, 1999.

Honorable Philip Angelides
Treasurer of the State of California

Bear, Stearns & Co. Inc.

Dain Rauscher Incorporated | **E.J. DeLaRosa & Co.** | **Goldman, Sachs & Co.**
Great Pacific Securities, Inc. | **JP Morgan & Co. Inc.** | **Lehman Brothers**
Merrill Lynch & Co. | **NationsBanc Montgomery Securities, LLC** | **Siebert, Brandford, Shank & Co.**

William E. Simon & Sons Municipal Securities, Inc.

April 14, 1999

MATURITIES, MANDATORY TENDER DATES, PRINCIPAL AMOUNTS, INTEREST RATES AND PRICES OR YIELDS

Fixed Rate New Issues

$8,500,000 Veterans Bonds Series BQ (Non-AMT)—Dated: April 1, 1999

Maturity Date (Dec. 1)	Principal Amount	Coupon	CUSIP Number	Maturity Date (Dec. 1)	Principal Amount	Coupon	CUSIP Number
2003	$100,000	3.60%	130629EG9	2006	$7,200,000	4 %	130629EK0
2004	100,000	3¾	130629EH7	2007	100,000	4.10	130629EL8
2005	100,000	3.85	130629EJ3	2008	900,000	4.20	130629EM6

(plus accrued interest from April 1, 1999)
First interest payment date: December 1, 1999
Price: 100%

$71,500,000 Veterans Bonds Series BR (AMT)—Dated: April 1, 1999

$25,100,000 Serial Bonds

Maturity Date (Dec. 1)	Principal Amount	Coupon	Price	CUSIP Number	Maturity Date (Dec. 1)	Principal Amount	Coupon	Price	CUSIP Number
2003	$ 800,000	3.70%	100%	130629EN4	2008	$ 880,000	4.30%	100%	130629ET1
2004	8,805,000	3.90	100	130629EP9	2009	930,000	4.40	100	130629EU8
2005	8,845,000	4	100	130629EQ7	2010	985,000	4½	100	130629EV6
2006	790,000	4.15	100	130629ER5	2011	1,040,000	4.60	100	130629EW4
2007	835,000	4¼	100	130629ES3	2012	1,190,000	4.70	100	130629EX2

$14,115,000 5⅛% Term Veterans Bonds due December 1, 2019 @ 99.625% CUSIP No. 130629EY0
$6,130,000 5¼% Term Veterans Bonds due December 1, 2026 @ 99.625% CUSIP No. 130629EZ7
$26,155,000 5.30% Term Veterans Bonds due December 1, 2029 @ 100% CUSIP No. 130629FA1

(plus accrued interest from April 1, 1999)
First interest payment date: December 1, 1999

Short-Term Remarketing

$271,500,000 Veterans Bonds Series BJ (AMT)—Dated: December 29, 1997
Term Bonds due December 1, 2032—Price: 100%

Each Series BJ Bond will bear interest at the rate set forth below to and including the date preceding its Mandatory Tender Date. Each Series BJ Bond is subject to mandatory tender **(with no right to retain)** on its Mandatory Tender Date. The Mandatory Tender Date for any Series BJ Bond is the applicable latest Mandatory Tender Date set forth below, *unless* one or more business days prior thereto on or after the applicable Earliest Mandatory Tender Date is designated as the Mandatory Tender Date for all or any portion of the applicable Series BJ Bonds. Individual Series BJ Bonds may have different Mandatory Tender Dates.

Series	Principal Amount	Interest Rate	Earliest Mandatory Tender Date	Latest Mandatory Tender Date	CUSIP No.
BJ 3/4	$100,000,000	3.20%	December 1, 1999	June 1, 2000	130629CF3
BJ 5/6	$171,500,000	3.60%	June 1, 2000	June 1, 2001	130629CG1

(plus accrued interest at 4⅛% from December 1, 1998)
First interest payment date: June 1, 1999.
(based upon an interest rate of 4⅛% from December 1, 1998 to April 27, 1999,
and of the respective interest rate set forth above from April 28, 1999 to May 31, 1999.)

No dealer, broker, salesperson or other person has been authorized by the State to give any information or to make any representations other than those contained herein and, if given or made, such other information or representations must not be relied upon as having been authorized by the State.

This Official Statement is not to be construed as a contract with the purchasers of the Offered Veterans G.O. Bonds. Statements contained in this Official Statement which involve estimates, forecasts or matters of opinion, whether or not expressly so described herein, are intended solely as such and are not to be construed as representations of facts.

The information set forth herein has been obtained from official sources which are believed to be reliable, but it is not guaranteed as to accuracy or completeness. The information and expressions of opinion herein are subject to change without notice, and neither delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the State since the date hereof.

IN CONNECTION WITH THIS OFFERING THE UNDERWRITERS MAY OVERALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICES OF THE OFFERED VETERANS G.O. BONDS OFFERED HEREBY AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

This Official Statement does not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of the Offered Veterans G.O. Bonds, by any person in any jurisdiction in which it is unlawful for such person to make such an offer, solicitation or sale.

Copies of this Official Statement may be obtained from:

HONORABLE PHILIP ANGELIDES
Treasurer of the State of California
P.O. Box 942809
Sacramento, California 94209–0001
(800) 900-3873

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OFFICIAL STATEMENT

$351,500,000

STATE OF CALIFORNIA
VETERANS GENERAL OBLIGATION BONDS

Fixed Rate New Issues	***Short-Term Remarketing***
$8,500,000 Series BQ (Non-AMT)	**$100,000,000 Series BJ 3/4 (AMT)**
$71,500,000 Series BR (AMT)	**$171,500,000 Series BJ 5/6 (AMT)**

INTRODUCTION

This introduction is a brief summary of the terms of the State of California Veterans General Obligation Bonds listed above (the "Offered Veterans G.O. Bonds") and a brief description of the Official Statement; a full review should be made of the entire Official Statement. All statements contained in this introduction are qualified in their entirety by reference to the entire Official Statement. Summaries of provisions of the Constitution and other laws of the State of California or of any other documents referred to in this Official Statement do not purport to be complete and such summaries are qualified in their entirety by references to the complete provisions.

Description of the Offered Veterans G.O. Bonds

The issuance of veterans general obligation bonds ("Veterans G.O. Bonds") is authorized by Bond Acts (defined below) approved by the voters of the State of California (the "State") and by resolutions of the Veterans Finance Committee of 1943. The Offered Veterans G.O. Bonds are authorized by specific Bond Acts and have been or are being issued to finance or refinance obligations issued to finance the purchase of homes and farms for California military veterans under the Farm and Home Purchase Program (the "Program") of the State Department of Veterans Affairs (the "Department") or to refund outstanding Veterans G.O. Bonds. The Series BQ Bonds and the Series BR Bonds are new bonds being issued in four separate series which are being offered in two groups, each of which groups is referred to in this Official Statement by its two-letter designation. The Series BJ Bonds being remarketed are a portion of the Series BJ Bonds issued in December 1997 as two separate series offered as one group, bearing interest at a short-term interest rate. Such Series BJ Bonds are being remarketed to new Bondholders for a new short-term period in connection with a mandatory tender on April 28, 1999 by existing Bondholders. The remaining portion of the Series BJ Bonds is being replaced and refunded by the Series BR Bonds. "Series BJ Bonds," as used in this Official Statement, refers to the Series BJ Bonds being remarketed, unless the context clearly indicates otherwise. See "THE OFFERED VETERANS G.O. BONDS—Identification and Authorization of the Offered Veterans G.O. Bonds."

The Offered Veterans G.O. Bonds will be registered in the name of a nominee of The Depository Trust Company ("DTC") which will act as securities depository for the Offered Veterans G.O. Bonds. Purchases of beneficial interests in the Offered Veterans G.O. Bonds may be in book-entry form only, in the principal amount of $5,000 or any integral multiple thereof. Principal and interest are payable as specified on the front cover page and inside front cover page of this Official Statement.

Security and Sources of Payment for the Veterans G.O. Bonds

The Veterans G.O. Bonds are general obligations of the State to which the full faith and credit of the State are pledged (see "AUTHORIZATION OF AND SECURITY FOR THE

OFFERED VETERANS G.O. BONDS—Security and Payment of Veterans G.O. Bonds" below). Principal of and interest on the Veterans G.O. Bonds are payable from moneys in the General Fund of the State Treasury (the "General Fund") (see Appendix A—"THE STATE OF CALIFORNIA— State Finances—The General Fund"), subject only to the prior application of moneys in the General Fund to the support of the public school system and public institutions of higher education. The Bond Acts authorizing the Veterans G.O. Bonds provide that the State shall collect annually, in the same manner and at the same time as it collects other State revenues, a sum sufficient, in addition to the ordinary revenues of the State, to pay the principal of and interest on the Veterans G.O. Bonds. In addition, State law requires funds for the payment of debt service on the Veterans G.O. Bonds to be transferred to the General Fund from the Veterans Farm and Home Building Fund of 1943 (the "1943 Fund"). See "AUTHORIZATION OF AND SECURITY FOR THE VETERANS G.O. BONDS—Security and Payment of Veterans G.O. Bonds" and Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND."

Mandatory Tender of Series BJ Bonds

Each Series BJ Bond is subject to mandatory tender **(with no right to retain)** on its Mandatory Tender Date set forth on the inside front cover page. **This Official Statement is not intended to provide any information with respect to any Series BJ Bond after its applicable Mandatory Tender Date.** See "THE OFFERED VETERANS G.O. BONDS—Mandatory Tender and Redemption of Series BJ Bonds."

Redemption

Offered Veterans G.O. Bonds are subject to redemption prior to maturity. The Series BR Bonds maturing on December 1, 2019, December 1, 2026, and December 1, 2029, respectively, are subject to mandatory redemption at par prior to their stated maturities, in part, from sinking fund payments made by the State. See "THE OFFERED VETERANS G.O. BONDS—Redemption of Series BQ Bonds and Series BR Bonds" and "—Mandatory Tender and Redemption of Series BJ Bonds."

Tax Matters

In the opinion of the The Honorable Bill Lockyer, Attorney General of the State of California (the "Attorney General") and Orrick, Herrington & Sutcliffe LLP ("Bond Counsel"), assuming compliance by the State and the Department with certain tax covenants described herein, the interest on the Series BQ Bonds and Series BR Bonds is not included in gross income for federal income tax purposes under existing statutes and court decisions, and the interest on the Series BQ Bonds and Series BR Bonds is exempt from personal income taxes of the State of California under present State law. The Attorney General and Bond Counsel are of the opinion that (i) the interest on the Series BQ Bonds is not treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Internal Revenue Code of 1986, as amended, with respect to individuals and corporations; such interest, however, is included in the adjusted current earnings of certain corporations for the purpose of calculating the alternative minimum tax imposed on such corporations, and (ii) interest on the Series BR Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed under the Internal Revenue Code of 1986, as amended, with respect to individuals and corporations.

The Honorable Daniel E. Lungren, then-Attorney General of the State of California, and Bond Counsel delivered an opinion in connection with the issuance of the Series BJ Bonds, dated December 29, 1997, stating that, based upon an analysis of then-existing laws, regulations, rulings and court decisions and assuming (among other matters) compliance with certain covenants, interest on the Series BJ Bonds was excluded from gross income for federal income tax purposes, was exempt from State of California personal income taxes and was a specific preference item for purposes of calculating the federal individual and corporate alternative minimum taxes. It is a condition to the remarketing of the Series BJ Bonds that the Attorney General and Bond Counsel deliver their opinion on the remarketing date of the Series BJ Bonds stating that not converting the interest rate on such bonds on such date to fixed interest rates will not, in and of itself, adversely affect the exclusion of interest on the Series BJ Bonds from gross income for federal income tax purposes.

See "TAX MATTERS" below, Appendix E—"PROPOSED FORM OF LEGAL OPINION WITH RESPECT TO THE SERIES BQ BONDS AND SERIES BR BONDS" and Appendix F—"LEGAL OPINION DELIVERED WITH RESPECT TO THE SERIES BJ BONDS."

Certain Information Related to this Official Statement

The information and expressions of opinion herein speak only as of their date and are subject to change without notice. Neither delivery of this Official Statement nor any sale made hereunder, shall, under any circumstances, create any implication that there has been no change in the affairs of the State since the date hereof.

All financial and other information presented in this Official Statement has been provided by, respectively, the State or the Department from its records, except for information expressly attributed to other sources. The presentation of information, including tables of receipts from taxes and other revenues, is intended to show recent historic information and is not intended to indicate future or continuing trends in the financial position or other affairs of, respectively, the State or the Department. No representation is made that past experience, as it might be shown by such financial and other information, will necessarily continue or be repeated in the future.

Continuing Disclosure

The State Treasurer, on behalf of the State, will provide annually certain financial information and operating data relating to the State by not later than April 1 of each year in which any Offered Veterans G.O. Bonds are outstanding (the "Treasurer's Annual Report"), commencing with the report for the 1998-99 Fiscal Year, and to provide notices of the occurrence of certain other enumerated events if material. The Secretary of the Department will provide certain financial information and operating data relating to the Program by no later than April 1 of each year in which any Offered Veterans G.O. Bonds are outstanding (the "Department's Annual Report"), commencing with the report for the 1998-1999 Fiscal Year. The specific nature of the information to be contained in the Treasurer's Annual Report and the Department's Annual Report or the notices of material events and certain other terms of the continuing disclosure obligations are summarized below under Appendix D—"SUMMARY OF CONTINUING DISCLOSURE CERTIFICATES."

Additional Information

Questions regarding this Official Statement and the issuance of these securities may be addressed to the office of the Honorable Philip Angelides, Treasurer of the State of California, P.O. Box 942809, Sacramento, CA 94209-0001, telephone (800) 900-3873. Questions regarding the Program should be addressed to the Bond Finance Division of the Department of Veterans Affairs, P.O. Box 942895, Sacramento, CA 94295-0001, telephone (916) 653-2081.

AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS

Authorization

Each general obligation bond act authorizing the issuance of Veterans G.O. Bonds (each, a "Bond Act") incorporates by reference the State General Obligation Bond Law (the "Law"), which is set forth in Chapter 4 (commencing with Section 16720) of Part 3 of Division 4 of Title 2 of the California Government Code. The Law provides a procedure for the authorization, sale, issuance, use of proceeds, repayment and refunding of State general obligation bonds.

Security and Payment of Veterans G.O. Bonds

The Veterans G.O. Bonds are general obligations of the State, payable in accordance with the Bond Acts out of the General Fund. The full faith and credit of the State are pledged for the punctual payment of principal of and interest on the Veterans G.O. Bonds. The Bond Acts provide that the State shall collect annually in the same manner and at the same time as it collects other State revenue an amount sufficient, in addition to the ordinary revenue of the State, to pay principal of and interest on the Veterans G.O. Bonds. Each Bond Act also contains a continuing appropriation from the General Fund of the sum annually necessary to pay principal of and interest on the Veterans G.O. Bonds. Payment of principal and purchase price of, premium, if any, and interest on the Veterans G.O. Bonds from the General Fund is subject only to the prior application of moneys in the General Fund to the support of the public school system and public institutions of higher education.

The Department's principal fund is the 1943 Fund described in Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The 1943 Fund." The Military and Veterans Code of the State (the "Veterans Code"), of which the Bond Acts are a part, requires that on the dates when funds are to be remitted to Bondowners for the payment of debt service on Veterans G.O. Bonds in each fiscal year, there shall be transferred to the General Fund to pay the debt service on Veterans G.O. Bonds all of the money in the 1943 Fund (but not in excess of the amount of debt service then due and payable). If the money so transferred on the remittance dates is less than the debt service then due and payable, the balance remaining unpaid is required by the Veterans Code to be transferred to the General Fund out of the 1943 Fund as soon as it shall become available, together with interest thereon from the remittance date until paid, at the same rate of interest as borne by the applicable Veterans G.O. Bonds, compounded semiannually.

The Veterans Code does not grant any lien on the 1943 Fund or the moneys therein to the holders of any Veterans G.O. Bonds. Outstanding home purchase revenue bonds in the aggregate principal amount of $323,305,000 previously issued by the Department, plus $86,085,000 aggregate principal amount of bonds previously sold by the Department and scheduled to be issued on May 4, 1999, and any additional home purchase revenue bonds issued by the Department in the future (collectively, the "Revenue Bonds") are and will be special obligations of the Department payable solely from, and secured by a pledge of, an undivided interest in the assets of the 1943 Fund (other than proceeds of Veterans G.O. Bonds or any amounts in any rebate account) and any reserve accounts established for the benefit of Revenue Bonds. The Veterans Code provides that this undivided interest in the 1943 Fund is secondary and subordinate to any interest or right in the assets of the 1943 Fund of the people of the State and of the holders of the Veterans G.O. Bonds (that is, the right to payment or reimbursement of debt service on Veterans G.O. Bonds described in the preceding paragraph). If debt service payments to the General Fund are current and all reimbursement of debt service payments with interest as described in the preceding paragraph have been made, no holder or beneficial owner of Veterans G.O. Bonds has any right to restrict disbursements by the Department from the 1943 Fund for any lawful purpose, including payment of debt service on or redemptions and purchases of Revenue Bonds.

While the Department's 1998 Financial Statement for the 1943 Fund reflects an increase in retained earnings, the Program has experienced significant losses during recent fiscal years, which have caused decreases in the retained earnings in the 1943 Fund. For additional information, see Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The 1943 Fund" and Exhibit 1 to Appendix B—"Department Audited Financial Statements."

PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES

Plan of Finance

Under the Program, the Department acquires residential property to be sold to eligible veterans under contracts of purchase between the Department and such veterans ("Contracts of Purchase"). Such acquisition is financed principally with the proceeds of Veterans G.O. Bonds and Revenue Bonds. The issuance of the Series BQ Bonds and Series BR Bonds is for the purpose of replacing and refunding $51,500,000 aggregate principal amount of outstanding Veterans G.O. Bonds and replacing and refunding $28,500,000 aggregate principal amount of Series BJ1 Bonds and Series BJ2 Bonds that are not being remarketed.

The Series BJ Bonds being remarketed were issued on December 29, 1997, currently bear interest at a short-term rate and are subject to mandatory tender and remarketing on April 28, 1999. Upon remarketing, each such remarketed Series BJ Bond will bear interest at a short-term rate to its applicable Mandatory Tender Date. The remainder of the Series BJ1 Bonds and Series BJ2 Bonds that are not being remarketed, will be retired on their scheduled June 1, 1999 mandatory tender date.

$54,170,000 aggregate principal amount of Revenue Bonds was issued in March 1999 and $86,085,000 aggregate principal amount of Revenue Bonds has been sold and is expected to be issued in May 1999 (collectively, the "1999 Revenue Bonds") as fixed rate long-term bonds (i) to refund outstanding Revenue Bonds, (ii) to replace and refund Veterans G.O. Bonds and Revenue Bonds on their mandatory tender date, upon special redemption, or at their maturity, and (iii) to finance new Contracts of Purchase.

The issuances of the Offered Veterans G.O. Bonds and the 1999 Revenue Bonds and certain federal tax-related reallocations are expected to result in approximately $182,700,000 becoming available for new Contracts of Purchase. These available moneys will be in addition to moneys also made available to finance new Contracts of Purchase through the issuance of the other Revenue Bonds and other Veterans G.O. Bonds in 1997 and 1998. In addition, proceeds of the remarketed Series BJ Bonds and the Home Purchase Revenue Bonds, 1997 Series C, will become available to finance new Contracts of Purchase only when and if the interest rates on such bonds are adjusted to long-term fixed interest rates. See Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—Exhibit 2—Certain Department Financial Information and Operating Data—Contracts of Purchase—Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments."

Department's Recent Programmatic Changes

In the past two years, the Department has completed a number of significant changes to the Program. The Department's principal goals have been to lower the interest rate on existing Contracts of Purchase, provide an interest rate on new Contracts of Purchase which more closely reflects its borrowing costs, better service Contracts of Purchase to reduce real estate losses, obtain mortgage insurance or guaranties to reduce exposure to future real estate losses, increase accessibility by reducing down payment requirements for borrowers and allowing mortgage brokers to originate Contracts of Purchase, and revamp the various insurance products the Department offers to veterans with Contracts of Purchase.

Amendments made in 1998 to the Veterans Code eliminated the uniform interest rate requirement for Contracts of Purchase executed on and after January 1, 1999 and permit the Department to establish fixed interest rates or variable interest rates for these Contracts of Purchase. The interest rates established can be different for different Contracts of Purchase. However, the Veterans Code still requires that all Contracts of Purchase originated prior to January 1, 1999 bear a uniform interest rate which is subject to periodic adjustment. (There are statutory exceptions to the uniform rate requirement but these exceptions have little impact on the Program.) The new Contracts of Purchase to be financed with moneys allocable to the Offered Veterans G.O. Bonds or 1999 Revenue Bonds will be, and Contracts of Purchase originated after January 1, 1999 are being, originated under the new statutory provisions. The current interest rates for Contracts of Purchase are 5.95% per annum for Contracts of Purchase financed with Qualified Mortgage Bond Proceeds, and 6.65% per annum for all other Contracts of Purchase. These rates are subject to change by the Department.

The current uniform interest rate on approximately 98% of the existing Contracts of Purchase is 6.95% per annum, reduced during 1998 from 8.0% per annum. The Department believes that, in the past, the high 8.0% interest rate reduced demand for new Contracts of Purchase. In late 1997, the Department began a series of steps which restructured a large part of the outstanding indebtedness which financed the Program. The restructuring has enabled the Department to lower the interest rate on existing Contracts of Purchase. Legislation effective January 1, 1998 expanded veteran eligibility under State law to include Early Vietnam Veterans and Peacetime Veterans, as such terms are defined in Appendix B. Prior to January 1, 1999, Contracts of Purchase were originated only by the Department. Recent revisions to the Veterans Code allow the Department to require a 1% loan origination fee. As a result, the Department has begun to allow loan origination through mortgage brokers certified to participate by the Department. The Department expects that this eligibility expansion, together with the lowered interest rates on Contracts of Purchase, lowered down payment requirements, and expanded marketing efforts through the use of mortgage brokers, will increase Program demand.

The Department has undertaken a series of steps designed to address real estate losses and loss exposure. It has reorganized its loan servicing and updated its automated loan accounting and servicing functions. It has set aside additional reserves for loan losses. It has obtained primary mortgage insurance (with a deductible) for a large portion of the existing Contracts of Purchase with high loan-to-value ratios, and is obtaining loan guaranties from the United States Department of Veterans Affairs for most new Contracts of Purchase with high loan-to-value ratios. There can be no assurance, however, that the Department can continue to obtain mortgage insurance or guaranties on terms and prices acceptable to the Department.

The Veterans Code and/or long-standing Department policies have called for the Department to provide casualty and life and disability insurance for veterans with Contracts of Purchase. During the period that the Department self-insured this liability, the Department experienced significant losses. Over the past few years the Department has undertaken steps to reduce its losses, including obtaining outside providers for some portions of these various types of insurance.

Additional information regarding the Department's programmatic changes is set forth under Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The Program." For additional discussion of qualifying veterans and interest rates on Contracts of Purchase, see, respectively, Appendix B— "THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The Program—Qualifying Veteran Status" and "—Contracts of Purchase." For additional discussion of real estate losses, see Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The Program—Loan Insurance" and "—Selected Financial Data of the 1943 Fund and Department's Discussion." For additional discussion of the Department's insurance programs, see Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The Program—Property and Life and Disability Insurance."

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THE OFFERED VETERANS G.O. BONDS

General

The Offered Veterans G.O. Bonds are or will be registered in the name of a nominee of The Depository Trust Company ("DTC"), which will act as securities depository for the Offered Veterans G.O. Bonds. Purchases of beneficial interests in the Offered Veterans G.O. Bonds may be made in book-entry form only, in the principal amount of $5,000 or any integral multiple thereof. See Appendix C—"BOOK-ENTRY SYSTEM."

The Offered Veterans G.O. Bonds are or will be dated the applicable date, and will mature on the dates and in the amounts, set forth on the inside front cover page hereof. Interest is payable on June 1 and December 1 in each year (each, an "Interest Payment Date"), commencing the respective first interest payment date, at the respective rates shown on the inside front cover page of this Official Statement. Interest on the Offered Veterans G.O. Bonds shall be calculated on the basis of a 360-day year comprised of twelve thirty-day months.

Each remarketed Series BJ Bond bears interest at a short-term rate until its applicable Mandatory Tender Date, when it is subject to mandatory tender with no right to retain. The interest payable with respect to each remarketed Series BJ Bond on its June 1, 1999 first interest payment date will be the sum of (i) 4⅛% per annum for the period from December 1, 1998 to April 27, 1999, and (ii) the applicable interest rate per annum set forth on the inside front cover page for the period from April 28, 1999 to May 31, 1999. **This Official Statement is not intended to provide any information with respect to any Series BJ Bond after its applicable Mandatory Tender Date.** See "THE OFFERED VETERANS G.O. BONDS—Mandatory Tender and Redemption of Series BJ Bonds."

Principal and interest are payable directly to DTC by the State Treasurer. Upon receipt of payments of principal and interest, DTC is to in turn remit such principal and interest to the participants in DTC for disbursement to the beneficial owners of the Offered Veterans G.O. Bonds. The record date for the payment of interest on the Offered Veterans G.O. Bonds is the close of business on the 15th day of the month immediately preceding an Interest Payment Date, whether or not the day is a business day.

Identification and Authorization of the Offered Veterans G.O. Bonds

The Series BJ Bonds were issued under two Bond Acts, each authorized by the voters, as described below, for the purpose of financing new Contracts of Purchase when the short-term interest rate borne by such bonds is adjusted to fixed interest rates to maturity. The Series BQ Bonds and Series BR Bonds are issued under four Bond Acts, each authorized by the voters, as described below. See Appendix A—"THE STATE OF CALIFORNIA—State Indebtedness." The Series BQ Bonds and Series BR Bonds are being issued for the purpose of replacing available moneys to be used to pay the principal amount of certain outstanding Veterans G.O. Bonds becoming due at maturity or upon special redemption, or to pay the principal amount of, Series BJ1 Bonds and Series BJ2 Bonds that are not being remarketed upon mandatory tender. The Veterans G.O. Bonds being retired will all be repaid within ninety days after the delivery of the Series BQ Bonds and Series BR Bonds, so as to constitute a "current refunding" for federal tax purposes. See "PLAN OF FINANCE AND DEPARTMENT'S PROGRAMMATIC CHANGES—Plan of Finance."

Short-Term Remarketing

1. $23,200,000 principal amounts of Veterans Bonds, Series BJ3, authorized under the Veterans Bond Act of 1988 (AMT);
2. $39,795,000 principal amount of Veterans Bonds, Series BJ5, authorized under the Veterans Bond Act of 1988 (AMT);
3. $76,800,000 principal amount of Veterans Bonds, Series BJ4, authorized under the Veterans Bond Act of 1990 (AMT);
4. $131,705,000 principal amount of Veterans Bonds, Series BJ6, authorized under the Veterans Bond Act of 1990 (AMT).

Fixed Rate New Issues

1. $8,500,000 principal amount of Veterans Bonds, Series BQ, authorized under the Veterans Bond Act of 1980 (Non-AMT);
2. $29,810,000 principal amount of Veterans Bonds, Series BR1, authorized under the Veterans Bond Act of 1986 (AMT);
3. $15,230,000 principal amount of Veterans Bonds, Series BR2, authorized under the Veterans Bond Act of 1988 (AMT);
4. $26,460,000 principal amount of Veterans Bonds, Series BR3, authorized under the Veterans Bond Act of 1990 (AMT).

Redemption of Series BQ Bonds and Series BR Bonds

Sinking Fund Redemption

Series BR Bonds maturing on December 1, 2019, December 1, 2026, and December 1, 2029 respectively, are subject to redemption prior to their respective stated maturity dates, in part, by lot, from sinking fund payments, at a redemption price of 100 percent of the principal amount thereof, plus accrued interest to the date fixed for redemption, without premium, on the respective dates and in the respective amounts shown below.

SINKING FUND REDEMPTION SCHEDULE

Date (December 1)	Series BR Bonds Maturing December 1, 2019	Series BR Bonds Maturing December 1, 2026	Series BR Bonds Maturing December 1, 2029
2013	$1,700,000		
2014	1,800,000		
2015	1,900,000		
2016	2,005,000		
2017	2,115,000		
2018	2,235,000		
2019	2,360,000 †		
2020		$880,000	$1,615,000
2021		880,000	1,755,000
2022		880,000	1,905,000
2023		880,000	2,060,000
2024		880,000	2,225,000
2025		880,000	2,400,000
2026		850,000 †	2,610,000
2027			3,655,000
2028			3,855,000
2029			4,075,000 †

† Stated Maturity

If less than all of the Term Bonds of a maturity of a Series of the Offered Veterans G.O. Bonds are purchased or called for redemption (other than in satisfaction of sinking fund payments), the State Treasurer will credit the principal amount of such Term Bonds that are so purchased or redeemed against applicable remaining sinking fund payments (including the principal amounts due on the respective maturity dates, as shown above), as requested by the Department.

Optional Redemption

The Series BQ Bonds and Series BR Bonds maturing on and after December 1, 2004 are subject to optional redemption prior to their respective stated maturity dates, at the option of the State upon request of the Department, in whole or in part (of either Series, of any maturity within a Series, and by lot within each maturity of each Series), on any date on or after June 1, 2004 at the redemption prices stated below, plus accrued interest to the date fixed for redemption:

Redemption Dates (both dates inclusive)	Redemption Price (as percentage of principal amount redeemed)
June 1, 2004 to May 31, 2005	101.0%
June 1, 2005 and thereafter	100.0%

Special Redemption from Unexpended Proceeds and Excess Revenues

The Series BQ Bonds and Series BR Bonds are also subject to special redemption prior to their respective stated maturity dates, at the option of the State upon request of the Department, from (i) moneys deposited in the related Series Proceeds Subaccount with respect to the Series BQ Bonds and Series BR Bonds on the date of issuance of such bonds that have not been applied to finance Contracts of Purchase and (ii) Excess Revenues (as defined below) derived from any Veterans G.O. Bonds and any Revenue Bonds. Any such redemption may be on any date, in whole or in part (of any Series and of any maturities within a Series at the option of the State upon request of the Department, and by lot within such maturity of such Series), at the principal amount thereof plus accrued interest to the date fixed for redemption, without premium.

Moneys are currently available through the issuance of Veterans G.O. Bonds and Revenue Bonds to finance Contracts of Purchase, and additional moneys may become available to finance Contracts of Purchase through the future issuances of Revenue Bonds and Veterans G.O. Bonds. Since the Department has full discretion, subject to eligibility requirements and the requirements of the Internal Revenue Code of 1954, as amended, and the Internal Revenue Code of 1986, as amended (collectively, the "Federal Tax Code"), in applying the proceeds of all of these bonds to finance the Program, the proceeds of prior and future bonds may be used to finance Contracts of Purchase before proceeds of the Offered Veterans G.O. Bonds.

Although the Department's goal is to use moneys made available through the issuance of the Offered Veterans G.O. Bonds (including recycled prepayments) to finance Contracts of Purchase, such expectation is subject to change, and such moneys or prepayments would then be available to redeem Offered Veterans G.O. Bonds, other Veterans G.O. Bonds, and Revenue Bonds. See "PLAN OF FINANCE AND DEPARTMENT'S PROGRAMMATIC CHANGES—Plan of Finance."

Excess Revenues can include prepayments and repayments on Contracts of Purchase funded by Revenue Bonds and Veterans G.O. Bonds, and also includes Revenues which had been set aside to be recycled into new Contracts of Purchase. All payments on Contracts of Purchase are deposited in the 1943 Fund and applied to pay or reimburse debt service on the Veterans G.O. Bonds, to pay debt service on Revenue Bonds, to pay for mandatory redemptions of Veterans G.O. Bonds and Revenue Bonds, to pay Program and Department expenses, and to pay certain insurance claims. The Department, subject to applicable bond authorizing resolutions, may apply Excess Revenues to redeem any Veterans G.O. Bonds or Revenue Bonds eligible for redemption. The Department's decision to apply Excess Revenues to redeem bonds, to finance new Contracts of Purchase, or for any other permitted purpose depends on many factors, including applicable bond authorizing resolution requirements, demand for Contracts of Purchase, debt service cost savings, investment earnings, and Federal Tax Code requirements.

Certain of the outstanding Veterans G.O. Bonds are not subject to redemption prior to maturity. See Exhibit 2 to Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—Certain Department Financial Information and Operating Data."

"Excess Revenues" means all Revenues, including prepayments and repayments on Contracts of Purchase which represent at any time an excess over Accrued Debt Service. See Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The 1943 Fund—Excess Revenues."

Mandatory Tender and Redemption of Series BJ Bonds

Mandatory Tender

Each Series BJ Bond will be subject to mandatory tender **(with no right to retain)** on its Mandatory Tender Date at a purchase price equal to 100% of the principal amount thereof, plus accrued interest to but not including such Mandatory Tender Date. "Mandatory Tender Date" means each date on which the Series BJ Bonds or any portion thereof are subject to adjustment to a new rate or rates of interest. The Mandatory Tender Date is the applicable Latest Mandatory Tender Date, unless one or more business days prior thereto on or after the applicable Earliest Mandatory Tender Date are designated as the Mandatory Tender Dates for all or any portion of the Series BJ Bonds. The Earliest Mandatory Tender Dates and Latest Mandatory Tender Dates are set forth on the inside front cover page. References to "its Mandatory Tender Date" or "the applicable Mandatory Tender Date" with respect to a Series BJ Bond shall mean the date on which the interest rate on such Bond is adjusted to a new rate or rates of interest. **This Official Statement is not intended to provide any information with respect to any Series BJ Bond after its applicable Mandatory Tender Date.** Payment of the purchase price of Series BJ Bonds will be made to the holders thereof upon surrender of their Series BJ Bonds. In the event of a failure to remarket all or a portion of such Series BJ Bonds subject to mandatory tender on a Mandatory Tender Date, such unremarketed Series BJ Bonds will be redeemed by the State (without further notice to the Bondholders) with any moneys available for such purpose and will be cancelled and retired by the State.

If the Department requests the State to designate a Mandatory Tender Date for all or any portion of the Series BJ Bonds to be a date other than the applicable Latest Mandatory Tender Date, then no later than the 30th day prior to such earlier Mandatory Tender Date (the "Notification Date"), the State will send written notice by first class mail, postage prepaid, to each Bondowner of a Series BJ Bond for which such date is its Mandatory Tender Date, stating (i) the

Mandatory Tender Date, (ii) that such Series BJ Bond will be deemed to be tendered for purchase on such Mandatory Tender Date at a purchase price equal to 100% of the principal amount thereof, plus accrued interest to the Mandatory Tender Date, (iii) that such Series BJ Bond will be purchased or redeemed without further notice on the Mandatory Tender Date, and (iv) that the purchase price or redemption price of each Series BJ Bond will be payable by the State upon delivery to the State of such Series BJ Bond. So long as all of the Series BJ Bonds for which such date is a Mandatory Tender Date are immobilized in the custody of DTC, such notices will be delivered and payments will be made by the State to DTC or its nominee as Bondowner of such Series BJ Bonds. DTC is responsible for notifying Participants, and Participants and Indirect Participants are responsible for notifying Beneficial Owners. Neither the State nor the Department is responsible for sending notices to Beneficial Owners or for the consequences of any action or inaction by the Department as a result of the response or failure to respond to DTC or its nominee as Bondowner. See Appendix C—"BOOK-ENTRY SYSTEM."

Redemption

Each Series BJ Bond is subject to optional redemption, at the option of the State upon request of the Department, on its Mandatory Tender Date or on any date which could be designated as its Mandatory Tender Date, at a redemption price of 100% of the principal amount thereof plus accrued interest to the date fixed for redemption without premium.

Notice of Redemption

When redemption is required while the Offered Veterans G.O. Bonds are in book-entry only form, the State Treasurer shall give notice of redemption by mailing copies of such notice only to DTC (not to the beneficial owners of the Offered Veterans G.O. Bonds) not less than thirty or more than sixty days prior to the date fixed for redemption. DTC, in turn, is to send the notice of redemption to its participants for distribution to the beneficial owners of the Offered Veterans G.O. Bonds. See Appendix C—"BOOK-ENTRY SYSTEM." The notice will state, among other things, that the Offered Veterans G.O. Bonds or a designated portion thereof (in the case of redemption of a Offered Veterans G.O. Bond in part but not in whole) are to be redeemed, the dated date of the Offered Veterans G.O. Bonds, the redemption date, the Series and maturities of the Offered Veterans G.O. Bonds to be redeemed and the redemption price. The notice will also state that after the date fixed for redemption, no further interest will accrue on the principal of any Offered Veterans G.O. Bonds called for redemption. Notice of redemption will also be provided by mail to certain financial services and securities depository services.

New York Stock Exchange Listing

The State Treasurer expects to list the Series BR Bonds due December 1, 2029 on the New York Stock Exchange. There can be no assurance that such Term Bonds will be listed or will continue to be listed for the duration of the time they will be outstanding.

TAX MATTERS

In the opinion of The Honorable Bill Lockyer, Attorney General of the State of California, and Orrick, Herrington & Sutcliffe LLP, Bond Counsel, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, compliance with certain covenants, interest on the Series BQ Bonds and Series BR Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Code and is exempt from State of California personal income taxes. The Attorney General and Bond Counsel are also of the opinion that interest on the Series BQ Bonds is not a specific preference item for purposes of calculating the federal individual and corporate alternative minimum taxes, although such counsel observe that such interest is included in adjusted current earnings in calculating federal corporate alternative minimum taxable income. In the opinion of the Attorney General and Bond Counsel, interest on the Series BR Bonds is a specific preference item for purposes of calculating the federal individual and corporate alternative minimum taxes. A complete copy of the proposed form of legal opinion for the Series BQ Bonds and Series BR Bonds is set forth in Appendix E.

The then-Attorney General and Orrick, Herrington & Sutcliffe LLP, Bond Counsel, delivered an opinion in connection with the issuance of the Series BJ Bonds, dated December 29, 1997. Such opinion stated that based upon an analysis of then-existing laws, regulations, rulings and court decisions, and assuming, among other matters, compliance with certain covenants, interest on the Series BJ Bonds was excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 (the "Code") and was exempt from State of California personal income taxes. The then-Attorney General and Bond Counsel also stated that in their opinion interest on the Series BJ Bonds was a specific preference item for purposes of calculating the federal individual and corporate alternative minimum taxes. A complete copy of the legal opinion for the Series BJ Bonds is set forth in Appendix F.

The Series BJ Bonds are part of a single issue for federal income tax purposes with certain outstanding Veterans G.O. Bonds and Revenue Bonds issued in 1997 and 1998. Hawkins, Delafield & Wood, bond counsel for such Revenue Bonds, rendered an opinion that interest on such Revenue Bonds was excluded from gross income for federal income tax purposes under Section 103 of the Code, subject to certain conditions, assumptions and restrictions as described therein, including compliance with certain loan eligibility restrictions contained in the Federal Tax Code (see Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The Program—Contracts of Purchase.") In rendering their tax opinion in respect of the Series BJ Bonds, the then-Attorney General and Bond Counsel expressly relied, with such firm's consent, on the opinion of Hawkins, Delafield & Wood, to the extent that the exclusion of interest on the Series BJ Bonds from federal gross income was affected by the exclusion of interest on such Revenue Bonds from federal gross income.

It is a condition to the remarketing of the Series BJ Bonds that the Attorney General and Bond Counsel deliver an opinion on the remarketing date that not converting the interest rate on the Series BJ Bonds on such date to fixed rates of interest will not, in and of itself, adversely affect the exclusion of interest on the Series BJ Bonds from gross income for federal income tax purposes.

The difference (if any) between the issue price of any maturity of the Offered Veterans G.O. Bonds and the amount to be paid at maturity of such Offered Veterans G.O. Bonds (excluding amounts stated to be interest and payable at least annually over the term of such Offered Veterans G.O. Bonds) constitutes "original issue discount," the accrual of which, to the extent properly allocable to each owner thereof, is treated as interest on the Offered Veterans G.O. Bonds which is excluded from gross income for federal income tax purposes and State of California personal income taxes. For this purpose, the issue price of a particular maturity of the Offered Veterans G.O. Bonds is the first price at which a substantial amount of such maturity of the Offered Veterans G.O. Bonds is sold to the public (excluding bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents or wholesalers). The original issue discount with respect to any maturity of the Offered Veterans G.O. Bonds accrues daily over the term to maturity of such Offered Veterans G.O. Bonds on the basis of a constant interest rate compounded semiannually (with straight-line interpolations between compounding dates). The accruing original issue discount is added to the adjusted basis of such Offered Veterans G.O. Bonds to determine taxable gain or loss upon disposition (including sale, redemption, or payment on maturity) of such Offered Veterans G.O. Bonds. Owners of the Offered Vererans G.O. Bonds should consult their own tax advisors with respect to the tax consequences of ownership of such Offered Veterans G.O. Bonds with original issue discount, including the treatment of purchasers who do not purchase such Offered Veterans G.O. Bonds in the original offering to the public at the first price at which a substantial amount of such Offered Veterans G.O. Bonds is sold to the public.

The Code imposes various restrictions, conditions and requirements relating to the exclusion from gross income for federal income tax purposes of interest on obligations such as the Offered Veterans G.O. Bonds. The State and the Department have covenanted to comply with certain restrictions applicable to the Offered Veterans G.O. Bonds, which restrictions are designed to assure that interest on the Offered Veterans G.O. Bonds will not be included in federal gross income. Failure to comply with these covenants with respect to both the Series BQ Bonds and Series BR Bonds may result in interest on the Series BQ Bonds and Series BR Bonds being included in federal gross income, possibly from the date of issuance of the Series BQ Bonds and Series BR Bonds. Since the Series BJ Bonds are treated as part of a common plan of finance with other Veterans G.O. Bonds and Revenue Bonds, failure to comply with such covenants with respect to the Series BJ Bonds and such other Veterans G.O. Bonds and Revenue Bonds may result in interest on the Series BJ Bonds being included in federal gross income, possibly from the date of issuance of the Series BJ Bonds. The opinions of the Attorney General and Bond Counsel discussed above assume or assumed compliance with these covenants. Neither the Attorney General nor Bond Counsel has undertaken in either of the aforementioned opinions to determine (or to inform any person) whether any actions are or were taken (or omitted) or any events do occur or have occurred, or whether any other matters come or have come to their attention, after the respective dates of issuance of the Offered Veterans G.O. Bonds, which may adversely affect the tax status of the interest on the respective issues of the Offered Veterans G.O. Bonds. Further, no assurance can be given that pending or future legislation or amendments to the Code, if enacted into law, or any proposed legislation or amendments to the Code, will not adversely affect the value of, or the tax status of interest on, the Offered Veterans G.O. Bonds. Prospective Owners are urged to consult their own tax advisors with respect to proposals to restructure the federal income tax.

Although the Attorney General and Bond Counsel have rendered opinions that interest on the Offered Veterans G.O. Bonds is excluded from gross income for federal income tax purposes and is exempt from State of California personal income taxes, the ownership or disposition of, or the accrual or receipt of interest on, the Offered Veterans G.O. Bonds may otherwise affect a Bondholder's federal or state tax liability. The nature and extent of these other tax consequences will depend upon the particular tax status of the Bondholder or the Bondholder's other items of income or deduction. The Attorney General and Bond Counsel express no opinion regarding any such other tax consequences.

LEGAL OPINIONS

The opinion of the Attorney General and Orrick, Herrington & Sutcliffe, LLP, Bond Counsel, approving the validity of the Series BQ Bonds and Series BR Bonds and stating the opinions expressed under "TAX MATTERS," will be substantially in the form set forth in Appendix E. The opinion of the then-Attorney General and Orrick, Herrington & Sutcliffe LLP, Bond Counsel, set forth in Appendix F, approving the validity of the Series BJ Bonds and stating the opinions expressed under "TAX MATTERS" with respect to the Series BJ Bonds was delivered on the date of issuance of the Series BJ Bonds. The Attorney General and Bond Counsel undertake no responsibility for the accuracy, completeness or fairness of this Official Statement. Certain legal matters will be passed on for the Underwriters by their counsel, Hawkins, Delafield & Wood.

LITIGATION

There is not now pending or known to the Attorney General to be threatened any material litigation seeking to prevent the remarketing or sale and delivery of the Offered Veterans G.O. Bonds or questioning the validity of the Offered Veterans G.O. Bonds. As stated above, debt service on the Veterans G.O. Bonds is a continuing appropriation in the Bond Acts. See "AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS—Security and Payment of Veterans G.O. Bonds." In June 1998, a complaint was filed in Los Angeles County Superior Court in the case of *Howard Jarvis Taxpayers Association v. Connell* challenging the authority of the State Controller to make payments in the absence of a State budget. The lawsuit did not specifically attack the validity of the law or the continuing appropriations under the Bond Acts. The Superior Court judge, however, issued a preliminary injunction preventing the State Controller from making payments, including those made pursuant to continuing appropriations, while the State's annual budget act had not yet been enacted. As permitted by the State Constitution, the State Legislature immediately enacted and the Governor of the State signed, an emergency appropriations bill which allowed continued payment of various State obligations, including debt service. Subsequently, the State Legislature enacted and the Governor of the State signed the budget act for the 1998-99 fiscal year. See Appendix A—"THE STATE OF CALIFORNIA—Litigation" for more information about the status of this case.

The Attorney General and Bond Counsel have rendered an opinion that the conclusion of the Superior Court judge in the *Jarvis* case (which is now stayed pending appeal) questioning the validity of continuing appropriations, if and to the extent it would apply to the Offered Veterans G.O. Bonds, is without merit and that the California appellate courts would hold that the appropriations are valid under the State Constitution and that the State Controller may make payments pursuant to such appropriations. While there can be no assurance as to the outcome of the litigation, the State believes that moneys will be available in due course on a timely basis to make all future payments of debt service on the Offered Veterans G.O. Bonds.

While at any given time, including the present, there are numerous civil actions pending against the State, which could, if determined adversely to the State, affect the State's expenditures and, in some cases, its revenues, the Attorney General is of the opinion that no pending actions are likely to have a material adverse effect on the State's ability to pay principal and purchase price of, premium, if any, and interest on the Offered Veterans G.O. Bonds when due.

See Appendix A—"THE STATE OF CALIFORNIA—Litigation." See Appendix B—"THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND—The 1943 Fund" for a discussion of certain litigation which may affect the 1943 Fund.

UNDERWRITING

The Offered Veterans G.O. Bonds are being purchased by the Underwriters listed on the front cover page. The Underwriters have jointly and severally agreed to purchase the Offered Veterans G.O. Bonds for a purchase price of (i) $79,924,081.25 plus accrued interest with respect to the Series BQ Bonds and Series BR Bonds, and (ii) par, plus accrued interest, with respect to the Series BJ Bonds. In connection therewith the Department will pay a fee to the Underwriters of (i) $542,579.14 with respect to the Series BQ Bonds and Series BR Bonds, and (ii) $865,790.47 with respect to the Series BJ Bonds. The initial public offering prices of the Offered Veterans G.O. Bonds may be changed from time to time by the Underwriters.

The purchase contract relating to the Offered Veterans G.O. Bonds provides that the Underwriters will purchase all the applicable Offered Veterans G.O. Bonds if any are purchased, and that the obligation to make such purchase is subject to certain terms and conditions set forth in such purchase contract including, among others, the approval of certain legal matters by counsel.

FINANCIAL STATEMENTS

Attached as Exhibit 1 to Appendix A are the Audited General Purpose Financial Statements of the State for the Fiscal Year ended June 30, 1998. These statements have been examined by the State Auditor to the extent indicated in his report appearing in Appendix A. Certain unaudited financial information is also included in Appendix A.

Attached as Exhibit 1 to Appendix B are the Financial Statements for the Veterans Farm and Home Building Fund of 1943 for the years ended June 30, 1998 and 1997. These statements have been audited by Deloitte & Touche LLP, independent auditors, as indicated in their report appearing in Appendix B.

RATINGS

The Offered Veterans G.O. Bonds have received ratings of "Aa3" by Moody's Investors Service ("Moody's"), "AA-" by Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc. ("Standard & Poor's") and "AA-" by Fitch IBCA, Inc. ("Fitch"). In addition, Series BJ Bonds which bear interest at a short-term rate have received ratings of "VMIG1" by Moody's, "A-1+" by Standard & Poor's and "F1+" by Fitch until the mandatory tender date on which the interest rate thereon converts to fixed rate(s) to maturity or prior redemption. An explanation of the significance and status of such credit ratings may be obtained from the rating agencies furnishing the same. There is no assurance that such ratings will continue for any given period of time or that they will not be revised or withdrawn entirely by any such rating agencies, if in their respective judgments, circumstances so warrant. A revision or withdrawal of any such credit ratings could have an effect on the market price of the applicable Offered Veterans G.O. Bonds. After the Offered Veterans G.O. Bonds are rated, the State Treasurer intends to provide appropriate periodic credit information to the bond rating agencies to assist in maintaining the ratings on the Offered Veterans G.O. Bonds.

ADDITIONAL INFORMATION

The purpose of this Official Statement is to supply information to prospective buyers of the Offered Veterans G.O. Bonds. Public Resources Advisory Group has served as Financial Advisor in connection with the issuance of the Offered Veterans G.O. Bonds.

All financial and statistical data contained herein have been taken or constructed from State (including Department) records, except for information expressly attributed to other sources. The presentation of information, including tables of receipts from taxes and other revenues, is intended to show recent historic information and is not intended to indicate future or continuing trends in the financial position or other affairs of the State, including the Department. No representation is made that past experience, as it might be shown by such financial and other information, will necessarily continue or be repeated in the future. Any statements made in this Official Statement involving matters of opinion, projections or estimates, whether expressly stated or not, are set forth as such and not as representations of fact.

STATE OF CALIFORNIA
PHILIP ANGELIDES
Treasurer of the State of California

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APPENDIX A

THE STATE OF CALIFORNIA

Honorable Philip Angelides
Treasurer of the State of California

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OVERVIEW OF STATE GOVERNMENT

Organization of State Government

The State Constitution provides for three separate branches of government: the legislative, the judicial and the executive. The Constitution guarantees the electorate the right to make basic decisions, including amendments to the Constitution and local government charters. In addition, the State voters may directly influence State government through the initiative, referendum and recall processes.

California's Legislature consists of a forty-member Senate and an eighty-member Assembly. Assembly members are elected for two-year terms and Senators are elected for four-year terms. Assembly members are limited to three terms in office, and Senators to two terms. The Legislature meets almost year round for a two-year session. The Legislature employs the Legislative Analyst, who provides reports on State finances, among other subjects. The Bureau of State Audits, headed by the State Auditor, an independent office since 1993, has annually issued an auditor's report based on an examination of the General Purpose Financial Statements of the State Controller, in accordance with generally accepted accounting principles.

The Governor is the chief executive officer of the State and is elected for a four-year term. The Governor presents the annual budget and traditionally presents an annual package of bills constituting a legislative program. In addition to the Governor, State law provides for seven other statewide elected officials in the executive branch. The current elected statewide officials, their party affiliation and the dates on which they were first elected, are as follows:

Office	Name	Party Affiliation	First Elected
Governor	Gray Davis	Democrat	1998
Lieutenant Governor	Cruz Bustamante	Democrat	1998
Treasurer	Philip Angelides	Democrat	1998
Attorney General	Bill Lockyer	Democrat	1998
Controller	Kathleen Connell	Democrat	1994
Secretary of State	Bill Jones	Republican	1994
Superintendent of Public Instruction	Delaine Eastin	Democrat	1994
Insurance Commissioner	Chuck Quackenbush	Republican	1994

The current term for each office expires in January 2003. Persons elected to statewide offices are limited to two terms in office.

The executive branch is principally administered through twelve major agencies and departments: Business, Transportation and Housing Agency, Child Development and Education Agency, Environmental Protection Agency, Department of Finance, Department of Food and

Agriculture, Health and Human Services Agency, Department of Industrial Relations, Resources Agency, State and Consumer Services Agency, Department of Veterans Affairs, Trade and Commerce Agency, and Youth and Adult Correctional Agency. In addition, some state programs come under boards and commissions, such as The Regents of the University of California, Public Utilities Commission, Franchise Tax Board and California Transportation Commission, which have authority over many functions of state government with the power to establish policy and promulgate regulations. The appointment of members of boards and commissions is usually shared by the Legislature and the Governor, and often includes ex officio members.

California has a comprehensive system of public higher education, comprising three sectors. The highest level is the University of California, which provides undergraduate, graduate and professional degrees to about 162,000 full-time equivalent students at nine campuses, plus the Hastings College of Law. The California State University system provides undergraduate and graduate degrees to about 272,000 full-time equivalent students at 22 campuses. The third sector consists of over 100 campuses operated by 71 community college districts which provide associate degrees and continuing education to nearly 1.5 million students (about 950,000 full-time equivalents).

Employee Relations

In 1998-99, the state work force is estimated to be comprised of approximately 290,000 personnel years. Of this total, approximately 90,000 personnel years represent employees of institutions of higher education. Civil service employees who are subject to collective bargaining represent approximately 147,000 personnel years. The California State Employees' Association (CSEA), represents 9 of the 21 collective bargaining units, or approximately 52 percent of those employees subject to collective bargaining.

The Ralph C. Dills Act provides that state employees, defined as any civil service employee of the State and teachers under the jurisdiction of the Department of Education or the Superintendent of Public Instruction, and excluding certain other categories, have a right to form, join, and participate in the activities of employee organizations for the purpose of representation on all matters of employer-employee relations. Law enforcement employees have the right to be represented separately from other employees. The chosen employee organization has the right to represent its members, except that once an employee organization is recognized as the exclusive representative of a bargaining unit, only that organization may represent employees in that unit.

The scope of representation is limited to wages, hours, and other terms and conditions of employment. Representatives of the Governor are required to meet and confer in good faith and endeavor to reach agreement with the employee organization, and, if agreement is reached, to prepare a memorandum of understanding (MOU) and present it to the Legislature for ratification. The Governor and the recognized employee organization are authorized to agree mutually on the appointment of a mediator for the purpose of settling any disputes between the parties, or either party could request the Public Employment Relations Board to appoint a mediator.

As of mid-March 1999, for 1998-99, all twenty-one collective bargaining units have reached agreement with the State. Five have ratified Memorandums of Understanding (MOU) which will expire on June 30, 1999, and the other sixteen MOUs are pending Legislative and union members' ratification. The State has not experienced a major work stoppage in the last 23 years.

Employees' Retirement Systems

Major retirement benefit programs administered by the State are described in Note 24 to the State's Audited Financial Statements, in Exhibit 1 to Appendix A, at page 67. This note includes information on the unfunded actuarial accrued liability of all the State's major retirement programs.

The two largest programs are the Public Employees' Retirement System ("PERS") and the State Teachers' Retirement System ("STRS"). PERS had assets with a market value of $139.7 billion as of October 31, 1998, a decrease of $3.6 billion from June 30, 1998. STRS had assets with a market value in excess of $88.3 billion as of June 30, 1998, an increase of $13.5 billion from June 30, 1997.

Information Technology

The State's reliance on information technology in every aspect of its operations has made Year 2000-related ("Y2K") information technology ("IT") issues a high priority for the State. The Department of Information Technology ("DOIT"), an independent office reporting directly to the Governor, is responsible for ensuring the State's information technology processes are fully functional before the year 2000. The DOIT has created a Year 2000 Task Force and a California 2000 Office to establish statewide policy requirements; to gather, coordinate, and share information; and to monitor statewide progress. In December 1996, the DOIT began requiring departments to report on Y2K activities and currently requires departmental monthly reporting of Y2K status. The DOIT has emphasized to departments that efforts should be focused on applications that support mission-critical business practices.

The risks posed by Y2K information technology related issues are not confined to computer systems, but also include problems presented by embedded microchips (products or systems that contain microchips to perform functions such as traffic control, instruments used in hospitals or medical laboratories, and California Aqueduct monitoring). To address these problems, the Governor issued Executive Order W-163-97, broadening the responsibilities of the DOIT to resolve these issues as well as legal questions associated with Y2K issues. The executive order also required that mission critical systems be remediated by December 31, 1998, that purchases of new systems, hardware, software and equipment be Year 2000 compliant and further limited new computer projects to those required by law until a department's Y2K problems are resolved. The DOIT has also more recently required departments to address interfacing of State IT systems with external IT systems, and to report on contingency planning status for problems which might occur if IT systems are not fully remediated by the end of 1999.

In its quarterly report for the period ending December 31, 1998 (the "January Quarterly

Report," available on the DOIT's site at www.doit.ca.gov), the DOIT unveiled the new administration's strategy for addressing Y2K issues. The key components of this strategy include centralization and coordination of the State's Y2K efforts, delivery of essential services and emergency preparedness, elimination of obstacles and barriers in an effort to streamline the current funding request process, and broad-based collaboration across public and private sectors through a comprehensive communication plan. Departments, programs and systems will be categorized by tier according to the amount of assistance required to become Y2K compliant. The first tier, which consists of departments that are of no specific cause of concern, will be required to report their status and may be subject to independent review. The second tier consists of departments that require targeted assistance. The California 2000 Project Office will deploy an Action team to provide the necessary assistance. The third tier consists of seriously troubled departments where the California Year 2000 Project Office will assume Y2K management responsibility.

In addition to setting forth a new action plan, the January Quarterly Report updated the survey of State departments and reported that of a total of about 564 mission critical IT systems, 372 had completed remediation. Of the remaining 192 systems, 54 systems are scheduled to be retired and 138 are in the process of being remediated. The January Quarterly Report also updated the status of embedded systems, noting that State entities have not yet reported on all facilities nor have they completed the survey of all of their facilities. Of the 606 facilities that were reported, remediation has been completed in 52 facilities.

In the January Quarterly Report, the DOIT estimates total Y2K costs identified by the departments under its supervision at about $342 million, of which more than $200 million was projected to be expended in fiscal years 1998-1999 and 1999-2000. These costs are part of much larger overall IT costs incurred annually by the State, including costs incurred by certain independent State entities, such as the judiciary, the Legislature, the University of California and California State University System. Furthermore, cost estimates for embedded systems only apply to the subset of embedded systems posing the highest risk to essential programs. For fiscal year 1998-99, the Legislature created a $20 million fund for unanticipated Y2K costs, which can be increased if necessary.

On February 18, 1999, the Bureau of State Audits (the "BSA") presented its report concerning state agencies' progress in resolving Y2K problems (available on the BSA's site at www.bsa.ca.gov). The report highlighted the following issues: remediation efforts at 14 agencies that it identified as critical; the status of Y2K compliance for other State programs; deficiencies in Y2K planning at one of the primary data centers for the State; and coordination among public and private entities to ensure uninterrupted service of essential utilities.

The BSA indicated that each of the 14 agencies identified as administering programs critical to the State has appointed a Y2K project manager, developed an overall Y2K plan and is actively working to complete planned tasks. However, the report further noted that although state agencies are making progress toward correcting critical computer systems, remediation efforts at 11 of these agencies are not complete. The report defined completion as including three key steps: completion of all planned testing, removal of threats from embedded technology, and resolution of potential problems caused by data exchange partners. None of these 11 agencies have fully tested the systems reviewed, which industry experts consider to be the most crucial and time-consuming phase. Furthermore, seven agencies have not yet replaced or corrected embedded microchips in equipment their systems rely upon.

As part of the audit, the BSA also surveyed all 140 agencies, which administer 462 separate budgetary programs, listed in the Governor's Budget. Although the BSA does not consider all of these programs to be as critical as those administered by the 14 agencies it reviewed, the BSA has similar concerns about testing, embedded technology and coordination with data exchange partners. The report also contained certain recommendations for one of the State's two primary data centers to enhance their Y2K efforts. Finally, the BSA noted that no single entity is charged with overseeing the Y2K preparedness of all utilities in California and recommended that the Governor or Legislature should designate one representative or agency to assess and disclose the Y2K readiness of critical public utilities.

The State Treasurer's Office reports that as of December 31, 1998, its systems for bond payments were fully Y2K compliant. The State Controller's Office reported that it had completed the necessary Y2K remediation projects for the State fiscal and accounting system by December 31, 1998, consistent with the Governor's Executive Order. The final steps of testing will be completed during 1999. Both offices are actively working with the outside entities with whom they interface to ensure that they are also compliant.

In sum, although substantial progress has been made toward the goal of Y2K compliance, the task is very large and will likely encounter unexpected difficulties. The State cannot predict whether all mission critical systems will be ready and tested by late 1999 or what the impact failure of any particular IT system(s) or of outside interfaces with IT systems might have.

STATE INDEBTEDNESS

General

The State Treasurer is responsible for the sale of debt obligations of the State and its various authorities and agencies. The State has always paid the principal of and interest on its general obligation bonds, general obligation commercial paper, lease-purchase debt and short-term obligations, including revenue anticipation notes and revenue anticipation warrants, when due.

Capital Facilities Financing

General Obligation Bonds - The State Constitution prohibits the creation of general obligation indebtedness of the State unless a bond law is approved by a majority of the electorate voting at a general election or a direct primary. General obligation bond acts provide that debt service on general obligation bonds shall be appropriated annually from the General Fund and all debt service on general obligation bonds is paid from the General Fund. Under the State Constitution, debt service on general obligation bonds is the second charge to the General Fund after the application of moneys in the General Fund to the support of the public school system and public institutions of higher education. Certain general obligation bond programs receive revenues from sources other than the sale of bonds or the investment of bond proceeds.

As of February 1, 1999, the State had outstanding $19,184,961,000 aggregate principal amount of long-term general obligation bonds, and unused voter authorizations for the future issuance of $14,326,874,000 of long-term general obligation bonds. This latter figure consists of $3,566,744,000 of authorized commercial paper notes, described below (of which $484,250,000 had been issued), which had not yet been refunded by general obligation bonds, and $10,760,130,000 of other authorized but unissued general obligation debt. See the table "Authorized and Outstanding State Debt" under "STATE DEBT TABLES" following page A-42.

At the November 3, 1998 election, voters approved a bond measure ("Proposition 1A") totaling $9.2 billion for public school construction and renovation, and for higher education facilities. Not more than half the total bond authorization from Proposition 1A can be issued (including bonds in the form of commercial paper) before June 30, 2000. Proposition 1A also encourages the Treasurer to sell the bonds in a manner such that the ratio of State debt service to General Fund revenue does not exceed 6 percent.

Commercial Paper Program - Pursuant to legislation enacted in 1995, voter approved general obligation indebtedness may be issued either as long-term bonds, or, for some but not all bond acts, as commercial paper notes. Commercial paper notes may be renewed or may be refunded by the issuance of long-term bonds. The State intends to issue long-term general obligation bonds from time to time to retire its general obligation commercial paper notes. Pursuant to the terms of the bank credit agreement presently in effect supporting the general obligation commercial paper program, not more than $2.0 billion of general obligation commercial paper notes may be outstanding at any time; this amount may be increased or decreased in the future. Commercial paper notes are deemed issued upon authorization by the respective Finance Committees, whether or not such notes are actually issued. As of February 1, 1999 the Finance Committees had authorized the issuance of up to $3,566,744,000 of commercial paper notes; as of that date $484,250,000 aggregate principal amount of general obligation commercial paper notes was actually issued and outstanding.

Lease-Purchase Debt - In addition to general obligation bonds, the State builds and acquires capital facilities through the use of lease-purchase borrowing. Under these arrangements, the State Public Works Board, another State or local agency or a joint powers authority issues bonds to pay for the construction of facilities such as office buildings, university buildings or correctional institutions. These facilities are leased to a State agency or the University of California under a long-term lease which provides the source of payment of the debt service on the lease-purchase bonds. In some cases, there is not a separate bond issue, but a trustee directly creates certificates of participation in the State's lease obligation, which are marketed to investors. Under applicable court decisions, such lease arrangements do not constitute the creation of "indebtedness" within the meaning of the Constitutional provisions which require voter approval. For purposes of this section of the Official Statement and the tables following, "lease-purchase debt" or "lease-purchase financing" means principally bonds or certificates of participation for capital facilities where the rental payments providing the security are a direct or indirect charge against the General Fund and also includes revenue bonds for a State energy efficiency program secured by payments made by various State agencies under energy service contracts. Certain of the lease-purchase financings are supported by special funds rather than the General Fund (see "STATE FINANCES--Sources of Tax Revenue"). The table does not include equipment leases or leases which were not sold, directly or indirectly, to the public capital market. The State had $6,689,709,397 General Fund-supported lease-purchase debt outstanding at February 1, 1999. The State Public Works Board, which is authorized to sell lease revenue bonds, had $1,594,712,000 authorized and unissued as of February 1, 1999. Also, as of that date certain joint powers authorities were authorized to issue approximately $69,500,000 of revenue bonds to be secured by State leases. See Notes 8, 10, 12 and 15 to the Financial Statements, Exhibit 1 to Appendix A, for additional information on State lease commitments.

Non-Recourse Debt - Certain State agencies and authorities issue revenue obligations for which the General Fund has no liability. Revenue bonds represent obligations payable from State revenue-producing enterprises and projects, which are not payable from the General Fund, and conduit obligations payable only from revenues paid by private users of facilities financed by the revenue bonds. The enterprises and projects include transportation projects, various public works projects, public and private educational facilities (including the California State University and University of California systems), housing, health facilities and pollution control facilities. There are 17 agencies and authorities authorized to issue revenue obligations (excluding lease-purchase debt). State agencies and authorities had $25,463,613,639 aggregate principal amount of revenue bonds and notes which are non-recourse to the General Fund outstanding as of December 31, 1998, as further described in the table "State Agency Revenue Bonds and Conduit Financing" under "STATE DEBT TABLES" following page A-42.

Detailed tables showing the State's long-term debt appear after page A-42.

Cash Flow Borrowings

As part of its cash management program, the State has regularly issued short-term obligations to meet cash flow needs. The following table shows the amount of revenue anticipation notes ("Notes") and revenue anticipation warrants ("Warrants") issued over the past five fiscal years. Between spring 1992 and summer 1994, the State had depended upon external borrowing, including borrowings extending into the subsequent fiscal year, to meet its cash needs, including repayment of maturing Notes and Warrants. The State has not had to resort to such cross-year borrowing after the 1994-95 Fiscal Year. See "STATE FINANCES--State Warrants," "PRIOR FISCAL YEARS' FINANCIAL RESULTS" and "CURRENT STATE BUDGET" below.

The State issued $1.7 billion of revenue anticipation notes for the 1998-99 Fiscal Year to mature on June 30, 1999. The Governor's Proposed Budget anticipates the issuance of $2.5 billion of revenue anticipation notes for the 1999-00 Fiscal Year.

State of California
Revenue Anticipation Notes and Warrants Issued
Fiscal Years 1994-95 to 1998-99

Fiscal Year	Type	Principal Amount (Billions)	Date of Issue	Maturity Date
1994-1995	Warrants Series C-D	$4.0	July 26, 1994	April 25, 1996
	Notes Series A-C	3.0	August 3, 1994	June 28, 1995
1995-1996	Notes	2.0	April 25, 1996	June 28, 1996
1996-1997	Notes Series A-C	3.0	August 6, 1996	June 30, 1997
1997-1998	Notes	3.0	September 9, 1997	June 30, 1998
1998-1999	Notes	1.7	October 1, 1998	June 30, 1999

SOURCE: State of California, Office of the Treasurer.

STATE FINANCES

The Budget Process

The State's fiscal year begins on July 1 and ends on June 30. The State operates on a budget basis, using a modified accrual system of accounting, with revenues credited in the period in which they are measurable and available and expenditures debited in the period in which the corresponding liabilities are incurred.

The annual budget is proposed by the Governor by January 10 of each year for the next fiscal year (the "Governor's Budget"). Under state law, the annual proposed Governor's Budget cannot provide for projected expenditures in excess of projected revenues and balances available from prior fiscal years. Following the submission of the Governor's Budget, the Legislature takes up the proposal.

Under the State Constitution, money may be drawn from the Treasury only through an appropriation made by law. The primary source of the annual expenditure authorizations is the Budget Act as approved by the Legislature and signed by the Governor. The Budget Act must be approved by a two-thirds majority vote of each House of the Legislature. The Governor may reduce or eliminate specific line items in the Budget Act or any other appropriations bill without vetoing the entire bill. Such individual line-item vetoes are subject to override by a two-thirds majority vote of each House of the Legislature.

Appropriations also may be included in legislation other than the Budget Act. Bills containing appropriations (except for K-14 education) must be approved by a two-thirds majority vote in each House of the Legislature and be signed by the Governor. Bills containing K-14 education appropriations only require a simple majority vote. Continuing appropriations, available without regard to fiscal year, may also be provided by statute or the State Constitution. There is litigation pending concerning the validity of such continuing appropriations. See "LITIGATION" below.

Funds necessary to meet an appropriation need not be in the State Treasury at the time such appropriation is enacted; revenues may be appropriated in anticipation of their receipt.

The General Fund

The moneys of the State are segregated into the General Fund and over 900 special funds, including bond, trust and pension funds. The General Fund consists of revenues received by the State Treasury and not required by law to be credited to any other fund, as well as earnings from the investment of state moneys not allocable to another fund. The General Fund is the principal operating fund for the majority of governmental activities and is the depository of most of the major revenue sources of the State. For additional financial data relating to the General Fund, see Exhibit 1 to this Appendix A. The General Fund may be expended as a consequence of appropriation measures enacted by the Legislature and approved by the Governor, as well as appropriations pursuant to various constitutional authorizations and initiative statutes.

The Special Fund for Economic Uncertainties

The Special Fund for Economic Uncertainties ("SFEU") is funded with General Fund revenues and was established to protect the State from unforeseen revenue reductions and/or unanticipated expenditure increases. Amounts in the SFEU may be transferred by the State Controller as necessary to meet cash needs of the General Fund. The State Controller is required to return moneys so transferred without payment of interest as soon as there are sufficient moneys in the General Fund.

The legislation creating the SFEU (Government Code §16418) contains a continuous appropriation from the General Fund authorizing the State Controller to transfer to the SFEU, as of the end of each fiscal year, the lesser of (i) the unencumbered balance in the General Fund and (ii) the difference between the State's "appropriations subject to limitation" for the fiscal year then ended and its "appropriations limit" as defined in Section 8 of Article XIII B of the State Constitution and established in the Budget Act for that fiscal year, as jointly estimated by the State's Legislative Analyst's Office and the Department of Finance. For a further description of Article XIII B, see "State Appropriations Limit" below. In certain circumstances, moneys in the SFEU may be used in connection with disaster relief.

For budgeting and accounting purposes, any appropriation made from the SFEU is deemed an appropriation from the General Fund. For year-end reporting purposes, the State Controller is required to add the balance in the SFEU to the balance in the General Fund so as to show the total moneys then available for General Fund purposes.

The June 30, 1999, SFEU projection reflects the latest revenue projections and expenditure amounts as updated in the 1999-00 Governor's Budget. As in any year, the Budget Act and related trailer bills are not the only pieces of legislation which appropriate funds. Other factors including re-estimates of revenues and expenditures, existing statutory requirements, and additional legislation introduced and passed by the Legislature may impact the reserve amount.

In the 1999-00 Governor's Budget, released January 8, 1999, the Department of Finance projects the SFEU will have a balance of about $617 million at June 30, 1999 and $415 million at June 30, 2000. The June 30, 1999 estimate is reduced from an estimate of approximately $1.2 billion after adoption of the 1998-99 Budget Act. See "CURRENT STATE BUDGET" below.

Inter-Fund Borrowings

Inter-fund borrowing has been used for many years to meet temporary imbalances of receipts and disbursements in the General Fund. As of June 30, 1998, the General Fund had no outstanding loans from the SFEU, General Fund special accounts or any other special funds.

In the event the General Fund is or will be exhausted, the State Controller is required to notify the Governor and the Pooled Money Investment Board (the "PMIB," consisting of the State Director of Finance, the State Treasurer and the State Controller). The Governor may then order the State Controller to direct the transfer of all or any part of the moneys not needed in special funds to the General Fund from such special funds, as determined by the PMIB. All money so transferred must be returned to the special fund from which it was transferred as soon as there is sufficient money in the General Fund to do so. Transfers cannot be made from a Special Fund which will interfere with the objective for which such Special Fund was created, or from certain specific funds. When moneys transferred to the General Fund in any fiscal year from any Special Fund pursuant to the inter-fund borrowing mechanism exceed ten percent of the total additions as shown in the statement of operations of the preceding fiscal year as set forth in the Budgetary (Legal Basis) annual report of the State Controller, interest must be paid on such excess at a rate determined by the PMIB to be the current earning rate of the Pooled Money Investment Account.

Although any determination of whether a proposed borrowing from one of the Special Funds is permissible, any such determination must be made with regard to the facts and circumstances existing at the time of the proposed borrowing. The Attorney General of the State has identified certain criteria relevant to such a determination. For instance, amounts in the special funds eligible for inter-fund borrowings are legally available to be transferred to the General Fund if a reasonable estimate of expected General Fund revenues, based upon legislation already enacted, indicates that such transfers can be paid from the General Fund promptly if needed by the special funds or within a short period of time if not needed. In determining whether this requirement has been met, the Attorney General has stated that consideration may be given to the fact that General Fund revenues are projected to exceed expenditures entitled to a higher priority than payment of internal transfers, i.e., expenditures for the support of the public school system and public institutions of higher education and the payment of debt service on general obligation bonds of the State.

At the November, 1998 elections, voters approved Proposition 2. This proposition requires the General Fund to repay loans made from certain transportation special accounts (such as the State Highway Account) at least once per fiscal year, or up to 30 days after adoption of the annual budget act. Since the General Fund may reborrow from the transportation accounts soon after the annual repayment is made, the proposition is not expected to have any adverse impact on the State's cash flow.

The following chart shows General Fund internal borrowable resources on June 30 of each of the Fiscal Years 1994-95 through 1997-98 and estimates for 1998-99:

General Fund Internal Borrowable Resources
(Cash Basis)
(Millions)

	June 30,				
	1995	**1996**	**1997**	**1998**	**1999**
Available Internal Borrowable Resources	$5,376.0	$5,211.0	$6,242.2	$6,866.8	$8,295 3*
Outstanding Loans					
From Special Fund for Economic Uncertainties	-0-	20 3	281.2	-0-	1,255.0
From Special Funds and Accounts	-0-	1,433.7	909.2	-0-	1,418.1
Total Outstanding Internal Loans	-0-	1,454.0	1,190.4	-0-	2,673.1
Unused Internal Borrowable Resources†	$5,376.0	$3,757.0	$5,051.8	$6,866.8	$5,622.2*

* These figures are about $2.2 billion higher than the equivalent figures in the Governor's Budget for FY 1999-00, because the Governor's Budget assumed that Proposition 2 required transportation account loans to be fully repaid by June 30, 1999. It has since been determined that Proposition 2 does not require such repayment until after the 1999-00 Budget Act is adopted, which is expected to occur after June 30, 1999.

† In addition, the State had external borrowings represented by Revenue Anticipation Warrants, in the amount of $4.0 billion at June 30, 1995. See "STATE INDEBTEDNESS--Cash Flow Borrowings."

SOURCE: State of California, Office of the State Controller. Information for the Fiscal Years ended June 30, 1995 through 1998 are actual figures. For the year ending June 30, 1999, these figures were estimated as of January 8, 1999.

Investment of Funds

Moneys on deposit in the State's Centralized Treasury System are invested by the Treasurer in the Pooled Money Investment Account (the "PMIA"). As of January 31, 1999, the

PMIA held approximately $21.4 billion of State moneys, and $15.4 billion of moneys invested for about 2,649 local governmental entities through the Local Agency Investment Fund ("LAIF"). The assets of the PMIA as of January 31, 1999 are shown in the following table:

Analysis of the Pooled Money Investment Account Portfolio

Type of Security	Amount (Millions)	Percent Of Total
U.S. Treasury Bills and Notes	$8,243	22.4%
Commercial Paper (corporate)	9,840	26.7
Certificates of Deposits	5,454	14.8
Corporate Bonds	1,627	4.4
Federal Agency Securities	6,382	17.4
Bankers Acceptances	77	0.2
Bank Notes	1,818	4.9
Loans Per Government Code	2,126	5.8
Time Deposits	2,005	5.5
Repurchases	0	0
Reverse Repurchases	(763)	2.1
	$36,809	100%

*Total may not add due to rounding.

SOURCE: State of California, Office of the Treasurer.

The State's treasury operations are managed in compliance with the California Government Code and according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters and maximum maturity of investments. The PMIA operates with the oversight of the Pooled Money Investment Board (consisting of the State Treasurer, the State Controller and the Director of Finance). The LAIF portion of the PMIA operates with the oversight of the Local Agency Investment Advisory Board (consisting of the State Treasurer and four other appointed members).

The Treasurer does not invest in leveraged products or inverse floating rate securities. The investment policy permits the use of reverse repurchase agreements subject to limits of no more than 10 percent of the PMIA. All reverse repurchase agreements are cash matched either to the maturity of the reinvestment or an adequately positive cash flow date which is approximate to the maturity of the reinvestment.

The average life of the investment portfolio of the PMIA as of January 31, 1999 was 184 days.

State Warrants

No money may be drawn from the State Treasury except upon a warrant duly issued by the State Controller. The State Controller is obligated to draw every warrant on the fund out of which it is payable for the payment of money directed by State law to be paid out of the State Treasury; however, a warrant may not be drawn unless authorized by law and unless unexhausted specific appropriations provided by law are available to meet it. State law provides two methods for the State Controller to respond if the General Fund has insufficient "Unapplied Money" available to pay a warrant when it is drawn, referred to generally as "registered warrants" and "reimbursement warrants." "Unapplied Money" consists of money in the General Fund for which outstanding warrants have not already been drawn and which would remain in the General Fund if all outstanding warrants previously drawn and then due were paid. Unapplied Money may include moneys transferred to the General Fund from the SFEU and internal borrowings from the Special Funds (to the extent permitted by law).

If a warrant is drawn on the General Fund for an amount in excess of the amount of Unapplied Money in the General Fund, after deducting from such Unapplied Money the amount, as estimated by the State Controller, required by law to be set apart for obligations having priority over obligations to which such warrant is applicable, the warrant must be registered by the State Treasurer on the reverse side as not paid because of the shortage of funds in the General Fund. The State Controller then delivers such a "registered warrant" to persons or entities (e.g., employees, suppliers and local governments) otherwise entitled to receive payments from the State. A registered warrant bears interest at a rate designated by the PMIB up to a maximum of 5 percent per annum. Registered warrants have no fixed maturity date, but are redeemed when the Controller, with the approval of the PMIB, determines there would be sufficient Unapplied Money in the General Fund. The State Controller notifies the State Treasurer, who publishes a notice that the warrants in question are payable.

In lieu of issuing individual registered warrants to numerous creditors, there is an alternative procedure whereby the Governor, upon request of the State Controller, may create a General Cash Revolving Fund in the State Treasury which may borrow from other State special funds to meet payments authorized by law. The State Controller may then issue "reimbursement warrants" at competitive bid to reimburse the General Cash Revolving Fund, thereby increasing cash resources for the General Fund to cover required payments. The General Cash Revolving Fund is created solely to facilitate the issuance of registered reimbursement warrants. Reimbursement warrants have a fixed maturity date, and must be paid by the State Treasurer on their maturity date from any Unapplied Money in the General Fund and available therefor.

See "PRIOR FISCAL YEARS' FINANCIAL RESULTS" below and "STATE INDEBTEDNESS--Cash Flow Borrowings" above for a discussion of warrants issued by the State in recent years to meet the State's cash needs.

Welfare Reform

Congress passed and the President signed (on August 22, 1996) the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104-193, the "Law") fundamentally reforming the nation's welfare system. Among its many provisions, the Law includes: (i) conversion of Aid to Families with Dependent Children from an entitlement program to a block grant titled Temporary Assistance for Needy Families (TANF), with lifetime time limits on TANF recipients, work requirements and other changes; (ii) provisions denying certain federal welfare and public benefits to legal noncitizens (this provision has been amended by subsequent federal law), allowing states to elect to deny additional benefits (including TANF) to legal noncitizens, and generally denying almost all benefits to illegal immigrants; and (iii) changes in the Food Stamp program, including reducing maximum benefits and imposing work requirements.

California's response to the federal welfare reforms is embodied in Chapter 270, Statutes of 1997. This new basic state welfare program is called California Work Opportunity and Responsibility to Kids ("CalWORKs"), which replaced the former Aid to Families with Dependent Children (AFDC) and Greater Avenues to Independence (GAIN) programs, effective January 1, 1998. Consistent with the federal law, CalWORKs contains new time limits on receipt of welfare aid, both lifetime as well as for any current period on aid. The centerpiece of CalWORKs is the linkage of eligibility to work participation requirements. Administration of the new CalWORKs program is largely at the county level, and counties are given financial incentives for success in this program.

The long-term impact of the new federal Law and CalWORKs cannot be determined until there has been more experience and until an independent evaluation of the CalWORKs program is completed. In the short-term, the implementation of the CalWORKs program has continued the trend of declining welfare caseloads. The CalWORKs caseload trend is projected to be 651,350 in 1998-99 and 598,000 in 1999-00, down from a high of 921,000 cases in 1994-95.

The 1999-00 Governor's Budget limits CalWORKs expenditures to the annual $3.7 billion federal TANF Block Grant and prior year carryover amounts, and the state General Fund and county General Fund combined Maintenance of Effort Requirement of $2.9 billion. Any decision to maintain or exceed the Maintenance of Effort Requirement would need to be made in the context of available resources and competing budget demands.

Local Governments

The primary units of local government in California are the counties, ranging in population from 1,200 in Alpine County to over 9,600,000 in Los Angeles County. Counties are responsible for the provision of many basic services, including indigent health care, welfare, jails and public safety in unincorporated areas. There are also about 470 incorporated cities, and thousands of other special districts formed for education, utility and other services. The fiscal condition of local governments has been constrained since the enactment of "Proposition 13" in 1978, which reduced and limited the future growth of property taxes, and limited the ability of local governments to impose "special taxes" (those devoted to a specific purpose) without two-thirds voter approval. Counties, in particular, have had fewer options to raise revenues than many other local government entities, and have been required to maintain many services.

In the aftermath of Proposition 13, the State provided aid to local governments from the General Fund to make up some of the loss of property tax moneys, including taking over the principal responsibility for funding K-12 schools and community colleges. During the recession, the Legislature eliminated most of the remaining components of post-Proposition 13 aid to local government entities other than K-14 education districts by requiring cities and counties to transfer some of their property tax revenues to school districts. However, the Legislature also provided additional funding sources (such as sales taxes) and reduced certain mandates for local services. Since then the State has also provided additional funding to counties and cities through such programs as health and welfare realignment, welfare reform, trial court restructuring, the COPs program supporting local public safety departments, and various other measures. In his 1999-00 Budget Proposal, the Governor has proposed a review and "accounting" of state – local fiscal relationships, with the goal of ultimately restoring local government finances to an equivalent fiscal condition to the period prior to the 1991-93 recession – induced tax shifts. Litigation has been brought challenging the legality of the property tax shifts from counties to schools. See "LITIGATION" below.

Historically, funding for the State's trial court system was divided between the State and the counties. However, Chapter 850, Statutes of 1997, implemented a restructuring of the State's trial court funding system. Funding for the courts, with the exception of costs for facilities, local judicial benefits, and revenue collection, was consolidated at the State level. The county contribution for both their general fund and fine and penalty amounts is capped at the 1994-95 level and becomes part of the Trial Court Trust Fund, which supports all trial court operations. The State assumed responsibility for future growth in trial court funding. The consolidation of funding is intended to streamline the operation of the courts, provide a dedicated revenue source, and relieve fiscal pressure on the counties. Beginning in 1998-99, the county general fund contribution for court operations is reduced by $300 million, and cities will retain $62 million in fine and penalty revenue previously remitted to the State; the General Fund reimbursed the $362 million revenue loss to the Trial Court Trust Fund. The 1999-00 Governor's Budget would further reduce the county general fund contribution by an additional $48 million to reduce by 50 percent the contributions of the next 18 smallest counties and reduce by 5 percent the general fund contribution of the remaining 21 counties.

The entire statewide welfare system has been changed in response to the change in federal welfare law enacted in 1996 (see "Welfare Reform" above). Under the CalWORKs program, counties are given flexibility to develop their own plans, consistent with state law, to implement the program and to administer many of its elements, and their costs for administrative and supportive services are capped at the 1996-97 levels. Counties are also given financial incentives if, at the individual county level or statewide, the CalWORKs program produces savings associated with specified standards. Counties will still be required to provide "general assistance" aid to certain persons who cannot obtain welfare from other programs.

In 1996, voters approved Proposition 218, entitled the "Right to Vote on Taxes Act," which incorporates new Articles XIIIC and XIIID into the California Constitution. These new provisions place limitations on the ability of local government agencies to impose or raise various taxes, fees, charges and assessments without voter approval. Certain "general taxes" imposed after January 1, 1995, must be approved by voters in order to remain in effect. In addition, Article XIIIC clarifies the right of local voters to reduce taxes, fees, assessments or charges through local initiatives. There are a number of ambiguities concerning the Proposition and its impact on local governments and their bonded debt which will require interpretation by the courts or the Legislature. Proposition 218 does not affect the State or its ability to levy or collect taxes.

State Appropriations Limit

The State is subject to an annual appropriations limit imposed by Article XIII B of the State Constitution (the "Appropriations Limit"). The Appropriations Limit does not restrict appropriations to pay debt service on voter-authorized bonds.

Article XIII B prohibits the State from spending "appropriations subject to limitation" in excess of the Appropriations Limit. "Appropriations subject to limitation," with respect to the State, are authorizations to spend "proceeds of taxes," which consist of tax revenues, and certain other funds, including proceeds from regulatory licenses, user charges or other fees to the extent that such proceeds exceed "the cost reasonably borne by that entity in providing the regulation, product or service," but "proceeds of taxes" exclude most state subventions to local governments, tax refunds and some benefit payments such as unemployment insurance. No limit is imposed on appropriations of funds which are not "proceeds of taxes," such as reasonable user charges or fees and certain other non-tax funds.

Not included in the Appropriations Limit are appropriations for the debt service costs of bonds existing or authorized by January 1, 1979, or subsequently authorized by the voters, appropriations required to comply with mandates of courts or the federal government, appropriations for qualified capital outlay projects, appropriations of revenues derived from any increase in gasoline taxes and motor vehicle weight fees above January 1, 1990 levels, and appropriation of certain special taxes imposed by initiative (e.g., cigarette and tobacco taxes). The Appropriations Limit may also be exceeded in cases of emergency.

The State's Appropriations Limit in each year is based on the limit for the prior year, adjusted annually for changes in state per capita personal income and changes in population, and adjusted, when applicable, for any transfer of financial responsibility of providing services to or from another unit of government or any transfer of the financial source for the provisions of services from tax proceeds to non tax proceeds. The measurement of change in population is a blended average of statewide overall population growth, and change in attendance at local school and community college ("K-14") districts. The Appropriations Limit is tested over consecutive two-year periods. Any excess of the aggregate "proceeds of taxes" received over such two-year period above the combined Appropriations Limits for those two years is divided equally between transfers to K-14 districts and refunds to taxpayers.

The Legislature has enacted legislation to implement Article XIII B which defines certain terms used in Article XIII B and sets forth the methods for determining the Appropriations Limit. California Government Code Section 7912 requires an estimate of the Appropriations Limit to be included in the Governor's Budget, and thereafter to be subject to the budget process and established in the Budget Act.

The following table shows the State's Appropriations Limit for the past three fiscal years, the current fiscal year, and the next fiscal year. In the Governor's Budget for Fiscal Year 1999-00 proposed on January 8, 1999, the Department of Finance projects the State's Appropriations Subject to Limitations will be $ 7.1 billion under the State's Appropriations Limit in Fiscal Year 1999-00 .

State Appropriations Limit
(Millions)

	Fiscal Years				
	1995-96	**1996-97**	**1997-98**	**1998-99***	**1999-00***
State Appropriations Limit	$39,309	$42,002	$44,778	$47,573	$50,052
Appropriations Subject to Limit	(34,186)	(35,103)	(40,735)	(40,797)	(42,926)
Amount (Over)/Under Limit	$5,123	$6,899	$4,043	$6,776	$7,126

*Estimated/Projected

SOURCE: State of California, Department of Finance.

Proposition 98

On November 8, 1988, voters of the State approved Proposition 98, a combined initiative constitutional amendment and statute called the "Classroom Instructional Improvement and Accountability Act." Proposition 98 changed State funding of public education below the university level and the operation of the State Appropriations Limit, primarily by guaranteeing K-14 schools a minimum share of General Fund revenues. Under Proposition 98 (as modified by Proposition 111, which was enacted on June 5, 1990), K-14 schools are guaranteed the greater of (a) in general, a fixed percent of General Fund revenues ("Test 1"), (b) the amount appropriated to K-14 schools in the prior year, adjusted for changes in the cost of living (measured as in Article XIII B by reference to State per capita personal income) and enrollment ("Test 2"), or (c) a third test, which would replace Test 2 in any year when the percentage growth in per capita General Fund revenues from the prior year plus one half of one percent is less than the percentage growth in State per capita personal income ("Test 3"). Under Test 3, schools would receive the amount appropriated in the prior year adjusted for changes in enrollment and per capita General Fund revenues, plus an additional small adjustment factor. If Test 3 is used in any year, the difference between Test 3 and Test 2 would become a "credit" to schools which would be the basis of payments in future years when per capita General Fund revenue growth exceeds per capita personal income growth. Legislation adopted prior to the end of the 1988-89 Fiscal Year, implementing Proposition 98, determined the K-14 schools' funding guarantee under Test 1 to be 40.3 percent of the General Fund tax revenues, based on 1986-87 appropriations. However, that percent has been adjusted to approximately 35 percent to account for a subsequent redirection of local property taxes, since such redirection directly affects the share of General Fund revenues to schools.

Proposition 98 permits the Legislature by two-thirds vote of both houses, with the Governor's concurrence, to suspend the K-14 schools' minimum funding formula for a one-year period. Proposition 98 also contains provisions transferring certain State tax revenues in excess of the Article XIII B limit to K-14 schools (see "STATE FINANCES--State Appropriations Limit" above).

During the recession in the early 1990s, General Fund revenues for several years were less than originally projected, so that the original Proposition 98 appropriations turned out to be higher than the minimum percentage provided in the law. The Legislature responded to these developments by designating the "extra" Proposition 98 payments in one year as a "loan" from future years' Proposition 98 entitlements, and also intended that the "extra" payments would not be included in the Proposition 98 "base" for calculating future years' entitlements. By implementing these actions, per-pupil funding from Proposition 98 sources stayed almost constant at approximately $4,200 from Fiscal Year 1991-92 to Fiscal Year 1993-94.

In 1992, a lawsuit was filed, called *California Teachers' Association v. Gould*, which challenged the validity of these off-budget loans. The settlement of this case, finalized in July, 1996, provides, among other things, that both the State and K-14 schools share in the repayment of prior years' emergency loans to schools. Of the total $1.76 billion in loans, the State will repay $935 million by forgiveness of the amount owed, while schools will repay $825 million. The State share of the repayment will be reflected as an appropriation above the current Proposition 98 base calculation. The schools' share of the repayment will count as appropriations that count toward satisfying the Proposition 98 guarantee, or from "below" the current base. Repayments are spread over the eight-year period of 1994-95 through 2001-02 to mitigate any adverse fiscal impact.

Substantially increased General Fund revenues, above initial budget projections, in the fiscal years 1994-95 through 1998-99 have resulted in retroactive increases in Proposition 98 appropriations from subsequent fiscal years' budgets. Because of the State's increasing revenues, per-pupil funding at the K-12 level has increased by about 42 percent from the level in place from 1991-92 through 1993-94, and is estimated at about $5,944 per ADA in 1999-00. A significant amount of the "extra" Proposition 98 monies in the last few years have been allocated to special programs, most particularly an initiative to allow each classroom from grades K-3 to have no more than 20 pupils by the end of the 1997-98 school year. Although General Fund revenue growth is expected to slow in 1999-00, there are also new initiatives proposed to improve pupil reading skills, to enhance teacher quality, and to increase school accountability. See "CURRENT STATE BUDGET" for further discussion of education funding.

Sources of Tax Revenue

The following is a summary of the State's major revenue sources. Further information on State revenues is contained under "CURRENT STATE BUDGET" and "STATE FINANCES -- Recent Tax Receipts" below.

In August, 1998, a major tax relief package was enacted, which included a 25 percent vehicle license fee offset (see *Special Fund Revenues* below), an increase in the personal income tax dependent credit, and a reinstatement of the renters' credit. Also included in the 1998-99 tax relief package were a variety of federal conformity provisions, targeted tax cuts and a reduction in horse racing license fees.

Personal Income Tax

The California personal income tax, which in 1997-98 contributed about 51 percent of General Fund revenues and transfers, is closely modeled after the federal income tax law. It is imposed on net taxable income (gross income less exclusions and deductions). The tax is progressive with rates ranging from 1 to 9.3 percent. Personal, dependent and other credits are allowed against the gross tax liability. In addition, taxpayers may be subject to an alternative minimum tax (AMT) which is much like the federal AMT.

The personal income tax is adjusted annually by the change in the consumer price index to prevent taxpayers from being pushed into higher tax brackets without a real increase in income.

Sales Tax

The sales tax is imposed upon retailers for the privilege of selling tangible personal property in California. Sales tax accounted for about 32 percent of General Fund revenue and transfers in 1997-98. Most retail sales and leases are subject to the tax. However, exemptions have been provided for certain essentials such as food for home consumption, prescription drugs, gas delivered through mains and electricity. Other exemptions provide relief for a variety of sales ranging from custom computer software to aircraft.

The breakdown of the basic 7.25 percent rate currently imposed on a statewide basis is:

- 5.00 percent represents the State General Fund tax rate.
- 2.00 percent is dedicated to cities and counties.
- 0.25 percent is dedicated to county transit systems.

Legislation in July 1991 raised the sales tax rate by 1.25 percent to its current level. Of this amount, 0.25 percent was added to the General Fund tax rate, and the balance was dedicated to cities and counties. One-half percent was a permanent addition to counties, but with the money earmarked to trust funds to pay for health and welfare programs whose administration was transferred to counties. Another 0.5 percent of the State General Fund tax rate that was scheduled to terminate after June 30, 1993 was extended until December 31, 1993 and allocated to local agencies for public safety programs. Voters in a special election on November 2, 1993, approved a constitutional amendment to permanently extend this 0.5 percent sales tax for local public safety programs.

Currently, 0.25 percent of the state tax rate may be terminated upon certification by the Director of Finance that the balance in the budget reserve for two consecutive years will exceed 4 percent of General Fund revenues. The 0.25 percent rate can be reinstated if the Director of

Finance subsequently determines that the reserve will not exceed 4 percent of General Fund revenues.

Bank and Corporation Tax

Bank and corporation tax revenues, which comprised about 11 percent of General Fund revenues and transfers in 1997-98, are derived from the following taxes:

1. The franchise tax and the corporate income tax are levied at an 8.84 percent rate on profits. The former is imposed on corporations for the privilege of doing business in California, while the latter is imposed on corporations that derive income from California sources but are not sufficiently present to be classified as doing business in the State.

2. Banks and other financial corporations are subject to the franchise tax plus an additional tax at the rate of 2.0 percent on their net income. This additional tax is in lieu of personal property taxes and business license taxes.

3. The alternative minimum tax (AMT) is similar to that in federal law. In general, the AMT is based on a higher level of net income computed by adding back certain tax preferences. This tax is imposed at a rate of 6.65 percent.

4. A minimum franchise tax of $800 is imposed on corporations subject to the franchise tax but not on those subject to the corporate income tax. New corporations with gross receipts under $1 million pay a reduced minimum tax of $300 for their first year of incorporation and $500 for their second year.

5. Sub-Chapter S corporations are taxed at 1.5 percent of profits.

Insurance Tax

The majority of insurance written in California is subject to a 2.35 percent gross premium tax. For insurers, this premium tax takes the place of all other state and local taxes except those on real property and motor vehicles. Exceptions to the 2.35 percent rate are certain pension and profit-sharing plans which are taxed at the lesser rate of 0.5 percent, surplus lines and nonadmitted insurance at 3 percent and ocean marine insurers at 5 percent of underwriting profits. Insurance taxes comprised approximately 2.2 percent of General Fund revenues and transfers in 1997-98.

Other Taxes

Other General Fund major taxes and licenses include: Estate, Inheritance and Gift Taxes, Cigarette Taxes, Alcoholic Beverage Taxes, Horse Racing Revenues and trailer coach license fees. These other sources totaled approximately 2.4 percent of General Fund revenues and transfers in the 1997-98 Fiscal Year.

Special Fund Revenues

The California Constitution, codes and statutes specify the uses of certain revenue. Such receipts are accounted for in various special funds. In general, special fund revenues comprise three categories of income:

1. Receipts from tax levies which are allocated to specified functions, such as motor vehicle taxes and fees and certain taxes on tobacco products.

2. Charges for special services to specific functions, including such items as business and professional license fees.

3. Rental royalties and other receipts designated for particular purposes (e.g., oil and gas royalties).

Motor vehicle related taxes and fees accounted for about 58 percent of all special fund revenues and transfers in 1997-98. Principal sources of this income are motor vehicle fuel taxes, registration and weight fees and vehicle license fees. During the 1997-98 Fiscal Year, $8.4 billion was derived from the ownership or operation of motor vehicles. About $4.8 billion of this revenue was returned to local governments. The remainder was available for various state programs related to transportation and services to vehicle owners. These amounts (as well as those shown below in the table "Comparative Yield of State Taxes--All Funds") include the additional fees and taxes derived from the passage of Proposition 111 in June 1990.

Chapter 322, Statutes of 1998, reduced vehicle license fees by 25 percent beginning January 1, 1999. In addition, this percentage reduction could be increased in annual stages up to a maximum of 67.5 percent in 2003 depending on whether future General Fund revenues reach specified target levels. Vehicle license fees, over and above the costs of collection and refunds authorized by law, are constitutionally defined local revenues. A continuous appropriation from the General Fund will replace the vehicle license fee revenue that local governments would otherwise lose due to the fee reductions. If in any year the Legislature fails to appropriate enough funds to fully offset the then-applicable vehicle license fee reduction, the percentage offset would be reduced to assure that local governments are not disadvantaged. Therefore, the amount of revenue going to local governments will remain the same as under prior law.

On November 8, 1988, voters approved Proposition 99, which imposed, as of January 1, 1989, an additional 25 cents per pack excise tax on cigarettes, and a new, equivalent excise tax on other tobacco products. The initiative requires that funds from this tax be allocated to anti-tobacco education and research and indigent health services, and environmental and recreation programs. Legislation enacted in 1993 added an additional 2 cents per pack excise tax for the purpose of funding breast cancer research.

Beginning January 1, 1999, after voters approved a constitutional amendment (Proposition 10 of 1998), the excise tax imposed on distributors selling cigarettes in California was increased from 37 to 87 cents per package. At the same time, this amendment imposed a new excise tax on cigars, chewing tobacco, pipe tobacco, and snuff that was implemented at a rate "equivalent" to a 50 cent per pack tax on cigarettes. Proceeds of this new state excise tax are to be allocated primarily for early childhood development programs. Under current law, any increase in the tax on cigarettes automatically triggers an increase in the tax on other tobacco products. Thus, this amendment increased the excise tax on other tobacco products in total by the equivalent of a $1 per pack increase in the tax on cigarettes.

Tobacco Litigation

In late 1998, the State signed a settlement agreement with the four major cigarette manufacturers, which was later ratified by a State court judge having jurisdiction over a pending lawsuit brought by the State against these companies. Under the settlement, the companies will pay California governments a total of approximately $25 billion over a period of 25 years, starting with some payments in the spring of 1999. In addition, payments of approximately $1 billion per year will continue in perpetuity. Under the settlement, half of these moneys will be paid to the State, and half to local governments (all counties and the cities of San Diego, Los Angeles, San Francisco and San Jose).

The specific amount to be received by the State and local governments is, however, subject to adjustment for a number of reasons. First, the federal government has indicated that it may seek recovery of part of the State's settlement as reimbursement for federal Medicaid funding in prior years. The State expects to resist such a claim, which may ultimately be resolved by Congress. Second, various details in the settlement allow reduction of the companies' payments because of events such as certain federal government actions, or reductions in cigarette sales. In the event that any of the companies goes into bankruptcy, the State has the option to terminate the agreement and reinstate litigation.

Recent Tax Receipts

The following table shows the trend of major General Fund and total taxes per capita and per $100 of personal income for the past four years and the current fiscal year.

Trend of State Taxes

	Taxes per Capita(a)		Taxes per $100 of Personal Income	
Fiscal Year	**General Fund**	**Total**	**General Fund**	**Total**
1994-95	$1,292.83	$1,593.22	$5.72	$7.05
1995-96	1,398.03	1,709.28	5.94	7.27
1996-97	1,480.87	1,803.40	6.01	7.32
1997-98(b)	1,634.22	1,965.86	6.37	7.66
1998-99(c)	1,660.51	1,994.51	6.18	7.43

(a) Data reflect population figures benchmarked to the 1990 Census.
(b) Preliminary.
(c) Estimated.

SOURCE: State of California, Department of Finance.

The following table gives the actual and estimated growth in revenues by major source for the last four years and the current fiscal year.

COMPARATIVE YIELD OF STATE TAXES—ALL FUNDS
1994-95 THROUGH 1998-99
(Modified Accrual Basis)
(Thousands of Dollars)

Year Ending June 30	Sales and Use(a)(b)	Personal Income	Bank and Corporation(c)	Tobacco(d)	Inheritance, Estate and Gift	Insurance	Alcoholic Beverages	Horse Racing(e)	Motor Vehicle Fuel(f)	Motor Vehicle Fees(g)
1995	17,758,933	18,608,181(h)	5,685,618	674,727	595,238	998,868	268,957	107,605	2,685,731	4,749,594
1996	19,088,313	20,877,687(h)	5,862,420	666,779	659,338	1,131,737	269,227	104,158	2,757,289	5,009,319
1997	20,111,743	23,275,990	5,788,414	665,415	599,255	1,199,554	271,065	90,627	2,824,589	5,260,355
1998	21,331,691	27,927,940	5,836,881	644,297	780,197	1,221,285	270,947	81,930	2,853,846	5,660,574
1999(i)	20,673,207(j)	28,526,000	5,926,000	949,500	838,000	1,238,000	267,600	61,155	2,951,252	5,373,225

(a) Beginning in 1994-95, includes "Realignment Portion" which is transferred to local governments.

(b) For 1994-95 through 1997-98, numbers include local tax revenue from the 0.5 percent rate increase that the voters passed in November 1993, for local public safety services. For 1998-99 the estimates do not include this revenue.

(c) Includes the corporation income tax and, from 1993 through 1998, the unitary election fee.

(d) Proposition 99 (November 1988) increased the cigarette tax to $0.35 per pack and added an equivalent tax to other tobacco products. The Breast Cancer Act added $0.02 per pack effective January 1, 1994. Proposition 10 (November 1998) increased the cigarette tax to $0.87 per pack and added the equivalent of $1.00 tax to other tobacco products.

(e) The State Controller numbers shown here do not reflect revenues from satellite wagering. The estimates, however, do include revenues from satellite wagering.

(f) Motor vehicle fuel tax (gasoline), use fuel tax (diesel and other fuels), and jet fuel.

(g) Registration and weight fees, motor vehicle license fees and other fees. Reflects a 25 percent reduction in vehicle license fees effective January 1, 1999.

(h) Reflects temporary increase in top marginal rate to 11 percent, which reverted to 9.3 percent for tax years after January 1, 1996.

(i) Estimated. See "CURRENT STATE BUDGET."

(j) As stated in footnote (b), the estimates for 1998-99 do not include voter approved local revenue.

SOURCE:

1994-95 through 1997-98: State of California, Office of the State Controller.

1998-99: State of California, Department of Finance.

State Expenditures

The following table summarizes the major categories of State expenditures, including both General Fund and Special Fund programs.

GOVERNMENTAL COST FUNDS
(Budgetary Basis)
Schedule of Expenditures by Function and Character
1993-94 to 1997-98 Fiscal Years
(Thousands)

	1993-94	1994-95	1995-96	1996-97	1997-98
Function					
Legislative, Judicial, Executive					
Legislative	$ 175,792	$ 180,769	$ 187,768	$ 196,642	$ 209,690
Judicial	616,862	635,916	704,112	716,712	766,932
Executive	564,997	653,583	691,264	961,025	919,606
State and Consumer Services	630,515	697,555	749,368	734,238	771,444
Business, Transportation and Housing					
Business and Housing	224,217	225,398	243,185	115,089	136,558
Transportation	3,363,335	3,188,749	3,334,648	3,650,506	3,924,428
Trade and Commerce	34,122	47,595	51,280	63,789	62,235
Resources	1,088,492	1,141,488	1,179,481	1,310,074	1,323,860
Environmental Protection	510,274	459,492	505,206	507,156	605,584
Health and Welfare	15,953,388	16,675,380	17,275,117	17,987,919	18,059,611
Correctional Programs	3,074,471	3,280,762	3,638,672	3,606,674	3,901,296
Education					
Education–K through 12	13,820,462	14,973,978	16,773,927	19,916,015	21,574,341
Higher Education	4,951,535	5,436,640	5,844,282	6,599,573	7,022,658
General Government					
General Administration	1,015,089	1,000,650	672,935	743,024	764,615
Debt Service	1,802,833	2,189,529	2,153,682	2,048,475	1,979,211
Tax Relief	473,707	480,430	474,179	454,509	453,030
Shared Revenues	3,162,558	3,188,090	3,346,240	3,690,512	3,892,036
Other Statewide Expenditures	(129,338)	(92,508)	202,158	133,309	1,373,823
Expenditure Adjustment for Encumbrances	(162,958)	694,288	(7,691)	(190,609)	(162,630)
Credits for Overhead Services by General Fund	(184,336)	(156,118)	(130,016)	(147,019)	(125,678)
Statewide Indirect Cost Recoveries	(35,399)	(31,132)	(48,730)	(23,307)	(48,963)
Total	$50,950,618	$54,870,534	$57,841,067	$63,074,306	$67,403,687
Character					
State Operations	$15,322,082	$16,403,401	$17,341,247	$17,924,850	$20,199,031
Local Assistance	35,166,791	37,680,952	39,973,320	44,686,447	46,666,925
Capital Outlay	461,745	786,181	526,500	463,009	537,731
Total	$50,950,618	$54,870,534	$57,841,067	$63,074,306	$67,403,687

SOURCE: State of California, Office of the State Controller.

PRIOR FISCAL YEARS' FINANCIAL RESULTS

Fiscal Years Prior to 1995-96

Pressures on the State's budget in the late 1980's and early 1990's were caused by a combination of external economic conditions (including a recession which began in 1990) and growth of the largest General Fund Programs – K-14 education, health, welfare and corrections – at rates faster than the revenue base. During this period, expenditures exceeded revenues in four out of six years up to 1992-93, and the State accumulated and sustained a budget deficit approaching $2.8 billion at its peak at June 30, 1993. Between the 1991-92 and 1994-95 Fiscal Years, each budget required multibillion dollar actions to bring projected revenues and expenditures into balance, including significant cuts in health and welfare program expenditures; transfers of program responsibilities and funding from the State to local governments; transfer of about $3.6 billion in annual local property tax revenues from other local governments to local school districts, thereby reducing state funding for schools under Proposition 98; and revenue increases (particularly in the 1991-92 Fiscal Year budget), most of which were for a short duration.

Despite these budget actions, the effects of the recession led to large, unanticipated budget deficits. By the 1993-94 Fiscal Year, the accumulated deficit was so large that it was impractical to budget to retire it in one year, so a two-year program was implemented, using the issuance of revenue anticipation warrants to carry a portion of the deficit over the end of the fiscal year. When the economy failed to recover sufficiently in 1993-94, a second two-year plan was implemented in 1994-95, again using cross-fiscal year revenue anticipation warrants to partly finance the deficit into the 1995-96 fiscal year. See "STATE INDEBTEDNESS – Cash Flow Borrowings" above.

Another consequence of the accumulated budget deficits, together with other factors such as disbursement of funds to local school districts "borrowed" from future fiscal years and hence not shown in the annual budget, was to significantly reduce the State's cash resources available to pay its ongoing obligations. When the Legislature and the Governor failed to adopt a budget for the 1992-93 Fiscal Year by July 1, 1992, which would have allowed the State to carry out its normal annual cash flow borrowing to replenish its cash reserves, the State Controller issued registered warrants to pay a variety of obligations representing prior years' or continuing appropriations, and mandates from court orders. See "STATE FINANCES – State Warrants" above. Available funds were used to make constitutionally-mandated payments, such as debt service on bonds and warrants. Between July 1 and September 4, 1992, when the budget was adopted, the State Controller issued a total of approximately $3.8 billion of registered warrants.

For several fiscal years during the recession, the State was forced to rely on external debt markets to meet its cash needs, as a succession of notes and revenue anticipation warrants, often needed to pay previously maturing notes or warrants, were issued in the period from June 1992 to July 1994. These borrowings were used also in part to spread out the repayment of the accumulated budget deficit over the end of a fiscal year, as noted earlier. The last and largest of these borrowings was $4.0 billion of revenue anticipation warrants which were issued in July, 1994 and matured on April 25, 1996. See "STATE INDEBTEDNESS – Cash Flow Borrowings" above.

1995-96 through 1997-98 Fiscal Years

The State's financial condition improved markedly during the 1995-96, 1996-97 and 1997-98 fiscal years, with a combination of better than expected revenues, slowdown in growth of social welfare programs, and continued spending restraint based on the actions taken in earlier years. The State's cash position also improved, and no external deficit borrowing has occurred over the end of these three fiscal years.

The economy grew strongly during these fiscal years, and as a result, the General Fund took in substantially greater tax revenues (around $2.2 billion in 1995-96, $1.6 billion in 1996-97 and $2.4 billion in 1997-98) than were initially planned when the budgets were enacted. These additional funds were largely directed to school spending as mandated by Proposition 98, and to make up shortfalls from reduced federal health and welfare aid in 1995-96 and 1996-97. The accumulated budget deficit from the recession years was finally eliminated.

The following were major features of the 1997-98 Budget Act:

1. For the second year in a row, the Budget contained a large increase in funding for K-14 education under Proposition 98, reflecting strong revenues which exceeded initial budgeted amounts. Part of the nearly $1.75 billion in increased spending was allocated to prior fiscal years. Funds were provided to fully pay for the cost-of-living-increase component of Proposition 98, and to extend the class size reduction and reading initiatives. See "STATE FINANCES - Proposition 98" above.

2. The Budget Act reflected payment of $1.228 billion to satisfy a court judgment in a lawsuit regarding payments to the State pension fund, and brought funding of the State's pension contribution back to the quarterly basis which existed prior to the deferral actions which were invalidated by the courts.

3. Funding from the General Fund for the University of California and California State University was increased by about 6 percent ($121 million and $107 million, respectively), and there was no increase in student fees.

4. Because of the effect of the pension payment, most other State programs were continued at 1996-97 levels, adjusted for caseload changes.

5. Health and welfare costs were contained, continuing generally the grant levels from prior years, as part of the initial implementation of the new CalWORKs program.

6. Unlike prior years, this Budget Act did not depend on uncertain federal budget actions. About $300 million in federal funds, already included in the federal FY 1997 and 1998 budgets, was included in the Budget Act, to offset incarceration costs for illegal aliens.

7. The Budget Act contained no tax increases, and no tax reductions. The Renters Tax Credit was suspended for another year, saving approximately $500 million.

CURRENT STATE BUDGET

The discussion below of the 1998-99 Fiscal Year budget and the Proposed 1999-00 Fiscal Year budget and the table under "Summary of State Revenues and Expenditures" are based on estimates and projections of revenues and expenditures for the current and upcoming fiscal years and must not be construed as statements of fact. These estimates and projections are based upon various assumptions as updated in the 1999-00 Governor's Budget, which may be affected by numerous factors, including future economic conditions in the State and the nation, and there can be no assurance that the estimates will be achieved. See "CURRENT STATE BUDGET -- Revenue and Expenditure Assumptions" below.

Periodic reports on revenues and/or expenditures during the fiscal year are issued by the Administration, the State Controller's Office and the Legislative Analyst's Office. The Department of Finance issues a monthly Bulletin which reports the most recent revenue receipts as reported by state departments, comparing them to Budget projections. The Administration also formally updates its budget projections three times during each fiscal year, in January, May, and at budget enactment. These bulletins and other reports are available on the Internet at the following websites:

Department of Finance	www.dof.ca.gov
State Controller	www.sco.ca.gov
Legislative Analyst	www.lao.ca.gov

1998-99 Fiscal Year Budget

When the Governor released his proposed 1998-99 Fiscal Year Budget on January 9, 1998, he projected General Fund revenues for the 1998-99 Fiscal Year of $55.4 billion, and proposed expenditures in the same amount. By the time the Governor released the May Revision to the 1998-99 Budget ("May Revision") on May 14, 1998, the Administration projected that revenues for the 1997-98 and 1998-99 Fiscal Years combined would be more than $4.2 billion higher than was projected in January. The Governor proposed that most of this increased revenue be dedicated to fund a 75 percent cut in the Vehicle License Fee ("VLF").

The Legislature passed the 1998-99 Budget Bill on August 11, 1998, and the Governor signed it on August 21, 1998. Some 33 companion bills necessary to implement the budget were also signed. In signing the Budget Bill, the Governor used his line-item veto power to reduce expenditures by $1.360 billion from the General Fund, and $160 million from special funds. Of this total, the Governor indicated that about $250 million of vetoed funds were "set aside" to fund programs for education. Vetoed items included education funds, salary increases and many individual resources and capital projects.

The 1998-99 Budget Act was based on projected General Fund revenues and transfers of $57.0 billion (after giving effect to various tax reductions enacted in 1997 and 1998), a 4.2 percent increase from the then revised 1997-98 figures. Special Fund revenues were estimated at $14.3 billion. The revenue projections were based on the May Revision. Economic problems overseas since that time may affect the May Revision projections. See "Economic Assumptions" below.

After giving effect to the Governor's vetoes, the Budget Act provided authority for expenditures of $57.3 billion from the General Fund (a 7.3 percent increase from 1997-98), $14.7 billion from Special Funds, and $3.4 billion from bond funds. The Budget Act projected a balance in the SFEU at June 30, 1999 (but without including the "set aside" veto amount) of $1.255 billion, a little more than 2 percent of General Fund revenues. The Budget Act assumed the State will carry out its normal intra-year cash flow borrowing in the amount of $1.7 billion of revenue anticipation notes, which were issued on October 1, 1998.

Revenues and expenditures for 1998-99 as updated in the 1999-00 Governor's Budget are $56.3 billion and $58.3 billion, respectively. As a result, the projected balance in the SFEU at June 30, 1999 has been reduced to $617 million. (See "Proposed 1999-00 Budget" below for discussion of more recent revenue estimates from the Legislative Analyst's Office.)

The most significant feature of the 1998-99 budget was agreement on a total of $1.4 billion of tax cuts. The central element is a bill which provides for a phased-in reduction of the VLF. Since the VLF is currently transferred to cities and counties, the bill provides for the General Fund to replace the lost revenues. Started on January 1, 1999, the VLF has been reduced by 25 percent, at a cost to the General Fund of approximately $500 million in the 1998-99 Fiscal Year and about $1 billion annually thereafter. See "STATE FINANCES – Sources of Tax Revenue – Special Fund Revenues" above.

In addition to the cut in VLF, the 1998-99 budget includes both temporary and permanent increase in the personal income tax dependent credit ($612 million General Fund cost in 1998-99, but less in future years), a nonrefundable renters tax credit ($133 million), and various targeted business tax credits ($106 million).

Other significant elements of the revised 1998-99 Budget are as follows:

1. Proposition 98 funding for K-12 schools is increased by $2.2 billion in General Fund moneys over the latest revised 1997-98 levels, over $1 billion higher than the minimum Proposition 98 guarantee. Of the 1998-99 funds, major new programs include money for instructional and library materials, deferred maintenance, support for increasing the school year to 180 days and reduction of class sizes in Grade 9. Overall, per-pupil spending for K-12 schools under Proposition 98 is increased to $5,752, which is $478 over the 1997-98 level. The Budget also includes $250 million as repayment of prior years' loans to schools, as part of the settlement of the *CTA v. Gould* lawsuit. (See "STATE FINANCES - Proposition 98" above.)

2. Funding for higher education increased substantially above the actual 1997-98 level. General Fund support was increased by $339 million (15.6 percent) for the University of California and $271 million (14.5 percent) for the California State University system. In addition, Community Colleges increased by $183 million (9.0 percent).

3. The Budget includes increased funding for health, welfare and social services programs. A 4.9 percent grant increase was included in the basic welfare grants, the first increase in those grants in 9 years. Future increases will depend on sufficient General Fund revenue to trigger the phased cuts in VLF described above.

4. Funding for the judiciary and criminal justice programs increased by about 15 percent over 1997-98, primarily to reflect increased state support for local trial courts and rising prison population.

5. Various other highlights of the revised Budget included new funding for resources projects, dedication of $240 million of General Fund moneys for capital outlay projects, funding of a state employee salary increase, funding of 2,000 new Department of Transportation positions to accelerate transportation construction projects, and funding of the Infrastructure and Economic Development Bank ($50 million).

6. The State of California received approximately $167 million of federal reimbursements to offset costs related to the incarceration of undocumented alien felons for federal fiscal year 1997. The state anticipates receiving approximately $173 million in federal reimbursements for federal fiscal year 1998.

The revised 1998-99 budget as reported in the 1999-00 Governor's Budget, also reflects the latest estimated costs or savings as provided in various pieces of legislation passed and signed after the 1998 Budget Act. Major budget items include costs for the All-American Canal, state's share of purchase of Headwaters Forest, and additional funds for state prisons and juvenile facilities. The revised budget reflects a $433 million reduction in the State's obligation to contribute to STRS in 1998-99.

Proposed 1999-00 Budget

On January 8, 1999, Governor Davis released his proposed budget for Fiscal Year 1999-2000 (the "Governor's Budget"). The Governor's Budget generally reported that General Fund revenues for FY 1998-99 and FY 1999-00 would be lower than earlier projections (primarily due to the overseas economic downturn), while some caseloads would be higher than earlier projections. The Governor's Budget was designed to meet ongoing caseloads and basic inflation adjustments, and included certain new programs.

The Governor's Budget projects General Fund revenues and transfers in 1999-00 of $60.3 billion. This includes anticipated initial payments from the tobacco litigation settlement of about $560 million, and receipt of one-time revenue from sale of assets. The Governor also assumes receipt of about $400 million of federal aid for certain health and welfare programs and reimbursement for costs for incarceration of undocumented felons, above the amount presently received by California from the federal government. The Governor's Budget notes that more accurate revenue estimates will be available in May and June before adoption of the budget. Among other things, the amount of realized capital gains for 1998 is still unknown, given the large fluctuations in the stock market last year. The Governor has not proposed any tax cuts or increases.

The Governor's Budget proposes General Fund expenditures of $60.5 billion. The Governor's Budget gives highest priority to education, with Proposition 98 funding increasing by almost 5 percent. The Governor proposed certain new education initiatives focused on improving reading skills, teacher quality and school accountability. The Governor proposed modest increase in funding for higher education, and an 8 percent increase in SSP payments (a State-funded welfare program), while assuming decreases in Medi-Cal and CalWORKs grant costs due to lowering caseloads. The Governor also proposes to reduce expenditures by deferring certain previously budgeted expenditures totaling about $170 million.

Based on the proposed revenues and expenditures, the Governor's Budget projects the June 30, 2000 balance in the SFEU would drop to about $415 million.

On February 16, 1999, the Legislative Analyst released a report on the 1999-00 Governor's Budget (the "LAO Report"). The LAO Report was based in part on actual revenues received in December, 1998 and January, 1999, which had not been available when the Governor's Budget was prepared. These revenues were higher than had been predicted in the Governor's Budget, apparently reflecting stronger than expected economic activity in the nation and the State. The LAO report projected that General Fund revenues in 1998-99 could be as much as $750 million higher than predicted in the Governor's Budget, and 1999-00 revenues could be $550 million above the Governor's Budget.

The Governor's Budget includes a proposal to implement changes in law to make "mid-course corrections" in the State's budget if ongoing revenues fall short of projections during a fiscal year or expenditures increase significantly. The proposals include two components: restoring authority for the Director of Finance to reduce expenditures in certain circumstances, and an automatic "trigger" mechanism which would produce spending cuts if certain conditions were met. These proposals will require legislative action.

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Summary of State Revenues and Expenditures

STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCE–GENERAL FUND (Budgetary Basis)(a) FISCAL YEARS 1995-96 THROUGH 1999-00 (Millions)

	1995-96	1996-97	1997-98	Estimated[b] 1998-99	Proposed[c] 1999-00
Fund Balance–Beginning of Period	$ (393.8)	$ 1,073.9	639.8	$ 2,792.5	$ 1,097.4
Restatements					
Prior Year Revenue, Transfer Accrual Adjustments	(5.3)	(59.0)	(165.3)	29.3	--
Prior Year Expenditure, Accrual Adjustments	118.9	88.8	498.1	252.8	--
Fund Balance–Beginning of Period, as Restated	$ (280.2)	$ 1,103.7	$ 972.6	$ 3,074.6	$ 1,097.4
Revenues	$ 46,082.1	$ 49,161.4	$ 54,797.7	$ 56,410.3	$60,164.9
Other Financing Sources					
Transfers from Other Funds	4,540.8[d]	181.5	132.0	(116.9)	106.9
Other Additions	61.4	49.3	154.4	--	--
Total Revenues and Other Sources	$ 50,684.3	$ 49,392.2	$ 55,084.1	$ 56,293.4	$ 60,271.8
Expenditures					
State Operations	$ 11,687.7	$ 12,151.5	$ 14,042.1	$ 14,607.5	$ 14,707.4
Local Assistance	33,132.5	37,433.8	38,990.4	43,220.8	45,480.3
Capital Outlay	28.9	53.5	57.2	442.3	287.0
Other Uses					
Transfer to Other Funds	4,481.1[d]	217.3	174.5	-- (e)	--(e)
Total Expenditures and Other Uses	$ 49,330.2	$ 49,856.1	$ 53,264.2	$ 58,270.6	$ 60,474.7
Revenues and Other Sources Over or (Under) Expenditures and Other Uses	$ 1,354.1	$ (463.9)	$ 1,819.9	$ (1,977.2)	$ (202.9)
Fund Balance					
Reserved for Encumbrances	$ 450.8	$ 442.4	$ 478.7	$ 480.0	$ 480.0
Reserved for Unencumbered Balances of Continuing Appropriations[f]	123.0	68.1	122.8	568.3	476.9
Reserved for School Loans[g]	1,609.7	1,459.7	1,259.7	1,009.7	699.7
Unreserved–Undesignated[h]	(1,109.6)	(1,330.4)	931.3	(960.6)	(762.1)
Fund Balance–End of Period	$ 1,073.9	$ 639.8	$ 2,792.5	$ 1,097.4	$ 894.5

Footnotes on following page.

SOURCE: Fiscal Years 1995-96 to 1997-98: State of California, Office of the State Controller.
Fiscal Years 1998-99 and 1999-00: State of California, Department of Finance.

(a) These statements have been prepared on a budgetary basis in accordance with State law and some modifications would be necessary in order to comply with generally accepted accounting principles ("GAAP"). See Exhibit 1 to this Appendix A for the audited general purpose financial statements of the State for the year ended June 30, 1998, prepared in accordance with generally accepted accounting principles. See Note 2 to the Financial Statements for a description of the differences between the budgetary basis and the GAAP basis of accounting.

(b) Estimates are shown net of reimbursements and abatements.

(c) 1999-00 Proposed Governor's Budget, January 8, 1999. These projections are subject to completion of the legislative process to enact the 1999-00 budget.

(d) $4.2 billion was transferred from the General Fund to the Warrant Payment Fund in four installments on specified dates in the 1995-96 fiscal year. On April 25, 1996, the $4.2 billion was transferred back to the General Fund from the Warrant Payment Fund to pay and redeem at maturity $4.0 billion of 1994 Revenue Anticipation Warrants, Series C and D.

(e) "Transfer to Other Funds" is included either in the expenditure totals detailed above or as "Transfer from Other Funds."

(f) Pursuant to Chapter 1238, Statutes of 1990, the unencumbered balances of continuing appropriations which exist when no commitment for an expenditures is made should be an item of disclosure, but the amount shall not be deducted from the fund balance. Accordingly, the General Fund condition included in the 1999-00 Governor's Budget includes the unencumbered balances of continuing appropriations as a footnote to the statement ($568.3 million in 1998-99 and $476.9 million in 1999-00). However, the State Controller's financial statements continue to reflect a specific reserve for the unencumbered balance for continuing appropriations.

(g) During 1995, a reserve was established in the General Fund balance for the $1.7 billion of previously recorded school loans which had been authorized by Chapter 703, Statutes of 1992 and Chapter 66, Statutes of 1993. These loans are deferred and are to be repaid from future General Fund appropriations. See "STATE FINANCES - Proposition 98" above for a discussion of the settlement of the CTA v. Gould lawsuit. This accounting treatment is consistent with the State's audited financial statements prepared in accordance with GAAP.

(h) Includes Special Fund For Economic Uncertainties (SFEU). The State Controller reports the balance in the SFEU as of June 30, 1998 to be $931.3 million in compliance with Government Code §16418(e) (see "STATE FINANCES – The Special Fund for Economic Uncertainties"). Therefore, the Undesignated-Unreserved fund balance at June 30, 1998 is $0. The Department of Finance estimates a total SFEU balance of $618 million on June 30, 1999, and $415 million on June 30, 2000, based on the 1999-00 Governor's Budget.

Revenue and Expenditure Assumptions

The table below presents the Department of Finance's budget basis statements of major General Fund revenue sources and expenditures for the 1997-98 and 1998-99 Fiscal Years and the Budget Act estimated for the 1999-00 Fiscal Year.

Revenues
(Millions)

Source	Actual Fiscal Year 1997-98*	Original Fiscal Year 1998-99*	Revised Fiscal Year 1998-99†	Projected Fiscal Year 1999-00†
Personal Income Tax	$27,925	$28,963	$28,526	$30,175
Sales and Use Tax	17,583	18,739	18,620	19,680
Bank and Corporation Tax	5,837	6,100	5,926	6,295
Insurance Tax	1,221	1,281	1,238	1,232
All Other	2,407	1,902	1,983	2,890
Total Revenues and Transfers	$54,973	$56,985	$56,293	$60,272

Expenditures
(Millions)

Function	Actual Fiscal Year 1997-98*	Original Fiscal Year 1998-99*	Revised Fiscal Year 1998-98†	Projected Fiscal Year 1999-00†
K-12 Education	$22,080	$23,847	$23,648	$25,642
Health and Welfare	14,639	15,343	16,311	16,385
Higher Education	6,625	7,561	7,477	7,726
Youth and Adult Correctional	4,139	4,443	4,510	4,589
Legislative, Judicial and Executive	1,569 (a)	1,808	1,887	1,996
Tax Relief	454	994	1,022	1,618
Resources	718	1,086	1,209	945
State and Consumer Services	394	438	459	446
Business, Transportation and Housing	274	359	302	356
All Other	1,982 (b)	1,383	1,446	772
Total Expenditures	$52,874	$57,262	$58,271	$60,475

(a) Includes expenditure of fine and penalty revenue up to December 31, 1997, for support of Trial Courts.
(b) Includes $1.2 billion for payment to Public Employees Retirement Fund in response to legal judgment.
* Enacted 1998-99 Budget Act, August 21, 1998.
† 1999-00 Governor's Budget, January 8, 1999.

SOURCE: State of California, Department of Finance.

Economic Assumptions

The Revenue and Expenditure assumptions set forth have been based upon certain estimates of the performance of the California and National economies in calendar years 1999 and 2000. In the Governor's Budget released on January 8, 1999, the Department of Finance projected that the California economy will show moderate growth through 2000, at a slower pace than in 1998. The economic expansion has been marked by strong growth in high technology business services (including computer software), construction, and computer and electronic components manufacturing. The Asian economic crisis, which began in 1997, has had some dampening effects on the State's economy, particularly in high technology manufacturing. The widening trade deficit, continuing weakness in Asia, initial signs of economic weakness in Latin America, and uncertainty in stock prices worldwide all support moderating growth in 1999. Other impacts of the international situation may help California, such as the reduction in long-term interest rates.

The Department set out the following estimates for California economic performance which were used in predicting revenues and expenditures for the 1999-00 Fiscal Year Budget. Also shown was the Department's previous forecast for 1999, contained in the May Revisions of the 1998-99 Governor's Budget.

	For 1999		For 2000	
	Governor's Budget*	May Revision†	Governor's Budget*	May Revision
Nonfarm wage and salary employment (000)	13,873	13,975	14,205	N/A
Percent Change	2.1	2.9	2.4	
Personal income ($ billions)	945.5	982.1	997.1	
Percent Change	5.1	6.7	5.5	
Housing Permits (Units 000)	152	153	166	
Consumer Price Index Percent Change	2.4	3.4	3.0	

* January 8, 1999 (for "Governor's Budget").
† May 14, 1998 (for "May Revision").

SOURCE: State of California, Department of Finance.

ECONOMY AND POPULATION

Introduction

California's economy, the largest among the 50 states and one of the largest in the world, has major components in high technology, trade, entertainment, agriculture, manufacturing, tourism, construction and services. Since 1994, California's economy has been performing strongly after suffering a deep recession between 1990-94.

Population and Labor Force

The State's July 1, 1997 population of over 32.9 million represented over 12 percent of the total United States population.

California's population is concentrated in metropolitan areas. As of the April 1, 1990 census, 96 percent resided in the 23 Metropolitan Statistical Areas in the State. As of July 1, 1997, the 5-county Los Angeles area accounted for 49 percent of the State's population, with 16.0 million residents, and the 10-county San Francisco Bay Area represented 21 percent, with a population of 6.9 million.

The following table shows California's population data for 1993 through 1998.

Population 1993-98

Year	California Population[a]	% Increase Over Preceding Year	United States Population[a]	% Increase Over Preceding Year	California as % of United States
1993	31,517,000	1.1	257,753,000	1.1	12.2
1994	31,790,000	0.9	260,292,000	1.0	12.2
1995	32,063,000	0.9	262,761,000	0.9	12.2
1996	32,383,000	1.0	265,179,000	0.9	12.2
1997	32,957,000	1.8	267,636,000	0.9	12.3
1998	33,494,000	1.6	270,029,000	0.9	12.4

[a] Population as of July 1.

SOURCE: U.S. Department of Commerce, Bureau of the Census; State of California, Department of Finance.

The following table presents civilian labor force data for the resident population, age 16 and over, for the years 1992 to 1998.

Labor Force
1992-98

	Labor Force Trends (Thousands)		Unemployment Rate (%)	
Year	Labor Force	Employment	California	United States
1992	15,404	13,973	9.3	7.5
1993	15,359	13,918	9.4	6.9
1994	15,450	14,122	8.6	6.1
1995	15,412	14,203	7.8	5.6
1996	15,568	14,444	7.2	5.4
1997	15,971	14,965	6.3	4.9
1998 p/	16,260	15,302	5.9	4.5

p/ Preliminary

SOURCE: State of California, Employment Development Department.

Employment, Income, Construction and Export Growth

The following table shows California's nonagricultural employment distribution and growth for 1990 and 1998.

Payroll Employment By Major Sector
1990 and 1998

	Employment (Thousands)		% Distribution of Employment	
Industry Sector	1990	1998	1990	1998
Mining	39	29	0.3	0.2
Construction	605	605	4.8	4.5
Manufacturing				
Nondurable goods	721	739	5.7	5.4
High Technology	686	520	5.4	3.8
Other Durable goods	690	683	5.4	5.0
Transportation and Utilities	624	680	4.9	5.0
Wholesale and Retail Trade	3,002	3,129	23.7	23.0
Finance, Insurance And Real Estate	825	781	6.5	5.7
Services	3,395	4,234	26.8	31.2
Government				
Federal	362	279	2.9	2.1
State and Local	1,713	1,906	13.5	14.0
TOTAL NONAGRICULTURAL	12,662	13,586	100	100

SOURCE: State of California, Employment Development Department and State of California, Department of Finance.

The following tables show California's total and per capita income patterns for selected years.

Total Personal Income 1992-97

Year		California Millions	California % Change	California % of U.S.
1992	....	684,674	4.8*	13.1
1993	....	698,130	2.0	12.8
1994[a]	....	718,321	2.9	12.5
1995	....	754,269	5.0	12.4
1996	....	798,020	5.8	12.5
1997	....	846,017	6.0	12.5

* Change from prior year.
[a] Reflects Northridge earthquake, which caused an estimated $15 billion drop in personal income.
Note: Omits income for government employees overseas.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

Per Capita Personal Income 1992-97

Year		California	% Change	United States	% Change	California % of U.S.
1992	....	22,163	3.2*	20,546	4.7*	107.9
1993	....	22,388	1.0	21,220	3.3	105.5
1994[a]	....	22,899	2.3	22,056	3.9	103.8
1995	....	23,901	4.4	23,063	4.6	103.6
1996	....	25,050	4.8	24,169	4.8	103.6
1997	....	26,218	4.7	25,298	4.7	103.6

*Change from prior year
[a] Reflects Northridge earthquake, which caused an estimated $15 billion drop in personal income.

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

The following tables show California's residential and nonresidential construction authorized by permits for selected years.

Residential Construction Authorized by Permits

Year	Units Total	Units Single	Units Multiple	Valuation a/ ($ mill.)
1993	84,656	69,901	14,755	12,954
1994	97,047	77,115	19,932	14,852
1995	85,293	68,689	16,604	13,879
1996	94,283	74,923	19,360	15,289
1997	111,716	84,780	26,936	18,752

a/ Valuation includes additions and alterations.
SOURCE: Construction Industry Research Board

Nonresidential Construction
(Thousands of dollars)

Year	Commercial	Industrial	Other	Additions and Alterations	Total
1993	2,136,925	489,229	1,067,307	3,863,428	7,556,889
1994	2,108,067	649,632	1,051,276	4,080,657	7,889,632
1995	2,308,912	732,877	1,050,684	4,062,271	8,154,744
1996	2,751,909	1,140,575	1,152,425	4,539,219	9,584,128
1997	4,271,378	1,598,428	1,378,220	5,021,792	12,269,818

SOURCE: Construction Industry Research Board

The following tables show California's export growth for the period from 1991 through 1997.

Exports Through California Ports
(In millions)

Year	Exports a/	% Change
1991	$73,860.3	7.7%
1992	$81,139.0	9.9%
1993	$82,173.5	1.3%
1994	$95,614.6	16.4%
1995	$116,825.5	22.2%
1996	$124,291.0	6.4%
1997	$131,292.2	5.6%

a/ "free along ship" Value Basis
SOURCE: U.S. Department of Commerce, Bureau of the Census

LITIGATION

In addition to litigation discussed in Note 22 to the Audited Financial Statements (see Exhibit 1 to this Appendix A at Page 72), the following information is provided concerning those matters and other matters which either have arisen since the date of the Audited Financial Statements or are not discussed in Note 22.

On December 24, 1997, a consortium of California counties filed a test claim with the Commission on State Mandates (the "Commission") asking the Commission to determine whether the property tax shift from counties to school districts beginning in 1993-94, is a reimbursable state mandated cost. See "STATE FINANCES – Local Government" above. The test claim was heard on October 29, 1998, and the Commission on State Mandates found in favor of the State. In March, 1999, Sonoma County filed suit in the Superior Court to overturn the Commission's decision. The State is contesting this lawsuit. Should the courts find in favor of the counties, the impact to the State General Fund could be as high as $10.0 billion with an annual Proposition 98 General Fund cost of at least $3.6 billion. This cost would grow in accordance with the annual assessed value growth rate.

In *Professional Engineers in California Government v. Wilson,* described on page 73 of Exhibit 1 to this Appendix, the Superior Court ruled in December 1998 that $30.7 million of the $258.2 million transferred from the State Highway Account to the General Fund violated the California Constitution. The court also invalidated $130.9 million transferred from the Motor Vehicle Account to the General Fund. The court ordered further briefing on the $130 million transfer from the State Highway Account to the Motor Vehicle Account. A hearing on this transfer is scheduled for April 1999. No decision has been made as to whether an appeal will be taken from the court's ruling.

On June 24, 1998, plaintiffs in *Howard Jarvis Taxpayers Association et al. v Kathleen Connell* filed a complaint for certain declaratory and injunctive relief challenging the authority of the State Controller to make payments from the State Treasury in the absence of a state budget. On July 21, 1998, the trial court issued a preliminary injunction prohibiting the State Controller from paying moneys from the State Treasury for fiscal year 1998-99, with certain limited exceptions, in the absence of a state budget. The preliminary injunction, among other things, prohibited the State Controller from making any payments pursuant to any continuing appropriation.

On July 22 and 27, 1998, various employee unions which had intervened in the case appealed the trial court's preliminary injunction and asked the Court of Appeal to stay the preliminary injunction. On July 28, 1998, the Court of Appeal granted the unions' requests and stayed the preliminary injunction pending the Court of Appeal's decision on the merits of the appeal. On August 5, 1998, the Court of Appeal denied the plaintiffs' request to reconsider the stay. Also on July 22, 1998, the State Controller asked the California Supreme Court to immediately stay the trial court's preliminary injunction and to overrule the order granting the preliminary injunction on the merits. On July 29, 1998, the Supreme Court transferred the State

Controller's request to the Court of Appeal. The matters are now pending before the Court of Appeal. Briefs are being submitted; no date has yet been set for oral argument.

In *Thomas Hayes v. Commission on State Mandates*, described on page 73 of Exhibit 1 of this Appendix, the Commission on State Mandates issued a decision in December 1998 determining that a portion, but not all, of the claims constituted state mandated local costs. The Commission is now developing parameters and guidelines for claims for reimbursement. The Department of Finance has not yet determined whether to seek judicial review of the Commission's decision.

In *Capitola Land v. Anderson* and other related state and federal cases, plaintiffs sought payments from the State under the AFDC-Foster Care program. Judgment was rendered against the State in *Capitola*, which the State appealed and lost. The State then filed a state plan amendment with the federal Department of Health and Human Services to enable the State to comply with the *Capitola* ruling and receive federal funding. The DHHS denied the state plan amendment, and the State has filed suit against DHHS. The Legislature also enacted a statute which required federal funding in order to comply with the *Capitola* judgment. The State then refused to implement the *Capitola* judgment based on the new statute. Certain plaintiffs moved for an order of contempt against the State, which was granted by the trial court, but was stayed and annulled by the Court of Appeal. The plaintiffs are petitioning the California Supreme Court for review. If, as a result of this litigation, compliance with the *Capitola* judgment is required and the judgment is applied retroactively, liability to the State could exceed $200 million.

In the Northern California 1997 Flood Litigation, described on page 72 of Exhibit 1 to this Appendix, a substantial number of plaintiffs have joined the suit against the State, local agencies, and private companies and contractors seeking compensation for the damages they suffered as a result of the 1997 flooding. As indicated in the description in Exhibit 1, property damages have been estimated up to $2 billion. The State is vigorously defending the action.

In *Just Say No to Tobacco Dough Campaign v. State of California*, described on page 74 of Exhibit 1 to this Appendix, the superior court issued an order in December 1998, granting the State's demurrer to the entire action and dismissing the case. Plaintiffs have asked the court to reconsider its ruling.

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STATE DEBT TABLES

The tables which follow provide information on outstanding State debt, authorized but unissued general obligation bonds and commercial paper notes, debt service requirements for State general obligation and lease-purchase bonds, and authorized and outstanding State revenue bonds. For purposes of these tables, "General Fund bonds," also known as "non-self liquidating bonds," are general obligation bonds expected to be paid from the General Fund without reimbursement from any other fund. Although the principal of general obligation commercial paper notes in the "non-self liquidating" category is legally payable from the General Fund, the State expects that principal of such commercial paper notes will be paid only from the issuance of new commercial paper notes or the issuance of long-term general obligation bonds to retire the commercial paper notes. Interest on "non-self liquidating" general obligation commercial paper notes is payable from the General Fund.

"Enterprise Fund bonds," also known as "self liquidating bonds," are general obligation bonds for which program revenues are expected to be sufficient to reimburse in full the General Fund for debt service payments, but any failure to make such a reimbursement does not affect the obligation of the State to pay principal and interest on the bonds from the General Fund.

OUTSTANDING STATE DEBT
FISCAL YEARS 1993-94 THROUGH 1997-98
(Dollars in Thousands Except for Per Capita Information)

	1993-94	1994-95	1995-96	1996-97	1997-98
Outstanding Debt(a)					
General Obligation Bonds					
General Fund (Non-Self Liquidating)................	$ 14,368,506	$ 14,903,326	$ 14,322,086	$ 14,250,536	$ 14,932,766
Enterprise Fund (Self Liquidating)....................	4,028,865	4,171,775	3,934,630	3,699,060	3,906,950
Total..	$ 18,397,371	$ 19,075,101	$ 18,256,716	$ 17,949,596	$ 18,839,716
Lease-Purchase Debt..	5,096,508	5,565,162	5,845,237	6,175,044	6,639,620
Total Outstanding General Obligation Bonds and Lease-Purchase Debt....................	$ 23,493,879	$ 24,640,263	$ 24,101,953	$ 24,124,640	$ 25,479,336
Bond Sales During Fiscal Year					
Non-Self Liquidating General Obligation Bonds.	$ 2,042,665	$ 1,505,600	$ 620,810	$ 1,025,000	$ 1,667,820
Self Liquidating General Obligation Bonds.........	$ 2,000	$ 386,930	$ 0	$ 0	$ 447,535
Lease-Purchase Debt..	$ 1,765,400	$ 598,817	$ 779,575	$ 1,257,630	$ 1,245,190
Debt Service(b)					
Non-Self Liquidating General Obligation Bonds.	$ 1,748,001	$ 1,901,265	$ 1,960,603	$ 1,946,333	$ 1,878,026
Lease-Purchase Debt..	$ 364,543	$ 425,940	$ 482,751	$ 532,783	$ 577,987
General Fund Receipts(b)....................................	$ 40,527,732	$ 44,547,812	$ 46,731,104	$ 49,831,217	$ 55,261,557
Non-Self Liquidating General Obligation Bonds Debt Service as a Percentage of General Fund Receipts...	4.31%	4.27%	4.20%	3.91%	3.40%
Lease-Purchase Debt Service as a Percentage of General Fund Receipts..............	0.90%	0.96%	1.03%	1.07%	1.05%
Population(c)..	31,517,000	31,790,000	32,063,000	32,383,000	32,957,000
Non-Self Liquidating General Obligation Bonds Outstanding Per Capita......................................	$ 455.90	$ 468.81	$ 446.69	$ 440.06	$ 453.10
Lease-Purchase Debt Outstanding Per Capita......	$ 161.71	$ 175.06	$ 182.30	$ 190.69	$ 201.46
Personal Income(d)...	$ 722,002,000	$ 764,435,000	$ 807,975,000	$ 867,200,000	$ 929,400,000
Non-Self Liquidating General Obligation Bonds Outstanding as Percentage of Personal Income..	1.99%	1.95%	1.77%	1.64%	1.61%
Lease-Purchase Debt Outstanding as Percentage of Personal Income...........................	0.71%	0.73%	0.72%	0.71%	0.71%

(a) As of last day of fiscal year

(b) Calculated on a cash basis; debt service costs of bonds issued in any fiscal year largely appear in subsequent fiscal year.

(c) As of July 1, the beginning of the fiscal year.

(d) Calendar year in which fiscal year ends; 1998 estimated.

SOURCES: Population and Personal Income: State of California, Department of Finance
Outstanding Debt, Bonds Sales During Fiscal Year and Debt Service: State of California, Office of the Treasurer.
General Fund Receipts: State of California, Office of the State Controller.

AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS

As of February 1, 1999

(Thousands)

	Voter Authorization		Bonds	CP Program	
	Date	Amount	Outstanding	Authorized (a)	Unissued (b)
GENERAL FUND BONDS (Non-Self Liquidating)					
California Earthquake Safety and Housing Rehabilitation Bond Act of 1988.	6/7/88	$ 150,000	$ 95,515	$ n.a.	$ 0
California Library Construction and Renovation Bond Act of 1988................	11/8/88	75,000	50,345	6,725	1,900
California Park and Recreational Facilities Act of 1984..................................	6/5/84	370,000	206,960	n.a.	1,100
California Parklands Act of 1980...	11/4/80	285,000	68,295	n.a.	0
California Safe Drinking Water Bond Law of 1976...	6/8/76	175,000	69,210	n.a.	2,500
California Safe Drinking Water Bond Law of 1984...	11/6/84	75,000	41,130	n.a.	0
California Safe Drinking Water Bond Law of 1986...	11/4/86	100,000	69,415	n.a.	8,000
California Safe Drinking Water Bond Law of 1988...	11/8/88	75,000	45,730	16,265	2,000
California Wildlife, Coastal, and Park Land Conservation Act of 1988...........	6/7/88	776,000	527,875	n.a.	39,980
Class Size Reduction Public Education Facilities Bond Act of 1998 (Hi Ed)	11/3/98	2,500,000	0	130,000	2,370,000
Class Size Reduction Public Education Facilities Bond Act of 1998 (K-12)	11/3/98	6,700,000	0	1,250,000	5,450,000
Clean Air and Transportation Improvement Bond Act of 1990........................	6/5/90	1,990,000	1,062,460	152,420	544,300
Clean Water and Water Conservation Bond Law of 1978...............................	6/6/78	375,000	87,675	n.a.	0
Clean Water and Water Reclamation Bond Law of 1988................................	11/8/88	65,000	39,865	12,505	0
Clean Water Bond Law of 1970...	11/3/70	250,000	6,000	n.a.	0
Clean Water Bond Law of 1974...	6/4/74	250,000	12,290	n.a.	0
Clean Water Bond Law of 1984...	11/6/84	325,000	125,625	n.a.	0
Community Parklands Act of 1986..	6/3/86	100,000	61,320	n.a.	0
County Correctional Facility Capital Expenditure and Youth Facility Bond Act of 1988..	11/8/88	500,000	356,460	7,880	0
County Correctional Facility Capital Expenditure Bond Act of 1986..............	6/3/86	495,000	311,490	n.a.	0
County Jail Capital Expenditure Bond Act of 1981..	11/2/82	280,000	117,675	n.a.	0
County Jail Capital Expenditure Bond Act of 1984..	6/5/84	250,000	109,500	n.a.	0
Earthquake Safety and Public Buildings Rehabilitation Bond Act of 1990.......	6/5/90	300,000	83,400	70,000	135,000
Fish and Wildlife Habitat Enhancement Act of 1984.......................................	6/5/84	85,000	43,125	n.a.	3,500
Hazardous Substance Cleanup Bond Act of 1984..	11/6/84	100,000	42,095	n.a.	0
Higher Education Facilities Bond Act of 1986...	11/4/86	400,000	219,200	n.a.	0
Higher Education Facilities Bond Act of 1988...	11/8/88	600,000	362,250	4,705	7,000
Higher Education Facilities Bond Act of June 1990..	6/5/90	450,000	290,740	14,500	7,000
Higher Education Facilities Bond Act of June 1992..	6/2/92	900,000	672,415	83,420	22,700
Housing and Homeless Bond Act of 1988...	11/8/88	300,000	116,315	n.a.	0
Housing and Homeless Bond Act of 1990...	6/5/90	150,000	82,365	n.a.	0
Lake Tahoe Acquisitions Bond Act..	8/2/82	85,000	46,715	n.a.	0

AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS
(Continued)

	Voter Authorization Date	Voter Authorization Amount	Bonds Outstanding	CP Program Authorized (a)	Unissued (b)
New Prison Construction Bond Act of 1981	6/8/82	$ 495,000	$ 153,000	n.a.	$ 0
New Prison Construction Bond Act of 1984	6/5/84	300,000	107,500	n.a.	0
New Prison Construction Bond Act of 1986	11/4/86	500,000	293,215	n.a.	1,500
New Prison Construction Bond Act of 1988	11/8/88	817,000	500,500	7,600	8,400
New Prison Construction Bond Act of 1990	6/5/90	450,000	279,060	40,100	0
Passenger Rail and Clean Air Bond Act of 1990	6/5/90	1,000,000	694,030	54,900	0
Public Education Facilities Bond Act of 1996	3/26/96	3,000,000	2,016,940	434,805	478,700
1988 School Facilities Bond Act	11/8/88	800,000	473,665	45,000	0
1990 School Facilities Bond Act	6/5/90	800,000	532,720	3,745	0
1992 School Facilities Bond Act	11/3/92	900,000	690,646	65,094	0
Safe, Clean Reliable Water Supply Act of 1996	11/5/96	995,000	117,335	169,000	707,000
Seismic Retrofit Bond Act of 1996	3/26/96	2,000,000	681,500	857,145	448,000
School Building and Earthquake Bond Act of 1974	11/5/74 (c)	40,000	37,330	n.a.	0
School Facilities Bond Act of 1988	6/7/88	800,000	475,415	n.a.	0
School Facilities Bond Act of 1990	11/6/90	800,000	511,245	55,000	0
School Facilities Bond Act of 1992	6/2/92	1,900,000	1,433,280	65,000	0
Senior Center Bond Act of 1984	11/6/84	50,000	19,750	n.a.	0
State Beach, Park, Recreational and Historical Facilities Bonds	6/4/74	250,000	2,975	n.a.	0
State School Building Lease-Purchase Bond Law of 1982	11/2/82	500,000	120,175	n.a.	0
State School Building Lease-Purchase Bond Law of 1984	11/6/84	450,000	214,600	n.a.	0
State School Building Lease-Purchase Bond Law of 1986	11/4/86	800,000	466,300	n.a.	0
State, Urban, and Coastal Park Bond Act of 1976	11/2/76	280,000	21,615	n.a.	2,450
Water Conservation and Water Quality Bond Law of 1986	6/3/86	150,000	70,410	n.a.	47,000
Water Conservation Bond Law of 1988	11/8/88	60,000	29,980	20,935	3,000
Total General Fund Bonds		$ 37,668,000	$ 15,366,641	$ 3,566,744	$ 10,291,030
ENTERPRISE FUND BONDS (Self Liquidating)					
California Water Resources Development Bond Act of 1959	11/8/60	$ 1,750,000	$ 998,930	$ n.a.	$ 167,600
State School Building Aid and Earthquake Reconstruction and Replacement Bond Law of 1974	11/5/74 (c)	110,000	2,500	n.a.	0
Veterans Bonds	(d)	5,610,000	2,816,890	n.a.	301,500
Total Enterprise Fund Bonds		$ 7,470,000	$ 3,818,320	$ 0	$ 469,100
TOTAL GENERAL OBLIGATION BONDS		$ 45,138,000	$ 19,184,961	3,566,744	$ 10,760,130

(a) Total commercial paper authorized to be issued by the respective Finance Committees. Of this total $484,250,000 is outstanding as of February 1, 1999. Pursuant to terms of the Finance Committee resolutions, no more than $2.0 billion of commercial paper can be outstanding at any one time. Bond acts marked "n.a." are not legally permitted to utilize commercial paper, or all bonds were issued before the commercial paper program began.

(b) Treats full commercial paper authorization as issued; see footnote (a).

(c) Pursuant to Prop 203, passed by the voters in the March 26, 1996 primary election, $40 million in bonds unissued at that time became general fund supported, while all previously issued bonds will remain under "State School Building Aid Bonds" as self-liquidating Enterprise Bonds.

(d) Various dates.

SOURCE: State of California, Office of the Treasurer.

SCHEDULE OF DEBT SERVICE REQUIREMENTS
FOR GENERAL FUND GENERAL OBLIGATION BONDS(a)
(Non-Self Liquidating)
As of February 1, 1999

Fiscal Year Ending June 30	Current Debt Interest	Principal (b)	Total
1999	$372,309,677.41	$277,620,000.00	$649,929,677.41 (c)
2000	876,646,540.00	1,056,760,000.00	1,933,406,540.00
2001	818,069,613.00	1,050,643,068.25	1,868,712,681.25
2002	747,008,312.57	1,094,605,000.00	1,841,613,312.57
2003	682,075,505.14	1,043,921,391.80	1,725,996,896.94
2004	616,065,673.75	969,965,000.00	1,586,030,673.75
2005	559,517,713.84	906,894,388.71	1,466,412,102.55
2006	500,631,025.00	843,845,000.00	1,344,476,025.00
2007	447,303,728.02	799,075,000.00	1,246,378,728.02
2008	400,264,927.94	782,093,078.31	1,182,358,006.25
2009	350,609,308.75	773,025,000.00	1,123,634,308.75
2010	302,026,412.50	707,615,000.00	1,009,641,412.50
2011	260,198,961.09	632,874,045.16	893,073,006.25
2012	219,464,200.05	489,310,000.00	708,774,200.05
2013	193,124,537.10	378,415,000.00	571,539,537.10
2014	175,031,079.64	302,985,000.00	478,016,079.64
2015	160,414,362.19	291,555,000.00	451,969,362.19
2016	145,606,868.49	289,270,000.00	434,876,868.49
2017	130,112,327.81	289,345,000.00	419,457,327.81
2018	115,422,652.48	288,625,000.00	404,047,652.48
2019	100,622,063.75	287,590,000.00	388,212,063.75
2020	85,985,795.00	283,890,000.00	369,875,795.00
2021	72,450,140.00	282,565,000.00	355,015,140.00
2022	58,676,742.50	266,295,000.00	324,971,742.50
2023	44,388,600.45	268,615,000.00	313,003,600.45
2024	32,039,154.34	198,875,000.00	230,914,154.34
2025	22,486,064.33	159,525,000.00	182,011,064.33
2026	14,703,021.09	121,745,000.00	136,448,021.09
2027	8,582,852.34	105,105,000.00	113,687,852.34
2028	3,827,372.34	87,605,000.00	91,432,372.34
2029	842,381.25	36,390,000.00	37,232,381.25
Total	$8,516,507,614.16	$15,366,640,972.23	$23,883,148,586.39

(a) Does not include commercial paper outstanding.
(b) Includes scheduled mandatory sinking fund payments as well as serial maturities.
(c) Total represents the remaining debt service requirements from March 1, 1999 through June 30, 1999.

SOURCE: State of California, Office of the Treasurer.

SCHEDULE OF DEBT SERVICE REQUIREMENTS
FOR ENTERPRISE FUND GENERAL OBLIGATION BONDS(a)
(Self Liquidating)
As of February 1, 1999

Fiscal Year Ending June 30	Current Debt		
	Interest	Principal (b)	Total
1999	$83,234,815.57	$37,000,000.00	$120,234,815.57 (c)
2000	223,884,586.15	159,820,000.00	383,704,586.15
2001	212,353,541.25	157,710,000.00	370,063,541.25
2002	200,796,906.25	161,175,000.00	361,971,906.25
2003	189,113,586.35	161,255,000.00	350,368,586.35
2004	177,080,918.75	183,620,000.00	360,700,918.75
2005	164,284,632.25	191,165,000.00	355,449,632.25
2006	151,684,777.25	167,840,000.00	319,524,777.25
2007	140,180,568.51	167,685,000.00	307,865,568.51
2008	128,267,016.05	172,800,000.00	301,067,016.05
2009	116,670,105.00	171,575,000.00	288,245,105.00
2010	105,554,252.80	167,395,000.00	272,949,252.80
2011	95,840,610.75	122,765,000.00	218,605,610.75
2012	88,509,469.75	161,010,000.00	249,519,469.75
2013	80,493,614.75	161,135,000.00	241,628,614.75
2014	73,461,127.50	126,755,000.00	200,216,127.50
2015	67,393,380.10	125,375,000.00	192,768,380.10
2016	60,956,471.35	130,580,000.00	191,536,471.35
2017	54,595,970.10	122,050,000.00	176,645,970.10
2018	48,720,892.60	101,425,000.00	150,145,892.60
2019	41,974,319.24	166,840,000.00	208,814,319.24
2020	36,180,356.94	62,250,000.00	98,430,356.94
2021	32,640,781.29	56,155,000.00	88,795,781.29
2022	29,375,941.14	52,420,000.00	81,795,941.14
2023	26,247,018.75	39,195,000.00	65,442,018.75
2024	23,935,570.00	41,585,000.00	65,520,570.00
2025	21,483,762.50	44,085,000.00	65,568,762.50
2026	18,876,815.00	64,465,000.00	83,341,815.00
2027	15,562,301.25	47,860,000.00	63,422,301.25
2028	12,786,015.00	8,355,000.00	21,141,015.00
2029	12,158,648.75	14,200,000.00	26,358,648.75
2030	11,506,147.50	9,250,000.00	20,756,147.50
2031	10,972,887.50	9,795,000.00	20,767,887.50
2032	10,408,407.50	10,365,000.00	20,773,407.50
2033	5,058,863.36	241,365,000.00	246,423,863.36
Total	$2,772,245,078.80	$3,818,320,000.00	$6,590,565,078.80

(a) Does not include commercial paper outstanding. Includes $300 million of convertible option bonds which are subject to mandatory tender on 6/1/99.
(b) Includes scheduled mandatory sinking fund payments as well as serial maturities.
(c) Total represents the remaining debt service requirements from March 1, 1999 through June 30, 1999.

SOURCE: State of California, Office of the Treasurer.

SCHEDULE OF DEBT SERVICE REQUIREMENTS
FOR LEASE-PURCHASE DEBT
As of February 1, 1999

Fiscal Year Ending June 30	Current Debt			
	Interest	**Principal (a)**	**Total**	
1999	$161,641,683.76	$64,410,000.00	$226,051,683.76	(b)
2000	349,943,485.97	286,044,962.79	635,988,448.76	
2001	336,237,401.06	313,734,019.75	649,971,420.81	
2002	321,534,180.46	291,030,773.02	612,564,953.48	
2003	309,953,916.03	294,071,118.58	604,025,034.61	
2004	294,541,663.99	301,706,386.24	596,248,050.23	
2005	280,446,917.80	315,184,507.20	595,631,425.00	
2006	261,774,911.74	333,727,554.60	595,502,466.34	
2007	249,539,796.34	285,663,920.44	535,203,716.78	
2008	231,863,309.54	292,381,787.98	524,245,097.52	
2009	220,572,009.43	312,912,732.44	533,484,741.87	
2010	198,617,269.02	299,871,633.76	498,488,902.78	
2011	171,578,418.68	310,935,000.00	482,513,418.68	
2012	154,962,444.81	292,460,000.00	447,422,444.81	
2013	139,206,191.08	298,705,000.00	437,911,191.08	
2014	123,247,454.70	299,160,000.00	422,407,454.70	
2015	106,948,838.08	314,885,000.00	421,833,838.08	
2016	90,055,034.37	293,395,000.00	383,450,034.37	
2017	73,971,103.44	295,340,000.00	369,311,103.44	
2018	58,354,041.06	306,655,000.00	365,009,041.06	
2019	42,608,310.54	261,900,000.00	304,508,310.54	
2020	28,976,661.23	228,175,000.00	257,151,661.23	
2021	18,292,074.27	167,645,000.00	185,937,074.27	
2022	9,449,946.23	141,345,000.00	150,794,946.23	
2023	3,794,375.65	83,125,000.00	86,919,375.65	
2024	271,065.63	2,515,000.00	2,786,065.63	
2025	93,267.50	2,730,000.00	2,823,267.50	
Total	$4,238,475,772.41	$6,689,709,396.80	$10,928,185,169.21	

(a) Includes scheduled mandatory sinking fund payments as well as serial maturities.
(b) Total represents the remaining debt service requirements from March 1, 1999 through June 30, 1999.

SOURCE: State of California, Office of the Treasurer.

STATE PUBLIC WORKS BOARD AND OTHER LEASE-PURCHASE FINANCING OUTSTANDING ISSUES

As of February 1, 1999

Name of Issue		Outstanding
GENERAL FUND SUPPORTED ISSUES:		
State Public Works Board		
California Community Colleges	$	639,990,000
Department of Corrections *		2,726,712,932
Energy Efficiency Program (Various State Agencies) (a)		149,615,000
The Regents of The University of California * (b)		1,133,061,465
Trustees of The California State University		746,775,000
Various State Office Buildings		329,540,000
Total State Public Works Board Issues	**$**	**5,725,694,397**
Total Other State Building Lease Purchase Issues (c)	**$**	**964,015,000**
Total General Fund Supported Issues	**$**	**6,689,709,397**
SPECIAL FUND SUPPORTED ISSUES:		
East Bay State Building Authority Certificates of Participation (State of California Department of Transportation) *	$	88,960,101
San Bernardino Joint Powers Financing Authority (State of California Department of Transportation)		62,220,000
San Francisco State Building Authority (State of California Department of General Services Lease) (d)		51,950,000
Total Special Fund Supported Issues	**$**	**203,130,101**
TOTAL	**$**	**6,892,839,498**

* Includes the initial value of capital appreciation bonds rather than the accreted value.

(a) This program is self-liquidating based on energy cost savings.

(b) The Regents' obligations to the State Public Works Board are payable from lawfully available funds of The Regents which are held in The Regents' treasury funds and are separate from the State General Fund. A portion of The Regents' annual budget is derived from General Fund appropriations.

(c) Includes $196,615,000 Sacramento City Financing Authority Lease Revenue Bonds State of California - Cal EPA Building, 1998 Series A, which are supported by lease rentals from the California Environmental Protection Agency; these rental payments are subject to annual appropriation by the State Legislature.

(d) The sole tenant is the California Public Utilities Commission.

SOURCE: State of California, Office of the Treasurer.

STATE AGENCY REVENUE BONDS AND CONDUIT FINANCING
As of December 31, 1998

Issuing Agency	Outstanding[a]
State Programs Financing:	
California State University	$ 438,058,000
California Transportation Commission	--
Department of Water Resources	2,393,345,000
The Regents of the University of California	2,739,545,000
Trade and Commerce Agency	--
Housing Financing:	
California Housing Finance Agency	5,809,630,928
Veterans Revenue Debenture	269,135,000
Conduit Financing:	
California Alternative Energy and Advanced Transportation Financing Authority	59,585,000
California Economic Development Financing Authority	523,433,775
California Educational Facilities Authority	1,909,777,093
California Health Facilities Financing Authority	6,195,753,842
California Infrastructure and Economic Development Bank[b]	--
California Passenger Rail Financing Commission	--
California Pollution Control Financing Authority	5,052,505,000
California School Finance Authority	14,580,000
California Student Loan Authority	55,260,000
California Urban Waterfront Area Restoration Financing Authority	3,005,000
TOTAL	$ 25,463,613,639

[a] Total Outstanding does not include defeased bonds and includes the accreted values for capital appreciation bonds.

[b] Does not include $6.0 billion of "rate reduction bonds" issued by special purpose trusts for the benefit of three investor-owned electric utility companies representing interests in certain electric rate surcharges.

SOURCE: State of California, Office of the Treasurer.

Appendix A- Exhibit 1

AUDITED GENERAL PURPOSE FINANCIAL STATEMENTS OF THE STATE OF CALIFORNIA AS OF AND FOR THE YEAR ENDED JUNE 30, 1998

Prepared under the direction of
KATHLEEN CONNELL, State Controller

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CALIFORNIA STATE AUDITOR

KURT R. SJOBERG
STATE AUDITOR

MARIANNE P. EVASHENK
CHIEF DEPUTY STATE AUDITOR

Independent Auditors' Report

THE GOVERNOR AND THE LEGISLATURE OF THE
STATE OF CALIFORNIA

We have audited the general purpose financial statements of the State of California as of and for the year ended June 30, 1998, as listed in the table of contents. These general purpose financial statements are the responsibility of the State's management. Our responsibility is to express an opinion on these general purpose financial statements based on our audit. We did not audit the financial statements of the pension trust funds, which reflect total assets constituting 87 percent of the fiduciary funds. We also did not audit the financial statements of certain enterprise funds, which reflect total assets and revenues, constituting 89 percent and 90 percent, respectively, of the enterprise funds. In addition, we did not audit the University of California funds. Finally, we did not audit the financial statements of certain component unit authorities, which reflect total assets and revenues, constituting 97 percent and 93 percent, respectively, of the component unit authorities. The financial statements of the pension trust funds, certain enterprise funds, the University of California funds, and certain component unit authorities referred to above were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for these funds and entities is based solely upon the reports of the other auditors.

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards 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 general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general purpose financial statement presentation. We believe that our audit and the reports of the other auditors provide a reasonable basis for our opinion.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues,* requires disclosure of certain matters regarding the year 2000 issue. The State has included such disclosures in Note 27. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the State's disclosures with respect to the year 2000 issue made in Note 27. Further, we do not provide assurance that the State is or will be year 2000 ready, that the State's year 2000 remediation efforts will be successful in whole or in part, or that parties with which the State does business will be year 2000 ready.

In our opinion, based upon our audit and the reports of other auditors, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, the general purpose financial statements as listed in the table of contents present fairly, in all material respects, the financial position of the State of California as of June 30, 1998, and the results of its operations and the cash flows of its proprietary funds and component unit authorities for the year then ended, in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the general purpose financial statements taken as a whole. The required supplementary information and the combining financial statements and schedules listed in the accompanying table of contents are presented for purposes of additional analysis and are not a required part of the general purpose financial statements of the State of California. Such information has been subjected to the auditing procedures applied in the audit of the general purpose financial statements and, in our opinion, based upon our audit and the reports of other auditors, is fairly presented in all material respects in relation to the general purpose financial statements taken as a whole.

We did not audit the data included in the introductory and statistical sections of this report, and accordingly, we express no opinion on them. In accordance with *Government Auditing Standards*, reports on the State's internal control structure and on its compliance with laws and regulations will be issued in our single audit report.

BUREAU OF STATE AUDITS

Philip Jelicich

PHILIP J. JELICICH, CPA
Deputy State Auditor

November 20, 1998

STATE OF CALIFORNIA

GENERAL PURPOSE FINANCIAL STATEMENTS

For the Year Ended
June 30, 1998

Prepared by the Office of the State Controller

KATHLEEN CONNELL
State Controller

Combined Balance Sheet
All Fund Types, Account Groups, and Discretely Presented Component Units

June 30, 1998
(Amounts in thousands)

	Governmental Fund Types			Proprietary Fund Types	
	General	Special Revenue	Capital Projects	Enterprise	Internal Service
ASSETS AND OTHER DEBITS					
Cash and pooled investments (Note 3)	$ 1,176,939	$ 5,538,465	$ 232,125	$ 2,984,951	$ 301,564
Investments (Note 3)	—	—	2,839	4,753,309	184,297
Amount on deposit with U.S. Treasury	—	—	—	—	—
Receivables (net)	256,134	309,369	47	122,540	3,732
Due from other funds (Note 4)	5,161,485	2,606,438	61,367	256,799	449,682
Due from primary government	—	—	—	—	—
Due from other governments	308,064	4,952,278	114	62,506	5,748
Prepaid items	—	—	—	22,535	17,298
Food stamps (Note 1D)	—	591,952	—	—	—
Inventories, at cost	—	—	—	13,156	69,277
Net investment in direct financing leases (Note 6)	—	—	—	4,941,288	—
Advances and loans receivable	545,840	1,407,801	—	2,545,195	—
Deferred charges	—	—	—	1,129,982	—
Fixed assets (Note 7)	—	—	—	4,894,090	460,765
Investment in UCSF Stanford Health Care	—	—	—	—	—
Other assets	1,179	22,445	2	44,644	9,090
Amount to be provided for retirement of long-term obligations	—	—	—	—	—
Total Assets and Other Debits	**$ 7,449,641**	**$ 15,428,748**	**$ 296,494**	**$ 21,770,995**	**$ 1,501,453**

The notes to the financial statements are an integral part of this statement.

Fiduciary Fund Type	Account Groups		Total Primary	Component Units		Total Reporting
Trust and Agency	General Fixed Assets	General Long-Term Obligations	Government (Memorandum Only)	University of California	Special Purpose Authorities	Entity (Memorandum Only)
$ 18,538,010	$ —	$ —	$ 28,772,054	$ 82,075	$ 649,620	$ 29,503,749
263,128,261	—	—	268,068,706	54,678,587	7,630,478	330,377,771
4,485,855	—	—	4,485,855	—	—	4,485,855
10,125,541	—	—	10,817,363	1,655,950	320,583	12,793,896
5,343,688	—	—	13,879,459	152,648	—	14,032,107
—	—	—	—	135,356	2,564	137,920
1,047,233	—	—	6,375,943	158,840	264	6,535,047
8,359	—	—	48,192	—	—	48,192
—	—	—	591,952	—	—	591,952
—	—	—	82,433	88,267	—	170,700
—	—	—	4,941,288	—	—	4,941,288
1,510,824	—	—	6,009,660	—	4,768,258	10,777,918
—	—	—	1,129,982	52,243	59,998	1,242,223
—	16,771,485	—	22,126,340	14,570,910	581,650	37,278,900
—	—	—	—	417,349	—	417,349
96,707	—	—	174,067	2,099	884,761	1,060,927
—	—	23,030,548	23,030,548	—	—	23,030,548
$ 304,284,478	$ 16,771,485	$ 23,030,548	$ 390,533,842	$ 71,994,324	$ 14,898,176	$ 477,426,342

(Continued)

The notes to the financial statements are an integral part of this statement.

Combined Balance Sheet
All Fund Types, Account Groups, and Discretely Presented Component Units

June 30, 1998
(Amounts in thousands)

	Governmental Fund Types			Proprietary Fund Types	
	General	Special Revenue	Capital Projects	Enterprise	Internal Service
LIABILITIES					
Accounts payable	$ 1,292,643	$ 1,281,269	$ 26,485	$ 144,379	$ 140,951
Due to other funds (Note 4)	1,841,764	4,448,733	48,729	379,220	221,843
Due to component units (Note 4)	36,487	98,869	—	—	—
Due to other governments	2,856,839	1,622,202	3,064	150,391	69,488
Dividends payable	—	—	—	—	—
Deferred revenue (Note 1D)	—	591,952	—	—	—
Advances from other funds	590,995	53,564	—	25,656	92,951
Tax overpayments	—	7,642	—	—	—
Benefits payable	—	—	—	267,767	41,085
Deposits	4	12,805	—	9,526	1,257
Contracts and notes payable	—	—	—	1,000	39,637
Lottery prizes and annuities	—	—	—	2,914,419	—
Compensated absences payable (Note 9)	119,742	—	—	24,568	36,040
Certificates of participation, commercial paper, and other borrowings (Notes 10, 11)	—	—	—	29,277	—
Capital lease obligations (Note 12)	—	—	—	—	23,527
Advance collections	20,570	284,260	2,691	303,647	171,738
General obligation bonds payable (Note 14)	—	—	—	4,016,865	—
Revenue bonds payable (Note 15)	—	—	—	8,789,010	—
Interest payable	—	—	27,048	153,221	—
Securities lending obligation	—	—	—	—	—
Other liabilities	143,216	183,022	—	588,096	33,310
Total Liabilities	6,902,260	8,584,318	108,017	17,797,042	871,827
FUND EQUITY AND OTHER CREDITS					
Contributed capital (Notes 1K, 17B)	—	—	—	195,233	344,184
Investment in general fixed assets (Notes 1K, 7)	—	—	—	—	—
Retained earnings					
Reserved for regulatory requirements (Note 1K)	—	—	—	250,560	—
Unreserved (Note 1K)	—	—	—	3,528,160	285,442
Total Retained Earnings	—	—	—	3,778,720	285,442
Fund balances					
Reserved for					
Encumbrances (Note 1K)	478,684	2,475,179	299,525	—	—
Local agencies (Notes 1K, 3)	—	—	—	—	—
Advances and loans (Note 1K)	545,840	1,407,801	—	—	—
Employees' pension benefits (Note 1K)	—	—	—	—	—
Continuing appropriations (Note 1K)	122,836	2,209,751	40,779	—	—
Other specific purposes (Note 1K)	—	—	—	—	—
Total Reserved	1,147,360	6,092,731	340,304	—	—
Unreserved					
Undesignated (Deficit) (Note 1K)	(599,979)	751,699	(151,827)	—	—
Total Fund Equity and Other Credits (Note 1K)	547,381	6,844,430	188,477	3,973,953	629,626
Total Liabilities, Fund Equity, and Other Credits	$ 7,449,641	$15,428,748	$ 296,494	$21,770,995	$ 1,501,453

The notes to the financial statements are an integral part of this statement.

Fiduciary Fund Type	Account Groups		Total Primary	Component Units		Total Reporting
Trust and Agency	General Fixed Assets	General Long-Term Obligations	Government (Memorandum Only)	University of California	Special Purpose Authorities	Entity (Memorandum Only)
$ 5,287,984	$ —	$ —	$ 8,173,711	$ 1,419,674	$ 25,390	$ 9,618,775
6,939,170	—	—	13,879,459	152,648	—	14,032,107
2,564	—	—	137,920	—	—	137,920
3,321,484	—	—	8,023,468	—	10,301	8,033,769
—	—	—	—	—	205,102	205,102
—	—	—	591,952	—	—	591,952
423,729	—	—	1,186,895	—	—	1,186,895
1,682,760	—	—	1,690,402	—	—	1,690,402
867,203	—	—	1,176,055	—	4,684,083	5,860,138
4,636,691	—	—	4,660,283	924,278	97,077	5,681,638
34,890	—	—	75,527	—	3,928	79,455
—	—	—	2,914,419	—	—	2,914,419
—	—	1,003,960	1,184,310	303,015	27,175	1,514,500
—	—	1,141,511	1,170,788	1,081,618	—	2,252,406
—	—	3,546,867	3,570,394	1,284,984	—	4,855,378
70,508	—	—	853,414	—	185,957	1,039,371
—	—	14,894,090	18,910,955	—	—	18,910,955
—	—	759,440	9,548,450	2,184,171	5,679,927	17,412,548
—	—	—	180,269	—	138,381	318,650
28,118,114	—	—	28,118,114	6,434,432	—	34,552,546
2,074,918	—	1,684,680	4,707,242	—	909,784	5,617,026
53,460,015	—	23,030,548	110,754,027	13,784,820	11,967,105	136,505,952
—	—	—	539,417	—	99	539,516
—	16,771,485	—	16,771,485	10,720,683	—	27,492,168
—	—	—	250,560	—	548,700	799,260
—	—	—	3,813,602	—	2,382,272	6,195,874
—	—	—	4,064,162	—	2,930,972	6,995,134
—	—	—	3,253,388	—	—	3,253,388
11,732,527	—	—	11,732,527	—	—	11,732,527
588,003	—	—	2,541,644	—	—	2,541,644
232,074,642	—	—	232,074,642	39,977,633	—	272,052,275
—	—	—	2,373,366	—	—	2,373,366
6,429,291	—	—	6,429,291	4,451,726	—	10,881,017
250,824,463	—	—	258,404,858	44,429,359	—	302,834,217
—	—	—	(107)	3,059,462	—	3,059,355
250,824,463	16,771,485	—	279,779,815	58,209,504	2,931,071	340,920,390
$ 304,284,478	$ 16,771,485	$ 23,030,548	$ 390,533,842	$ 71,994,324	$ 14,898,176	$ 477,426,342

(Concluded)

The notes to the financial statements are an integral part of this statement.

Combined Statement of Revenues, Expenditures, and Changes in Fund Balances

All Governmental Fund Types and Expendable Trust Funds

Year Ended June 30, 1998
(Amounts in thousands)

	Governmental Fund Types			Fiduciary Fund Type	Total Primary Government (Memorandum Only)
	General	Special Revenue	Capital Projects	Expendable Trust	
REVENUES					
Taxes	$ 53,575,173	$ 4,444,397	$ —	$ 4,361,940	$ 62,381,510
Intergovernmental	5,993	26,497,691	—	472,959	26,976,643
Licenses and permits	108,542	3,079,853	—	—	3,188,395
Natural resources	9,793	29,911	—	—	39,704
Charges for services	129,189	477,964	—	4,470	611,623
Fees and penalties	274,765	1,697,858	—	525,044	2,497,667
Interest	298,741	288,390	13,481	382,507	983,119
Escheat	—	—	—	139,397	139,397
Receipts from depositors	—	—	—	147,281	147,281
Other	97,411	268,069	4,715	445,138	815,333
Total Revenues	54,499,607	36,784,133	18,196	6,478,736	97,780,672
EXPENDITURES					
Current					
General government	1,524,130	2,501,969	12	62,488	4,088,599
Education	25,429,938	4,071,318	3	1,505,691	31,006,950
Health and welfare	14,344,376	22,989,501	—	4,437,364	41,771,241
Resources	558,659	1,410,931	6,071	30,790	2,006,451
State and consumer services	388,088	356,666	2,457	562	747,773
Business and transportation	63,433	5,889,876	23	11,206	5,964,538
Correctional programs	3,819,686	272,516	—	—	4,092,202
Property tax relief	617,030	290	—	—	617,320
Payments to depositors	—	—	—	120,541	120,541
Capital outlay	630,482	255,543	474,763	—	1,360,788
Debt service					
Principal retirement	978,134	4,951	19,026	—	1,002,111
Interest and fiscal charges	995,600	76,908	28,857	—	1,101,365
Total Expenditures	49,349,556	37,830,469	531,212	6,168,642	93,879,879
Excess (Deficiency) of Revenues Over (Under) Expenditures	5,150,051	(1,046,336)	(513,016)	310,094	3,900,793
OTHER FINANCING SOURCES (USES)					
Proceeds from general obligation bonds, commercial paper, and capital leases	630,482	3,252,840	242,667	—	4,125,989
Proceeds from refunding long-term debt	—	784,670	246,058	—	1,030,728
Proceeds from revenue bonds	—	—	197,418	—	197,418
Operating transfers in	222,113	2,546,969	79,139	259,389	3,107,610
Operating transfers out	(646,018)	(2,152,646)	(3,360)	(211,846)	(3,013,870)
Transfers out - component unit	(2,332,356)	(52,053)	(12,219)	—	(2,396,628)
Payment to refunding escrow agent	—	(784,670)	(246,058)	—	(1,030,728)
Payment to refund commercial paper	—	(1,577,100)	—	—	(1,577,100)
Total Other Financing Sources (Uses)	(2,125,779)	2,018,010	503,645	47,543	443,419
Excess of Revenues and Other Financing Sources Over (Under) Expenditures and Other Financing Uses	3,024,272	971,674	(9,371)	357,637	4,344,212
Fund Balances (Deficit), July 1, 1997	(2,476,891)	5,872,756	197,848	6,659,657 *	10,253,370
Fund Balances, June 30, 1998	$ 547,381	$ 6,844,430	$ 188,477	$ 7,017,294	$ 14,597,582

*Restated (see Note 1L)

The notes to the financial statements are an integral part of this statement.

Combined Statement of Revenues, Expenses, and Changes in Retained Earnings

All Proprietary Fund Types and Discretely Presented Component Units – Special Purpose Authorities

Year Ended June 30, 1998
(Amounts in thousands)

	Proprietary Fund Types		Total Primary Government (Memorandum Only)	Component Units	Total Reporting Entity (Memorandum Only)
	Enterprise	Internal Service		Special Purpose Authorities	
OPERATING REVENUES					
Lottery ticket sales	$ 2,294,424	$ —	$ 2,294,424	$ —	$ 2,294,424
Service and sales	1,227,415	2,187,446	3,414,861	155,108	3,569,969
Earned premiums (net)	336	—	336	1,052,835	1,053,171
Investment and interest	294,507	—	294,507	346,295	640,802
Contributions	—	—	—	2,636	2,636
Rent	364,332	—	364,332	20,164	384,496
Other	9,682	7,544	17,226	59,465	76,691
Total Operating Revenues	4,190,696	2,194,990	6,385,686	1,636,503	8,022,189
OPERATING EXPENSES					
Lottery prizes	1,182,038	—	1,182,038	—	1,182,038
Personal services	288,942	306,855	595,797	60,293	656,090
Supplies	74,274	29,107	103,381	—	103,381
Services and charges	921,538	1,775,067	2,696,605	213,132	2,909,737
Depreciation	99,191	70,146	169,337	12,012	181,349
Benefit payments	536	—	536	1,263,074	1,263,610
Interest expense	542,005	3,947	545,952	346,029	891,981
Amortization of deferred charges	21,239	—	21,239	147,160	168,399
Total Operating Expenses	3,129,763	2,185,122	5,314,885	2,041,700	7,356,585
Operating Income (Loss)	1,060,933	9,868	1,070,801	(405,197)	665,604
NONOPERATING REVENUES (EXPENSES)					
Grants received	329	—	329	71,253	71,582
Grants provided	(26,890)	—	(26,890)	(71,253)	(98,143)
Interest revenue	155,458	16,271	171,729	731,082	902,811
Interest expense and fiscal charges	(203,266)	(33)	(203,299)	(3,269)	(206,568)
Dividends paid	—	—	—	(73,012)	(73,012)
Lottery payments for education	(803,525)	—	(803,525)	—	(803,525)
Other	(3,161)	1,405	(1,756)	4,210	2,454
Total Nonoperating Revenues (Expenses)	(881,055)	17,643	(863,412)	659,011	(204,401)
Income Before Operating Transfers	179,878	27,511	207,389	253,814	461,203
OPERATING TRANSFERS					
Operating transfers in	24,974	13,461	38,435	—	38,435
Operating transfers out	(132,002)	(173)	(132,175)	—	(132,175)
Total Operating Transfers	(107,028)	13,288	(93,740)	—	(93,740)
Net Income	72,850	40,799	113,649	253,814	367,463
Retained Earnings, July 1, 1997	3,705,870 *	244,643 *	3,950,513	2,677,158 *	6,627,671
Retained Earnings, June 30, 1998	$ 3,778,720	$ 285,442	$ 4,064,162	$ 2,930,972	$ 6,995,134

*Restated (see Note 1L)

The notes to the financial statements are an integral part of this statement.

Combined Statement of Revenues, Expenditures, and Changes in Fund Balances Non-GAAP Budgetary Basis - Budget and Actual

All Governmental Cost Funds

Year Ended June 30, 1998
(Amounts in thousands)

	General Fund		
	Budget	Actual	Variance Favorable (Unfavorable)
REVENUES			
Major taxes and licenses			
Bank and corporation taxes	—	$ 5,836,627	—
Cigarette and tobacco tax	—	161,503	—
Inheritance, estate and gift taxes	—	780,197	—
Insurance gross premiums tax	—	1,221,285	—
Vehicle license fees	—	34,978	—
Motor vehicle fuel tax	—	—	—
Personal income tax	—	27,925,096	—
Retail sales and use taxes	—	17,582,517	—
Other major taxes and licenses	—	316,635	—
Total Major Taxes and Licenses	—	53,858,838	—
Minor revenues	—	938,884	—
Total Revenues	—	54,797,722	—
EXPENDITURES			
Legislative, judicial, executive	$ 1,522,990	1,508,438	$ 14,552
State and consumer services	397,490	392,690	4,800
Business, transportation and housing	26,866	26,492	374
Trade and commerce	48,603	48,437	166
Resources	522,410	514,161	8,249
Environmental protection	89,727	68,133	21,594
Health and welfare	15,130,856	14,665,907	464,949
Correctional programs	3,925,730	3,891,431	34,299
Education	27,895,601	27,862,055	33,546
General government			
Tax relief and shared revenues	626,972	619,309	7,663
Debt service	1,990,440	1,978,878	11,562
Other general government	1,533,114	1,513,762	19,352
Total Expenditures	$ 53,710,799	53,089,693	$ 621,106
OTHER FINANCING SOURCES (USES)			
Transfers from other funds	—	132,009	—
Transfers to other funds	—	(174,501)	—
Other additions and deductions	—	154,355	—
Total Other Financing Sources (Uses)	—	111,863	—
Excess of Revenues and Other Sources Over Expenditures and Other Uses	—	1,819,892	—
FUND BALANCES			
Fund Balances, July 1, 1997, Restated (Note 2C)	—	972,592	—
Fund Balances, June 30, 1998	—	$ 2,792,484	—

The notes to the financial statements are an integral part of this statement.

Other Governmental Cost Funds			Total		
Budget	Actual	Variance Favorable (Unfavorable)	Budget	Actual	Variance Favorable (Unfavorable)
—	$ 254	—	—	$ 5,836,881	—
—	482,794	—	—	644,297	—
—	—	—	—	780,197	—
—	—	—	—	1,221,285	—
—	3,880,841	—	—	3,915,819	—
—	2,853,846	—	—	2,853,846	—
—	2,844	—	—	27,927,940	—
—	3,749,174	—	—	21,331,691	—
—	1,780,997	—	—	2,097,632	—
—	12,750,750	—	—	66,609,588	—
—	3,493,803	—	—	4,432,687	—
—	16,244,553	—	—	71,042,275	—
$ 405,841	387,790	$ 18,051	$ 1,928,831	1,896,228	$ 32,603
415,465	378,754	36,711	812,955	771,444	41,511
4,164,375	4,034,494	129,881	4,191,241	4,060,986	130,255
18,395	13,798	4,597	66,998	62,235	4,763
881,645	809,699	71,946	1,404,055	1,323,860	80,195
547,164	537,451	9,713	636,891	605,584	31,307
3,407,308	3,393,704	13,604	18,538,164	18,059,611	478,553
10,163	9,865	298	3,935,893	3,901,296	34,597
758,424	734,943	23,481	28,654,025	28,596,998	57,027
3,725,757	3,725,757	—	4,352,729	4,345,066	7,663
501	333	168	1,990,941	1,979,211	11,730
304,438	287,389	17,049	1,837,552	1,801,151	36,401
$ 14,639,476	14,313,977	$ 325,499	$ 68,350,275	67,403,670	$ 946,605
—	12,344,854	—	—	12,476,863	—
—	(14,012,727)	—	—	(14,187,228)	—
—	196,521	—	—	350,876	—
—	(1,471,352)	—	—	(1,359,489)	—
—	459,224	—	—	2,279,116	—
—	4,131,191	—	—	5,103,783	—
—	$ 4,590,415	—	—	$ 7,382,899	—

The notes to the financial statements are an integral part of this statement.

Combined Statement of Cash Flows

All Proprietary Fund Types and Discretely Presented Component Units – Special Purpose Authorities

Year Ended June 30, 1998
(Amounts in thousands)

	Proprietary Fund Types		Component Units
	Enterprise	Internal Service (1)	Special Purpose Authorities
CASH FLOWS FROM OPERATING ACTIVITIES			
Operating income (loss)	$ 1,060,933	$ 9,868	$ (405,197)
ADJUSTMENTS TO RECONCILE OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY OPERATIONS			
Interest expense on operating debt	(4,599)	3,947	343,967
Depreciation	99,191	70,146	12,012
Accretion of capital appreciation bonds	11,173	—	9,956
Provisions and allowances	12,407	—	14,863
Accrual of deferred charges	(3,117)	—	(143,053)
Amortization of deferred credits	(254)	—	(4,600)
Amortization of discounts	(18,130)	—	6,136
Amortization of deferred charges	19,342	—	145,980
Purchase of program loans	—	—	(774,636)
Collection of principal from program loans	355	—	364,385
Other	(6,560)	2,274	(12,643)
Change in assets and liabilities			
Receivables	(37,597)	(1,763)	(21,617)
Due from other funds	4,466	(176,745)	446
Due from primary government	—	—	1,061
Due from other governments	(3,675)	(2,032)	—
Prepaid items	16	(1,248)	(35)
Inventories	7,457	(4,838)	—
Net investment in direct financing leases	180,904	—	—
Advances and loans receivable	221,090	—	—
Other assets	8,010	(3,421)	(118,862)
Accounts payable	(38,726)	(69,342)	1,926
Interest payable	(28,768)	(27)	—
Due to other funds	(24,136)	109,602	—
Due to component units	(1,556)	—	—
Due to other governments	28,737	68,915	3
Benefits payable	101,725	41,085	77,940
Deposits	3,195	(143)	8,656
Lottery prizes and annuities	(17,497)	—	—
Contract and notes payable	53	1,435	—
Compensated absences payable	(1,239)	(615)	1,416
Advance collections	(23,171)	49,061	(20,903)
Other liabilities	(7,220)	9,978	99,442
Total Adjustments	**481,876**	**96,269**	**(8,160)**
Net Cash Provided by (Used In) Operating Activities	**1,542,809**	**106,137**	**(413,357)**

(Continued)

(1) Internal service funds made *non-cash transactions* for installment purchases totaling approximately $17 million to acquire equipment and equipment totaling approximately $232 million moved from the General Fixed Assets Account Group. Noncash transactions are those portions of investing, financing, or capital activities that affected assets and liabilities but did not result in cash receipts or payments during the period.

	Proprietary Fund Types		Component Units
	Enterprise	Internal Service (1)	Special Purpose Authorities
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES			
Dividends paid	—	—	(83,991)
Return of advances from other funds	(72,806)	(360)	—
Proceeds from general obligation bonds	447,535	—	—
Proceeds from revenue bonds	—	—	1,148,159
Retirement of general obligation bonds	(138,670)	—	—
Retirement of revenue bonds	(52,525)	—	(670,442)
Interest paid on operating debt	—	—	(337,224)
Operating transfers in	20,969	13,461	—
Operating transfers out	(134,771)	(173)	—
Grants provided	(26,890)	—	(71,253)
Lottery payments for education	(762,917)	—	—
Net Cash Provided by (Used In) Noncapital Financing Activities	**(720,075)**	**12,928**	**(14,751)**
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES			
Unamortized water project costs	(8,809)	—	—
Acquisition of intangible assets	—	(3,453)	—
Acquisition of fixed assets	(431,526)	(60,492)	(20,020)
Proceeds from sale of fixed assets	596	13,400	2,175
Advances from other funds	296,280	—	—
Return of advances from other funds	(321,020)	(1,280)	—
Proceeds from notes payable and commercial paper	44,552	—	—
Principal paid on notes payable and commercial paper	(75,085)	(10,958)	—
Payment of capital lease obligations	—	(6,735)	—
Retirement of general obligation bonds	(37,595)	—	—
Proceeds from revenue bonds	1,392,228	—	25,000
Retirement of revenue bonds	(1,084,626)	—	(2,261)
Interest paid	(201,024)	(3,980)	(3,432)
Contributed capital	—	423	—
Grants received	327	—	71,253
Operating transfers in	7,268	—	8,086
Payment to refunding bond escrow agent	(31,324)	—	—
Net Cash Provided by (Used In) Capital and Related Financing Activities	**(449,758)**	**(73,075)**	**80,801**
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of investments	(738,463)	(179,935)	(670,063)
Advances and loans provided	(8,405)	—	—
Collection of advances and loans	10,957	—	—
Proceeds from maturity and sale of investments	396,249	—	180,738
Interest on investments	119,928	16,303	720,243
Net Cash Provided by Investing Activities	**(219,734)**	**(163,632)**	**230,918**
Net Increase (Decrease) in Cash and Pooled Investments	**153,242**	**(117,642)**	**(116,389)**
Cash and Pooled Investments at July 1, 1997	**2,831,709**	**419,206**	**766,009**
Cash and Pooled Investments at June 30, 1998	**$ 2,984,951**	**$ 301,564**	**$ 649,620**

(Concluded)

The notes to the financial statements are an integral part of this statement.

Combined Statement of Changes in Plan Net Assets

Pension Trust Funds and Discretely Presented Component Unit – University of California

Year Ended June 30, 1998
(Amounts in thousands)

	Primary Government — Pension Trust Funds	Component Unit — University of California Retirement System Funds
ADDITIONS		
Contributions		
Employer	$ 4,728,616	$ 328
Plan member	2,765,336	386,293
Total Contributions	7,493,952	386,621
Investment income		
Net appreciation in fair value of investments	28,858,222	5,618,711
Interest, dividends, and other investment income	9,492,675	1,514,107
Less: Investment expense	(1,857,285)	(279,623)
Net Investment Income	36,493,612	6,853,195
Other	8,836	—
Total Additions	43,996,400	7,239,816
DEDUCTIONS		
Benefits	7,612,916	948,977
Refunds of contributions	231,788	—
Administrative expense	166,029	21,171
Total Deductions	8,010,733	970,148
Net Increase in Fund Balance Reserved for Employees' Pension Benefits	35,985,667	6,269,668
Fund Balance Reserved for Employees' Pension Benefits, July 1, 1997	196,088,975 *	33,707,965
Fund Balance Reserved for Employees' Pension Benefits, June 30, 1998	$ 232,074,642	$ 39,977,633

*Restated (see Note 1L)

Statement of Changes in Net Assets

Investment Trust Fund – Local Agency Investment

Year Ended June 30, 1998
(Amounts in thousands)

CHANGE IN NET ASSETS RESULTING FROM OPERATIONS	
Income from investments	$ 628,067
Less: Operating expenditures and expenses	(1,365)
Net Increase in Net Assets Resulting From Operations	626,702
DISTRIBUTIONS TO PARTICIPANTS	
Distributions paid and payable	(626,702)
CHANGE IN NET ASSETS RESULTING FROM DEPOSITOR TRANSACTIONS	
Receipts from depositors	14,385,660
Less: Withdrawals by depositors	(13,459,365)
Net Increase in Net Assets Resulting from Depositor Transactions	926,295
Total Change in Net Assets	926,295
Net Assets Held in Trust for Pool Participants, July 1, 1997	10,806,232 *
Net Assets Held in Trust for Pool Participants, June 30, 1998	$ 11,732,527

*Restated (see Note 1L)

The notes to the financial statements are an integral part of these statements.

Combined Balance Sheet – Discretely Presented Component Unit – University of California

June 30, 1998
(Amounts in thousands)

	Current Funds	Loan Funds	Endowment and Similar Funds	Plant Funds	Agency Funds	Retirement System Funds	Total (Memorandum Only)
ASSETS							
Cash	$ 80,046	$ —	$ —	$ 2,029	$ —	$ —	$ 82,075
Investments	3,745,954	53,111	4,216,843	1,358,594	665,295	44,638,790	54,678,587
Receivables (net)	980,338	275,968	119,359	1,791	—	278,494	1,655,950
Due from other funds	12,442	—	13,729	3,213	—	123,264	152,648
Due from primary government	135,356	—	—	—	—	—	135,356
Due from other governments	153,553	5,287	—	—	—	—	158,840
Inventories, at cost	88,267	—	—	—	—	—	88,267
Deferred charges	52,243	—	—	—	—	—	52,243
Fixed assets	—	—	—	14,570,910	—	—	14,570,910
Investment in UCSF Stanford Health Care	—	—	—	417,349	—	—	417,349
Other assets	—	—	—	2,099	—	—	2,099
Total Assets	$ 5,248,199	$ 334,366	$ 4,349,931	$ 16,355,985	$ 665,295	$ 45,040,548	$ 71,994,324
LIABILITIES AND FUND EQUITY							
Liabilities							
Accounts payable	$ 1,300,316	$ —	$ 44,463	$ 47,899	$ —	$ 26,996	$ 1,419,674
Due to other funds	123,265	2,000	12,327	15,056	—	—	152,648
Deposits	255,053	—	—	3,930	665,295	—	924,278
Compensated absences	303,015	—	—	—	—	—	303,015
Commercial paper and other borrowings	57,686	—	—	1,023,932	—	—	1,081,618
Capital lease obligations	—	—	—	1,284,984	—	—	1,284,984
Revenue bonds payable	—	11,480	—	2,172,691	—	—	2,184,171
Securities lending obligation	747,953	10,798	404,910	234,852	—	5,035,919	6,434,432
Total Liabilities	2,787,288	24,278	461,700	4,783,344	665,295	5,062,915	13,784,820
Fund Equity							
Investment in general fixed assets	—	—	—	10,720,683	—	—	10,720,683
Fund balances							
Employees' pension benefits	—	—	—	—	—	39,977,633	39,977,633
Reserved for other specific purposes	739,178	279,406	3,026,808	406,334	—	—	4,451,726
Undesignated	1,721,733	30,682	861,423	445,624	—	—	3,059,462
Total Fund Equity	2,460,911	310,088	3,888,231	11,572,641	—	39,977,633	58,209,504
Total Liabilities and Fund Equity	$ 5,248,199	$ 334,366	$ 4,349,931	$ 16,355,985	$ 665,295	$ 45,040,548	$ 71,994,324

The notes to the financial statements are an integral part of this statement.

Combined Statement of Changes in Fund Balances – Discretely Presented Component Unit – University of California

Year Ended June 30, 1998
(Amounts in thousands)

	Current Funds	Loan Funds	Endowment and Similar Funds	Plant Funds
REVENUES AND OTHER ADDITIONS				
Student tuition and fees	$ 1,056,843	$ —	$ —	$ 16,432
U.S. government	4,212,471	3,182	—	9,759
Local government	102,484	—	—	—
Sales and services				
Educational activities	792,875	—	—	—
Medical centers	1,956,546	—	—	—
Auxiliary enterprises	571,698	—	—	—
Private gifts, grants, and contracts	631.430	313	26,210	90,936
Investment income				
Endowment activities	121,143	—	4,409	—
Securities lending	79,896	722	—	7,032
Other	185,102	9,153	—	46,949
Net appreciation in fair value of investments	9,989	42	659,332	5,020
Expended for plant facilities (including $400,861 of current funds)	—	—	—	614,404
Retirement of indebtedness	—	—	—	179,527
Other revenues	285,381	—	—	—
Transfers in — primary government	2,349,812	—	—	46,816
Other additions	46,719	5,469	451	7,491
Total Revenues and Other Additions	**12,402,389**	**18,881**	**690,402**	**1,024,366**
EXPENDITURES AND OTHER DEDUCTIONS				
Current fund expenditures				
Educational and general	6,405,386	—	—	—
Medical centers	1,854,194	—	—	—
Auxiliary enterprises	474,390	—	—	—
Department of Energy laboratories	2,726,809	—	—	—
Securities lending fees and rebates	76,989	695	—	6,776
Plant fund expenditures (including noncapitalized expenditures of $23,069)	—	—	—	236,612
Debt service				
Principal retirement	—	—	—	179,527
Interest	—	—	—	231,448
Disposal of plant assets	—	—	—	398,917
Debt extinguishment	—	—	—	1,895
Other	168,874	7,591	294	—
Total Expenditures and Other Deductions	**11,706,642**	**8,286**	**294**	**1,055,175**
TRANSFERS AMONG FUNDS				
Mandatory contractual arrangements				
Loan funds matching grants	(890)	890	—	—
Principal and interest	(309,839)	—	—	309,839
Nonmandatory (discretionary allocations)	(386,314)	1,834	28,706	355,774
Total Transfers Among Funds	**(697,043)**	**2,724**	**28,706**	**665,613**
Net Increase (Decrease) in Fund Balances	**(1,296)**	**13,319**	**718,814**	**634,804**
Fund Balances, July 1, 1997	**2,462,207**	**296,769**	**3,169,417**	**10,937,837**
Fund Balances, June 30, 1998	**$ 2,460,911**	**$ 310,088**	**$ 3,888,231**	**$ 11,572,641**

The notes to the financial statements are an integral part of this statement.

Combined Statement of Current Funds Revenues, Expenditures, and Other Changes -- Discretely Presented Component Unit – University of California

Year Ended June 30, 1998
(Amounts in thousands)

	Current Funds		Total (Memorandum Only)
	Unrestricted	Restricted	
REVENUES			
Student tuition and fees	$ 1,056,843	$ —	$ 1,056,843
U.S. government appropriations, grants and contracts	280,923	1,177,840	1,458,763
Local government grants and contracts	1,645	99,765	101,410
Sales and services			
Education activities	792,875	—	792,875
Medical centers	1,956,546	—	1,956,546
Auxiliary enterprises	571,698	—	571,698
Private gifts, grants and contracts	56,950	510,462	567,412
Investment income			
Endowment and similar funds	27,527	73,435	100,962
Securities lending	52,379	26,516	78,895
Other	147,151	—	147,151
Net appreciation in fair value of investments	8,803	—	8,803
Department of Energy laboratories	29,625	2,726,809	2,756,434
Other revenues	285,341	—	285,341
Transfers in — primary government	1,998,232	249,798	2,248,030
Total Revenues	7,266,538	4,864,625	12,131,163
EXPENDITURES AND MANDATORY TRANSFERS			
Educational and general			
Instructional	1,971,751	139,494	2,111,245
Research	273,573	1,436,356	1,709,929
Public service	96,735	101,405	198,140
Academic support	753,227	107,961	861,188
Student services	261,187	9,817	271,004
Institutional support	492,663	30,916	523,579
Operation and maintenance of plant	287,121	2,644	289,765
Student financial aid	169,088	271,448	440,536
Total Educational and General	4,305,345	2,100,041	6,405,386
Mandatory transfers			
Loan fund matching grant	795	95	890
Debt service	91,931	105,762	197,693
Total Mandatory Transfers	92,726	105,857	198,583
Medical Centers			
Expenditures	1,851,361	2,833	1,854,194
Mandatory transfers	63,315	—	63,315
Total Medical Centers	1,914,676	2,833	1,917,509
Auxiliary enterprises			
Expenditures	465,964	8,426	474,390
Mandatory transfers	48,831	—	48,831
Total Auxiliary Enterprises	514,795	8,426	523,221
Department of Energy laboratories	—	2,726,809	2,726,809
Securities lending fees and rebates	50,473	26,516	76,989
Total Expenditures and Mandatory Transfers	6,878,015	4,970,482	11,848,497
OTHER TRANSFERS AND ADDITIONS (DEDUCTIONS)			
Restricted receipts in excess of restricted expenditures	—	224,508	224,508
Nonmandatory transfers	(337,300)	(49,014)	(386,314)
Other	(124,680)	2,524	(122,156)
Total Other Transfers and Additions (Deductions)	(461,980)	178,018	(283,962)
Net Increase (Decrease) in Fund Balances	$ (73,457)	$ 72,161	$ (1,296)

The notes to the financial statements are an integral part of this statement.

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Notes to the Financial Statements

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements present information on the financial activities of the State of California over which the Governor, the Legislature, and other elected officials have direct or indirect governing and fiscal control. These financial statements have been prepared in conformity with generally accepted accounting principles (GAAP). The provisions of Governmental Accounting Standards Board (GASB) Statement No. 31, Accounting and Financial Reporting for Certain Investments and for External Investment Pools, have been implemented in this report. The provisions of GASB Technical Bulletin No. 98-1, Disclosures about Year 2000 Issues, have also been implemented in this report, except for the University of California. The University of California did not implement the provisions of this bulletin in its audited financial statements, since its auditor's report was dated before October 31, 1998, and the implementation was not required. The provisions of GASB Statement No. 32, Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans, have been implemented in this report for the public agency deferred compensation program that adopted the requirements of subsection (g) of the Internal Revenue Code Section 457 in the year ended June 30, 1998. However, GASB Statement No. 32 has not been implemented for the deferred compensation program for primary government employees.

A. Reporting Entity

As required by GASB Statement No. 14, The Financial Reporting Entity, these financial statements present the primary government of the State and its component units. The **primary government** consists of all funds, account groups, organizations, institutions, agencies, departments, and offices that are not legally separate from the State. GASB Statement No. 14 does not modify the fiduciary fund reporting requirements of the primary government. As a result, funds such as the Public Employees' Retirement Fund and the State Teachers' Retirement Fund are reported in the appropriate fiduciary funds. Component units are organizations that are legally separate from the State but for which the State is financially accountable, or for which the nature and significance of their relationship with the State is such that exclusion would cause the State's financial statements to be misleading or incomplete. The decision to include a potential component unit in the State's reporting entity is based on several criteria including legal standing, fiscal dependency, and financial accountability. Following is information on blended and discretely presented component units for the State.

Blended component units, although legally separate entities, are in substance part of the primary government's operations. Therefore, data from these blended component units are integrated into the appropriate funds for reporting purposes.

Building authorities are blended component units because they have been created through the use of Joint Exercise of Powers Agreements with various cities to finance the construction of state buildings. The building authorities are reported as capital projects funds. As a result, the $319 million of capital lease arrangements between the building authorities and the State have been eliminated from the combined balance sheet. Instead, only the underlying fixed assets and the debt used to acquire them are reported in the appropriate account groups. Copies of the financial statements of the building authorities may be obtained from the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250-5876.

Discretely presented component units are reported in separate columns in the combined financial statements. Discretely presented component units are legally separate from the primary government, and mostly provide services to entities and individuals outside the State. For ease of presentation, discretely presented component units, other than the University of California, are included in the statements under the heading of special purpose authorities.

The University of California was founded in 1868 as a public, state-supported, land grant institution. It was written into the State Constitution of 1879 as a public trust to be administered by a governing board, the Regents of the University of California. The University of California is a component unit of the State because the State appoints a voting majority of the Regents of the University of California, and expenditures for the support of various University of California programs and capital outlay are appropriated by the annual Budget Act.

Copies of the University of California's separately issued financial statements may be obtained from the University of California, Financial Management, 1111 Franklin Street, 10th Floor, Oakland, California 94607-5200.

Special purpose authorities are presented in three separate categories for condensed financial statement reporting purposes: State Compensation Insurance Fund (SCIF), California Housing Finance Agency (CHFA), and Non-Major Component Units. SCIF and CHFA are considered major component units while all other component units are shown as Non-Major Component Units.

The SCIF is a self-supporting enterprise created to offer insurance protection to employers at the lowest possible cost. It operates in competition with other insurance carriers to provide services to the State, counties, cities, school districts, or other public corporations. It is a component unit of the State because the State appoints all five voting members of the SCIF's governing board and has the authority to approve or modify the SCIF's budget. Copies of the SCIF's financial statements for the year ended December 31, 1997, may be obtained from the State Compensation Insurance Fund, 1275 Market Street, San Francisco, California 94103.

The CHFA was created by the Zenovich-Moscone-Chacon Housing and Home Finance Act, as amended. The CHFA's purpose is to meet the housing needs of persons and families of low and moderate income. It is a component unit of the State because the State appoints a voting majority of the CHFA's governing board and has the authority to approve or modify its budget. Copies of the CHFA's financial statements may be obtained from the California Housing Finance Agency, 1121 L Street, Sacramento, California 95814.

State legislation created various other Non-Major Component Units to provide certain services outside the primary government and to provide certain private and public entities with a low-cost source of financing for programs deemed to be in the public interest. These entities are considered component units because the majority of governing board members are appointed by, or are members of, the primary government. Copies of the financial statements of these component units may be obtained from the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250-5876. The Non-Major Component Units are:

The California Infrastructure and Economic Development Bank, which provides financing for an interconnected system of public improvements;

The California Alternative Energy and Advanced Transportation Financing Authority, which provides financing for the alternative energy and advanced transportation technologies;

The California Pollution Control Financing Authority, which provides financing for pollution control facilities;

The California Health Facilities Financing Authority, which provides financing for the construction, equipping, or acquiring of health facilities;

The California Educational Facilities Authority, which issues revenue bonds to assist private educational institutions of higher learning in the expansion and construction of educational facilities;

The California School Finance Authority, which provides loans to school and community college districts to assist in obtaining equipment and facilities;

The California Economic Development Financing Authority, which issues revenue and general obligation bonds to finance business development and public infrastructure projects;

The District Agricultural Associations, which exhibit all of the industries, industrial enterprises, resources, and products of the State;

The San Joaquin River Conservancy, which was created to acquire and manage public lands within the San Joaquin River Parkway; and

The California Urban Waterfront Area Restoration Financing Authority, which provides financing for coastal and inland urban waterfront restoration projects.

A joint venture is an entity, resulting from a contractual arrangement, that is owned, operated, or governed by two or more participants as a separate and specific activity subject to joint control. In such an arrangement, the participants retain an ongoing financial interest or an ongoing financial responsibility in the entity. These entities are not part of the primary government or a component unit.

The State participates in a joint venture with the Capitol Area Development Authority (CADA). The CADA was created in 1978 by the Joint Exercise of Powers Agreement between the primary government and the City of Sacramento for the location of state buildings and other improvements. The CADA is a public entity separate from the primary government and the City, and is administered by a board of five members: two appointed by the primary government, two appointed by the City, and one appointed by the affirmative vote of at least three of the other four members of the board. The primary government designates the chairperson of the board. Although the primary government does not have an equity interest in the CADA, it does have an ongoing financial interest. Based upon the appointment authority, the primary government has the ability to indirectly influence the CADA to undertake special projects for the citizenry of the participants. The primary government subsidizes the CADA's operations by leasing land to the CADA without consideration; however, the primary government is not obligated to do so. Since the primary government does not have an equity interest in the CADA, the CADA's financial information is not included in the financial statements of this report. Separately issued financial statements can be obtained from the Capitol Area Development Authority, 1530 Capitol Avenue, Sacramento, California 95814.

Effective November 1, 1997, the University of California, San Francisco (UCSF) Medical Center (a portion of a discretely presented component unit) and Stanford Health Services, which manages and operates Stanford University's medical center, merged through the formation of UCSF Stanford Health Care, a separate non-profit corporation (the Corporation). The Corporation is governed by a seventeen member Board of Directors consisting of representatives from both universities, selected officers of the new corporation and three independent directors. The primary purpose of the

Corporation is to support, benefit, and further the charitable, scientific, and educational purposes of the Schools of Medicine at UCSF and Stanford. The UC's investment in the Corporation is accounted for as a joint venture using the equity method of accounting. The UC's interest in the earnings of the Corporation is recorded as revenue within the current unrestricted fund and as an increase in UC's assets. Equity distributions are recorded as a reduction in the UC's assets.

Substantially all of the medical center and clinical practice assets and liabilities of both the UCSF Medical Center and Stanford Health Services were either contributed or leased to the Corporation. The UC leased real property to the Corporation under long-term leases for a nominal annual rent and all personal property for terms ranging from 5 to 20 years, with bargain purchase options available at the end of the lease term. Such amounts have been accounted for as part of the investment in the Corporation.

Under the terms of the agreement, the Corporation's income or losses are allocated equally between the UC and Stanford University. The agreement provides for the Corporation's Board of Directors to annually determine whether to distribute a portion of operating income as academic contributions to each university. During the year ended June 30, 1998, the UC's share of the Corporation's income was $18 million; no distributions were received by the UC.

The UC also entered into certain operating agreements with the Corporation, primarily for the use of UC employees, facilities, and technical expertise. The UC recorded revenue of $153 million under these agreements during the fiscal year ended June 30, 1998. In addition to the operating agreements, the UC may manage a portion of the investments of the Corporation. The fair value of these investments totaled $206 million at June 30, 1998.

Information on the finances of the Corporation may be obtained from the University of California, Financial Management, 1111 Franklin Street, 10th Floor, Oakland, California 94607-5200.

B. Fund Accounting

The financial statements of the State are organized and operated on the basis of funds, account groups, and component units. A fund is an independent fiscal and accounting entity with a self-balancing set of accounts. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with finance-related legal and contractual provisions. The minimum number of funds are maintained consistent with legal and managerial requirements. Account groups are a reporting device to account for certain assets and liabilities of the governmental funds that are not recorded directly in those funds. A component unit is an organization which is legally separate from the State but for which the State is financially accountable, or for which the nature and significance of their relationship with the State is such that exclusion would cause the State's financial statements to be misleading or incomplete.

The financial activities of the State accounted for in the accompanying financial statements are classified as follows.

Governmental Fund Types are used primarily to account for services provided to the general public without charging directly for those services. The State has three governmental fund types.

The *General Fund* is the main operating fund of the State. It accounts for transactions related to resources obtained and used for those services that do not need to be accounted for in another fund.

Special Revenue Funds account for transactions related to resources obtained from specific revenue sources (other than expendable trusts or major capital projects) that are legally restricted to expenditures for specified purposes.

Capital Projects Funds account for transactions related to resources obtained and used to acquire or construct major capital facilities.

Proprietary Fund Types present financial data on activities that are similar to those found in the private sector. Users are charged for the goods or services provided. Pursuant to GASB Statement No. 20, the State applies all applicable GASB pronouncements as well as all applicable Financial Accounting Standards Board (FASB) Statements and Interpretations issued on or before November 30, 1989, unless the FASB Statements and Interpretations conflict with or contradict GASB pronouncements for its proprietary funds. However, the State has elected not to apply FASB Statements and Interpretations issued after November 30, 1989, with one exception. The exception is Prison Industries, an internal service fund, which has elected to follow FASB pronouncements issued after November 30, 1989, unless they conflict with or contradict GASB pronouncements. The State has two proprietary fund types.

Enterprise Funds account for goods or services provided to the general public on a continuing basis when (1) the State intends that all or most of the cost involved is to be financed by user charges, or (2) periodic measurement of the results of operations is appropriate for management control, accountability, capital maintenance, public policy, or other purposes.

Internal Service Funds account for goods or services provided to other agencies, departments, or governments on a cost-reimbursement basis.

Fiduciary Fund Types are used to account for assets held by the State. The State acts as a trustee or as an agent for individuals, private organizations, other governments, or other funds. The State has four fiduciary fund types.

Expendable Trust Funds account for assets held in a trustee capacity when principal, income, and earnings on principal, may be expended in the course of a fund's designated operations.

Pension Trust Funds account for transactions, assets, liabilities, and net assets available for plan benefits of the retirement systems.

Agency Funds account for assets held by the State, which acts as an agent for individuals, private organizations, other governments, or other funds. They are custodial in nature and do not measure the results of operations.

The *Investment Trust Fund* accounts for the deposits, withdrawals, and earnings of the Local Agency Investment Fund, an external investment pool for local governments and public agencies.

Account Groups are used to establish control over and accountability for the government's general fixed assets and general long-term obligations. The State has two account groups.

The *General Fixed Assets Account Group* accounts for governmental fixed assets not reported in a proprietary fund or a trust fund.

The *General Long-Term Obligations Account Group* accounts for unmatured general obligation bonds and other long-term obligations generally expected to be financed from governmental funds.

Discretely Presented Component Units are reported in separate columns in the combined financial statements to emphasize that they are legally separate from the primary government. The discretely presented component units are classified as the University of California and as special purpose authorities. The University of California's financial statements are prepared in conformity with GAAP using the American Institute of Certified Public Accountants College Guide Model. As a result, the University of California's activities are accounted for in the following funds: Current Funds; Loan Funds; Endowment and Similar Funds; Plant Funds; Agency Funds; and Retirement System Funds. Special purpose authorities account for their activities as enterprise funds.

C. Measurement Focus and Basis of Accounting

Governmental Fund Types and **Expendable Trust Funds** are presented using the flow of current financial resources measurement focus. With this measurement focus, operating statements present increases and decreases in net current assets; the unreserved fund balance is a measure of available spendable resources.

The accounts of the governmental fund types and expendable trust funds are reported using the modified accrual basis of accounting. Under the modified accrual basis, revenues are recorded as they become measurable and available, and expenditures are recorded at the time the liabilities are incurred. Principal tax revenues susceptible to accrual are recorded as taxpayers earn income (personal income and bank and corporation taxes), as sales are made (consumption and use taxes), and as the taxable event occurs (miscellaneous taxes), net of estimated tax overpayments. Other revenue sources are recorded when they are earned or when they are due, provided they are measurable and available within the ensuing 12 months.

Compensated absences are accounted for on a modified accrual basis of accounting. Except for expenditures in the General Fund for earned leave of academic-year faculty, compensated absences expenditures are not accrued since it is not anticipated that compensated absences will be used in excess of a normal year's accumulation.

Agency Funds are custodial in nature and do not measure the results of operations. Assets and liabilities are recorded using the modified accrual basis of accounting.

Proprietary Fund Types, the Investment Trust Fund, and Pension Trust Funds are accounted for on the flow of economic resources measurement focus.

The accounts of the proprietary fund types, the investment trust fund, and pension trust funds are reported using the accrual basis of accounting. Under the accrual basis, revenues are recognized when they are earned, and expenses are recognized when they are incurred.

Lottery revenue and the related prize expense are recognized when sales are made. Certain prizes are payable in deferred installments. Such liabilities are recorded at the present value of amounts payable in the future.

For purposes of the statement of cash flows, all cash and pooled investments in the State Treasurer's Office pooled investment program are considered to be cash and cash equivalents.

Discretely Presented Component Units, which are classified as the University of California and special purpose authorities, are accounted for on the flow of current resources and flow of economic resources measurement focus, respectively. All use the full accrual basis of accounting.

D. Food Stamps

The distribution of food stamp benefits is recognized as revenue and expenditures in a special revenue fund, as required by GAAP. Revenue and expenditures are recognized when the benefits are distributed to the recipients. Food stamp balances held by the counties are reported as an asset and offset by deferred revenue. Revenues, expenditures, and balances of food stamp benefits are measured based on face value.

E. Inventories

Inventories are primarily stated at either the lower of average cost or market, or at cost utilizing the weighted average valuation method. In governmental fund types, inventories are recorded as expenditures when purchased. In proprietary fund types, inventories are expensed when consumed.

The discretely presented component units have inventory policies similar to the primary government's.

F. Net Investment in Direct Financing Leases

The State Public Works Board, an agency that accounts for its activities as an enterprise fund, has entered into lease-purchase agreements with various other primary government agencies, the University of California, and certain local agencies. The payments from these leases will be used to satisfy the principal and interest requirements of revenue bonds issued by the State Public Works Board to finance the construction of facilities and energy efficiency projects. Upon expiration of these leases, jurisdiction of the facilities and projects will be with the primary government agency, University of California, or local agency. The State Public Works Board records the net investment in direct financing leases at the net present value of the minimum lease payments.

G. Deferred Charges

The deferred charges account in the enterprise fund type primarily represents operating and maintenance costs and unrecovered capital costs that will be recognized as expenses over the remaining life of long-term state water supply contracts. These costs are billable in future years. In addition, the account includes unbilled interest earnings on unrecovered capital costs that are recorded as deferred charges. These charges are recognized when billed in future years under the terms of water supply contracts.

H. Fixed Assets

The **General Fixed Assets Account Group** includes capital assets that are not assets of any specific fund, but rather of the primary government as a whole. Most of these assets arise from the expenditure of the financial resources of governmental funds and expendable trust funds used to acquire or construct them. The General Fixed Assets Account Group does not include fixed assets of proprietary funds or pension trust funds. These fixed assets are accounted for in their respective funds.

The General Fixed Assets Account Group is presented in the financial statements at cost or estimated historical cost. Donated fixed assets are stated at fair market value at the time of donation. Interest during construction has not been capitalized. Also, public domain or "infrastructure" fixed assets are not capitalized. Accumulated depreciation is not recorded in the General Fixed Assets Account Group. Purchased fixed assets are stated at historical cost. Tangible and intangible property are capitalized if the property has a normal useful life of at least one year and an acquisition cost of at least $5,000.

Proprietary Fund Type fixed assets, consisting of property, plant, and equipment, are stated at cost at the date of acquisition, less accumulated depreciation. They are depreciated over their estimated useful or service lives, ranging from two to 100 years, using the straight-line method of depreciation. Dormitory facilities, which represent 15.2% of the fixed assets of the enterprise funds, are not depreciated.

The fixed assets of the **discretely presented component units** are stated at cost at the date of acquisition, or fair market value at the date of donation in the case of gifts. Depreciation on the majority of the fixed assets of the discretely presented component units is not recorded, which is consistent with GAAP.

I. Long-Term Obligations

The primary government reports long-term obligations of governmental funds in the General Long-Term Obligations Account Group. Long-term obligations consist of unmatured general obligation bonds, certain unmatured revenue bonds, capital lease obligations, certificates of participation, commercial paper, the net pension obligation of the pension trust funds, the liability for employees' compensated absences and workers' compensation claims, amounts owed for lawsuits, and the primary government's share of the University of California pension liability.

With approval in advance from the Legislature, certain authorities and state agencies may issue revenue bonds. Principal and interest on revenue bonds are payable from the pledged revenues of the respective funds, the building authorities, and agencies. The General Fund has no legal liability for payment of principal and interest on revenue bonds. With the exception of the building authorities, which are included in capital projects funds, the liability for revenue bonds is recorded in the respective fund.

J. Compensated Absences

In the governmental funds, only the amounts of compensated absences that normally would be liquidated with expendable available financial resources are accrued at year end, such as costs of academic year faculty. The costs of the academic-year faculty represent services rendered over a ten-month period that are paid over a 12-month period. The balance of the amounts owed for services rendered are reported as a current liability in the General Fund. Unless it is anticipated that compensated absences will be used in excess of a normal year's accumulation, no additional liabilities are accrued. As a result, the unpaid liability for governmental funds is recorded in the General Long-Term Obligations Account Group. Accumulated sick-leave balances are not included in the compensated absences because they do not vest to employees. However, unused sick-leave balances convert to service credits upon retirement.

The amounts of vested unpaid vacation and annual leave accumulated by state employees are accrued when incurred in proprietary funds. In the discretely presented component units, the compensated absences are accounted for in a similar manner as the proprietary funds in the primary government.

K. Fund Equity

Fund equity accounts present the difference between assets and liabilities of a fund. The fund equity accounts consist of *contributed capital* and *retained earnings* for proprietary funds and certain component units, *investment in general fixed assets* for the General Fixed Assets Account Group and certain component units, and *fund balance* for governmental funds, trust funds, and certain component units.

Contributed capital is the permanent fund capital of a proprietary fund. Contributed capital is created when a residual equity transfer is received by a proprietary fund, when a general fixed asset is "transferred" to a proprietary fund, or when a grant is received that is externally restricted to capital acquisition or construction.

Retained earnings are divided into two sections: *reserved for regulatory requirements* and *unreserved.* The reserved for regulatory requirements represents a segregation of the retained earnings in enterprise funds and certain component units for amounts that are unavailable for general use as a result of specific legal requirements. Unreserved retained earnings represent the accumulated earnings of proprietary funds and certain component units that are not reserved for any specific purpose.

The fund balances for governmental funds and trust funds are divided into two sections: *reserved* and *unreserved-undesignated.* Part or all of the total fund balance may be reserved as a result of law or generally accepted accounting principles. Reserves represent those portions of the fund balances that are legally segregated for specific uses. The reserves of the fund balance for governmental funds, trust funds, and component units are as follows:

Reserved for encumbrances represents goods and services that are ordered, but not received, by the end of the year.

Reserved for Local Agencies represents amounts held on behalf of local governments and local public agencies in the Local Agency Investment Fund, an investment trust fund.

Reserved for advances and loans receivable represents advances to other funds and the non-current portion of loans receivable that do not represent expendable available financial resources.

Reserved for employees' pension benefits represents reserves of the pension trust funds and the University of California, a discretely presented component unit. These reserves include accumulated contributions made by employees and employers, and undistributed interest and investment earnings.

Reserved for continuing appropriations represents the unencumbered balance of all appropriations for which the period of availability extends beyond the period covered by this report. These appropriations are legally segregated for a specific future use.

Reserved for other specific purposes includes trust and agency fund amounts of the Unemployment Fund, other expendable trust funds, and the University of California, a discretely presented component unit, that are not available for future appropriations other than those for which the funds were established.

The *unreserved-undesignated* amounts represent the net of total fund balance, less reserves, for governmental funds and certain component units.

Investment in general fixed assets represents the fixed assets of the governmental funds and expendable trust funds reported in the General Fixed Assets Account Group and the fixed assets of the University of California, a discretely presented component unit, that are restricted for specific purposes.

L. Restatement of Beginning Fund Equity

The beginning retained earnings in the enterprise funds have been increased by $0.9 million as a result of reclassifying a program (Public Employees' Retirement System (PERS) Long-Term Care Program) from expendable trust fund, and by $24 million as a result of restatement of investments to fair value per GASB 31. The beginning retained earnings in the enterprise funds have been decreased by $245 million as a result of establishing a liability that should have been recognized in a prior year.

The beginning retained earnings in the internal service funds have been increased by $111 million as a result of reclassifying certain programs (PERS Health Care Fund and PERS Contingency Reserve Fund) from the expendable trust funds.

The beginning fund balance of the expendable trust funds has been reduced by $65 million (net) as a result of: (1) reclassifying the PERS Health Care Program and PERS Contingency Reserve Program to internal service funds; (2) reclassifying PERS Long-Term Care Program to enterprise funds; (3) reclassifying the Volunteer Firefighter Length/Service Program from pension trust funds, and (4) changing the accounting policy, as required by GASB Statement No. 32, which added the Public Agency Deferred Compensation Program (IRC 457).

The beginning net assets of the pension trust funds have been increased by $18 million (net) as a result of reclassifying the State Teachers' Retirement System 403 (b) program from an agency fund to a pension trust fund and reclassifying the Volunteer Firefighter Length/Service Program from a pension trust fund to an expendable trust fund.

The net assets of the investment trust fund have been established this year by reclassifying the Local Agency Investment Fund from an agency fund to an investment trust fund, as a result of implementation of GASB Statement No. 31.

The beginning retained earnings in the special purpose authorities have been increased by $89 million as a result of the State Compensation Insurance Fund converting from accounting practices prescribed by the California Department of Insurance to generally accepted accounting principles for the year ended December 31, 1997.

M. Guaranty Deposits

The State is custodian of guaranty deposits held to protect consumers, to secure the State's deposits in financial institutions, and to ensure payment of taxes and fulfillment of obligations to the State. Guaranty deposits of securities and other properties are not shown on the financial statements.

N. Memorandum Only Total Columns

Total columns captioned "memorandum only" do not represent consolidated financial information and are presented only to facilitate financial analysis. The columns do not present information that reflects financial position, results of operations, or cash flows in accordance with generally accepted accounting principles. Interfund eliminations have not been made in the aggregation of this data.

NOTE 2. BUDGETARY AND LEGAL COMPLIANCE

A. Budgeting and Budgetary Control

The State's annual budget is prepared primarily on a modified accrual basis for governmental funds. The Governor recommends a budget for approval by the Legislature each year. This recommended budget includes estimated revenues; however, revenues are not included in the budget adopted by the Legislature. Under state law, the State cannot adopt a spending plan that exceeds estimated revenues.

Under the State Constitution, money may be drawn from the treasury only through a legal appropriation. The appropriations contained in the Budget Act, as approved by the Legislature and signed by the Governor, are the primary sources of annual expenditure authorizations and establish the legal level of control at the appropriation level for the annual operating budget. The budget can be amended throughout the year by special legislative action, budget revisions by the Department of Finance, or executive orders by the Governor.

Amendments to the initial budget for the year ended June 30 were legally made, and are included in the budget data in the financial statements. The amendments had the effect of increasing spending authority and expenditures for the year.

Appropriations are generally available for expenditure or encumbrance either in the year appropriated or for a period of three years if the legislation does not specify a period of availability. At the end of the availability period, the encumbering authority for the unencumbered balance lapses. Some appropriations continue indefinitely while others are available until fully spent. Generally, encumbrances must be liquidated within two years from the end of the period when the appropriation is available. If the encumbrances are not liquidated within this additional two-year period, the spending authority for these encumbrances lapses.

Legislative appropriations are based on when commitments for goods and services are incurred. However, for financial reporting purposes, the State reports expenditures based on the year goods and services are received. The Combined Statement of Revenues, Expenditures, and Changes in Fund Balances Non-GAAP Budgetary Basis-Budget and Actual includes all the current year expenditures for governmental cost funds and their related appropriations that are legislatively authorized annually, continually, or by project.

B. Legal Compliance

State agencies are responsible for exercising basic budgetary control and ensuring that appropriations are not overspent. The State Controller's Office is responsible for overall appropriation control and does not allow expenditures in excess of authorized appropriations.

Financial activities are mainly controlled at the appropriation level but can vary depending on the presentation and wording contained in the Budget Act. Certain items which are established at the category, program, component, or element levels can be adjusted by the Department of Finance. While the financial activities are controlled at various levels, the legal level of budgetary control has been established in the Budget Act at the appropriation level for the annual operating budget.

The Combined Statement of Revenues, Expenditures, and Changes in Fund Balances Non-GAAP Budgetary Basis-Budget and Actual is not presented in this document at the legal level of budgetary control, as such a presentation would be extremely lengthy and cumbersome. The State of California prepares a separate report, the *Budgetary/Legal Basis Annual Report Supplement*, which includes statements that demonstrate compliance with the legal level of budgetary control in accordance with GASB's Codification of Governmental Accounting and Financial Reporting Standards Section 2400.112. The Statement of Appropriations, Expenditures, and Balances and the Comparative Statement of Actual and Budgeted Expenditures include the comparison of the annual appropriated budget with expenditures at the legal level of control. A copy of this report is available from the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250-5876.

C. Reconciliation of Budgetary Basis with GAAP Basis

The State annually reports its financial condition based on GAAP (GAAP basis) and on the State's budgetary provisions (budgetary basis). The Combined Statement of Revenues, Expenditures, and Changes in Fund Balances Non-GAAP Budgetary Basis-Budget and

Actual is compiled on the budgetary basis. The differences between budgetary basis fund balances and the fund equity prepared in accordance with GAAP are explained and reconciled in the following paragraphs and Table 1.

The beginning fund balance on the budgetary basis is restated for "prior year revenue adjustments" and "prior year expenditure adjustments." A prior year revenue adjustment occurs when the actual amount received in the current year differs from the prior year accrual of revenues. A prior year expenditure adjustment results when the actual amount paid in the current year differs from the prior year accrual for appropriations whose ability to encumber funds has lapsed in previous periods. The beginning fund balance on a GAAP basis is not affected by this adjustment.

Perspective Difference

Fund classification: On a budgetary basis, the State's funds are classified as either governmental cost funds or nongovernmental cost funds. The governmental cost funds consist of the General Fund and other governmental cost funds into which revenues from taxes, licenses, and fees that support the general operations of the State are deposited. The nongovernmental cost funds are not subject to annual appropriated budgets and consist of funds into which monies derived from sources other than general and special taxes, licenses, fees, or other state revenues are deposited. On a GAAP basis, the financial information is classified as governmental, proprietary, or fiduciary funds, or as component units.

Basis Difference

Advances and loans receivable: Loans made to other funds or to other governments are normally recorded as expenditures on the budgetary basis. However, in accordance with GAAP, these loans are recorded as assets. The General Fund had education loans outstanding as of June 30, 1998, of $785 million, which will be forgiven and charged to expenditures in the year of appropriation on a budgetary basis. On a GAAP basis, these education loans were charged to expenditures for the year ended June 30, 1996, the year that the agreement was made to forgive the loans. The adjustments related to advances and loans caused a decrease to the fund balance of $714 million in the General Fund and an increase to the fund balance of $1.4 billion in special revenue funds, $395 million in enterprise funds, and $588 million in trust and agency funds.

Escheat property: A liability for the estimated amount of escheat property ultimately expected to be reclaimed and paid is not reported on a budgetary basis, while it is required to be reported on a GAAP basis. This adjustment caused a $478 million decrease to the General Fund balance.

Authorized and unissued bonds: General obligation bonds that are not self-liquidating are recorded as additions to the fund balance for the special revenue and capital projects funds on the budgetary basis when voters authorize the sale of bonds. However, in accordance with GAAP, only the bonds issued during the year are recorded as additions to the fund balance. The adjustments related to authorized and unissued bonds caused a decrease to fund balance of $2.8 billion in special revenue funds and $1.1 billion in capital projects funds.

Provision for long-term obligations: On the budgetary basis, a provision for long-term obligations is used to offset certain bonds payable. However, in accordance with GAAP, this account is not used for enterprise funds. This adjustment caused a $2.6 billion decrease to the enterprise fund balance.

Encumbrances: The State does not record certain encumbrances on a budgetary basis that are recorded on a GAAP basis. The adjustments related to encumbrances caused an increase to the fund balance of $488 million in special revenue funds.

Fixed assets: For certain enterprise programs, the budgetary basis uses the modified accrual basis of accounting for fixed assets, which expenses fixed asset costs. In accordance with GAAP, fixed assets for enterprise funds should be capitalized and depreciated using the accrual basis of accounting. This adjustment caused a $1.4 billion increase to the enterprise fund balance.

Fair value of investments: The increase in Lottery Fund investments for adjustments to fair value does not result in a corresponding increase in a liability on the budgetary basis. However, on a GAAP basis, the liability is increased since the investments will be used for lottery prizes and annuities. This adjustment caused a $327 million decrease to the enterprise fund balance.

Fund balances in agency funds: Fund balances are reported in agency funds on the budgetary basis. In accordance with GAAP, agency funds do not have a fund balance since they account for assets held solely in a custodial capacity. Accordingly, assets in agency funds are always matched with liabilities to the owners of these assets. This adjustment caused a $23.8 billion decrease to the agency fund balance.

Escrow fund investments: Investments in a certain escrow fund are reported on a budgetary basis. However on a GAAP basis, they are not considered to belong to the primary government since they are related to the proceeds from debt refundings for an escrow agent. This adjustment caused a decrease to the fund balance of $972 million in special revenue funds.

Contributed capital: Contributed capital within the fund balance and the corresponding assets are not reported for certain programs on the budgetary basis. In accordance with GAAP, the fund balance is increased for contributed capital and the corresponding assets. This adjustment caused a $232 million increase to the internal service fund balance.

Other: Certain other adjustments and reclassifications are necessary to present the financial statements in accordance with GAAP. The other adjustments caused a decrease in fund balance of $112 million in the General Fund, $331 million in special revenue funds, $481 million in enterprise funds, $9 million in internal service funds, and $93 million in trust and agency funds and an increase in fund balance of $72 million in capital projects funds and $242 million in component units.

Timing Difference

Liabilities budgeted in subsequent years: The primary government does not, on a budgetary basis, accrue liabilities for which there is no existing appropriation or no currently available appropriation. The adjustments made to account for these liabilities in accordance with GAAP caused a net decrease to the fund balance of $941 million in the General Fund and $114 million in special revenue funds.

Entity Difference

Entities not included in the State's accounting system: There are some discretely presented component units that are not included in the budgetary basis accounting system, but are included on a GAAP basis. This adjustment caused a $58.5 billion increase to the component units fund balance, of which $58.2 billion is related to the University of California.

Table 1

Reconciliation of Budgetary Basis Fund Balances and GAAP Basis Fund Equity

June 30, 1998
(Amounts in thousands)

	Total Budgetary Fund Classifications	Primary Government						Component Units
		Governmental Funds Types			Proprietary Fund Types		Fiduciary Fund Types	
		General	Special Revenue	Capital Projects	Enterprise	Internal Service	Trust and Agency	
Perspective Difference								
Budgetary / Legal Basis Annual Report								
General Fund	$ 2,792,484	$ 2,792,484	$ —	$ —	$ —	$ —	$ —	$ —
Other Governmental Cost Funds	4,590,415	—	4,349,649	48,484	77,757	11,719	102,766	40
Non–Governmental Cost Funds	288,298,356	—	4,806,554	1,183,694	5,523,839	395,146	274,034,853	2,354,270
Total Budgetary Fund Balances Reclassified into GAAP Statement Fund Structure	**$ 295,681,255**	2,792,484	9,156,203	1,232,178	5,601,596	406,865	274,137,619	2,354,310
Basis Difference								
Advances and loans receivable		(713,841)	1,407,801	—	395,025	—	588,003	—
Escheat property		(477,913)	—	—	—	—	—	—
Authorized and unissued bonds		—	(2,791,401)	(1,115,401)	—	—	—	—
Provision for long–term obligations		—	—	—	(2,579,631)	—	—	—
Encumbrances		—	488,481	—	—	—	—	—
Fixed assets		—	—	—	1,364,223	—	—	—
Fair value of investments		—	—	—	(326,749)	—	—	—
Fund balances in agency funds		—	—	—	—	—	(23,808,359)	—
Escrow fund investments		—	(971,774)	—	—	—	—	—
Contributed capital		—	—	—	—	231,993	—	—
Other		(112,167)	(331,103)	71,700	(480,511)	(9,232)	(92,800)	242,171
Timing Difference								
Liabilities budgeted in subsequent years		(941,182)	(113,777)	—	—	—	—	—
Entity Difference								
Entities not included in State's accounting system		—	—	—	—	—	—	58,544,094
GAAP Fund Equity, June 30		**$ 547,381**	**$ 6,844,430**	**$ 188,477**	**$ 3,973,953**	**$ 629,626**	**$ 250,824,463**	**$ 61,140,575**

NOTE 3. DEPOSITS AND INVESTMENTS

As required, the State has adopted GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools." This statement, with a few exceptions, requires investments to be reported at fair value.

State statutes authorize investments in certain types of securities. 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). There is a single portfolio of investments with all participants having an undivided interest in the portfolio. Both pools are administered in the same manner as described below. In addition, certain programs have the authority to separately invest their funds.

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

The State Treasurer's Office administers a pooled investment program for the primary government and for certain special purpose authorities. As of June 30, the special purpose authorities' cash and pooled investments were approximately 2% of the State Treasurer's Office 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. The State Treasurer's Office maintains cash deposits with certain banks that do not earn interest income. Income earned on these deposits compensates the banks for services and uncleared checks that are deposited in the pooled investment program's accounts.

All demand and time deposits, totaling approximately $2.2 billion, which were held by financial institutions as of June 30, were insured by federal depository insurance or by collateral held by the State Treasurer's Office or by an agent of the State Treasurer's Office in the State's name. The California Government Code requires collateral pledged for demand and time deposits to be deposited with the State Treasurer.

As of June 30, the State Treasurer's Office had amounts on deposit with fiscal agents totaling approximately $12 million. These deposits are related to principal and interest payments due to bondholders. These deposits are insured by federal depository insurance or by collateral held by an agent of the State Treasurer's Office in the State's name.

The State Treasurer's Office reports its investments at fair value. The fair value of all securities in the State Treasurer's Office pooled investment program is based on quoted market prices. As of June 30, the average remaining life of the securities in the pooled money investment program administered by the State Treasurer's Office was approximately 215 days.

The Pooled Money Investment Board provides regulatory oversight over the State Treasurer's Office pooled investment program. The purpose of the Board is to design 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 consistent with the goals of safety, liquidity and yield. The Pooled Money Investment Board is comprised of the State Treasurer, as chair; the State Controller; and the Director of Finance. This Board designates the amounts of temporarily idle money available for investment. The State Treasurer is charged with making the actual investment transactions for this investment program. This program is not registered with the Securities and Exchange Commission as an investment company.

The value of the deposits of the State Treasurer's Office 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, 1998, this difference was immaterial to the valuation of the program. The pool is run with a "dollar-in dollar-out" participation. There are no share value adjustments to reflect changes in fair value.

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

Certain funds, which have deposits in the State Treasurer's Office pooled investment program, do not receive the interest earnings on their deposits. The earnings on the investments related to those funds are legally required to be assigned to the State's General Fund. A major portion of the $279 million interest revenue received by the General Fund from the pooled money investment program comes from these funds.

The State Treasurer's Office pooled investment program values participants' shares on an amortized cost basis. Specifically, the program distributes income to participants on a quarterly basis 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 method differs from the fair value method used to value investments in these financial statements because 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. Since the total difference between the fair values of the investments in the pool and the values 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 reports participant fair value as a ratio of amortized cost on a quarterly basis, with the June 30 valuation being externally audited. The State Treasurer's Office has not provided or obtained a legally binding guarantee to support the principal invested in the investment program.

The fair value, the ranges of interest rates, and the maturity dates of each major investment classification in the State Treasurer's Office pooled investment program are summarized in Table 4.

Tables 2 and 3 present summary financial statements of the Local Agency Investment Fund (LAIF), an Investment Trust Fund.

Table 2

Condensed Statement of Net Assets – LAIF
June 30, 1998
(Amounts in thousands)

Assets	
Cash and pooled investments	$ 11,732,527
Due from other funds	166,839
Total Assets	**$ 11,899,366**
Liabilities	
Due to other funds	$ 267
Due to other governments	166,572
Total Liabilities	**166,839**
Net Assets Held in Trust for Pool Participants	**$ 11,732,527**

Table 3

Condensed Statement of Changes in Net Assets - LAIF
Year Ended June 30, 1998
(Amounts in thousands)

Changes in Net Assets Resulting from Operations	$ 626,702
Distributions to Participants	(626,702)
Changes in Net Assets Resulting from Depositor Transactions	926,295
Total Change in Net Assets	**926,295**
Net Assets Held in Trust for Pool Participants, July 1, 1997	**10,806,232**
Net Assets Held in Trust for Pool Participants, June 30, 1998	**$ 11,732,527**

As of June 30, floating rate notes and mortgage-backed assets comprised less than 5% of the pooled investments. For the floating rate notes in the portfolio, the interest received by the State Treasurer's Office pooled investment program will rise or fall as the underlying index rate rises or falls. The structure of the floating rate notes in the State Treasurer's Office pooled investment program portfolio is such that it hedges the portfolio against the risk of increasing interest rates. The mortgage-backed securities are called real estate mortgage investment conduits (REMICs). A REMIC is a security backed by a pool of mortgages. The REMICs in the State's portfolio have a fixed principal payment schedule.

The California Government Code allows the State Treasurer's Office to enter into reverse repurchase agreements, as part of its pooled investment program. A reverse repurchase agreement is a sale of securities with a simultaneous agreement to repurchase them in the future at the same price plus a contract rate of interest. The market value of the securities underlying reverse repurchase agreements normally exceeds the cash received, providing the dealers a margin against a decline in market value of the securities. If the dealers default on their obligations to resell these securities to the State Treasurer's Office or provide securities or cash of equal value, the State Treasurer's Office pooled investment program will suffer an economic loss equal to the difference between the market value plus the accrued interest of the underlying securities and the agreement obligation, including accrued interest. During the year ended June 30, the State Treasurer's Office entered into 21 reverse repurchase agreements by temporarily selling investments with a carrying value of approximately $2.4 billion. The maturities of investments made with the proceeds from reverse repurchase agreements were matched to the maturities of the agreements. As of June 30, the State Treasurer's Office did not have any reverse repurchase agreements outstanding.

Enterprise funds, trust and agency funds, an internal service fund, and a building authority in the capital projects funds also make separate investments, which are presented at fair value. California Public Employees' Retirement System (CalPERS) and State

Teachers' Retirement System (STRS) had $258.9 billion in these separately invested funds.

Under the State Constitution, CalPERS has the authority to invest in stocks, bonds, mortgages, real estate, and other investments. CalPERS maintains certain deposits, cash equivalents, and other investments with financial institutions.

The fair value of CalPERS' investments in securities is generally based on published market prices and quotations from major investment firms. Many factors are considered in arriving at that fair value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common stocks are valued at the quoted market price of the issuer's unrestricted common stock, less an appropriate discount.

CalPERS' mortgages are valued on the basis of their future principal and interest payments discounted at prevailing interest rates for similar instruments. The fair value of real estate investments, principally rental property subject to long-term net leases, is estimated based on independent appraisals. Short-term investments are reported at market value, when available, or at cost plus accrued interest, which approximates market value when market values are not available. For investments where no readily ascertainable market value exists, management, in consultation with their investment advisors, has determined the fair values for the individual investments.

Under the State Constitution and statutory provisions governing CalPERS investment authority, CalPERS, through its outside investment managers, holds investments in futures and options and enters into forward foreign currency exchange contracts. Futures and options of approximately $76 million were held for investment purposes as of June 30, 1998. Gains and losses on futures and options are determined based upon quoted market values and recorded in the statement of changes in net assets. Forward foreign currency exchange contracts are used primarily to hedge against changes in exchange rates related to foreign securities. As of June 30, 1998, CalPERS had approximately $76 million net exposure to loss from forward foreign currency exchange transactions related to the $30 billion international debt and equity portfolios. CalPERS could be exposed to risk if the counterparties to the contracts are unable to meet the terms of the contracts. CalPERS investment managers seek to control this risk through counterparty credit evaluations and approvals, counterparty credit limits, and exposure monitoring procedures. CalPERS anticipates that the counterparties will be able to satisfy their obligations under the contracts.

The investments of the STRS consist of government, corporate, and international bonds, domestic and international equities, mutual funds, limited partnership holdings, real estate, mortgages, and other investments. The majority of the securities held in the STRS investment portfolio as of June 30, 1998, are in the custody of, or controlled by, the State Street Bank and Trust Company, the master custodian of the STRS.

The fair value of investments for STRS is generally based on published market prices and quotations from major investment firms. In the case of debt securities acquired through private placements, management computes fair value based on market yields and average maturity dates of comparable quoted securities. Mortgages are valued on the basis of future principal and interest payments, and are discounted at prevailing interest rates for similar instruments. Real estate equity investment fair value represent the most recent appraisals. Short-term investments are reported at cost, or amortized cost, which approximates fair value.

Purchases and sales of debt securities, equity securities, and short term investments by STRS are recorded on the trade date. Real estate equity transactions are recorded on the settlement date.

The State Constitution, state statutes, and agency policies permit CalPERS and STRS to lend its securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. Third party securities lending agents have been contracted to lend domestic and international equity and debt securities. All securities loans can be terminated on demand by the lender or the borrower. Collateral, in the form of cash or other securities, is required at 102% and 105% of the fair value of domestic and international securities loaned, respectively. As of June 30, 1998, there was no credit risk of exposure to borrowers because the amount of collateral held exceeded the amounts owed to the borrowers. The cash received as collateral is invested in accordance with investment guidelines. The weighted-average maturity of all investments of the cash collateral was less than 90 days as of June 30. Collateral securities received are not permitted to be pledged or sold unless the borrower defaults. The contracts with the securities lending agents require them to indemnify CalPERS and STRS if the borrowers fail to return the securities (or if the collateral is not sufficient to replace the securities lent) or if the borrower fails to pay for income distributions by the securities' issuers while the securities are on loan.

As of June 30, the State, including discretely presented component units, had investments in securities lending agreements, real estate, investment contracts, mutual funds, and other investments totaling $56.6 billion. These investments are not subject to classification. All remaining investments reported as of June 30 are categorized in three categories of credit risk:

1. Insured or registered, or securities held by the State or its agent in the State's name.
2. Uninsured and unregistered, with securities held by the counterparty's trust department or by an agent in the State's name.

3. Uninsured and unregistered, with securities held by the counterparty or by its trust department or by an agent but not in the State's name.

The types of investments reported at year end are representative of the types of investments made during the year. Furthermore, the credit risk associated with the investments reported at year end is representative of the credit risk associated with investments made during the year.

Table 4 presents the risk categories of the primary government as of June 30.

Table 4

Schedule of Investments – Primary Government
June 30, 1998
(Amounts in thousands)

	Interest Rates	Maturity	Category 1	Category 2	Category 3	Total Fair Value
Pooled Investments *						
U.S. government securities	4.95 – 6.16	121 days – 4 years	$ 11,113,471	$ —	$ —	$ 11,113,471
Negotiable certificates of deposit	5.54 – 5.80	1 day – 1 year	4,761,260	—	—	4,761,260
Banker's acceptances	5.46 – 5.75	1 day – 180 days	20,845	—	—	20,845
Commercial paper	5.44 – 5.70	1 day – 150 days	9,446,571	—	—	9,446,571
Corporate bonds	5.68 – 6.28	1 day – 5 years+	1,723,059	—	—	1,723,059
Bank notes	5.54 – 5.80	1 day – 1 year	1,270,739	—	—	1,270,739
Total Pooled Investments			28,335,945	—	—	28,335,945
Separately Invested Funds Subject to Categorization						
Equity securities			133,929,222	—	—	133,929,222
Securities lending collateral			28,118,114	—	—	28,118,114
Mortgage loans and notes			15,829,572	—	—	15,829,572
U.S. government and agencies			9,469,700	76,287	—	9,545,987
Debt securities – STRS			16,718,122	—	—	16,718,122
Corporate bonds			8,070,690	—	—	8,070,690
Commercial paper			3,206,905	—	—	3,206,905
Other investments			5,426,111	—	—	5,426,111
Total Separately Invested Funds Subject To Categorization			220,768,436	76,287	—	220,844,723
Separately Invested Funds Not Subject to Categorization						
Investments held by broker–dealers under securities loans with cash collateral						28,163,284
Real estate						8,081,783
Venture capital and private equity funds						3,723,253
Investment contracts						2,728,643
Mutual funds						2,266,806
Mortgage loans						246,691
Other						2,013,523
Total Separately Invested Funds Not Subject to Categorization						47,223,983
Total Investments			$ 249,104,381	$ 76,287	$ —	$ 296,404,651

* Approximately 2% of the pooled investments are investments of special purpose authorities which are discretely presented component units. For special purpose authorities' separately invested funds, see Table 6.

The investments of the University of California, a discretely presented component unit, are stated at fair value. All of the University's investments recorded in each fund group are associated with the University of California Retirement System (UCRS), General Endowment Pool (GEP), High Income Pool (HIP), or Short Term Investment Pool (STIP) or are separately invested. Investments authorized by the Regents for the UCRS, GEP, HIP, and other separate investments include equities and fixed income securities. The equity portion of the investment portfolio may include common stocks, preferred stocks, venture capital partnerships, and emerging market funds. Where donor agreements place constraints on allowable investments, assets associated with endowment and similar funds are invested in accordance with the terms of the agreements. Investments authorized by the Regents for the STIP include fixed income securities with a maximum maturity of five years. In addition, the Regents have also authorized loans, with terms up to 30 years, to faculty members under the University of California's Mortgage Origination Program.

The GEP and HIP are balanced portfolios in which a large number of individual endowment funds participate in order to benefit from diversification and economies of scale. The net assets of the endowment and similar funds group are invested in either the GEP, HIP, or STIP or are separately invested. The separately invested funds cannot be pooled due to investment restrictions or income requirements. All of the University of California's fund groups participate in the STIP. Current funds to provide for the payroll, operating expenses, and construction expenditures of all campuses and medical centers are invested in the STIP until expended.

The UCRS contains funds associated with the University of California's defined benefit and defined contribution plans.

The University of California participates in a securities lending program as a means to augment income. Securities are lent to select brokerage firms for which collateral is received in excess of the fair value of such investments during the period of the loan. Collateral may be cash or securities issued by the U. S. Government or its agencies, or the sovereign or provincial debt of foreign countries. Collateral securities cannot be pledged or sold by the University unless the borrower defaults. Loans of domestic equities and all fixed income securities are initially collateralized at 102% of the fair value of securities lent. Loans of foreign equities are initially collateralized at 105%. All borrowers are required to provide additional collateral by the next business day if the value falls to less than 100% of the fair value of securities lent. The University receives interest and dividends during the loan period as well as a fee from the brokerage firm. Securities on loan for cash collateral are not considered to be categorized. As of June 30, the University had no credit risk exposure to borrowers because the amounts the University owes the borrowers exceed the amounts the borrowers owe the University. The University is fully indemnified by its custodial bank against any losses incurred as a result of borrower default.

Securities loans immediately terminate upon notice by either the University or the borrower. Cash collateral is invested by the University's lending agent, as an agent for the University, in a short term investment pool in the University's name, with guidelines approved by the Treasurer of the Regents. As of June 30, the securities in this pool had a weighted average maturity of 131 days. Table 5 presents risk categories of the University of California investments as of June 30.

Table 5

Schedule of Investments – University of California – Discretely Presented Component Unit
June 30, 1998
(Amounts in thousands)

	Category 1	Category 2	Category 3	Total Fair Value
Separately Invested Funds Subject to Categorization				
Equity securities	$ 24,953,325	$ —	$ —	$ 24,953,325
Securities lending collateral	6,456,961	—	—	6,456,961
U.S. government and agency securities	4,514,940	—	—	4,514,940
Corporate bonds	4,889,049	—	—	4,889,049
Other investments	5,784,419	—	—	5,784,419
Total Separately Invested Funds Subject to Categorization	46,598,694	—	—	46,598,694
Separately Invested Funds Not Subject to Categorization				
Investments held by broker–dealers under securities loans with cash collateral				6,299,890
Venture capital and private equity funds				1,210,622
Insurance contracts				205,398
Mortgage loans				242,230
Other investments				121,753
Total Separately Invested Funds Not Subject to Categorization				8,079,893
Total Investments	$ 46,598,694	$ —	$ —	$ 54,678,587

The cash and pooled investments of the special purpose authorities, which are discretely presented component units, are primarily invested in the State Treasurer's Office pooled investment program. Additionally, state law, bond resolutions, and investment policy resolutions allow the authorities to invest in United States government securities, state and municipal securities, commercial paper, corporate bonds, investment agreements, and other investments.

Table 6 presents the risk categories of the special purpose authorities investments outside of the State Treasurer's Office pooled investment program, as of June 30, 1998. Included in the investments of the special purpose authorities are the investments of the SCIF as of December 31, 1997. The SCIF represents 81% of the fair value of the authorities' investments.

Table 6

Schedule of Investments - Special Purpose Authorities - Discretely Presented Component Units *
June 30, 1998
(Amounts in thousands)

	Category 1	Category 2	Category 3	Total Fair Value
Separately Invested Funds Subject to Categorization				
U.S. government securities	$ 2,646,398	$ —	$ —	$ 2,646,398
Corporate bonds	2,383,267	—	—	2,383,267
Mortgage loans and notes	1,086,291	—	—	1,086,291
Commercial paper	19,269	—	—	19,269
Investment agreements	—	121,824	—	121,824
Other investments	64,748	—	—	64,748
Total Separately Invested Funds Subject to Categorization	6,199,973	121,824	—	6,321,797
Separately Invested Funds Not Subject to Categorization				
Investment agreements				1,202,030
Mutual funds				106,651
Total Separately Invested Funds Not Subject to Categorization				1,308,681
Total Investments	$ 6,199,973	$ 121,824	$ —	$ 7,630,478

* For special purpose authorities' pooled investments, see Table 4.

NOTE 4. DUE FROM OTHER FUNDS, DUE TO OTHER FUNDS, ADVANCES AND LOANS RECEIVABLE, ADVANCES FROM OTHER FUNDS, DUE FROM PRIMARY GOVERNMENT, AND DUE TO COMPONENT UNITS

The balances of Due from Other Funds, Due to Other Funds, Advances and Loans Receivable, Advances from Other Funds, Due from Primary Government, and Due to Component Units are shown in Table 7.

The total Advances and Loans Receivable of $10.8 billion is more than the total Advances from Other Funds of $1.2 billion because $9.6 billion of loans to other governmental entities and individuals are included in the loans receivable amounts.

Table 7

Schedule of Due from Other Funds, Due to Other Funds, Advances and Loans Receivable, Advances from Other Funds, Due from Primary Government, and Due to Component Units
June 30, 1998 (Amounts in thousands)

	Due from Other Funds	Due to Other Funds	Advances and Loans Receivable	Advances from Other Funds	Due from Primary Government	Due to Component Units
General Fund	$ 5,161,485	$ 1,841,764	$ 545,840	$ 590,995	$ —	$ 36,487
Special Revenue						
Federal	7,347	3,656,546	37,902	—	—	—
Transportation Construction	1,213,885	198,232	119,242	—	—	12
Transportation Safety	76,736	126,959	—	—	—	—
Business and Professions Regulatory and Licensing	134,615	50,684	1,434	—	—	—
Environmental and Natural Resources	143,479	82,018	1,207,391	41,995	—	—
Financing to Local Governments	19,602	6,382	—	—	—	—
Cigarette and Tobacco Tax	92,082	89,588	—	—	—	97,357
Local Revenue	194,072	28,378	—	—	—	—
Unemployment Programs	624,297	43,709	—	—	—	—
Financing to the Public	590	4,107	37,625	—	—	—
Trial Courts	51,765	110,027	—	—	—	—
Other Special Revenue	47,968	52,103	4,207	11,569	—	1,500
Total Special Revenue	2,606,438	4,448,733	1,407,801	53,564	—	98,869
Capital Projects						
Prison Construction	687	663	—	—	—	—
Higher Education Construction	1,482	11,892	—	—	—	—
Natural Resources Acquisition and Enhancement	17,369	1,397	—	—	—	—
Building Authorities	40,941	33,858	—	—	—	—
Other Capital Projects	888	919	—	—	—	—
Total Capital Projects	61,367	48,729	—	—	—	—
Enterprise						
Housing Loan	4,470	516	2,027,773	12,254	—	—
Water Resources	71,787	33,593	73,237	403	—	—
School Building Aid	—	52,265	192,640	—	—	—
Toll Facilities	11,077	15,587	16,687	6,160	—	—
California State University	14,786	16,000	2,632	2,632	—	—
Leasing of Public Assets	135,936	4,960	—	—	—	—
State Lottery	8,871	251,311	—	—	—	—
Health Facilities Construction Loan Insurance	3,632	149	—	—	—	—
Public Employees' Benefits	—	706	—	—	—	—
Other Enterprise	6,240	4,133	232,226	4,207	—	—
Total Enterprise	256,799	379,220	2,545,195	25,656	—	—
Internal Service						
Architecture Revolving	105,595	3,801	—	—	—	—
Service Revolving	68,796	118,315	—	—	—	—
Prison Industries	18,224	3,271	—	—	—	—
Stephen P. Teale Data Center	17,610	315	—	—	—	—
Health and Welfare Agency Data Center	49,707	231	—	—	—	—
Water Resources	59,744	303	—	91,517	—	—
Public Employees' Health Care	4,216	4,029	—	—	—	—
Equipment Service	125,090	88,399	—	—	—	—
Other Internal Service	700	3,179	—	1,434	—	—
Total Internal Service	449,682	221,843	—	92,951	—	—

(Continued)

Table 7 (continued)

Schedule of Due from Other Funds, Due to Other Funds, Advances and Loans Receivable, Advances from Other Funds, Due From Primary Government, and Due to Component Units
June 30, 1998 (Amounts in thousands)

	Due from Other Funds	Due to Other Funds	Advances and Loans Receivable	Advances from Other Funds	Due from Primary Government	Due to Component Units
Expendable Trust						
Unemployment	12,937	89,351	—	—	—	—
School Employees	1,726	5,260	—	—	—	—
Unemployment Compensation Disability	49,128	8,490	—	—	—	—
California State University and Colleges Trust	12,800	19,839	—	—	—	—
State Guaranteed Loan Reserve	2,110	443	—	—	—	—
Housing Loan	3,129	413	588,003	—	—	—
Unclaimed Property	—	2,567	477,913	—	—	—
Other Expendable Trust	17,140	9,064	—	—	—	—
Total Expendable Trust	98,970	135,427	1,065,916	—	—	—
Pension Trust						
Public Employees' Retirement	5,040	—	—	—	—	—
Judges' Retirement	8	374	—	—	—	—
Judges' Retirement II	20	—	—	—	—	—
Legislators' Retirement	5	206	—	—	—	—
Total Pension Trust	5,073	580	—	—	—	—
Agency						
Revenue Collecting and Disbursing	4,761,264	5,802,949	423,729	423,729	—	—
Deposit	28,507	625,514	21,179	—	—	—
Deferred Compensation Plan	124	370	—	—	—	—
Departmental Trust	3,254	228	—	—	—	—
Other Agency	279,657	373,835	—	—	—	2,564
Total Agency	5,072,806	6,802,896	444,908	423,729	—	2,564
Investment Trust Fund						
Local Agency Investment	166,839	267	—	—	—	—
Total Investment Trust	166,839	267	—	—	—	—
University of California						
Current Funds	12,442	123,265	—	—	135,356	—
Loan Funds	—	2,000	—	—	—	—
Endowment and Similar Funds	13,729	12,327	—	—	—	—
Plant Funds	3,213	15,056	—	—	—	—
Retirement System Funds	123,264	—	—	—	—	—
Total University of California	152,648	152,648	—	—	135,356	—
Special Purpose Authorities						
California Housing Finance Agency	—	—	4,768,258	—	—	—
Non-Major	—	—	—	—	2,564	—
Total Special Purpose Authorities	—	—	4,768,258	—	2,564	—
Total	$ 14,032,107	$ 14,032,107	$ 10,777,918	$ 1,186,895	$ 137,920	$ 137,920

(Concluded)

NOTE 5. RESTRICTED ASSETS

Table 8 presents a summary of the legal restrictions on assets as of June 30. The restricted assets of the primary government are in the enterprise funds, except for $1 million in the internal service funds.

Table 8

Schedule of Restricted Assets
June 30, 1998
(Amounts in thousands)

	Cash and Pooled Investments	Investments	Due From Other Funds	Other Assets
Primary Government				
Debt service	$ 765,067	$ 767,377	$ 171	$ 1,504
Construction	462,491	9,159	499	815
Deposits	9,354	—	—	—
Equipment repair and replacement	54,100	—	622	129
Operations	150	—	—	—
Other	15,035	—	—	—
Total Primary Government	1,306,197	776,536	1,292	2,448
Discretely Presented Component Units				
University of California				
Risk insurance	—	215,621	—	—
Debt service requirements	—	182,545	—	—
Plant acquisition, construction, and renovation	—	80,349	—	—
Plant renewal and replacement	—	531	—	—
Special Purpose Authorities				
Debt service	347,417	1,336,946	—	—
Total Discretely Presented Component Units	347,417	1,815,992	—	—
Total All Restricted Assets	$ 1,653,614	$ 2,592,528	$ 1,292	$ 2,448

NOTE 6. NET INVESTMENT IN DIRECT FINANCING LEASES

The State Public Works Board, an agency that accounts for its activities as an enterprise fund, has entered into lease-purchase agreements with various other primary government agencies, the University of California, and certain local agencies. Payments from these leases will be used to satisfy the principal and interest requirements of revenue bonds issued by the State Public Works Board.

The minimum lease payments to be received by the State Public Works Board for the primary government are summarized in Table 9.

Table 9

Schedule of Minimum Lease Payments to be Received by the State Public Works Board for the Primary Government
(Amounts in thousands)

Year Ending June 30	Primary Government Agencies	University of California	Local Agencies	Total
1999	$ 354,600	$ 106,157	$ 62,752	$ 523,509
2000	382,153	109,028	65,456	556,637
2001	362,826	106,102	65,129	534,057
2002	354,615	104,184	61,878	520,677
2003	356,691	103,313	57,171	517,175
Thereafter	4,264,671	1,438,145	682,316	6,385,132
Total Minimum Lease Payments	6,075,556	1,966,929	994,702	9,037,187
Less unearned income	2,730,342	925,530	440,027	4,095,899
Net Investment in Direct Financing Leases	$ 3,345,214	$ 1,041,399	$ 554,675	$ 4,941,288

NOTE 7. FIXED ASSETS

Table 10 is a summary of changes in the General Fixed Assets Account Group for the year ended June 30.

Table 10

Schedule of Changes in General Fixed Assets
(Amounts in thousands)

	Balance July 1, 1997	Additions	Deductions	Balance June 30, 1998
Land	$ 1,972,754	$ 54,224	$ 27,974	$ 1,999,004
Structures and improvements	10,657,038	915,404	162,003	11,410,439
Equipment	2,218,235	224,695	628,334	1,814,596
Construction in progress	1,107,266	724,614	284,434	1,547,446
Total	$ 15,955,293	$ 1,918,937	$ 1,102,745	$ 16,771,485

Table 11 summarizes the proprietary fund fixed assets of enterprise funds and internal service funds, and the fixed assets of the discretely presented component units as of June 30.

Table 11

Schedule of Fixed Assets for Proprietary Funds and Discretely Presented Component Units
June 30, 1998
(Amounts in thousands)

Primary Government	Enterprise	Internal Service
State water projects	$ 4,104,730	$ —
Toll facilities	1,073,095	—
Other land, improvements, buildings and equipment	934,982	984,357
Construction in progress	616,702	2,919
Total Primary Government Fixed Assets	**6,729,509**	**987,276**
Less: accumulated depreciation	1,835,419	526,511
Net Primary Government Fixed Assets	**$ 4,894,090**	**$ 460,765**

Discretely Presented Component Units	University of California	Special Purpose Authorities
Real estate		
Buildings and improvements	$ 7,869,164	$ 547,530
Land	262,393	43,767
Furniture and equipment	3,255,252	132,764
Libraries and collections	2,227,022	—
Construction in progress	957,079	808
Total Discretely Presented Component Unit Fixed Assets	**14,570,910**	**724,869**
Less: accumulated depreciation	—	143,219
Net Discretely Presented Component Unit Fixed Assets	**$ 14,570,910**	**$ 581,650**

NOTE 8. LONG-TERM OBLIGATIONS

As of June 30, the primary government had long-term obligations totaling $23.0 billion. These obligations are not expected to be financed from current resources in the governmental funds. Long-term obligations consist of the liability for employees' compensated absences, certificates of participation and commercial paper, long-term capital lease obligations, unmatured general obligation bonds, unmatured revenue bonds, and other liabilities. These other liabilities consist of $677 million for workers' compensation claims, $634 million for net pension obligations, $270 million owed for lawsuits, and the University of California pension liability of $103 million. These other liabilities do not have any required payment schedules, or will be paid when funds are appropriated. Of the total long-term obligations outstanding, 94% will be paid by the General Fund and 6% by special revenue funds. The changes in the General Long-Term Obligations Account Group during the year ended June 30, 1998, are summarized in Table 12.

Table 12

Schedule of Changes in General Long-Term Obligations
(Amounts in thousands)

	Balance July 1, 1997	Additions	Deductions	Balance June 30, 1998
Compensated absences payable	$ 1,066,491	$ 593,857	$ 656,388	$ 1,003,960
Certificates of participation and commercial paper	903,750	1,872,491	1,634,730	1,141,511
Capital lease obligations	2,964,285	704,483	121,901	3,546,867
General obligation bonds payable	14,208,431	1,669,029	983,370	14,894,090
Revenue bonds payable	569,525	201,970	12,055	759,440
Other liabilities	1,653,906	308,142	277,368	1,684,680
Totals	$ 21,366,388	$ 5,349,972	$ 3,685,812	$ 23,030,548

NOTE 9. COMPENSATED ABSENCES

As of June 30, the estimated liability for compensated absences related to accumulated vacation and annual leave totaled approximately $1.5 billion. Of this amount, $1.0 billion is reported in the General Long-Term Obligations Account Group, $61 million is reported in the proprietary fund types, $120 million is reported in the General Fund, and $330 million is reported for the discretely presented component units.

NOTE 10. CERTIFICATES OF PARTICIPATION

Debt service requirements for certificates of participation, which are financed by lease payments from the special revenue funds and the General Fund, are shown in Table 13.

Table 13

Schedule of Debt Service Requirements for Certificates of Participation – Primary Government
(Amounts in thousands)

Year Ending June 30	Principal	Interest	Total
1999	$ 7,643	$ 6,303	$ 13,946
2000	7,515	6,729	14,244
2001	7,644	6,252	13,896
2002	7,395	6,487	13,882
2003	7,645	6,224	13,869
Thereafter	78,443	62,753	141,196
Total	$ 116,285	$ 94,748	$ 211,033

Debt service requirements for certificates of participation for the University of California, a discretely presented component unit, are shown in Table 14.

Table 14

Schedule of Debt Service Requirements for Certificates of Participation – University of California – Discretely Presented Component Unit
(Amounts in thousands)

Year Ending June 30	Principal	Interest	Total
1999	$ 7,820	$ 13,376	$ 21,196
2000	8,285	12,767	21,052
2001	8,960	12,221	21,181
2002	7,645	11,806	19,451
2003	8,070	11,392	19,462
Thereafter	198,520	111,094	309,614
Total	$ 239,300	$ 172,656	$ 411,956

Current Year Defeasance: On October 30, 1997, the primary government issued approximately $51 million in refunding certificates of participation to advance refund approximately $48 million of outstanding 1991 certificates. The net proceeds of approximately $50 million (after payment of approximately $1 million in underwriting fees and other issuance costs) together with other available monies of approximately $1 million were deposited into an irrevocable trust with the State Treasurer to provide for all future debt service payments on the refunded certificates. As a result, the refunded certificates are considered to be defeased and the liability for those certificates has been removed from the General Long-Term Obligations Account Group. The primary government advance refunded the 1991 certificates to reduce its total debt service payments over the next 19 years by approximately $30 million and to obtain an economic gain (the difference between the present value of the debt service payments on the old and new debt) of approximately $3 million.

Prior Year Defeasance: In prior years, the primary government has defeased certificates of participation by placing the proceeds of new certificates in an irrevocable trust account to provide for all future debt service payments on the old certificates. Accordingly, the assets of the trust accounts and the liability for the defeased certificates are not included in the State's financial statements. At June 30, 1998, approximately $21 million of certificates of participation outstanding are considered defeased.

NOTE 11. COMMERCIAL PAPER AND OTHER BORROWINGS

The primary government has two commercial paper borrowing programs: a general obligation commercial paper program of up to $1.5 billion and an enterprise fund commercial paper program for the Department of Water Resources of up to $150 million. Under these programs, commercial paper may be issued at prevailing rates for periods not to exceed 270 days from the date of issuance.

To provide liquidity for the programs, a revolving credit agreement has been entered into with commercial banks equal to the authorized amount of commercial paper. The general obligation commercial paper program was increased to $1.8 billion on July 15, 1997. On October 22, 1997, the general obligation commercial paper program had $1.6 billion in outstanding commercial paper notes, the largest outstanding balance to date.

A new agreement was negotiated in March 1998, replacing the July 1997 agreement. The current agreement set the $1.5 billion limit on the general obligation commercial program. As of June 30, 1998, there were borrowings of $1.0 billion of general obligation commercial paper and $29 million of enterprise fund commercial paper outstanding.

The proceeds from the issuance of commercial paper are restricted primarily to construction costs of general obligation bond program projects and of certain water projects. Because the general obligation commercial paper is retired by long-term general obligation debt, it is recorded in the General Long-Term Obligations Account Group.

The University of California, a discretely presented component unit, has mortgages and other borrowings consisting of contractual obligations resulting from the acquisition of land or buildings and the construction and renovation of certain facilities. The mortgages are secured by real property. Included in mortgages and other borrowings, which total approximately $292 million, are various unsecured financing agreements with commercial banks that total approximately $106 million.

The University of California established a $550 million commercial paper program with tax-exempt and taxable components. The program is supported by a revolving line of credit and term loan agreement with a syndicate of banking institutions. Commercial paper has been issued to provide for interim financing of construction and related equipment and medical center working capital requirements. Commercial paper is not secured by any encumbrance, mortgage, or other pledge of property and does not constitute a general obligation of the University of California Regents. At June 30, 1998, outstanding tax-exempt and taxable commercial paper was $430 million and $120 million, respectively.

NOTE 12. LEASES

The aggregate amount of lease commitments for facilities and equipment of the primary government in effect as of June 30 is approximately $7.2 billion. This amount does not include any future escalation charges for real estate taxes and operating expenses. Most primary government leases are classified as operating leases, in accordance with the applicable standards, and contain clauses providing for termination. It is expected that in the normal course of business most of these operating leases will be replaced by similar leases.

The total present value of minimum lease payments for the primary government is composed of approximately $3.5 billion in the General Long-Term Obligations Account Group and $24 million in internal service funds. Lease expenditures for the year ended June 30 amounted to approximately $583 million.

Included in the capital lease commitments are lease-purchase agreements that certain state agencies have entered into with the State Public Works Board, an enterprise fund agency, amounting to a present value of net minimum lease payments of $3.3 billion. This amount represents 94% of the total present value of minimum lease payments of the primary government. Also included in the capital lease commitments are some lease-purchase agreements to acquire electronic data processing and other equipment.

The capital lease commitments do not include $319 million of lease-purchase agreements with building authorities that are blended component units. These building authorities acquire or develop office buildings and then lease the facilities to state agencies. Upon expiration of the leases, title will pass to the primary government. The costs of the buildings are reported in the General Fixed Assets Account Group and the revenue bonds and certificates of participation outstanding associated with the buildings are reported in the General Long-Term Obligations Account Group. Accordingly, the lease receivables or capital lease obligations associated with these buildings are not included in the financial statements pursuant to GASB Statement No. 14.

Future minimum lease commitments of the primary government are summarized in Table 15.

Table 15

Schedule of Future Minimum Lease Commitments – Primary Government
(Amounts in thousands)

Year Ending June 30	Operating Leases	Capital Leases: General Long-Term Obligations	Capital Leases: Internal Service Funds	Total
1999	$ 207,022	$ 378,225	$ 4,505	$ 589,752
2000	141,992	405,818	4,543	552,353
2001	107,879	384,215	4,547	496,641
2002	62,533	374,617	4,548	441,698
2003	40,273	376,697	4,491	421,461
Thereafter	111,638	4,580,570	8,509	4,700,717
Total Minimum Lease Payments	$ 671,337	6,500,142	31,143	$ 7,202,622
Less amount representing interest		2,953,275	7,616	
Present Value of Net Minimum Lease Payments		$ 3,546,867	$ 23,527	

The aggregate amount of discretely presented component units' lease commitments for land, facilities, and equipment in effect as of June 30, 1998, is approximately $2.5 billion. Table 16 presents the future minimum lease commitments for the University of California and the special purpose authorities, as of June 30. Operating lease expenditures for the year ended June 30 amounted to approximately $128 million for discretely presented component units.

Table 16

Schedule of Future Minimum Lease Commitments – Discretely Presented Component Units
(Amounts in thousands)

Year Ending June 30	University of California: Capital	University of California: Operating	Special Purpose Authorities: Operating	Total
1999	$ 132,597	$ 91,929	$ 18,640	$ 243,166
2000	121,715	37,832	13,421	172,968
2001	116,881	31,125	11,423	159,429
2002	107,566	24,548	6,962	139,076
2003	104,774	19,502	6,303	130,579
Thereafter	1,549,873	95,437	5,891	1,651,201
Total Minimum Lease Payments	2,133,406	$ 300,373	$ 62,640	$ 2,496,419
Less amount representing interest	848,422			
Present Value of Net Minimum Lease Payments	$ 1,284,984			

NOTE 13. COMMITMENTS

The primary government has made commitments of $2.9 billion for certain highway construction projects. These commitments are not included in the reserve for encumbrances in the special revenue funds because the future expenditures related to these commitments are expected to be reimbursed from local governments and proceeds of approved federal grants. The ultimate liability will not accrue to the State.

As of June 30, the primary government had other commitments totaling $1.6 billion that are not included as a liability on the balance sheet. These commitments included loan and grant programs for housing, school building aid, and rail system construction totaling approximately $659 million. The total commitments also include approximately $15 million for the rehabilitation of toll bridge facilities, approximately $761 million for the construction of water projects and the purchase of power, and up to $162 million for the operation and maintenance of the lottery's automated gaming system. The commitments are expected to be funded from existing program resources and from the proceeds of revenue and general obligation bonds to be issued.

As of June 30, the University of California, a discretely presented component unit, had authorized construction projects totaling $1.5 billion. Special purpose authorities, which are discretely presented component units, had outstanding commitments to provide $405 million for loans under various housing revenue bond programs.

NOTE 14. GENERAL OBLIGATION BONDS

The State Constitution permits the primary government to issue general obligation bonds for specific purposes and in such amounts as approved by a two-thirds majority of both houses of the Legislature and by a majority of voters in a general or direct primary election. The debt service for general obligation bonds is appropriated from the General Fund. Under the State Constitution, the General Fund is used first to support the public school system and public institutions of higher education. The General Fund can then be used to service the debt on outstanding general obligation bonds. Enterprise funds and certain other funds reimburse the General Fund for any debt service provided on their behalf.

General obligation bonds that are directly related to, and expected to be paid from, the resources of enterprise funds are included within the accounts of such funds in the financial statements. However, the General Fund may be liable for the payment of any principal and interest on these bonds that is not met from the resources of such funds.

As of June 30, $6.3 billion of general obligation bonds had been authorized but not issued. This amount includes $3.1 billion that has been authorized by the applicable finance committee for future issuance in the form of commercial paper notes. Of this amount, $1.0 billion in general obligation indebtedness has been issued in the form of commercial paper notes, but not yet retired by long-term bonds.

Table 17 summarizes the changes in general obligation bond debt for the year ended June 30.

Table 17

Schedule of Changes in General Obligation Bond Debt
(Amounts in thousands)

	General Long–Term Obligations	Enterprise Funds	Total
Balance, July 1, 1997	$ 14,208,431	$ 3,745,595	$ 17,954,026
Additions	1,669,029	447,535	2,116,564
Deductions	(983,370)	(176,265)	(1,159,635)
Balance, June 30, 1998	**$ 14,894,090**	**$ 4,016,865**	**$ 18,910,955**

Table 18 shows the debt service requirements for all general obligation bonds, including interest of $11.2 billion, as of June 30, 1998.

Table 18

Schedule of General Obligation Bonds Debt Service Requirements
(Amounts in thousands)

Year Ending June 30	General Long–Term Obligations	Enterprise Funds
1999	$ 1,904,628	$ 433,473
2000	1,830,777	389,465
2001	1,768,043	375,619
2002	1,719,409	390,902
2003	1,631,451	353,510
Thereafter	14,300,505	5,012,885
Total	$ 23,154,813	$ 6,955,854

Current Year Defeasances: On February 18, 1998, the primary government issued approximately $981 million in various purpose general obligation refunding bonds (the "1998 Bonds") for an advance refunding of approximately $913 million in outstanding general obligation bonds maturing in years 2008 to 2025 (the "1998 Refunded Bonds"). The primary government invested the net proceeds of approximately $985 million in U.S. government securities and placed the securities in an irrevocable trust to pay debt service on the 1998 Refunded Bonds. As a result, the 1998 Refunded Bonds are considered to be defeased and the liability for those bonds has been removed from the General Long-Term Obligations Account Group. This advance refunding was undertaken to reduce total debt service payments through

February 1, 2025, by approximately $83 million and to obtain an economic gain (the difference between the present value of the debt service payments on the 1998 Bonds and the 1998 Refunded Bonds) of approximately $49 million.

For the year ended June 30, 1998, the primary government issued approximately $1.3 billion in general obligation bonds, portions of which were used to refund approximately $754 million of outstanding general obligation bonds. Net proceeds were deposited in various escrow accounts held by the State Treasurer, as escrow trustee, to provide for all future debt service payments on the refunded bonds. As a result, the refunded bonds are considered to be defeased and the related liabilities have been removed from the financial statements.

The refunding will decrease the primary government's debt service payments by approximately $147 million over the next 22 years. The refunding also resulted in an economic gain of approximately $96 million.

Prior Year Defeasances: In prior years, the primary government has defeased certain bonds by placing the proceeds of new bonds in irrevocable escrow in a special trust account with the State Treasury to provide for all future debt service payments on the old bonds. Accordingly, the assets of the trust accounts and the liability for the defeased bonds are not included in the State's financial statements. At June 30, 1998, approximately $269 million of general obligation bonds outstanding are considered defeased.

NOTE 15. REVENUE BONDS

Revenue bonds that are directly related to, and expected to be paid from, the resources of enterprise funds are included within the accounts of such funds. Principal and interest on revenue bonds are payable from the pledged revenues of the respective funds of the authorities and agencies listed in the next section of this note. The General Fund has no legal liability for payment of principal and interest on revenue bonds.

Revenue bonds to acquire, construct, or renovate state facilities or to refund outstanding revenue bonds in advance are issued for Water Resources, California State University, and Leasing of Public Assets. Revenue bonds are also issued to make loans to finance the acquisition of farms and homes by California veterans. When the farm and home loans financed by the revenue bonds are fully paid, the farms and homes become the property of private individuals.

Certain building authorities, under state law, may issue revenue bonds. These revenue bonds are included in the General Long-Term Obligations Account Group. These bonds are issued for the purpose of acquiring and constructing buildings for public education purposes and for the purpose of constructing state office buildings. Leases with state agencies pay the principal and interest on the revenue bonds issued by the building authorities. The primary government has no legal liability for the payment of principal and interest on these revenue bonds.

The University of California, a discretely presented component unit, issues revenue bonds to finance the construction, renovation, and acquisition of certain facilities and equipment.

Under state law, a special purpose authority, which is a discretely presented component unit, issues revenue bonds to make loans to finance housing developments and to finance the acquisition of homes by low to moderate income families. When the housing developments and home loans are fully paid, the housing developments and homes become the property of private individuals or entities.

Table 19 shows revenue bonds outstanding as of June 30.

Table 19

Schedule of Revenue Bonds Outstanding
June 30, 1998
(Amounts in thousands)

Primary Government	
Enterprise Funds	
Housing Loan	$ 275,055
Water Resources	2,381,543
California State University	499,233
Leasing of Public Assets	5,633,179
Total Enterprise Funds	**8,789,010**
General Long-Term Obligations	
Building Authorities	
California State University	30,680
Los Angeles	162,645
San Francisco	394,825
Oakland	157,820
Riverside	13,470
Total General Long-Term Obligations	**759,440**
Total Primary Government	**9,548,450**
Discretely Presented Component Units	
University of California	2,184,171
Special Purpose Authorities	5,679,927
Total Discretely Presented Component Units	**7,864,098**
Total	**$ 17,412,548**

Table 20 shows the debt service requirements as of June 30, 1998. The debt service requirements primarily represent bond principal payments. Table 20 also includes certain unamortized refunding costs, premiums, discounts, and other costs not included in Table 19.

Table 20

Schedule of Revenue Bond Debt Service Requirements
(Amounts in thousands)

Year Ending June 30	Primary Government: General Long-Term Obligations	Primary Government: Enterprise Funds	Discretely Presented Component Units
1999	$ 11,360	$ 391,513	$ 132,128
2000	23,895	328,768	149,786
2001	25,710	357,434	162,882
2002	26,905	329,625	181,052
2003	28,135	328,167	196,191
Thereafter	643,435	7,405,403	7,055,097
Total	$ 759,440	$ 9,140,910	$ 7,877,136

Current Year Defeasances: For the year ended June 30, 1998, the primary government issued approximately $10 million in revenue bonds for Leasing of Public Assets to advance refund approximately $10 million of outstanding lease revenue bonds. The net proceeds were deposited into various escrow accounts held by the State Treasurer, as escrow trustee, to provide for all future debt service payments on the above noted refunded bonds. As a result, the refunded bonds listed are considered to be defeased and the liability for those bonds has been removed from the financial statements. The advance refunding reduced the primary government's aggregate debt service by $0.5 million over the next 4 years and resulted in an economic gain of $0.4 million.

The primary government also issued approximately $505 million in revenue bonds for Leasing of Public Assets to advance refund approximately $506 million of outstanding lease revenue bonds. The net proceeds of approximately $507 million (after payment of approximately $6 million in underwriter discount, original bond discount, insurance, and other bond issuance costs and receipt of approximately $8 million for original bond premium), together with other available moneys of $25 million were deposited in various escrow accounts held by the State Treasurer, as escrow trustee, to provide for all future debt service payments on the above noted refunded bonds. As a result, the refunded bonds listed are considered to be defeased and the liability for those bonds has been removed from the financial statements. The advance refunding reduced the primary government's aggregate debt service payments by $33 million over the next 23 years and resulted in an economic gain of $20 million.

For the year ended June 30, 1998, the primary government issued approximately $275 million of Home Purchase Revenue bonds, portions of which were used to refund approximately $235 million of outstanding Home Purchase Revenue bonds. Net proceeds were deposited in various escrow accounts held by the State Treasurer, as escrow trustee, to provide for all future debt service payments on the refunded bonds. As a result, the refunded bonds are considered to be defeased and the related liabilities have been removed from the financial statements.

The refunding will decrease the primary government's debt service payments by approximately $67 million over the next 22 years. The refunding also resulted in an economic gain of approximately $37 million.

In August 1997, the primary government issued $200 million in Central Valley Project (CVP) Revenue Bonds – Series S, a portion of which was used to advance refund $99 million of outstanding bonds. In August 1997, the primary government issued $134 million in CVP Revenue Bonds – Series T, a portion of which was used to advance refund $143 million of outstanding bonds in March 1998, the earliest redemption date of the refunded bonds.

The net proceeds of the advance refundings (after payment of underwriting refunding fees, other issuance costs, and deposits to the Debt Service Reserve Accounts) were used to purchase securities that were deposited in an irrevocable trust with an escrow agent to provide for all future debt service payments on the advance refunded bonds. As a result, the advance refunded bonds are considered to be defeased and the related liabilities have been removed from the financial statements.

Although the fiscal year 1997-1998 advance refunding resulted in the recognition of an accounting loss of $7 million, the primary government effectively reduced its aggregate debt service payments by approximately $44 million over the next 31 years and obtained an economic gain of $21 million.

On April 1, 1998, the primary government issued San Diego State University Student Union Series C refunding bonds of $20 million to provide for the advance refunding of all but $13 million of the San Diego State University Student Union Series B bonds. The net proceeds are invested by the State Treasurer in United States government securities until the bonds are redeemed. Those securities are deposited in an irrevocable trust with the State Treasurer to provide debt service payments on Series B bonds prior to their full redemption on November 1, 2004.

As of June 30, 1998, all but $13 million of Series B bonds are considered defeased, and the liability of $18 million for those bonds has been removed from the financial statements. The refinancing results in total savings over the life of the issue of $1 million which equates to an economic gain of $0.7 million.

On April 1, 1998, the primary government issued California State University (CSU), Northridge Student Union Series C refunding bonds of $11 million to provide funds for the advance refunding of all but $3 million of the CSU-Northridge Student Union Series B bonds. The net proceeds are invested by the State Treasurer in United States government securities until the bonds are redeemed. Those securities are deposited in an irrevocable trust with the State Treasurer to provide debt service payments of Series B bonds prior to their full redemption on November 1, 2002.

As of June 30, 1998, all but $3 million of Series B bonds are considered defeased, and the liability of $10 million for those bonds has been removed from the financial statements. The refinancing results in total savings over the life of the issue of $1 million which equates to an economic gain of $0.6 million.

In November 1997, the University of California, a discretely presented component unit, issued $284 million of Multiple Purpose Projects Refunding Revenue Bonds with a weighted average interest rate of 5.3% to advance refund and defease $283 million of outstanding Multiple Purpose Projects Revenue Bonds with a weighted average interest rate of 6.3%. The entire net bond proceeds of $284 million, together with an additional $19 million of other University funds, were used to purchase United States government securities sufficient to fund retirement of the specified obligations.

In March 1998, the University of California issued $138 million of Research Facility Revenue Bonds with a weighted average interest rate of 5.1% to finance the acquisition, construction, and equipping of certain research facilities and to advance refund and defease $93 million of outstanding Research Facilities Revenue Bonds with a weighted average interest rate of 6.4%. Bond proceeds totaling $89 million, together with an additional $11 million of other University funds, were used to purchase United States government securities sufficient to fund retirement of the specified obligations. Bond proceeds of $49 million were applied to repay interim tax-exempt commercial paper financing incurred prior to the issuance of the bonds, fund additional construction expenditures, and pay costs of issuance.

The University of California defeasances resulted in an increase of fund balance of $3 million for the year ended June 30, 1998 and is included in "Debt Extinguishment" in the Combined Statement of Changes in Fund Balances. The refunding reduced aggregate debt service payments by $91 million over the next 27 years and the University was able to obtain an economic gain of $23 million.

For the year ended June 30, 1998, the California Housing Finance Agency (CHFA), a discretely presented component unit, issued $273 million of single family and multifamily housing bonds, portions of which were used to redeem $272 million in outstanding single family and multifamily housing bonds. The CHFA considered these debt refundings to be an in-substance defeasance and accordingly, removed the redeemed bonds and related assets from the financial statements.

The refunding will decrease the debt service cash flow for the housing bonds by approximately $36 million. The refunding also resulted in an economic gain of approximately $29 million.

Prior Year Defeasances: In prior years, the primary government defeased certain bonds by placing the proceeds of new bonds in irrevocable trust accounts to provide for all future debt service requirements. Accordingly, the assets and liabilities for these defeased bonds are not included in the financial statements. As of June 30, 1998, $1.7 billion of revenue bonds outstanding are considered defeased.

In prior years, the University of California, a discretely presented component unit, defeased certain bonds. As of June 30, 1998, $837 million of University of California revenue bonds outstanding are considered defeased.

NOTE 16. MAJOR TAX REVENUES

Tax revenues for the year ended June 30, are presented in Table 21.

Table 21

Schedule of Major Tax Revenues
Year Ended June 30, 1998
(Amounts in thousands)

	General Fund	Special Revenue Funds	Expendable Trust Funds
Personal income	$ 27,858,619	$ —	$ —
Sales and use	17,564,572	3,740,212	—
Bank and corporation	5,601,526	—	—
Unemployment insurance	—	—	3,115,985
Disability insurance	—	—	1,203,761
Insurance	1,221,541	—	—
Inheritance, estate, and gift	864,680	—	—
Cigarette and tobacco	163,316	485,246	—
Other	300,919	218,939	42,194
Total	$ 53,575,173	$ 4,444,397	$ 4,361,940

NOTE 17. FUND EQUITY

A. Fund Deficits

The following funds had deficits at June 30, as shown in Table 22.

Table 22

Schedule of Fund Deficits
June 30, 1998
(Amounts in thousands)

	Capital Projects Funds	Enterprise Funds	Internal Service Funds	Discretely Presented Component Units
Higher Education Construction	$ 28,002	$ —	$ —	$ —
East Bay Building Authority	1,339	—	—	—
Los Angeles Building Authority	6,211	—	—	—
Health Facilities Construction Loan Insurance	—	103,652	—	—
Water Resources Revolving	—	—	14,764	—
Architecture Revolving	—	—	6,784	—
California Urban Waterfront Area Restoration Finance Authority	—	—	—	862
Total	$ 35,552	$ 103,652	$ 21,548	$ 862

B. Changes to Contributed Capital

The changes in the State's contributed capital accounts are shown in Table 23.

Table 23

Schedule of Changes in Contributed Capital
(Amounts in thousands)

Sources	Enterprise	Internal Service	Discretely Presented Component Units	Total
Balance, July 1, 1997	$ 216,247	$ 112,326	$ 99	$ 328,672
Government contributions	—	231,993	—	231,993
Fund dissolution	(21,014)	—	—	(21,014)
Other decreases	—	(135)	—	(135)
Balance, June 30, 1998	$ 195,233	$ 344,184	$ 99	$ 539,516

NOTE 18. RISK MANAGEMENT

The primary government has elected, with a few exceptions, to be self-insured against loss or liability. Generally, the exceptions are when a bond resolution or a contract requires the primary government 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. The primary government generally does not maintain reserves. Losses are covered by appropriations from each fund responsible for payment in the year in which the payment occurs. All claim payments are on a "pay as you go" basis. The potential amount of loss arising from risks other than workers' compensation benefits are not considered material in relation to the primary government's financial position.

Workers' compensation benefits for self-insured agencies are initially paid by the SCIF. The liability for future workers' compensation claims against the primary government's self-insured agencies is estimated to be approximately $886 million as of June 30. The liability represents the estimated total cost of all open and known disability claims as of June 30, including claims incurred but not reported. The estimates are based on established claims criteria such as age of the injured, occupation, and type of injury. Of the total, $118 million is included in the General Fund, $73 million in the special revenue fund type, $18 million in the proprietary fund types, and $677 million in the General Long-Term Obligations Account Group. Changes in the claims liabilities during the year ended June 30 are shown in Table 24.

The University of California, a discretely presented component unit, is self-insured for medical malpractice, workers' compensation, employee health care, and general liability claims. These risks are subject to various claim and aggregate limits, with excess liability coverage provided by an independent insurer. Liabilities are recorded when it is probable a loss has occurred and the amount of the loss can be reasonably estimated. These losses include an estimate for claims that have been incurred but not reported. The estimated liabilities are based upon an independent actuarial determination of the anticipated future payments, discounted at rates ranging from 6.5% to 8.0%. The special purpose authorities, which are discretely presented component units, do not have any significant liabilities related to self insurance.

Table 24

Schedule of Changes in the Self Insurance Claims
Years Ended June 30
(Amounts in thousands)

	Primary Government		University of California – Discretely Presented Component Unit	
	1998	1997	1998	1997
Unpaid claims, beginning	$ 869,000	$ 733,000	$ 324,800	$ 368,000
Incurred claims	240,000	341,000	173,800	127,900
Claim payments	(223,000)	(205,000)	(179,300)	(171,100)
Unpaid claims, ending	**$ 886,000**	**$ 869,000**	**$ 319,300**	**$ 324,800**

NOTE 19. SEGMENT INFORMATION

Selected financial information by enterprise fund activity for major segments is shown in Table 25. The primary sources of enterprise fund revenues are as follows.

Housing Loan: Interest charged on contracts of sale of properties to California veterans and to California National Guard members; loan origination fees; and interest on investments.

Water Resources: Charges to local water districts, sale of excess power to public utilities, and interest earned on investments.

School Building Aid: Interest charged on loans to school districts for acquisition, construction, or rehabilitation of classroom facilities; and income from the rental of portable classrooms to school districts.

Toll Facilities: Toll fees and interest earned on investments.

California State University: Charges to students for housing and parking; student fees for campus unions, health centers, and self-supporting educational programs; and interest earned on investments.

Leasing of Public Assets: Rental charges from the lease of public assets and interest earned on investments.

State Lottery: Sale of lottery tickets.

Health Facilities Construction Loan Insurance: Construction project fees and income from operations or proceeds of sales of property acquired by default of borrowers.

Public Employees' Benefits: Contributions for public employee long-term care plans and fees for managing a deferred compensation program.

Other Enterprise: Canteen revenues and fees charged by various other departments.

Table 25

Schedule of Enterprise Fund Activity by Separate Major Segments
As of and for the Year Ended June 30, 1998
(Amounts in thousands)

	Housing Loan	Water Resources	School Building Aid	Toll Facilities	California State University	Leasing of Public Assets	State Lottery	Health Facilities Construction Loan Insurance	Public Employees' Benefits	Other Enterprise
Operating revenue	$ 250,819	$ 560,017	$ 26,214	$ 145,394	$ 283,289	$ 386,923	$ 2,294,424	$ 9,634	$ 113,211	$ 120,771
Depreciation	727	66,460	3,720	17,351	—	—	10,914	—	—	19
Amortization of deferred charges	—	12,529	—	430	—	5,826	2,454	—	—	—
Operating income (loss)	671	150,042	9,824	95,808	60,125	(22,806)	785,812	384	(18,871)	(56)
Operating transfers in	8,441	—	—	—	1,307	7,122	—	—	—	8,104
Operating transfers out	8,441	—	80,094	4,153	26,101	7,123	—	—	—	6,090
Net income (loss)	5,558	(22,463)	(70,270)	106,421	30,705	(22,807)	—	15,712	12,118	17,876
Grants received	—	—	—	—	329	—	—	—	—	—
Grants provided	—	—	—	26,890	—	—	—	—	—	—
Property, plant, and equipment										
Additions	1,513	4,840	—	82,793	30,487	303,473	8,420	—	—	—
Deductions	727	66,460	3,720	17,351	—	—	11,485	—	—	44
Net working capital	1,520,573	118,144	(10,067)	690,629	473,387	627,340	3,194,523	133,184	225,475	99,944
Total assets	**3,643,638**	**4,934,052**	**303,448**	**1,330,388**	**1,308,892**	**5,894,030**	**3,519,459**	**142,165**	**230,881**	**464,042**
Bonds and other long-term liabilities	3,290,718	3,415,473	3,750	6,160	510,070	5,633,179	3,244,776	244,859	211,523	49,226
Total Equity (Deficit)	**293,942**	**1,096,428**	**247,422**	**1,303,925**	**710,730**	**127,341**	—	**(103,652)**	**13,952**	**283,865**

NOTE 20. CONDENSED FINANCIAL STATEMENTS - DISCRETELY PRESENTED COMPONENT UNITS

Tables 26 and 27 present summary financial statements of the special purpose authorities, which are the SCIF, the CHFA, and Non-Major Component Units. The financial statements of the University of California, a discretely presented component unit, are presented separately in the combined statements of this report.

The SCIF is a component unit created to offer insurance protection to employers at the lowest possible cost. This information is as of and for the year ended December 31, 1997. The CHFA was created for the purpose of meeting the housing needs of persons and families of low and moderate income. The Non-Major Component Units provide certain services that are not part of the primary government and also provide certain private and public entities with a low-cost source of financing for activities that are deemed to be in the public interest.

Table 26

Condensed Balance Sheet – Special Purpose Authorities – Discretely Presented Component Units

June 30, 1998
(Amounts in thousands)

	State Compensation Insurance	California Housing Finance Agency	Non-Major Component Units	Total
Assets				
Due from primary government	$ —	$ —	$ 2,564	$ 2,564
Other current assets	1,366,938	400,006	148,282	1,915,226
Investments	6,211,973	1,352,630	65,875	7,630,478
Advances and loans receivable	—	4,768,258	—	4,768,258
Fixed assets	234,410	—	347,240	581,650
Total Assets	$ 7,813,321	$ 6,520,894	$ 563,961	$ 14,898,176
Liabilities				
Other current liabilities	$ 1,236,137	$ 337,362	$ 25,668	$ 1,599,167
Benefits payable	4,684,083	—	—	4,684,083
Revenue bonds payable	—	5,578,485	101,442	5,679,927
Contracts and notes payable	—	—	3,928	3,928
Total Liabilities	5,920,220	5,915,847	131,038	11,967,105
Fund Equity				
Contributed capital	—	—	99	99
Retained earnings				
Reserved for regulatory requirements	—	548,700	—	548,700
Unreserved	1,893,101	56,347	432,824	2,382,272
Total Fund Equity	1,893,101	605,047	432,923	2,931,071
Total Liabilities and Fund Equity	$ 7,813,321	$ 6,520,894	$ 563,961	$ 14,898,176

Table 27

Condensed Statement of Revenues, Expenses, and Changes in Retained Earnings – Special Purpose Authorities – Discretely Presented Component Units
Year Ended June 30, 1998
(Amounts in thousands)

	State Compensation Insurance	California Housing Finance Agency	Non–Major Component Units	Total
Operating Revenues				
Earned premiums (net)	$ 1,052,835	$ —	$ —	$ 1,052,835
Other revenue	45,034	373,634	165,000	583,668
Total Operating Revenues	1,097,869	373,634	165,000	1,636,503
Operating Expenses				
Depreciation	7,219	465	4,328	12,012
Benefit payments	1,263,074	—	—	1,263,074
Interest expense	—	343,967	2,062	346,029
Amortization of deferred charges	145,847	1,313	—	147,160
Other operating expenses	68,690	48,752	155,983	273,425
Total Operating Expenses	1,484,830	394,497	162,373	2,041,700
Operating Income (Loss)	(386,961)	(20,863)	2,627	(405,197)
Nonoperating Revenues (Expenses)				
Interest revenue	620,557	106,220	4,305	731,082
Dividends paid	(73,012)	—	—	(73,012)
Other nonoperating revenues (expenses)	—	—	941	941
Net Nonoperating Revenues (Expenses)	547,545	106,220	5,246	659,011
Net Income	160,584	85,357	7,873	253,814
Retained Earnings, July 1, 1997	1,732,517	519,690	424,951	2,677,158
Retained Earnings, June 30, 1998	$ 1,893,101	$ 605,047	$ 432,824	$ 2,930,972

NOTE 21. NO COMMITMENT DEBT

Certain debt of the special purpose authorities, which are discretely presented component units, is issued to finance activities such as construction of new facilities and remodeling of existing facilities, as well as acquisition of equipment. This debt is collateralized solely by the credit of private and public entities and is administered by trustees independent of the State. As of June 30, the special purpose authorities had $13.0 billion of debt outstanding, which is not debt of the State.

The State has also entered into transactions which involve debt issued by three special purpose trusts that were created by another special purpose authority, called the California Infrastructure and

Economic Development Bank. The special purpose trusts are legally separate entities that issued long-term debt for the primary purpose of financing certain costs of assets and obligations that are recoverable by utilities through electric rate charges, but which may prevent the utilities from offering electricity at lower rates in a competitive market. As of June 30, the special purpose trusts had $5.8 billion of debt outstanding. Similar to the debt of the special purpose authorities, the debt of the special purpose trusts is not a debt of the State.

NOTE 22. CONTINGENT LIABILITIES

A. Litigation

The primary government is a party to numerous legal proceedings, many of which normally occur in governmental operations. The following were accrued as a liability in the financial statements: legal proceedings that were decided against the primary government before June 30, 1998; legal proceedings that were in progress as of June 30, 1998, and were settled or decided against the primary government as of November 20, 1998; and legal proceedings having a high probability of resulting in a decision against the primary government as of November 20, 1998, and for which amounts could be estimated. For governmental fund types and expendable trust funds, the portion of the liability that is expected to be paid within the next 12 months is recorded as a liability of the fund from which payment will be made; the remainder is shown as a liability of the General Long-Term Obligations Account Group. For other fund types, the entire liability is recorded in the fund involved. In addition, the primary government is involved in certain other legal proceedings that, if decided against the primary government, may require it to make significant future expenditures or may impair future revenue sources. Because of the prospective nature of these proceedings, no provision for this potential liability has been made in the financial statements.

Following are the more significant lawsuits pending against the primary government:

Northern California 1997 Flood Litigation: In January of 1997, California experienced major flooding in six different areas with preliminary estimates of property damage of approximately $1.6 to $2 billion. To date, three lawsuits have been filed. The anticipated number of lawsuits has not materialized. The exposure arising from the floods is not expected to exceed $100 million.

The primary government is a defendant in *Ceridian Corporation v. Franchise Tax Board*, a suit which challenges the validity of two sections of the California Tax laws. The first relates to deduction from corporate taxes for dividends received from insurance companies to the extent the insurance companies have California activities. The second relates to corporate deduction of dividends to the extent the earnings of the dividend paying corporation have already been included in the measure of their California tax. On

August 13, 1998, the court issued a judgment against the Franchise Tax Board on both issues. The Franchise Tax Board has appealed the judgment. If both sections of the California tax law are invalidated, and all dividends become deductible, in the future General Fund collections would be reduced annually in the $200–$250 million range for all taxpayers.

The primary government is involved in a lawsuit, *Thomas Hayes v. Commission on State Mandates*, related to state-mandated costs. The action involves an appeal by the Director of Finance from a 1984 decision by the State Board of Control (now succeeded by the Commission on State Mandates (COSM)). The Board of Control decided in favor of local school districts' claims for reimbursement for special education programs for handicapped students. The case was then brought to the trial court by the primary government and later remanded to the COSM for redetermination. The COSM has since expanded the claim to include supplemental claims filed by seven other educational institutions; a final hearing on the proposed statement of decision is scheduled for November 30, 1998. To date, the Legislature has not appropriated funds. The liability to the primary government, if all potentially eligible school districts pursue timely claims, has been estimated by the Department of Finance at more than $1 billion.

The primary government is involved in a lawsuit related to contamination at the Stringfellow toxic waste site. In *United States, People of the State of California v. J. B. Stringfellow, Jr., et al.*, the primary government is seeking recovery for past costs of cleanup of the site, a declaration that the defendants are jointly and severally liable for future costs, and an injunction ordering completion of the cleanup. However, the defendants have filed a counterclaim against the primary government for alleged negligent acts, resulting in significant findings of liability against the primary government as owner, operator, and generator of wastes taken to the site. The primary government has appealed the rulings. Present estimates of the cleanup range from $400 million to $600 million.

The primary government is a defendant in a coordinated action involving 3,000 plaintiffs seeking recovery for damages caused by the Yuba River flood of February 1986. The trial court has found liability in inverse condemnation and awarded damages of $500,000 to a sample of plaintiffs. The primary government's potential liability to the remaining plaintiffs ranges from $800 million to $1.5 billion. In 1992, the primary government and plaintiffs filed appeals; however, no hearing date has been set.

The primary government is a defendant in *Professional Engineers in California Government v. Wilson*. The petitioners are challenging several appropriations in the 1993, 1994, and 1995 Budget Acts. The appropriations mandate the transfer of approximately $258 million from the State Highway Account, within the special revenue funds, and $131 million from the Motor Vehicle Account, within the special revenue funds, to the General Fund and appropriate approximately $6 million from the State Highway Account to fund a highway-grade crossing program administered by the Public Utilities Commission. The petitioners are also challenging a $130 million transfer from the State Highway Account to the Motor Vehicle Account. Petitioners contend that the transfers violate several constitutional provisions and request that the moneys be returned to the State Highway Account and Motor Vehicle Account.

The primary government is a defendant in *Just Say No To Tobacco Dough Campaign v. State of California*, where the petitioners challenge the appropriation of approximately $166 million of Proposition 99 funds in the Cigarette and Tobacco Products Surtax Fund for years ended June 30, 1990, through June 30, 1995, for programs which were allegedly not health education or tobacco-related disease research. If the primary government loses, the General Fund and funds from other sources would be used to reimburse the Cigarette and Tobacco Products Surtax Fund, an agency fund, for approximately $166 million.

The primary government is a defendant in an action, *Emily Q., et al., v. Belshe, et al.*, to compel a change in early screening procedures for children with mental health needs. The lawsuit is limited to Los Angeles County. The primary government has filed an answer in this case. An adverse outcome is possible with the potential liability of $500 million per year.

The University of California and the special purpose authorities, which are discretely presented component units, are contingently liable in connection with claims and contracts, including those currently in litigation, arising in the normal course of their activities. The outcome of such matters is either not expected to have a material effect on the financial statements or cannot be estimated at this time.

B. Federal Audit Exceptions

The primary government receives substantial funding from the federal government in the form of grants and contracts. The primary government is entitled to these resources only if it complies with the terms and conditions of the grants and contracts and with the applicable federal laws and regulations; the primary government may spend these resources only for eligible purposes. If audits disclose exceptions, the primary government may incur a liability to the federal government.

NOTE 23. DEFERRED COMPENSATION PLANS

The primary government administers a long-term tax deferred savings program designed to supplement the retirement income of employees of the primary government, certain special purpose authorities, which are discretely presented component units, and local school districts. The special purpose authorities do not have a significant number of employees enrolled in the program. The program is comprised of a deferred compensation plan (457), and a thrift plan (401(k)), in accordance with Sections 457, and 401(k), of the Internal Revenue Code. In addition, the program includes a mandatory retirement plan for employees covered by neither the California Public Employees' Retirement System (CalPERS) nor Social Security, called the Part-Time, Seasonal and Temporary Plan (PST).

The 457 and 401(k) plans are optional plans for eligible employees. Under these plans, employees defer a portion of their salary on a pre-tax basis. The deferred salary amounts as well as any earnings gained are not taxable to the employees until funds are withdrawn from the plans and received by the employees. Participant withdrawals are subject to various conditions set forth in plan documents. Generally, funds may not be withdrawn, except in cases of emergency, until the participant has retired or separated from civil service, or has reached the required age. Participants of the 457 and 401(k) plans direct the primary government to invest the deferred amounts among various investment options. The primary government makes no contribution to any of these plans and the cost of the program is paid through administrative fees by the program participants. The assets of the 401(k) plan are held for the participants in a trust.

On August 20, 1996, the Small Business Job Protection Act of 1996 was signed into law. Under the new law, assets of the 457 plan are protected from the claims of the employer's creditors. In order to comply with the new law, changes must be implemented to its plan document prior to January 1, 1999. Until such time, the assets held in the 457 plan remain the property of the primary government and continue to be subject to its general creditors.

The PST is a mandatory plan for employees who are not members of the primary government's retirement system and who are not covered by social security. The primary government invests PST participants' deferred amounts into an investment option of the primary government's choosing. The employer makes no contribution to the PST, but the administrative costs to run the PST are paid by the primary government.

The primary government has no liability for losses under the plans but does have the responsibility to administer the plans in good faith. As of June 30, the market value of the three plans was approximately $3.3 billion for the 457, $647 million for the 401(k), and $63 million for the PST. The plans are accounted for as agency funds.

NOTE 24. PENSION TRUSTS

Two retirement systems, the California Public Employees' Retirement System (CalPERS) and the State Teachers' Retirement System (STRS), are included in the primary government. One retirement system, the University of California Retirement System

(UCRS), is included in the discretely presented component units. The pension liability for all pension trust funds was determined in accordance with GASB Statement No. 27, Accounting for Pensions by State and Local Government Employers. The amounts of the pension liability for all pension trust funds are presented on Tables 29 and 30 as the net pension obligation (NPO) as of June 30, 1998. Information on the investments of the retirement systems is included in Note 3, Deposits and Investments.

CalPERS administers four defined benefit retirement plans: the Public Employees' Retirement Fund (PERF), the Judges' Retirement Fund (JRF), the Judges' Retirement Fund II (JRF II), and the Legislators' Retirement Fund (LRF). CalPERS issues a publicly available financial report that includes financial statements and ten years of required supplementary information for these four plans. This report may be obtained by writing to the California Public Employees' Retirement System, Central Supply, P.O. Box 942715, Sacramento, California 94229-2715.

CalPERS uses the accrual basis of accounting. Member contributions are recorded when due. Employer contributions are recorded when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due in accordance with the terms of each plan.

The State Teachers' Retirement System (STRS) administers two defined benefit retirement plans: Teachers' Retirement Fund (TRF) and the Cash Balance Plan (CBPlan). STRS also offers, through a third party administrator, a defined contribution plan that meets the requirements of the Internal Revenue Code Section 403(b). STRS issues a publicly available financial report that includes financial statements and required supplementary information on the plans. This report may be obtained from the State Teachers' Retirement System, Audits Division, 7667 Folsom Blvd., 2nd Floor, Sacramento, California 95826.

STRS uses the accrual basis of accounting. Member contributions are recognized in the period in which the contributions are due. Employer and primary government contributions are recognized when due and the employer or the primary government has made a formal commitment to provide the contributions. Benefits are recognized when due and payable in accordance with the retirement program.

A. Public Employees' Retirement Fund

1. Fund Information

Plan Description: CalPERS administers the PERF, which is an agent multiple-employer retirement system. Employers participating in the PERF include the primary government and certain special purpose authorities, which are discretely presented component units, 61 school employers, and 1,304 public agencies as of June 30, 1998.

The excess of the actuarial value of assets over the actuarial accrued liability of PERF for the primary government and other participating agencies was $10.6 billion at June 30, 1997. This is a result of the difference between the actuarial value of assets of $108.5 billion and the actuarial accrued liability of $97.9 billion. Contributions are actuarially determined.

2. Employer's Information

Plan Description: The primary government and certain special purpose authorities contribute to the PERF. The fund acts as a common investment and administrative agent of the primary government and the other member agencies. The special purpose authorities' participation in PERF is not a material portion of the program. The primary government has six pension plans within the PERF: first tier miscellaneous, second tier miscellaneous, industrial, California Highway Patrol, police officers and firefighters, and other safety members. The payroll for employees covered by the PERF in the year ended June 30, 1998, was approximately $9.2 billion.

All employees who work on a half-time or more basis are eligible to participate in the CalPERS. The CalPERS administers several different plans, each providing benefits based on members' years of service, age, final compensation, and benefit formula. Vesting occurs after five or ten years, depending on the plan. All plans provide death, disability, and survivor benefits. The benefit provisions are established by statute.

Funding policy: Benefits are funded by contributions from members and the primary government and earnings from investments. Member and primary government contributions are a percentage of applicable member compensation. Member rates are defined by law and based on the primary government's benefit formula. The primary government contribution rates are determined by periodic actuarial valuations or by state statute.

Employees, with the exception of employees in the second tier plan, are required to contribute to the fund. The contribution rates of active plan members are based on a percentage of salary over a monthly base compensation amount of $238 to $863. With the exception of employees in the second-tier plan, employees' required contributions vary from 5.0% to 8.0% of their salary over their base compensation amount.

The required employer contribution rates for the primary government are shown in Table 28.

Table 28

Schedule of Required Employer Contribution Rates for the Primary Government by Member Category
Year Ending June 30, 1998

	Normal Cost	Unfunded Liability	Total Rate
Miscellaneous members			
First tier	9.92 %	2.78 %	12.70 %
Second tier	7.03	2.78	9.81
Industrial	10.57	(1.55)	9.02
California Highway Patrol	15.44	(0.06)	15.38
Police officers and firefighters	16.13	(0.89)	15.24
Other safety members	14.80	(1.18)	13.62

For the year ended June 30, 1998, the annual pension cost (APC) and the amount of contributions made for the primary government were each approximately $1.2 billion. The APC and the percentage of APC contributed for the last three years are shown in Table 29. Actuarial valuations of the PERF are performed annually. Information from the last valuation, which was performed as of June 30, 1997, is also shown in Table 29.

B. Judges' Retirement Fund

Plan Description: CalPERS administers the JRF, which is an agent multiple-employer defined benefit retirement plan. The JRF membership includes justices of the Supreme Court and courts of appeal, as well as judges of superior courts, municipal courts, and justice courts appointed or elected prior to November 9, 1994. There are 59 employers participating in the JRF for the fiscal year ended June 30, 1998. The payroll for employees covered by the JRF for the fiscal year ended June 30, 1998, was approximately $140 million. The primary government pays the employer contributions for all employees covered by the JRF.

All justices and judges appointed or elected prior to November 9, 1994, are required to participate in the JRF. The JRF provides benefits based on members' years of service, age, final compensation, and benefit formula. Vesting occurs after five years. The JRF provides death, disability, and survivor benefits. Benefits for the JRF are established by the Judges' Retirement Law.

Funding Policy: The required contribution rates of active plan members are based on a percentage of salary over a base compensation amount. For the year ended June 30, 1998, the required contribution rate for the JRF was 8.0%.

The contributions of the JRF are not actuarially determined. Contributions are pursuant to state statute. Employer contributions are required to be 8.0% of applicable member compensation. The other funding to meet benefit payment requirements of the JRF is currently provided from the following sources: filing fees, which require varying amounts, depending on fee rate and number of filings; investments, which earn the current yield on short term investments; and the primary government's balancing contributions, as required by the Judges' Retirement Law. The balancing contributions are equal to an amount at least equal to the estimated benefits payable during the ensuing fiscal year less the sum of the estimated member contributions during the ensuing fiscal year, and net assets available for benefits at the beginning of the fiscal year ("pay as you go" basis).

The APC and the amount of contributions made to the JRF for the year ended June 30, 1998, were $133 million and $56 million, respectively. The net pension obligation (NPO) of the JRF at June 30, 1998, was $623 million, an increase of $77 million over last year's balance of $546 million. The APC is comprised of $134 million for the annual required contribution (ARC), $46 million interest on the NPO, and $47 million for the adjustment to the ARC. An actuarial valuation of the JRF's assets and liabilities is made annually. The APC, the percentage of APC contributed, and the NPO for the last three years are shown in Table 29. Information on the last valuation, which was performed as of June 30, 1997, is also shown in Table 29. While the aggregate cost method that was used for the June 30, 1997, valuation does not identify or separately amortize the unfunded actuarial accrued liability, this liability, as shown on Table 29, was computed using the entry age normal method.

C. Judges' Retirement Fund II

Plan Description: CalPERS administers the JRF II, which is an agent multiple-employer defined benefit retirement plan. The membership of the JRF II includes justices of the same courts as covered by JRF who were appointed or elected on or subsequent to November 9, 1994. There are 59 employers participating in the JRF II. The payroll for employees covered by the JRF II for the fiscal year ending June 30, 1998, was approximately $24 million. The primary government pays the employer contributions for all employees covered by the JRF II.

All justices and judges appointed or elected on or subsequent to November 9, 1994, are required to participate in the JRF II. JRF II provides benefits based on members' years of service, age, final compensation, and benefit formula. Vesting occurs after five years. The JRF II provides death, disability, and survivor benefits. Benefits for the JRF II are established by the Judges' Retirement System II Law.

Funding policy: The required contribution rate of active plan members is based on a percentage of salary over a base compensation amount. For the year ended June 30, 1998, the required contribution rate for JRF II is 8.0%. For the year ended June 30, 1998, the primary government's contribution rate for the JRF II was 21.9% of applicable member compensation.

Actuarial valuations for the JRF II are required to be carried out annually. The legislated employer contribution rate will be adjusted periodically as part of the annual Budget Act in order to maintain or restore the actuarial soundness of the fund.

For the fiscal year ended June 30, 1998, the annual pension cost (APC) and the amount of contributions made for the JRF II were both approximately $5.4 million. The APC and the percentage of APC contributed for year ended June 30, 1998 are shown in Table 29. Information on the last valuation, which was performed as of June 30, 1997, is also shown in Table 29.

D. Legislators' Retirement Fund

Plan Description: CalPERS administers the LRF, which is a single-employer defined benefit retirement plan. The eligible membership of the LRF includes state legislators serving in the legislature prior to November 1, 1990, constitutional officers, and legislative statutory officers. The payroll for employees covered by the LRF in 1998 was approximately $4 million.

The LRF provides benefits based on members' years of service, age, final compensation, and benefit formula. Vesting occurs after five years. The plan provides death, disability, and survivor benefits. Benefits for the LRF are established by the Legislators' Retirement Law.

The LRF is currently in transition. The number of legislators eligible to participate in the LRF is rapidly declining as incumbent legislators leave office and are replaced by new legislators who are not eligible to participate in the program. Eventually, the only active members in the LRF will be approximately 12 Constitutional Officers (including the Insurance Commissioner and members of the Board of Equalization) and approximately four Legislative Statutory Officers.

Funding Policy: The contribution requirements of the LRF are based on actuarially determined rates. An actuarial valuation of the LRF's assets and liabilities is required at least every two years. For the year ended June 30, 1998, the actual contributions made by employees were approximately 8.3% of covered payroll. For the year ended June 30, 1998, the primary government's funding rate was 18.81% of covered payroll and the actuarially determined rate was 53.96%, based on the June 30, 1996, actuarial valuation.

The APC and the amount of contributions made by the primary government to the LRF for the year ended June 30, 1998, were $2.0 million and $0.7 million, respectively. The NPO of the LRF at June 30, 1998, was $11.4 million, an increase of $1.3 million over last year's balance of $10.1 million. The APC is comprised of $2.0 million for the ARC, $0.8 million interest on the NPO, and $0.8 million for the adjustment to the ARC. The APC, the percentage of APC contributed, and the NPO for the last three years are shown in Table 29. An actuarial valuation of the LRF's assets and liabilities is made annually. Information on the last valuation, which was performed as of June 30, 1997, is also shown in Table 29. While the aggregate cost method that was used for the June 30, 1997, valuation does not identify or separately amortize the unfunded actuarial accrued liability, this liability, as shown on Table 29, was computed using the entry age normal method.

E. Teachers' Retirement Fund

Plan Description: STRS administers the Teachers' Retirement Fund (TRF), a cost sharing multiple-employer defined benefit retirement plan, that provides pension benefits to teachers and certain other employees of the California public school system. Membership in the TRF is mandatory for all employees meeting the eligibility requirements. The TRF provides a benefit based on age, members' final compensation, and years of service. Vesting accrues after five years. In addition, the retirement plan provides benefits to members upon disability and to survivors upon the death of eligible members. The State Teachers' Retirement Law establishes the benefits for the TRF. At June 30, 1998, the TRF had approximately 1,157 contributing employers, approximately 423,000 plan members, and 154,000 benefit recipients. The primary government is a nonemployer contributor to the TRF. The payroll for employees covered by TRF in 1998 was approximately $15.3 billion.

Funding policy: Benefits are funded by contributions from members, employers, the primary government, and earnings from investments. Member and employer contributions are a percentage of applicable member earnings. The State Teachers' Retirement Law governs member rates, employer contribution rates, and primary government contributions.

Contribution rates of members are 8.0% of applicable member earnings. The employer contribution rate is 8.25% of applicable member earnings. The primary government's contribution to the system under the California Education Code Section 22955,"Elder Full Funding Act", is 4.3% of the previous calendar year's member payroll. Subsequent to achieving a fully funded system, the primary government will contribute only the amount necessary to help fund the normal cost of the current benefit program unless a subsequent unfunded obligation occurs. Additionally, under certain provisions of the California Education Code, employers are required to make contributions of 0.415% of the payroll to the primary government. These contributions are appropriated by the primary government to TRF.

For the year ended June 30, 1998, the APC and the amount of contributions made for the primary government was approximately $1.9 and $2.0 billion, respectively. The APC and the percentage of APC contributed for the last three years are shown in Table 29. Actuarial valuations of the TRF are performed biennially. Based on the last valuation, which was performed as of June 30, 1997, the estimated amortization period to retire the actuarial accrued liability is 3 years. Information from the last valuation is also shown in Table 29.

F. Cash Balance Fund

Cash Balance Plan Description: STRS administers the CBPlan as a separate defined benefit plan designed for employees of California public schools who are hired to perform creditable service for less than 50% of the full time equivalent for the position. Participation in the CBPlan is optional to employers, however, if the employer elects to offer the CBPlan, each eligible employee will automatically be covered by the CBPlan unless the member elects to participate in the TRF or an alternative plan provided by the employer within 60 days of hire. At June 30, 1998, the CBPlan had 13 contributing school districts and approximately 3,507 contributing members. For reporting purposes the CBPlan, with assets of $2 million, is combined with the TRF.

G. STRS 403(b) Program

STRS 403(b) Program Description: STRS administers a 403(b) program through a third party administrator. The 403(b) program plan is a defined contribution plan and is open to any employee who is eligible to participate. Contributions to the program are voluntary, however, the Internal Revenue Code does impose a maximum amount that can be contributed annually. At June 30, 1998, the 403(b) program had approximately 365 participating employers (school districts) and 1,498 plan members.

Table 29

Actuarial Information – Pension Trusts – Primary Government

June 30, 1998

	Public Employees' Retirement	Judges' Retirement	Judges' Retirement II	Legislators' Retirement	Teachers' Retirement
Last actuarial valuation	June 30, 1997	June 30, 1997	June 30, 1997	June 30, 1997	June 30, 1997
Actuarial cost method	Individual Entry Age Normal	Aggregate Cost	Aggregate Entry Age Normal	Aggregate Cost	Entry Age Normal
Amortization method	Level % of Payroll, Closed	None	Level % of Payroll, Closed	None	Level % of Payroll, Open
Remaining amortization period	32 years	None	4.5 years	None	3 years
Asset valuation method	Smoothed Market Value	Market Value	Market Value	Smoothed Market Value	Expected Value, 25% Adjustment to Market Value
Actuarial assumption					
Investment rate of return	8.25 %	6.00 %	8.50 %	7.50 %	8.00 %
Projected salary increase	3.5 – 17.99	3.75	5.75	3.75	5.50
Includes inflation at	3.50	3.50	4.50	3.50	4.50
Post retirement benefit increases	2 or 3	3.75	3.00	3.50	2.00
Annual pension costs (in millions)					
Year ended 6/30/96	$ 1,169	$ 104	$ 1.6	$ 2.3	$ 1,726
Year ended 6/30/97	1,283	133	3.0	1.9	1,835
Year ended 6/30/98	1,178	133	5.4	2.0	1,911
Percent contribution					
Year ended 6/30/96	93 %	58 %	100 %	25 %	100 %
Year ended 6/30/97	124	38	102	130	100
Year ended 6/30/98	100	42	102	34	105
Net pension obligation (in millions)					
Year ended 6/30/96	$ 201.3	$ 464.0	$ —	$ 10.6	$ —
Year ended 6/30/97	—	546.1	—	10.1	—
Year ended 6/30/98	—	623.0	—	11.4	—
Funding as of last valuation (in millions)					
Actuarial value – assets	44,822	6	7.2	105	67,980
Actuarial accrued liabilities (AAL)–Entry Age	43,504	1,664	7.9	97	69,852
Unfunded AAL (UAAL)–Entry Age	(1,318)	1,658	0.7	(8)	1,872
Covered payroll	9,102	148	15.4	3.9	14,521
Funded ratio	103 %	0.4 %	92 %	108 %	97 %
UAAL as percent of covered payroll	(14)%	1,120 %	4 %	(205)%	13 %

H. University of California Retirement System Discretely Presented Component Unit

The UCRS consists of a single-employer defined benefit plan funded with University and employee contributions, a defined benefit plan for University employees who elected early retirement under the Public Employees' Retirement System Voluntary Early Retirement Incentive Program (PERS-VERIP), and two defined contribution plans with several investment portfolios funded with employee non-elective and elective contributions. Most University career employees participate in UCRS.

The UCRS provides lifetime retirement income, disability protection, and survivor benefits to eligible employees of the University of California and its affiliates. Membership in the retirement plan is required for all employees appointed to work at least 50% time for a year or more. Generally, five years of service are required to be entitled to plan benefits. The maximum monthly benefit is 100% of the employee's highest average compensation over a 36-month period. The amount of the pension benefit is determined by salary rate, age, and years of service credit with certain cost-of-living adjustments.

Members' contributions are accounted for separately and accrue interest at 6% annually. Upon termination, members can elect a refund of their contributions plus accumulated interest. Vested terminated members who are eligible to retire can also elect a lump sum equal to the present value of their accrued benefits. Both actions thereby forfeit the member's rights to further accrued benefits.

The annually determined rates for employer contributions as a percentage of payroll are based on recommendations of the consulting actuary and appropriations received from the primary government.

Employee contributions may be required to be made to the University of California Retirement Plan. The rate of employee contributions is established annually as a percentage of covered wages, pursuant to the Regents' funding policy, recommended and certified by an enrolled, independent actuary and approved by the Regents, the plan's trustee. During the year ended June 30, 1998, employee contributions to the University of California Retirement Plan were redirected to the University of California Defined Contribution Plan.

There were no changes in actuarial assumptions or benefit provisions that significantly affected the actuarial accrued liability or contribution requirements during the year ended June 30, 1998.

The PERS-VERIP is a defined benefit pension plan providing lifetime supplemental retirement income and survivor benefits to members of the University of California CalPERS program (UC-PERS), who elected early retirement under provisions of the plan. The University contributed to the CalPERS on behalf of these UC-PERS members.

The cost of contributions made to the plan is borne entirely by the University and the Federal Department of Energy laboratories. Over the five-year period ended June 30, 1996, the University and the Federal Department of Energy laboratories were required to make contributions to the plan as determined by the plan's consulting actuary, sufficient to maintain the promised benefits and the qualified status of the plan.

The University of California maintains two defined contribution plans providing savings incentives and additional retirement security for all eligible University employees. The Defined Contribution Plan (the DC Plan) accepts both after-tax and pretax contributions. In addtion, the University has established a Tax Deferred 403(b) Plan (the 403(b) Plan). There are no employer contributions to either of these two plans. Participants in the DC Plan and 403(b) Plan may direct their elective and nonelective contributions to investment funds managed by the Treasurer of the Regents of the University. They may also invest contributions in, and transfer plan accumulations to, certain external mutual funds on a custodial plan basis.

The DC Plan pretax contributions are fully vested and are mandatory for all employees who are members of the University of California Retirement Plan. Monthly employee contributions range from approximately 2% to 4% of covered wages depending upon whether wages are above or below the Social Security wage base. The DC Plan and the 403(b) Plan after-tax options are generally available to all University employees. During the year ended June 30, participants contributed $383 million into these two plans.

Table 30

Actuarial Information – University of California – Discretely Presented Component Unit
June 30, 1998

	University of California Retirement Plan	Voluntary Early Retirement Incentive Plan
Last actuarial valuation	June 30, 1998	June 30, 1998
Actuarial cost method	Entry Age Normal	Unit Credit
Amortization method	Level % of Payroll, Open	N/A Closed
Remaining amortization period	11 years	N/A
Asset valuation method	Smoothed Fair Value	Fair Value
Actuarial assumption		
Investment rate of return	7.50 %	7.50 %
Projected salary increase	4.5 to 6.5	N/A
Includes inflation at	4.00	N/A
Annual pension costs (in millions)		
Year ended 6/30/98	$ —	$ —
Percent contribution		
Year ended 6/30/98	N/A	N/A
Net pension obligation (in millions)		
Year ended 6/30/98	$ —	$ —
Funding as of last valuation (in millions)		
Actuarial value – assets	$ 27,132	$ 72.5
Actuarial accrued liabilities (AAL)	20,617	44.5
Excess of actuarial value of assets over AAL	6,515	28.0
Covered payroll	4,960	N/A
Funded ratio	132 %	163 %

NOTE 25. POST-RETIREMENT HEALTH CARE BENEFITS

Health care and dental benefits are provided by the primary government and certain special purpose authorities, which are discretely presented component units, to annuitants of retirement systems to which the primary government contributes as an employer. The special purpose authorities' participation in these benefits is not a material portion of the program. To be eligible for these benefits, first-tier plan annuitants must retire on or after attaining age 50 with at least five years of service, and second-tier plan annuitants must retire on or after attaining age 55 with at least 10 years of service. In addition, annuitants must retire within

120 days of separation from employment to be eligible to receive these benefits. As of June 30, approximately 97,883 annuitants were enrolled to receive health benefits and approximately 93,705 annuitants were enrolled to receive dental benefits. In accordance with the Government Code, the primary government generally pays 100% of the health insurance cost for annuitants plus 90% of the additional premium required for the enrollment of family members of annuitants. Although the primary government generally pays 100% of the dental insurance premium for annuitants, the Government Code does not specify the primary government's contribution toward dental insurance costs. The primary government recognizes the cost of providing health and dental insurance to annuitants on a pay-as-you-go basis. The cost of these benefits for the year ended June 30 was approximately $281 million.

Also, the University of California, a discretely presented component unit, provides certain health plan benefits to retired employees in addition to pension benefits. Employees who meet specific requirements may continue their medical and dental benefits into retirement and continue to receive University of California contributions for those benefits. There are approximately 34,000 retirees currently eligible to receive such benefits. The cost of retiree medical and dental coverage is recognized when paid. The cost of providing medical and dental benefits for retirees and their families and survivors for the year ended June 30 was $89 million.

NOTE 26. SUBSEQUENT EVENTS

The following information represents significant events that occurred subsequent to June 30, 1998, but prior to the date of the auditors' report.

From July 1, 1998 through November 20, 1998, the primary government issued $1.7 billion in revenue anticipation notes that will mature on June 30, 1999. The primary government also issued $850 million in general obligation bonds, $271 million of which were used to refund $269 million of existing general obligation bonds and $573 million of which were used to retire previously issued commercial paper. In addition, the primary government issued approximately $376 million in revenue bonds, $127 million of which were used to refund $123 million of existing revenue bonds.

In the general election held on November 3, 1998, voters approved the sale of general obligation bonds with the passage of Proposition 1A, the "Class Size Reduction Kindergarten– University Public Education Facilities Bond Act of 1998," authorizes the issuance of $9.2 billion in bonds.

From July 1, 1998, to November 20, 1998, the Regents of the University of California issued approximately $363 million in revenue bonds. From July 1, 1998, to November 20, 1998, the special purpose authorities, which are discretely presented component units, issued approximately $436 million in revenue bonds.

NOTE 27. YEAR 2000 COMPLIANCE OF COMPUTER SYSTEMS AND OTHER EQUIPMENT

The year 2000 (Y2K) issue is the result of shortcomings in many electronic data-processing systems and other equipment that may adversely affect operations in the year 1999 and beyond. For many years, programmers eliminated the first two digits from the year when writing programs. Unfortunately, if not corrected many programs, will not be able to distinguish between the year 2000 and the year 1900. This may cause the programs to process data inaccurately or to stop processing data altogether. Another factor that may cause problems in programs is the leap-year calculation. Some programs are unable to detect the year 2000 as a leap year. Problems affecting a wide range of governmental activities could result if computers and other electronic equipment that are dependent upon date sensitive coding are not corrected. These problems have the potential for causing a disruption to some government operations and may temporarily increase the cost of those operations.

The State's reliance on information technology (IT) in every aspect of its operations has made Y2K related information technology issues a high priority for the State. A Y2K task force has been created to establish statewide policy requirements; to gather, coordinate, and share information; and to monitor statewide progress. A few departments with mission-critical systems, including the California State University System, the Public Employees' Retirement System, and the State Teachers' Retirement System do not report to this Y2K task force.

Efforts are being focused on applications that support mission-critical business practices. The Governor issued an Executive Order requiring that mission-critical systems be remediated by December 31, 1998; that purchases of new systems, hardware, software, and equipment be Y2K compliant; and limited the start of new computer projects to only those required by law until that department's Y2K problems are resolved. Departments are also required to address interfacing of IT systems with external IT systems, and to report on contingency planning for problems that might occur if IT systems are not fully remediated by the end of 1999.

The following stages have been identified as necessary to implement a Y2K compliant system:

Awareness and assessment stages - When a budget and project plan is established for dealing with the Y2K issue, and the actual process of identifying all of the organization's systems and individual components of the systems is begun;

Remediation stage - When the organization actually makes changes to systems and equipment. This stage deals primarily with the technical issues of converting existing systems or switching to compliant systems; and

Validation and testing stages - When the organization validates and tests the changes made during the remediation stage.

By June 30, 1998, the awareness and assessment stages had been completed for the 2,432 systems reporting to the Y2K task force, of which 642 are mission-critical. Of the mission-critical systems, 555 required remediation. Of these systems, 128 had been completed by June 30, 1998, and 427 required further remediation, validation, and testing.

Of the total Y2K costs identified by the Y2K task force, more than $100 million is projected to be expended in years ending June 30, 1999 and 2000. These costs are part of much larger overall IT costs incurred annually by state departments and do not include costs for remediation of embedded technology, desktop systems, and additional costs resulting from the testing process. For the fiscal year ending June 30, 1999, the Legislature created a $20 million fund for unanticipated Y2K costs, which can be increased if necessary. Additional information on the State's progress in implementing Y2K compliant systems is available from the Department of Information Technology, 801 K Street, Suite 2100, Sacramento, California 95814.

The California State University System, the Public Employees' Retirement System, and the State Teachers' Retirement System had completed the awareness and assessment stages and are in the remediation and validation and testing stages. They expect to spend approximately $34 million in years ending June 30, 1999 and 2000.

Although state departments are making substantial progress overall toward the goal of Y2K compliance, the task is very large and will likely encounter unexpected difficulties. The State cannot predict whether all mission-critical systems will be ready and tested by late 1999. It also cannot be predicted what impact failure of any particular IT system(s), or of outside interfaces with state IT systems, might have.

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Appendix A – Exhibit 2

STATE CONTROLLER'S STATEMENT OF
GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS
JULY 1, 1998 – JANUARY 31, 1999

Source: State of California, Office of the State Controller

STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS
A Comparison of Actual to 1999-00 Governor's Budget Estimates
(Amounts in thousands)
Attachment A

	July 1 through January 31				
	1999				1998
	Actual	Estimate (a)	Actual Over or (Under) Estimate Amount (b)	%	Actual
GENERAL FUND BEGINNING CASH BALANCE	$ $934,607	$ $934,606	$ 1	——	$ ——
Add Receipts:					
Revenues	31,237,603	30,510,826	726,777	2 4	29,057,263
Nonrevenues	40,606	162,328	(121,722)	(75.0)	539,762
Total Receipts	31,278,209	30,673,154	605,055	2.0	29,597,025
Less Disbursements:					
State Operations	9,046,326	8,835,231	211,095	2.4	9,319,559
Local Assistance	25,641,564	24,732,181	909,383	3 7	21,902,472
Capital Outlay	73,430	100,873	(27,443)	(27.2)	29,824
Nongovernmental	1,241,169	1,126,768	114,401	10.2	46,482
Total Disbursements	36,002,489	34,795,053	1,207,436	3.5	31,298,337
Receipts Over / (Under) Disbursements	(4,724,280)	(4,121,899)	(602,381)	——	(1,701,312)
Net Increase / (Decrease) in Temporary Loans	3,789,673	3,187,293	602,380	18.9	1,809,613
GENERAL FUND ENDING CASH BALANCE	——	——	——	——	108,301
Special Fund for Economic Uncertainties (c)	——	——	——	——	116,707
TOTAL CASH	$ ——	$ ——	$ ——	——	$ 225,008

BORROWABLE RESOURCES					
Available Borrowable Resources	$ 9,740,221	$ 9,491,931	$ 248,290	2.6	$ 9,092,743
Outstanding Loans	3,789,673	3,187,293	602,380	18 9	3,000,000
Unused Borrowable Resources	$ 5,950,548	$ 6,304,638	$ (354,090)	(5 6)	$ 6,092,743

General Note:

This report is based upon funded cash. Funded cash is cash reported to and recorded in the records of the State Controller's Office. Amounts reported as funded cash may differ from amounts in other reports to the extent there are timing differences in the recording of intransit items.

Footnotes:

(a) Statement of Estimated Cash Flow for the 1998-99 fiscal year as presented in the 1999-00 Governor's Budget.
(b) May not add to total due to rounding.
(c) Includes the Disaster Response-Emergency Operations Account within the Special Fund for Economic Uncertainties.
(d) Excludes State School Building Bonds.
(e) Negative balances are the result of repayments received that are greater than disbursements made.
(f) Non-Cash transaction.

SCHEDULE OF CASH RECEIPTS
(Amounts in thousands)

	Month of January		July 1 through January 31				
			1999				1998
					Actual Over or (Under) Estimate		
REVENUES	1999	1998	Actual	Estimate (a)	Amount (b)	%	Actual
Alcoholic Beverage Excise Tax	$ 7,743	$ 26,781	$ 149,079	$ 166,781	$ (17,702)	(10.6)	$ 169,530
Bank and Corporation Tax	(27,989)	44,050	2,549,246	2,594,117	(44,871)	(1.7)	2,460,093
Cigarette Tax	29,633	15,252	106,677	97,000	9,677	10.0	101,937
Horse Racing Fees	2,738	3,973	15,195	13,674	1,521	11.1	18,480
Inheritance, Gift and Estate Taxes	82,728	65,205	543,164	541,799	1,365	0 3	411,789
Insurance Companies Tax	16,082	6,347	625,859	618,405	7,454	1 2	565,744
Personal Income Tax	4,776,715	4,289,379	17,521,929	16,718,567	803,362	4.8	15,753,625
Retail Sales and Use Taxes	714,878	556,425	9,301,436	9,298,474	2,962	-----	8,925,490
Pooled Money Investment Interest	19,347	20,076	163,761	164,571	(810)	(0.5)	134,685
Trial Court	1,196	13,348	2,926	1,696	1,230	72.5	179,987
Not Otherwise Classified	16,002	66,343	258,331	295,742	(37,411)	(12.6)	335,903
Total Revenues	**5,639,073**	**5,107,179**	**31,237,603**	**30,510,826**	**726,777**	**2.4**	**29,057,263**
NONREVENUES							
Transfers from Special Fund for Economic Uncertainties	-----	275,397	2,943	112,000	(109,057)	(97.4)	275,397
Transfers from Other Funds	8,232	22,800	(131,850)	(107,883)	(23,967)	-----	129,972
Miscellaneous	18,470	6,333	169,513	158,211	11,302	7.1	134,393
Total Nonrevenues	**26,702**	**304,530**	**40,606**	**162,328**	**(121,722)**	**(75.0)**	**539,762**
Total Receipts	**$ 5,665,775**	**$ 5,411,709**	**$ 31,278,209**	**$ 30,673,154**	**$ 605,055**	**2.0**	**$ 29,597,025**

See notes on page FD-2.

SCHEDULE OF CASH DISBURSEMENTS
(Amounts in thousands)

	Month of January		July 1 through January 31				
			1999				1998
STATE OPERATIONS	1999	1998	Actual	Estimate (a)	Actual Over or (Under) Estimate Amount (b)	%	Actual
Legislative/Judicial/Executive	$ 60,766	$ 72,142	$ 534,334	$ 526,942	$ 7,392	1.4	$ 538,225
State and Consumer Services	32,369	30,241	230,633	231,891	(1,258)	(0.5)	211,562
Business, Transportation and Housing	195	(1,141)	6,716	30,181	(23,465)	(77.7)	11,088
Trade and Commerce	2,411	2,071	20,511	20,572	(61)	(0.3)	18,873
Resources	63,022	34,532	408,609	373,715	34,894	9.3	361,250
CA Environmental Protection Agency	20,136	10,204	70,370	63,793	6,577	10.3	49,340
Health and Welfare:							
Health Services	26,054	9,318	195,539	145,441	50,098	34 4	153,823
Mental Health Hospitals	28,201	21,628	186,955	196,959	(10,004)	(5.1)	204,660
Other Health and Welfare	35,549	(33,614)	264,084	162,567	101,517	62.4	87,763
Education:							
University of California	209,555	176,901	1,526,307	1,506,171	20,136	1.3	1,321,554
State Universities and Colleges	152,081	109,165	1,171,944	1,130,403	41,541	3.7	1,129,510
Other Education	10,036	13,058	82,875	80,840	2,035	2.5	89,992
Corrections and Youth Authority	334,329	340,476	2,326,583	2,325,046	1,537	0.1	2,317,338
General Government	48,944	47,237	408,826	422,910	(14,084)	(3.3)	413,408
Public Employees Retirement System	66,106	125,881	481,074	490,003	(8,929)	(1.8)	1,168,977
Debt Service (d)	(2,019)	160,692	1,117,547	1,114,395	3,152	0.3	1,232,747
Interest on Loans	17	——	13,419	13,402	17	0.1	9,449
Total State Operations	**1,087,752**	**1,118,791**	**9,046,326**	**8,835,231**	**211,095**	**2.4**	**9,319,559**
LOCAL ASSISTANCE							
Public Schools - K-12	2,499,392	1,553,356	12,275,788	11,441,969	833,819	7.3	9,983,896
Community Colleges	156,104	125,274	1,254,392	1,235,537	18,855	1.5	1,060,385
Debt Service - State School Building Bonds	——	——	——	——	——	——	288
Contributions to State Teachers' Retirement System	19,563	167,441	272,899	273,369	(470)	(0.2)	804,820
Other Education	336,619	19,795	1,000,678	804,876	195,802	24.3	677,862
Corrections and Youth Authority	1,162	1,433	63,829	67,793	(3,964)	(5.8)	52,249
Dept. of Alcohol and Drug Program	2,401	6,173	41,869	35,759	6,110	17.1	60,716
Dept. of Health Services:							
Medical Assistance Program	635,713	327,848	4,224,280	4,381,396	(157,116)	(3.6)	4,099,980
Other Health Services	21,976	26,868	217,865	251,027	(33,162)	(13.2)	147,610
Dept. of Developmental Services	31,149	87,508	629,087	621,987	7,100	1.1	450,300
Dept. of Mental Health	(54,201)	(12,457)	176,359	117,393	58,966	50.2	240,003
Dept. of Social Services:							
SSI/SSP/IHSS	545,085	167,415	1,600,340	1,587,595	12,745	0.8	1,157,974
CalWORKs	78,096	119,069	2,015,404	1,955,705	59,699	3.1	1,474,406
Other Social Services	(274,911)	96,588	541,434	494,164	47,270	9.6	689,551
Tax Relief	7,381	6,212	238,921	332,781	(93,860)	(28.2)	224,015
School Facility Aid Program	——	——	29,315	29,315	——	——	35,468
Other Local Assistance	49,708	73,510	1,059,104	1,101,515	(42,411)	(3.9)	742,949
Total Local Assistance	**4,055,237**	**2,766,033**	**25,641,564**	**24,732,181**	**909,383**	**3.7**	**21,902,472**

See notes on page FD-2.

(Continued)

SCHEDULE OF CASH DISBURSEMENTS (Continued)
(Amounts in thousands)

	Month of January		July 1 through January 31				1998
			1999				
	1999	1998	Actual	Estimate (a)	Actual Over or (Under) Estimate Amount (b)	%	Actual
CAPITAL OUTLAY	**12,354**	**2,433**	**73,430**	**100,873**	**(27,443)**	**(27.2)**	**29,824**
NONGOVERNMENTAL (e)							
Transfer to Special Fund for Economic Uncertainties	1,189,226	112,000	1,189,226	1,255,000	(65,774)	(5 2)	112,000
Transfer to Other Funds	251,045	14,870	375,035	123,542	251,493	203.6	140,289
Transfer to Revolving Fund	(556)	3,941	60,711	61,152	(441)	(0 7)	66,904
School Loan (f)	—	—	—	—	—	—	—
Advance:							
Earthquake Loan Repayment	—	—	—	—	—	—	45,490
State-County Property Tax Administration Program	2,168	5,538	28,376	10,675	17,701	165.8	(19,849)
Social Welfare Federal Fund	43,217	(27,911)	(178,458)	(67,080)	(111,378)	—	(141,201)
Tax Relief and Refund Account	22,800	(25,900)	22,800	—	22,800	—	26,100
Trial Court Trust Fund	—	—	(110,000)	(110,000)	—	—	—
Counties for Social Welfare	—	—	(146,521)	(146,521)	—	—	(183,251)
Total Nongovernmental	**1,507,900**	**82,538**	**1,241,169**	**1,126,768**	**114,401**	**10.2**	**46,482**
Total Disbursements	**$ 6,663,243**	**$ 3,969,795**	**$ 36,002,489**	**$ 34,795,053**	**$ 1,207,436**	**3.5**	**$ 31,298,337**
TEMPORARY LOANS							
Special Fund for Economic Uncertainties	$ 1,189,226	$ (280,105)	$ 1,260,772	$ 1,255,000	$ 5,772	0 5	$ (281,170)
Other Internal Sources	(191,758)	(1,054,500)	828,901	232,293	596,608	256.8	(909,217)
Revenue Anticipation Notes	—	—	1,700,000	1,700,000	—	—	3,000,000
Net Increase / (Decrease) Loans	**$ 997,468**	**$ (1,334,605)**	**$ 3,789,673**	**$ 3,187,293**	**$ 602,380**	**18.9**	**$ 1,809,613**

See notes on page FD-2.

(Concluded)

COMPARATIVE STATEMENT OF REVENUES RECEIVED
All Governmental Cost Funds
(Amounts in thousands)

	July 1 through January 31			
	General Fund		Special Funds	
	1999	1998	1999	1998
MAJOR TAXES, LICENSES, AND INVESTMENT INCOME:				
Alcoholic Beverage Excise Taxes	$ 149,079	$ 169,530	$ ------	$ ------
Bank and Corporation Tax	2,549,246	2,460,093	7	4
Cigarette Tax	106,677	101,937	313,221	293,084
Estate Tax	542,838	410,830	------	------
Gift Tax	30	2	------	------
Horse Racing Fees	15,195	18,480	25,882	27,622
Inheritance Tax	296	957	------	------
Insurance Companies Tax	625,859	565,744	------	------
Motor Vehicle Fuel Tax:				
Gasoline Tax	------	------	1,534,360	1,468,087
Diesel & Liquid Petroleum Gas	------	------	254,113	234,759
Jet Fuel Tax	------	------	1,089	970
Vehicle License Fees	------	------	2,175,316	2,184,361
Motor Vehicle Registration and Other Fees	------	------	985,618	1,015,822
Personal Income Tax	17,521,929	15,753,625	172	216
Retail Sales and Use Taxes	9,301,436	8,925,490	2,039,445	1,942,893
Pooled Money Investment Interest	163,761	134,685	215	356
Trial Court Revenue s	2,926	179,987	------	------
Total Major Taxes, Licenses, and Investment Income	**30,979,272**	**28,721,360**	**7,329,438**	**7,168,174**
NOT OTHERWISE CLASSIFIED:				
Alcoholic Beverage License Fe e	1,848	2,613	20,051	18,062
Electrical Energy Tax	------	------	22,046	22,846
Private Rail Car Tax	6,254	5,983	------	------
Penalties on Traffic Violations	------	------	42,083	40,012
Health Care Receipts	10,611	7,337	------	------
Revenues from State Lands	9,085	13,788	767	13,064
Water's Edge Election Fee	------	------	------	------
Abandoned Property	105,555	150,479	------	------
Miscellaneou s	124,978	155,703	2,226,571	2,030,058
Not Otherwise Classified	**258,331**	**335,903**	**2,311,518**	**2,124,042**
Total Revenues, All Governmental Cost Funds	**$ 31,237,603**	**$ 29,057,263**	**$ 9,640,956**	**$ 9,292,216**

See notes on page FD-2.

STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS
A Comparison of Actual to 1998-99 Budget Act Estimates
(Amounts in thousands)
Attachment B

	July 1 through January 31				
	1999				1998
	Actual	Estimate (a)	Actual Over or (Under) Estimate Amount (b)	%	Actual
GENERAL FUND BEGINNING CASH BALANCE	$ $934,607	$ $934,606	$ 1	----	$ ----
Add Receipts:					
Revenues	31,237,603	31,291,774	(54,171)	(0 2)	29,057,263
Nonrevenues	40,606	81,659	(41,053)	(50.3)	539,762
Total Receipts	31,278,209	31,373,433	(95,224)	(0.3)	29,597,025
Less Disbursements:					
State Operations	9,046,326	9,298,234	(251,908)	(2.7)	9,319,559
Local Assistance	25,641,564	25,342,180	299,384	1.2	21,902,472
Capital Outlay	73,430	209,403	(135,973)	(64.9)	29,824
Nongovernmental	1,241,169	1,017,783	223,386	21.9	46,482
Total Disbursements	36,002,489	35,867,600	134,889	0.4	31,298,337
Receipts Over / (Under) Disbursements	(4,724,280)	(4,494,167)	(230,113)	----	(1,701,312)
Net Increase / (Decrease) in Temporary Loans	3,789,673	3,559,561	230,112	6.5	1,809,613
GENERAL FUND ENDING CASH BALANCE	----	----	----	----	108,301
Special Fund for Economic Uncertainties (c)	----	----	----	----	116,707
TOTAL CASH	$ ----	$ ----	$ ----	----	$ 225,008

BORROWABLE RESOURCES					
Available Borrowable Resources	$ 9,740,221	$ 9,150,871	$ 589,350	6.4	$ 9,092,743
Outstanding Loans	3,789,673	3,559,561	230,112	6.5	3,000,000
Unused Borrowable Resources	$ 5,950,548	$ 5,591,310	$ 359,238	6.4	$ 6,092,743

General Note:
This report is based upon funded cash. Funded cash is cash reported to and recorded in the records of the State Controller's Office. Amounts reported as funded cash may differ from amounts in other reports to the extent there are timing differences in the recording of intransit items.

Footnotes:
(a) Statement of Estimated Cash Flow for the 1998-99 fiscal year as presented in the Budget Act of 1998.
(b) May not add to total due to rounding.
(c) Includes the Disaster Response-Emergency Operations Account within the Special Fund for Economic Uncertainties.
(d) Excludes State School Building Bonds.
(e) Negative balances are the result of repayments received that are greater than disbursements made.
(f) Non-Cash transaction.

SCHEDULE OF CASH RECEIPTS
(Amounts in thousands)

	Month of January		July 1 through January 31				
			1999				1998
REVENUES	1999	1998	Actual	Estimate (a)	Actual Over or (Under) Estimate Amount (b)	%	Actual
Alcoholic Beverage Excise Tax	$ 7,743	$ 26,781	$ 149,079	$ 168,097	$ (19,018)	(11.3)	$ 169,530
Bank and Corporation Tax	(27,989)	44,050	2,549,246	2,762,789	(213,543)	(7.7)	2,460,093
Cigarette Tax	29,633	15,252	106,677	97,856	8,821	9.0	101,937
Horse Racing Fees	2,738	3,973	15,195	16,481	(1,286)	(7.8)	18,480
Inheritance, Gift and Estate Taxes	82,728	65,205	543,164	466,879	76,285	16 3	411,789
Insurance Companies Tax	16,082	6,347	625,859	609,707	16,152	2 6	565,744
Personal Income Tax	4,776,715	4,289,379	17,521,929	17,198,515	323,414	1 9	15,753,625
Retail Sales and Use Taxes	714,878	556,425	9,301,436	9,488,870	(187,434)	(2.0)	8,925,490
Pooled Money Investment Interest	19,347	20,076	163,761	179,855	(16,094)	(8.9)	134,685
Trial Court	1,196	13,348	2,926	373	2,553	684.5	179,987
Not Otherwise Classified	16,002	66,343	258,331	302,352	(44,021)	(14 6)	335,903
Total Revenues	**5,639,073**	**5,107,179**	**31,237,603**	**31,291,774**	**(54,171)**	**(0.2)**	**29,057,263**
NONREVENUES							
Transfers from Special Fund for Economic Uncertainties	——	275,397	2,943	112,000	(109,057)	(97.4)	275,397
Transfers from Other Funds	8,232	22,800	(131,850)	(140,578)	8,728	——	129,972
Miscellaneous	18,470	6,333	169,513	110,237	59,276	53.8	134,393
Total Nonrevenues	**26,702**	**304,530**	**40,606**	**81,659**	**(41,053)**	**(50.3)**	**539,762**
Total Receipts	**$ 5,665,775**	**$ 5,411,709**	**$ 31,278,209**	**$ 31,373,433**	**$ (95,224)**	**(0.3)**	**$ 29,597,025**

See notes on page FD-7.

SCHEDULE OF CASH DISBURSEMENTS
(Amounts in thousands)

	Month of January		July 1 through January 31				
			1999				1998
STATE OPERATIONS	1999	1998	Actual	Estimate (a)	Actual Over or (Under) Estimate Amount (b)	%	Actual
Legislative/Judicial/Executive	$ 60,766	$ 72,142	$ 534,334	$ 546,710	$ (12,376)	(2.3)	$ 538,225
State and Consumer Services	32,369	30,241	230,633	232,251	(1,618)	(0.7)	211,562
Business, Transportation and Housing	195	(1,141)	6,716	24,199	(17,483)	(72.2)	11,088
Trade and Commerce	2,411	2,071	20,511	20,943	(432)	(2.1)	18,873
Resources	63,022	34,532	408,609	475,460	(66,851)	(14.1)	361,250
CA Environmental Protection Agency	20,136	10,204	70,370	103,541	(33,171)	(32.0)	49,340
Health and Welfare:							
Health Services	26,054	9,318	195,539	181,996	13,543	7.4	153,823
Mental Health Hospitals	28,201	21,628	186,955	219,111	(32,156)	(14 7)	204,660
Other Health and Welfare	35,549	(33,614)	264,084	163,942	100,142	61.1	87,763
Education:							
University of California	209,555	176,901	1,526,307	1,553,333	(27,026)	(1 7)	1,321,554
State Universities and Colleges	152,081	109,165	1,171,944	1,241,148	(69,204)	(5.6)	1,129,510
Other Education	10,036	13,058	82,875	83,882	(1,007)	(1.2)	89,992
Corrections and Youth Authority	334,329	340,476	2,326,583	2,530,981	(204,398)	(8.1)	2,317,338
General Government	48,944	47,237	408,826	330,398	78,428	23.7	413,408
Public Employees Retirement System	66,106	125,881	481,074	460,473	20,601	4.5	1,168,977
Debt Service (d)	(2,019)	160,692	1,117,547	1,116,528	1,019	0.1	1,232,747
Interest on Loans	17	——	13,419	13,338	81	0.6	9,449
Total State Operations	**1,087,752**	**1,118,791**	**9,046,326**	**9,298,234**	**(251,908)**	(2.7)	**9,319,559**
LOCAL ASSISTANCE							
Public Schools - K-12	2,499,392	1,553,356	12,275,788	11,553,205	722,583	6.3	9,983,896
Community Colleges	156,104	125,274	1,254,392	1,285,084	(30,692)	(2.4)	1,060,385
Debt Service - State School Building Bonds	——	——	——	——	——	——	288
Contributions to State Teachers' Retirement System	19,563	167,441	272,899	554,566	(281,667)	(50 8)	804,820
Other Education	336,619	19,795	1,000,678	852,762	147,916	17.3	677,862
Corrections and Youth Authority	1,162	1,433	63,829	54,591	9,238	16 9	52,249
Dept. of Alcohol and Drug Program	2,401	6,173	41,869	46,225	(4,356)	(9.4)	60,716
Dept. of Health Services:							
Medical Assistance Program	635,713	327,848	4,224,280	4,112,609	111,671	2.7	4,099,980
Other Health Services	21,976	26,868	217,865	223,840	(5,975)	(2.7)	147,610
Dept. of Developmental Services	31,149	87,508	629,087	637,630	(8,543)	(1.3)	450,300
Dept. of Mental Health	(54,201)	(12,457)	176,359	276,778	(100,419)	(36.3)	240,003
Dept. of Social Services:							
SSI/SSP/IHSS	545,085	167,415	1,600,340	1,344,986	255,354	19.0	1,157,974
CalWORKs	78,096	119,069	2,015,404	1,824,727	190,677	10.4	1,474,406
Other Social Services	(274,911)	96,588	541,434	1,141,518	(600,084)	(52.6)	689,551
Tax Relief	7,381	6,212	238,921	481,373	(242,452)	(50.4)	224,015
School Facility Aid Program	——	——	29,315	23,730	5,585	23.5	35,468
Other Local Assistance	49,708	73,510	1,059,104	928,556	130,548	14.1	742,949
Total Local Assistance	**4,055,237**	**2,766,033**	**25,641,564**	**25,342,180**	**299,384**	**1.2**	**21,902,472**

See notes on page FD-7.

(Continued)

SCHEDULE OF CASH DISBURSEMENTS (Continued)
(Amounts in thousands)

	Month of January		July 1 through January 31				
			1999				1998
	1999	1998	Actual	Estimate (a)	Actual Over or (Under) Estimate Amount (b)	%	Actual
CAPITAL OUTLAY	**12,354**	**2,433**	**73,430**	**209,403**	**(135,973)**	**(64.9)**	**29,824**
NONGOVERNMENTAL (e)							
Transfer to Special Fund for Economic Uncertainties	1,189,226	112,000	1,189,226	1,255,000	(65,774)	(5.2)	112,000
Transfer to Other Funds	251,045	14,870	375,035	93,594	281,441	300.7	140,289
Transfer to Revolving Fund	(556)	3,941	60,711	(5,717)	66,428	——	66,904
School Loan (f)	——	——	——	——	——	——	——
Advance:							
Earthquake Loan Repayment	——	——	——	——	——	——	45,490
State-County Property Tax Administration Program	2,168	5,538	28,376	339	28,037	8,270 5	(19,849)
Social Welfare Federal Fund	43,217	(27,911)	(178,458)	(163,812)	(14,646)	——	(141,201)
Tax Relief and Refund Account	22,800	(25,900)	22,800	4,900	17,900	365.3	26,100
Trial Court Trust Fund	——	——	*(110,000)*	*(20,000)*	*(90,000)*	——	——
Counties for Social Welfare	——	——	(146,521)	(146,521)	——	——	(183,251)
Total Nongovernmental	**1,507,900**	**82,538**	**1,241,169**	**1,017,783**	**223,386**	**21.9**	**46,482**
Total Disbursements	**$ 6,663,243**	**$ 3,969,795**	**$ 36,002,489**	**$ 35,867,600**	**$ 134,889**	**0.4**	**$ 31,298,337**
TEMPORARY LOANS							
Special Fund for Economic Uncertainties	$ 1,189,226	$ (280,105)	$ 1,260,772	$ 1,255,000	$ 5,772	0.5	$ (281,170)
Other Internal Sources	(191,758)	(1,054,500)	828,901	604,561	224,340	37.1	(909,217)
Revenue Anticipation Notes	——	——	1,700,000	1,700,000	——	——	3,000,000
Net Increase / (Decrease) Loans	**$ 997,468**	**$ (1,334,605)**	**$ 3,789,673**	**$ 3,559,561**	**$ 230,112**	**6.5**	**$ 1,809,613**

See notes on page FD-7.

(Concluded)

COMPARATIVE STATEMENT OF REVENUES RECEIVED
All Governmental Cost Funds
(Amounts in thousands)

	July 1 through January 31			
	General Fund		Special Funds	
	1999	1998	1999	1998
MAJOR TAXES, LICENSES, AND INVESTMENT INCOME:				
Alcoholic Beverage Excise Taxes	$ 149,079	$ 169,530	$ -----	$ -----
Bank and Corporation Tax	2,549,246	2,460,093	7	4
Cigarette Tax	106,677	101,937	313,221	293,084
Estate Tax	542,838	410,830	-----	-----
Gift Tax	30	2	-----	-----
Horse Racing Fees	15,195	18,480	25,882	27,622
Inheritance Tax	296	957	-----	-----
Insurance Companies Tax	625,859	565,744	-----	-----
Motor Vehicle Fuel Tax				
Gasoline Tax	-----	-----	1,534,360	1,468,087
Diesel & Liquid Petroleum Gas	-----	-----	254,113	234,759
Jet Fuel Tax	-----	-----	1,089	970
Vehicle License Fees	-----	-----	2,175,316	2,184,361
Motor Vehicle Registration and Other Fees	-----	-----	985,618	1,015,822
Personal Income Tax	17,521,929	15,753,625	172	216
Retail Sales and Use Taxes	9,301,436	8,925,490	2,039,445	1,942,893
Pooled Money Investment Interest	163,761	134,685	215	356
Trial Court Revenues	2,926	179,987	-----	-----
Total Major Taxes, Licenses, and Investment Income	**30,979,272**	**28,721,360**	**7,329,438**	**7,168,174**
NOT OTHERWISE CLASSIFIED:				
Alcoholic Beverage License Fee	1,848	2,613	20,051	18,062
Electrical Energy Tax	-----	-----	22,046	22,846
Private Rail Car Tax	6,254	5,983	-----	-----
Penalties on Traffic Violations	-----	-----	42,083	40,012
Health Care Receipts	10,611	7,337	-----	-----
Revenues from State Lands	9,085	13,788	767	13,064
Water's Edge Election Fee	-----	-----	-----	-----
Abandoned Property	105,555	150,479	-----	-----
Miscellaneous	124,978	155,703	2,226,571	2,030,058
Not Otherwise Classified	**258,331**	**335,903**	**2,311,518**	**2,124,042**
Total Revenues, All Governmental Cost Funds	**$ 31,237,603**	**$ 29,057,263**	**$ 9,640,956**	**$ 9,292,216**

See notes on page FD-7.

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APPENDIX B

THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND

This Appendix B includes information about the Department, its Program, the 1943 Fund (including audited financial statements), and the Department's allocation of receipts from Contracts of Purchase, including Excess Revenues.

THE DEPARTMENT

General

In 1921 the California Legislature created the Veterans' Welfare Board and the Program. The Department of Veterans Affairs became the successor to the Veterans' Welfare Board under the Farm and Home Purchase Act of 1943. The Department is a subdivision of the State and constitutes a public corporation. One of the Department's basic objectives is to afford to eligible veterans the opportunity of acquiring homes with long-term low-interest financing provided under the Program.

The California Veterans Board ("Board") determines the policies for all operations of the Department. The Board is composed of seven members: the Secretary of Veterans Affairs and six public members appointed by the Governor of the State for respective terms of four years. All of the members of the Board must be veterans, and membership is subject to confirmation by the State Senate. One of these members must be retired from the active or reserve forces of the United States military service. There are currently four vacancies on the Board.

There are four principal divisions within the Department: the Division of Veterans Services, the Division of Administration, the Veterans' Home Division and the Division of Farm and Home Purchases. The Program is administered by the Division of Farm and Home Purchases with support from the Division of Administration and other Department support units. See "THE PROGRAM."

Administration

In addition to its headquarters in Sacramento, the Division of Farm and Home Purchases maintains field offices located throughout the State. These local offices, in addition to providing information to all veterans concerning the Program, are responsible for Contract of Purchase originations and the initial collection and evaluation of data regarding applicants for the Program and the property to be acquired under the Program. This includes an examination as to the qualification of veterans to participate in the Program, a credit analysis, an appraisal of properties and the initial processing of the veteran's application for a Contract of Purchase.

Final processing and servicing of the Contracts of Purchase are performed by the Department at its headquarters and entail Contract of Purchase accounting, insurance and property damage claims adjustment and services, Contract of Purchase alterations and contract performance services. The Department has recently begun to allow Contracts of Purchase origination by mortgage brokers and has engaged the temporary services of an outside loan servicing company, Leader Mortgage Company ("Leader"), until its new Contract of Purchase monitoring computer system, the Integrated Loan Processing and Financial Information System, becomes operational, expected to occur by June 30, 1999. General administration of the Program, including fiscal, legal, personnel and other administrative functions, is also performed at the Department's headquarters. As of September 30, 1998 the Department's Farm and Home Purchases Division had a staff of 114 persons.

The Secretary and other staff personnel of the Department principally responsible for the administration of the Program are listed below. The Secretary is appointed by the Governor of the State, serves at the pleasure of the Governor, and must be a veteran.

James R. Ramos
Secretary of Veterans Affairs

Appointed to his position on January 4, 1999 by Governor Gray Davis, Secretary Ramos comes to the Department with an extensive background in veterans advocacy and small business management. A 1960 graduate of the United States Military Academy at West Point, New York, Secretary Ramos holds Master of Science degrees in System Engineering from Arizona State University and in Public Policy Analysis from California State University, Sacramento. A retired United States Army officer, Secretary Ramos served two tours of duty in Vietnam.

After leaving the Army, Secretary Ramos became a principal in two small businesses, CR Communications and Graphic Design and James R. Ramos Associates, a technical consulting firm. He remained a principal in those firms until assuming his current public duties. Throughout his business career, Secretary Ramos has been an active leader in the effort to make disabled veteran business owners competitive participants in the public contracting arena. He is the founder of the Disabled Veteran Business Enterprise Network. Republican Governor Pete Wilson named Secretary Ramos the *Small Business Person of 1994.*

Tomas Alvarado
Undersecretary of Veterans Affairs

Undersecretary Alvarado brings to his position a career-long commitment to veterans issues. Mr. Alvarado has an extensive background in public policy development at every level of government. For the past quarter century he has worked in county government and with the State Legislature and the United States Senate as a member of several public policy staffs. In addition to significant local and legislative experience, Mr. Alvarado has a strong background within the Executive Branch of State government. From 1991 to 1995, Mr. Alvarado served as Deputy Director of Veterans Affairs for then-Governor Wilson. In this position, Mr. Alvarado had as one of his responsibilities oversight of the Program. Mr. Alvarado is a decorated United States Marine veteran of the Vietnam conflict. Mr. Alvarado is a graduate of San Jose State University.

Bruce Thiesen
Deputy Secretary for Operations

Like Secretary Ramos, Deputy Secretary Thiesen is a Vietnam-era Army veteran with a long history as a veterans activist. Mr. Thiesen is an independent agribusinessman with more than 30 years of broad experience in farm management, farm labor acquisition and benefits administration. Mr. Thiesen served as National Commander of the American Legion in 1993-1994 and from 1995 through 1998 he was appointed by the Secretary of the United States Department of Veterans Affairs as a member of the Veterans Advisory Committee on Rehabilitation. In addition to his work on behalf of veterans, Mr. Thiesen is involved in a number of other community and philanthropic efforts.

Curtis Howard
Deputy Secretary, Administration since May 1998

Deputy Secretary Howard is a United States Air Force veteran who graduated from California State University, Sacramento in 1976 after completing the requirements for a teaching credential. He taught in the State public school system for several years, then moved into State government service where he has worked for over 19 years. He has performed a wide variety of assignments including computer programming and systems design, financial analysis, and health and safety officer duties. During the last seven years Mr. Howard has served in a number of senior level financial and program management positions with the State Department of Social Services (CDSS). While the Assistant Deputy Director for the Welfare Programs Division at CDSS, Mr. Howard was one of nine individuals selected to serve on the Governor's Welfare Reform Task force.

Sheryl A. Schmidt
Deputy Secretary of Women Veterans Affairs since November 1996

After leaving the accounting firm of Touche Ross (Deloitte & Touche) in 1987, Deputy Secretary Schmidt began her state career at the State Controller's Office as a Certified Public Accountant (CPA). In 1995, she accepted the newly created position of Chief of Audits at the Department and developed the Internal Audit Division. In 1996, the Governor of California appointed United States Air Force Veteran Sheryl Schmidt as the Deputy Secretary of Women Veterans Affairs. Ms. Schmidt holds a Bachelor's degree in management from St. Leo's College in Florida, a Master's of Business Administration (MBA) from California State University Sacramento, and a CPA license from the California State Board of Accountancy.

George Flores
Acting Chief, Farm and Home Purchases Division since April 1999

Mr. Flores was appointed Acting Chief of the Farm and Home Purchases Division on April 14, 1999. He is a United States Army veteran who graduated from the California State University, Sacramento in 1973 with a Bachelor of Science degree in Business Administration, and attended the McGeorge School of Law, University of the Pacific. He has been with the Department for 22 years. He has served as Manager of the Title and Escrow Unit, Headquarters Operation Manager, Southern Regional Manager and the Assistant Division Chief.

Kandis L. Mendonsa
Chief, Bond Finance Division since May 1998

Ms. Mendonsa brings to her current position more than a quarter century of service in California state government. For most of that time, she has worked exclusively in the area of financial management. Prior to joining the Department in 1998, Ms. Mendonsa was employed for 10 years by the Department of Social Services and for 12 years at the State Department of Corrections. While at Corrections, among Ms. Mendonsa's responsibilities was the management of a $4 billion tax exempt bond program for the construction of youth and adult correction facilities.

Arnulfo Hernandez, Jr.
Acting Chief Counsel since March 1999

Mr. Hernandez is a 17-year career employee of the Department. Hired as an entry level attorney, he became the Department's senior trial attorney and was appointed the Acting Chief Counsel of the Department in March 1999. Mr. Hernandez has a Bachelor's Degree in psychology from California State University, Los Angeles, a J.D. from University of the Pacific, McGeorge School of Law, Sacramento and is admitted to practice law in California. Mr. Hernandez is a U.S. Navy veteran, having served his country during the Viet Nam war, and was honorably discharged in 1971 with a V.A.-rated, service-connected disability.

Year 2000 Issues

Many existing computer programs used by the Department, its third-party vendors (which include investment contract providers), the Trustee, and The Depository Trust Company ("DTC"), have used only two (2) digits to identify a year in the date field and, if not remediated, such systems could fail or create erroneous results by the year 2000. Executive Order W-163-97 established that year 2000 solutions are a State priority. In keeping with the details of the order, the Department has issued a Year 2000 Compliance Policy and is taking steps intended to ensure that the Department's automated processes accurately perform all date related processing functions.

In its daily operations, the Department uses computer systems of other State departments for Statewide administrative functions, computer applications developed by outside vendors for the Department, and computer software which is widely available commercially. The State is addressing year 2000 compliance issues with respect to the Statewide administrative functions which the Department utilizes. In 1997, the Department initiated a Request for Proposal ("RFP") for a fully Integrated Loan Processing and Financial Information System, which, when operational, will be the mechanism used by the Department to manage its portfolio of Contracts of Purchase. The system selected is utilized by several other state housing finance agencies throughout the country. The system developer demonstrated to the Department during the RFP process that the system is year 2000 compliant. The Department is currently implementing and testing the new system which is expected to be fully functional by June 30, 1999. To the extent that a manufacturer of any of the widely available commercial software packages used by the Department in its daily operations does not make satisfactory representations regarding year 2000 compliance issues, the Department intends to replace such software packages with new software packages with respect to which such representations have been made or which have demonstrated year 2000 compliance.

The Department has required that all private contractors, consultants, and vendors who provide services or support functions to the Program, such as loan servicing and insurance, provide the Department either with assurance that they are year 2000 compliant, or with their plans to become year 2000 compliant and their time frames for achieving such compliance. Any failure by some or all of these parties to become year 2000 compliant may have a material negative impact on the Department's operations or financial status.

Department income is generated from two principal sources: principal and interest payments on Contracts of Purchase and earnings on investments. Payments from these sources are used to pay Department expenses, debt service on Revenue Bonds, and reimbursement of the State General Fund for debt service on Veterans G.O. Bonds. While some of the computer-assisted monitoring relied upon by the Department could possibly be done manually in case of a system failure, the Department has not identified an effective manual substitution for computer-assisted monitoring of its portfolio of Contracts of Purchase.

The Trustee is responsible for transmitting principal, purchase price, and interest payments on Veterans G.O. Bonds and Revenue Bonds to the registered owners of Revenue Bonds. DTC is the registered owner of the Veterans G.O. Bonds and Revenue Bonds, and payments of principal and interest on Veterans G.O. Bonds and Revenue Bonds is payable by the Trustee to DTC, and by DTC or its Participants to beneficial owners. Therefore, timely payment and receipt of principal and purchase price of and interest on the Veterans G.O. Bonds and Revenue Bonds after January 2000 are dependent on the successful functioning of the payment systems of both the Trustee and DTC. The Trustee has reported that, as of December 31, 1998, its systems for bond payments were fully year 2000 compliant. See Appendix A—"THE STATE OF CALIFORNIA—OVERVIEW OF STATE GOVERNMENT—Information Technology." See Appendix C—"BOOK-ENTRY SYSTEM—DTC's Year 2000 Efforts" for information provided by DTC regarding its year 2000 compliance efforts.

The Department has not independently reviewed the assurances of other parts of State government, the developers of the Department's computer systems (other than its Integrated Loan Processing and Financial Information System), DTC and the Trustee, and will not independently review the assurances made by its critical vendors (other than the developer of its Intergrated Loan Processing and Financial Information System). The State Controller's Office has reported that it had completed the necessary year 2000 remediation projects for the State fiscal and accounting systems by December 31, 1998, consistent with the Governor's Executive Order and that its final steps of testing will be completed during 1999. The Department, the Trustee, other parts of State government, the developers of its computer systems, the developers of widely available commercial software packages used by the Department, and the critical vendors may each subsequently discover areas of non-compliance.

The Department is not presently aware of any costs to achieve year 2000 compliance that will have a material negative impact on the Department's operations or financial status; however, the Department can give no assurance that any subsequently discovered non-compliance will not have such material negative impact.

Failure by one or more of the Department, the Trustee, other parts of State government, the developers of the Department's computer systems, DTC, the developers of the widely available commercial software packages used by the Department, and the critical vendors to be in year 2000 compliance could have a materially adverse effect on the programmatic and financial functionings of the Department.

THE PROGRAM

General

The Department began making low interest rate farm and home financing available to veterans after World War I, following the enactment by the California Legislature ("Legislature") of the Veterans Farm and Home Purchase Act of 1921. In 1943, the Legislature enacted the Veterans Farm and Home Purchase Act of 1943 ("1943 Act") which modified the Program to meet new needs of veterans. The 1943 Act was superseded by the Veterans Farm and Home Purchase Act of 1974 ("1974 Act") which again modified the Program. The 1943 Act established the 1943 Fund in the State Treasury, which is the principal fund utilized by the Program.

Since its inception, the Program has assisted over 405,000 veterans to purchase farms and homes throughout the State through long-term housing and farm loans. The sales of revenue bonds and Veterans G.O. Bonds, combined with surplus revenues from borrowers under the Program not needed at any given time to meet the then-current bond retirement schedules and operating costs, have financed the purchase of farms and homes since Program inception. As of

November 30, 1998 there were 34,847 Contracts of Purchase outstanding with a remaining principal balance of $2,071,536,000. See Exhibit 2 to this Appendix B—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase—Existing Contracts of Purchase" and "—Amounts Expected to be Available to Finance Contracts of Purchase and Related Investments" for information regarding existing Contracts of Purchase and moneys available to finance additional Contracts of Purchase.

The description of the Program under this heading is a description of the Program as it currently exists under the Veterans Code and the Department's implementation thereof, including recent programmatic changes. The Veterans Code and the Department's implementation thereof are subject to change. The Program is also subject to the Federal Tax Code, as noted below.

Qualifying Veteran Status

Veterans Code. A veteran must meet qualifications established under State law in the Veterans Code in order to participate in the Program. The qualifications specified in the Veterans Code are subject to change by the Legislature. The Veterans Code currently requires, generally, that a veteran must have served at least ninety days on active duty in the Armed Forces of the United States, unless sooner discharged because of a service-connected disability, or as a member of the National Guard or reserves called to active duty by Presidential order, and must have received an honorable discharge or been released from active duty under honorable conditions. The Veterans Code (including amendments effective January 1, 1998) allows the Department to finance Contracts of Purchase for:

(a) veterans who have served during a period which includes service in one of the following periods:

(i) April 6, 1917 through November 11, 1918; December 7, 1941 through December 31, 1946; or June 27, 1950 through January 31, 1955 (such veterans are referred to as "Earlier War Veterans");

(ii) February 28, 1961 through August 4, 1964 if the veteran served in the Republic of Vietnam during that period ("Early Vietnam Veterans"); or August 5, 1964 through May 7, 1975 (all veterans referred to in this clause (ii) are "Vietnam Era Veterans"); or

(iii) on or after August 2, 1990, through a date as yet to be determined by the President of the United States; at any time in Somalia, or in direct support of the troops in Somalia, during Operation Restore Hope; or at any time in an expedition or campaign for which a medal was authorized by the United States Government such as the Armed Forces Expeditionary and Vietnam Service Medals (such veterans are referred to as "Recent War Veterans"); and

(b) any person who qualifies under the Federal Tax Code for financing from revenue bonds or unrestricted funds of the Department and who served in the active military, naval, or air service for a period of not less than 90 consecutive days and who received an honorable discharge or was released from active duty under honorable conditions (such veterans are referred to as "Peacetime Veterans").

The amendments to the Veterans Code effective January 1, 1998 added Early Vietnam Veterans and Peacetime Veterans as veterans eligible to receive Contracts of Purchase. The Department expects these amendments to significantly increase the universe of potential contract holders, and to increase demand for Contracts of Purchase.

Federal Tax Code. In order to determine which Department moneys can be used to finance Contracts of Purchase, the Department must also take into account the requirements of federal law set forth in the Federal Tax Code, which limits the universe of veterans eligible to receive Contracts of Purchase financed from certain sources. Applying the current Federal Tax Code separates the Department's lendable moneys into three classes:

(a) "Unrestricted Moneys" (derived from certain moneys in the 1943 Fund and certain proceeds of pre-Ullman revenue bonds and veterans general obligation bonds, including certain future issues of taxable bonds, if any), which can finance Contracts of Purchase for those veterans who qualify under the applicable provisions of the Veterans Code (there are no loan eligibility requirements imposed by the Federal Tax Code with respect to Contracts of Purchase financed by Unrestricted Moneys; these are requirements principally limiting the family income of applicants and the property purchase price, and, subject to certain exceptions, requiring that the veteran not have had a present ownership interest in his principal residence in the three years prior to obtaining such financing ("QMB Loan Eligibility Requirements")). The Department has implemented a policy (which is subject to change) to make such moneys available for Earlier War Veterans, Vietnam Era Veterans, and Recent War Veterans. ("Pre-Ullman" refers to the period prior to enactment of Federal Tax Code restrictions on the use of proceeds of tax-exempt bonds to finance mortgage loans.);

(b) "Qualified Veterans Mortgage Bond Proceeds" (derived exclusively from proceeds of Veterans G.O. Bonds) which can finance Contracts of Purchase for any veteran who (i) qualifies under the Veterans Code, (ii) served on active duty prior to January 1, 1977, and (iii) was released from active duty fewer than 30 years before receiving such financing. The last date of veteran eligibility under clause (iii) is December 31, 2036 for a veteran with 30 years of continuous service after December 31, 1976. (The QMB Loan Eligibility Requirements do not apply to Contracts of Purchase financed by such moneys.) These proceeds can finance Contracts of Purchase for Earlier War Veterans and Vietnam Era Veterans; and

(c) "Qualified Mortgage Bond Proceeds" (which are principally derived from Revenue Bond proceeds), can finance Contracts of Purchase for any veteran who (i) qualifies under the Veterans Code, and (ii) satisfies the QMB Loan Eligibility Requirements. These proceeds can finance Contracts of Purchase for Earlier War Veterans, Vietnam Era Veterans, Recent War Veterans, and Peacetime Veterans.

Allocation of Lendable Moneys

For those veterans seeking financing who would qualify for Contracts of Purchase from two or more of the above-described financing sources, the Department will select the source of funds to use in its sole discretion. The Department's goal is to maximize the availability of Program benefits. The Board has approved a policy (which is subject to change) to make Qualified Mortgage Bond Proceeds derived from Revenue Bonds the only financing source for Contracts of Purchase for veterans who did not serve during "wartime" (as defined in the Veterans Code).

Administration of the Farm and Home Purchase Program

The Department finances new and existing single-family homes, farms and mobile homes located in the State by acquiring the property selected by a veteran under a Contract of Purchase. The Department also finances home improvements with respect to properties covered by existing Contracts of Purchase, subject to applicable restrictions of the Federal Tax Code. A Contract of Purchase creates an installment land contract between the Department and the veteran which is analogous to a loan from the Department to the veteran. The amount which the Department finances is reflected in the Contract of Purchase as the "purchase price."

At present under the Veterans Code, the maximum purchase price to the Department of an existing home or the sum to be expended by the Department pursuant to a Contract of Purchase for a home to be constructed is $250,000 and for farms is $300,000 (except that the limitation with respect to certain mobile homes in mobile home parks is $70,000 and except that the maximum purchase price for any home may be increased by an additional $5,000 for certain purposes). The Legislature has periodically made changes in the maximum amount that may be financed under a Contract of Purchase. The Federal Tax Code imposes maximum purchase prices on properties which are the subject of Contracts of Purchase financed by Qualified Mortgage Bond Proceeds, which maximums are adjusted periodically. (No Federal Tax Code purchase price limits apply to Contracts of Purchase financed from Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds). These Federal Tax Code requirements vary depending upon where the property is located, if it is in a targeted or non-targeted area, and whether it is a new or existing home. These Federal Tax Code limits currently range from $88,266 to $313,512. The maximum purchase price under the Program is, therefore, the Veterans Code maximum amount or, if the Contract of Purchase is being financed by Qualified Mortgage Bond Proceeds, the lesser of the Veterans Code maximum amount or the maximum amount under applicable provisions of the Federal Tax Code.

Although the Veterans Code does not impose maximum income limits, the Federal Tax Code imposes maximum income limits applicable only to veterans obtaining Contracts of Purchase financed by Qualified Mortgage Bond Proceeds. The income limits vary by statistical area and family size. No maximum income limits apply to veterans obtaining Contracts of Purchase financed by Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds.

Under amendments to the Veterans Code effective January 1, 1998, any veteran who qualifies under the Veterans Code and the Federal Tax Code may be granted a subsequent Contract of Purchase so long as any previous Contract of Purchase has been paid in full or the veteran lost his interest in the previous Contract of Purchase through divorce or dissolution of marriage.

Contracts of Purchase

General. Pursuant to the Program, the Department and the veteran enter into a Contract of Purchase for a farm, home or mobile home. Under a Contract of Purchase, the veteran has the benefits of ownership as the equitable owner, but title to the property and improvements is held by the Department as the legal owner until the final principal payment is made. Property sold under a Contract of Purchase may not be transferred, assigned, encumbered, leased, let or sublet without the written consent of the Department. Any permitted encumbrance must be junior or secondary to the Department's interest in the property.

In the past, Contracts of Purchase were not insured or guarantied by the Federal Housing Administration, the United States Department of Veterans Affairs (the "USDVA"), Rural Development (formerly, Farmers' Home Administration), or any private primary mortgage insurer. Now that the Department has been approved by the USDVA as an originator of loans eligible to receive a guaranty from the USDVA, USDVA guaranties are expected to be obtained for most new high loan-to-value ("LTV") Contracts of Purchase. In addition to the USDVA guaranty, the Department has secured primary mortgage insurance for a pool of certain Contracts of Purchase with LTV ratios above 80%, but not to exceed 97%, from Commonwealth Mortgage Assurance Company ("CMAC"). This insurance retroactively covers, effective February 1, 1998, aggregate losses incurred above a 2% deductible. Veterans and properties which are not USDVA eligible and which do not meet CMAC eligibility criteria are expected to continue to be the subject of the Department's Self Insurance Mortgage Loss Set-Aside account (described below). Any change to the foregoing insurance and guaranty expectations would require amending the Department's Program Operating Procedures and delivering a new Cash Flow Statement.

The terms of the Contracts of Purchase are substantially identical regardless of whether they are funded by Unrestricted Moneys, Qualified Veterans Mortgage Bond Proceeds or Qualified Mortgage Bond Proceeds, except for Federal Tax Code-mandated differences in Contracts of Purchase financed with Qualified Mortgage Bond Proceeds. Two ways in which such Contracts of Purchase are different are: (a) Contracts of Purchase financed by Qualified Mortgage Bond Proceeds have more restrictions on the right of a purchaser to assume the obligations under the Contract of Purchase than do Contracts of Purchase financed by Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds; and (b) certain Contracts of Purchase financed by Qualified Mortgage Bond Proceeds are subject to recapture provisions. In addition, the Federal Tax Code contains numerous loan eligibility restrictions on borrowers receiving financing from proceeds such as Qualified Mortgage Bond Proceeds. These restrictions require, among other things, and subject to certain exceptions contained in the Federal Tax Code, that borrowers (i) not have had a present ownership interest in their principal residence during the three-year period preceding the extension of financing, (ii) are eligible to finance the purchase of residences with purchase prices not in excess of limits stated in the Federal Tax Code, (iii) must not have family incomes in excess of limits stated in the Federal Tax Code, (iv) may not use the proceeds of the financing to refinance an existing mortgage loan and (v) may use the proceeds of the financing only to finance one-family or one-to-four family dwelling units meeting certain criteria. The Federal Tax Code includes certain procedures that an issuer of Qualified Mortgage Bonds may undertake to satisfy these requirements but requires that 95% or more of the proceeds of the issue be used in full compliance with the loan eligibility restrictions.

Since the number and value of Contracts of Purchase relating to farms and mobile homes, and Contracts of Purchase financed pursuant to the 1943 Act are statistically insignificant, the discussion below is limited to Contracts of Purchase financed under the 1974 Act for homes, excluding farms and mobile homes in rental parks, unless otherwise indicated. See Exhibit 2 to this Appendix B—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase—Existing Contracts of Purchase."

Origination. The Veterans Code, in most cases, requires the veteran to make an initial payment of 2% of either the purchase price or the market value of the property, whichever is less. The balance of the purchase price, including USDVA guaranty fees, may be amortized over a period fixed by the Department, not exceeding 30 years and 32 days for all Contracts of Purchase guaranteed by USDVA, and 40 years of any other Contracts of Purchase. Department policy is to issue all new Contracts of Purchase for terms of 30 years. Existing contracts are occasionally extended beyond 30 years in cases of extreme financial hardship.

A Loan Origination Fee ("LOF") of 1% is collected at close of escrow on all contracts issued after January 1, 1999. This fee must be paid in escrow by the buyer or seller. If the loan application is submitted through an approved mortgage broker, the 1% fee is paid directly to the broker through the escrow. Otherwise, the fee is retained by the Department. While the Department's field offices will continue to originate Contracts of Purchase, the Department expects the bulk of the Contracts of Purchase to be originated by mortgage loan brokers in the future. The brokers will deal directly with the central underwriting, escrow and administrative staff in Sacramento, not through the Department's field offices. An appraisal fee of $300 to $425 is collected from the applicant and is paid directly to the appraiser upon completion of the assignment. In rare cases, where the appraisal is performed by a Department employee, the fee is retained by the Department.

The Veterans Code permits the Department to finance permanent home and property improvements for veterans with existing Contracts of Purchase. Total financing, including the balance of the original loan, the amount of the improvement loan, and any other encumbrances, cannot exceed 90% of the improved market value of the property. Typically this total LTV ratio is much lower than 90%. Improvement loans are not approved for veterans who have had significant delinquencies in the 12 months immediately preceding the application. Funds are disbursed by the Department directly to the contractors (or vendors) as the improvements are completed. A separate Contract of Purchase is executed which bears interest at the same rate as the existing contract. The new Contract of Purchase is payable over a term up to 15 years based on the amount of the Contract of Purchase. In no event can the term, from the inception of the original Contract of Purchase through the pay-off of the improvement Contract of Purchase, exceed 40 years. A LOF of 1.5% of the improvement Contract of Purchase amount is charged. The maximum home improvement loan for veterans funded with Qualified Mortgage Bond Proceeds is $15,000 over the term of the original Contract of Purchase. Home improvement loans funded with Unrestricted Moneys or Qualified Veterans Mortgage Bond Proceeds are available up to a maximum of $50,000. Subsequent home improvement Contracts of Purchase may be granted, if funds are available, so long as there is only one home improvement Contract of Purchase to any veteran outstanding at any time.

Contracts of Purchase for the purchase of a building site and construction of a home are available. Qualifying sites include undeveloped sites/acreage, lots in subdivision developments, and sites in non-profit self help developments. Mobile homes in parks do not qualify. Construction of the improvements must be performed by a licensed California contractor. The Department does not submit Contracts of Purchase which finance home construction for USDVA guaranty during the construction phase. Procedures are being developed to obtain guaranties on the properties once construction is completed.

The Department also limits availability of financing to veterans on the basis of their personal credit status. The Department's current lending criteria conform to those of the USDVA for participation in the USDVA guaranty program for all Contracts of Purchase, including those not eligible for USDVA guarantees.

Department procedures are consistent with those established by USDVA for its loan guaranty program.

Servicing. Late penalty charges are applied to Contracts of Purchase that have a remaining amount due of $25 or more at the close of any account month. A $10 late penalty charge is imposed on Contracts of Purchase originated before October 1984. Contracts of Purchase originated during and after October 1984 are subject to a late penalty charge of 4% of the principal and interest portion of the installment, consistent with penalties authorized by USDVA.

The Department may, in any individual case and for good cause, permit the postponement from time to time, and upon such terms as it deems proper, of the payment of the whole or any part of any installment. Contracts of Purchase may also have terms in excess of 30 years if home improvement loans have been obtained, as discussed above. The terms of Contracts of Purchase guarantied by USDVA, however, cannot exceed 30 years and 32 days.

All Contracts of Purchase originated on or after April 1, 1998 are serviced under a contract with Leader under which Leader provides loan servicing, including USDVA reporting. Pursuant to such contract, Leader will service Contracts of Purchase until such time as the Department's new Integrated Loan Processing and Financial Information System is operational.

Contracts of Purchase originated prior to April 1, 1998 are maintained under the Department's existing loan servicing system. All Contracts of Purchase are expected to be serviced after July 1, 1999 by the Department using its new information system.

Prepayments. The Department currently imposes on Contacts of Purchase executed prior to April 1, 1998 a prepayment charge equivalent to 2% of the original purchase price if the Contract of Purchase is paid in full within two years of its origination date. After the two-year period has elapsed the veteran may prepay without charge any or all of the installments still remaining unpaid. In conformance with USDVA program requirements, there is no prepayment penalty on all Contracts of Purchase executed after April 1, 1998.

Cancellations and Delinquencies. The Department's policies regarding delinquencies and cancellations conform to USDVA loan guaranty program requirements. In the event of a failure to comply with any of the terms of a Contract of Purchase, the Department may cancel the Contract of Purchase and be released from all obligations, at law or in equity, to convey the property. In such event, the veteran's rights under the Contract of Purchase may be forfeited and all payments made by the veteran prior to termination of the Contract of Purchase deemed to be rental paid for occupancy. Upon such forfeiture, the Department takes possession of the property covered by the Contract of Purchase and resells it.

If a veteran does not make a payment by the close of the account month in which the payment is due (usually the 18th day of the month), the payment is considered "delinquent." A warning letter is issued on the 20th day of the same account month which advises the veteran that the account is delinquent. Department personnel initiate telephone contact with veterans with delinquent accounts. If the account remains delinquent through the second account month, a Notice of Intent to Cancel Contract is issued at the beginning of the third account month giving notice that the Contract of Purchase may be canceled at the end of the 30-day notice period unless the account is brought current. A schedule for liquidation of delinquent payments satisfactory to the Department is arranged during this period; *however,* if the account remains delinquent after such 30-day period and no schedule for liquidation of delinquent payments has been agreed upon, the Department may begin cancellation of the Contract of Purchase. The Department's headquarters Central Collections Unit monitors the delinquency throughout this process, orders a title search to identify any junior lienholders and forwards the pertinent information to the Department's Foreclosure Unit for further precancellation processing in accordance with the California Code of Regulations, Title 12, Section 344, Military and Veterans Affairs. Junior lienholders are identified and sent notices giving them 30 days (40 days in the case of federal tax liens) to protect their interest by beginning foreclosure proceedings. If the account is not brought current during such notice period to junior lienholders and no junior lienholder proceeds with a foreclosure action to protect its interest, the Department's Foreclosure Unit cancels the contract, and a Notice of Cancellation is mailed to the veteran and recorded. The Department's Foreclosure Unit then takes steps to evict occupants and clear any remaining liens. If judicial action is required, the case is referred to the Department's Law Division for additional processing.

After all remaining liens are removed and the property is vacant, the repossessed property is repaired and improved and is marketed through the Department's centralized repossession sales unit. The Department is required to advertise and accept sealed offers after a 2-week period, and the property is sold to the highest acceptable bidder. If no acceptable bids are received, the property is sold through a real estate broker and a commission of between 3% to 6% of the selling price is paid.

Federal law provides certain protections to military personnel on active duty or reservists ordered to report for military service under The Soldiers' and Sailors' Civil Relief Act of 1940, as amended. If a veteran obtained a Contract of Purchase prior to the relevant period of military service, then during the period of military service the interest rate on the Contract of Purchase cannot exceed 6% (unless the ability of the veteran to pay interest in excess of 6% is not materially impaired by such military service). Also, the veteran may seek a stay (or a court may on its own motion grant a stay) of any court action or proceeding.

See Exhibit 2 to this Appendix B—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Cancellations and Delinquencies" for additional information regarding the status of Contracts of Purchase.

Interest Rates. Contracts of Purchase originated prior to January 1, 1999 bear interest at a rate which is set at least annually by the Department, with the review of the Board and the Veterans' Finance Committee of 1943. Most of such Contracts of Purchase currently bear interest at a rate of 6.95%. The Veterans Code currently requires that, generally, all Contracts of Purchase originated prior to January 1, 1999 bear the same interest rate. In accordance with the current provisions of the Veterans Code, the interest rate for such Contracts of Purchase can be changed at any time and as often as necessary. The effective date of a higher rate of interest on Contracts of Purchase may occur only once in any calendar year unless a finding is made by the Board and the Veterans' Finance Committee of 1943 that such additional action is necessary to protect the solvency of the 1943 Fund.

Recent legislation (i) has eliminated the uniform interest rates requirement for Contracts of Purchase originated on or after January 1, 1999 and (ii) allows the Department to establish non-uniform fixed or variable interest rates for such Contracts of Purchase. The current interest rates for such Contracts of Purchase are: 5.95% for Contracts of Purchase financed using Qualified Mortgage Bond Proceeds, and 6.65% for all other loans. See "PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES."

Loan Insurance

As discussed above under "PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES," the Department has completed several programmatic changes, including obtaining loan insurance from private primary mortgage insurers for certain existing Contracts of Purchase with high LTVs and USDVA guaranties for new Contracts of Purchase with high LTVs. The Department collects a funding fee of from 1.25% up to 3% of the Contract of Purchase amount, based on the LTV for all Contracts of Purchase which exceed an LTV of 80%. With respect to eligible Contracts of Purchase, this fee is paid to the USDVA for the cost of the loan guaranty. The fee may be paid in escrow by the buyer or seller, or it may be added to the base loan amount. If the veteran or the property is not eligible for a USDVA loan guaranty, the funding fee is placed in the Self Insurance Mortgage Loss Set-Aside Account. A portion of the fee is used to purchase primary mortgage insurance. Any change to the insurance and guaranty expectations described under this subheading would require amending the Department's Program Operating Procedures and delivering a new Cash Flow Statement.

Primary Mortgage Insurance. The Department has purchased primary mortgage insurance for a pool of certain Contracts of Purchase with LTVs above 80% but not to exceed 97%. This insurance is being provided through a contract with CMAC. The CMAC policy provides coverage, retroactively to February 1, 1998, for aggregate losses incurred on Contracts of Purchase in the pool, following property disposition, above an aggregate 2% deductible based upon a percentage of originally insured balances. Under the CMAC policy, once the aggregate deductible has been reached, insurance claims may be made based upon the individual LTV of the particular defaulted Contract of Purchase, as set forth below. For these purposes, LTV is calculated using the original appraised value of the property.

CMAC Mortgage Insurance Coverage Rates Subject to a Deductible of 2% of the Total Original Dollar Amount of the Insured Pool

LTV Category	% of Coverage
95.01% to 97.00%	35%
90.01% to 95.00%	30%
85.01% to 90.00%	25%
80.01% to 85.00%	17%

The Department intends to include Contracts of Purchase with 80.01% to 97% LTV ratios that are not qualified for USDVA guaranties (except mobile homes in parks, construction loans and home improvement loans all of which are covered by the Department) in the 2% aggregate loss primary mortgage insurance contract with CMAC unless and until the aggregate principal amount of Contracts of Purchase so insured by CMAC exceeds the coverage amount of the insurance contract. At present the remaining available coverage amount under such CMAC contract is $250,000,000, although Contracts of Purchase in an aggregate principal amount of approximately $105,000,000 are currently in process for coverage under the CMAC policy. See Exhibit 2 to this Appendix B—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase—Existing Contracts of Purchase."

USDVA Guaranty Program. The Department has been approved by the USDVA as a "supervised lender with automatic processing authority" as of March 10, 1998. On July 27, 1998, the Department received USDVA approval under the Lender Appraisal Processing Program ("LAPP") to process appraisals and determine reasonable value without prior USDVA review. The Department seeks USDVA loan guaranties for all Contracts of Purchase with an LTV ratio of 80% or higher, unless the Contract of Purchase is not eligible for USDVA guaranty. Contracts of Purchase not eligible for guaranty are primarily contracts with veterans who have previously used their USDVA guaranty eligibility and do not qualify for reinstatement, and contract for the purchase of new homes not inspected by USDVA during construction. A very small number of veterans have service that meets Veterans Code eligibility requirements but does not meet USDVA eligibility requirements.

The Servicemen's Readjustment Act of 1944, as amended, permits a veteran (or in certain instances the veteran's spouse) to obtain a mortgage loan guaranty from USDVA covering mortgage financing of the purchase or construction of a one-to-four family dwelling unit at interest rates permitted by USDVA. The USDVA program has no preset mortgage loan limits and permits the guaranty of mortgage loans of up to 30 years and thirty-two days' duration. Under the USDVA program, the maximum USDVA guaranty on a loan is the lesser of the veteran's available entitlement (a maximum of $36,000, or if the original loan amount exceeds $144,000, a maximum of $50,750), or (1) 50% of the original loan amount if such amount does not exceed $45,000, (2) $22,500 if the original loan amount is between $45,000 and $56,250, (3) the lesser of $36,000 or 40% of the original loan amount, if such amount is between $56,250 and $144,000, or (4) the lesser of $50,750 or 25% of the original loan amount, if such amount is in excess of $144,000. The liability on the guaranty is reduced or increased pro rata with any reduction or increase in the amount of indebtedness, but in no event will the amount payable on the guaranty exceed the amount of the original guaranty. Notwithstanding the dollar and per centum limitations of the guaranty, a mortgage holder will ordinarily suffer a monetary loss only where the difference between the unsatisfied indebtedness and the proceeds of a foreclosure sale of a mortgaged property is greater than the original guaranty as adjusted. Extended periods without interest payments prior to foreclosure will also increase the potential for losses. In the event of a default in the payment of a USDVA loan, but prior to a suit or foreclosure, USDVA may, at its option, pay to a mortgage holder the unpaid balance of the obligation plus accrued interest and receive an assignment of the loan and security.

Self Insurance Mortgage Loss Set-Aside. The Department has established a mortgage loss account within the 1943 Fund to be funded by mortgage insurance charges (funding fees) paid by veteran recipients of Contracts of Purchase that do not qualify for USDVA guarantees and high LTV Contracts of Purchase that are not insured under the CMAC policy. A portion of these moneys are used to purchase primary mortgage insurance.

Property and Life and Disability Insurance

The Veterans Code and/or long-standing Department policy have called for a veteran to maintain certain insurance with respect to the property covered by a Contract of Purchase. Insurance must be in the amount and under the conditions specified by the Department, and is either provided by the Department or by insurance companies selected by the Department.

Fire and Hazard Coverage. The Department self-insures for fire and hazard losses, using the 1943 Fund to make payments, up to a deductible. The Master Policy described below (the "Master Policy") provides coverage in excess of the deductible, except that the Master Policy does not cover mobile homes, condominiums or planned unit development properties covered by blanket insurance policies provided by homeowners' associations. The Master Policy is provided by a commercial insurer.

Under each Contract of Purchase, the veteran is required to pay the sum charged to his or her account to cover costs of providing the insurance coverage including the insurance premium due under the Master Policy described below with respect to his or her property. From the amount charged to each veteran, the Department retains a portion to provide the sums necessary to pay all losses up to $1,250,000 per occurrence or $10,000,000 per policy year. If the total losses from a single occurrence exceed $1,250,000 or if the aggregate of all fire and hazard insurance losses for a policy year exceed $10,000,000 liability for the excess will be covered under the Master Policy. The current Master Policy will expire on October 31, 1999.

The Master Policy is an all-physical loss form. Fire and hazard insurance coverage for participants in the Program is adjusted annually to reflect increasing building costs and is maintained on a guarantied replacement cost basis for homes and on an actual cash value basis for outbuildings. A $250 deductible payable by the veteran applies to each loss. Claims must be submitted within 12 months of loss. Each veteran with a Contract of Purchase pays an annual insurance premium equal to $0.22 per $100 of insured value which is prorated and included in the veteran's monthly installment. Claims adjustments and payments are made on behalf of the Department and the provider of the Master Policy by an affiliate of such provider.

Disaster Indemnity Plan. The Department provides certain disaster indemnity and catastrophe real property insurance ("Disaster Indemnity Plan"). Neither such insurance nor the indemnity fund described below are payable from or a part of the 1943 Fund. The Disaster Indemnity Plan indemnifies participants against the cost of repairing damage in excess of a deductible caused by flood, earthquake or other perils not covered by the fire and hazard insurance policy (not otherwise excluded). The deductible for flood losses is $500 and the deductible for earthquake losses is $500 or 5% of the amount of loss, whichever is higher. The catastrophe insurance has been obtained from a consortium of nineteen insurance companies for a total of $50,000,000 of coverage with a $4,000,000 per occurrence and in the aggregate annually; $100,000 per occurrence maintenance deductible thereafter. The 1998 to 1999 annual premium for this coverage is $2,710,000.

Each veteran in the Program participates in the Disaster Indemnity Plan and pays his or her pro rata share of the annual premium. Such payments are deposited in an indemnity fund created in the Treasury of the State to be utilized to pay the deductible discussed above. Each veteran pays an initial assessment of $1.35 per $1,000 of insured value, and any assessments as may be required to sustain the indemnity fund. The value of the indemnity fund as of June 30, 1998 was $11,887,000.

Effective December 1, 1997, the Department has purchased individual flood policies through the Federal Emergency Management Agency ("FEMA") covering all properties financed by Contracts of Purchase that are located in designated flood zones. Coverage under this policy extends to December 1, 2000.

Life and Disability Coverage. In the past, the Department self-insured from the 1943 Fund life and disability coverage for veterans with Contracts of Purchase. Following a period of significant and recurring losses incurred by the 1943 Fund (see "THE 1943 FUND—Selected Financial Data of the 1943 Fund and Department's Discussion" in this Appendix B), the Department, effective June 1, 1996, replaced most of the Department's self-insured life and disability insurance program with an interim life and disability insurance plan (the "Life and Disability Plan") provided by PM Group Life Insurance Company ("PM Group"). Effective February 1, 1998, the interim plan after a competitive bidding process was replaced by a replacement, long-term life insurance and disability plan, also provided by PM Group Life Insurance. The Department continues to self-insure those veterans who were already receiving disability benefits at the time the Life and Disability Plan was implemented. Benefits are equal to the amount of the monthly Contract of Purchase payment at the time of their disability. Those benefits will continue under the provisions of the self-insured plan until the beneficiary returns to active employment or dies, or his contract is paid off. Loss reserves for these obligations have been actuarially determined. A portion of the required loss reserves are maintained under a third-party administrator agreement and are shown in the financial statements for the 1943 Fund as investments with insurance administrators. The remaining amount is unfunded, but reserved in the form of a loss against retained earnings. See "THE 1943 FUND—Selected Financial Data of the 1943 Fund and Department's Discussion" in this Appendix B.

Effective February 1, 1998, the Department implemented a new life and disability protection plan which is provided by PM Group. All holders of Contracts of Purchase who had life and disability coverage under the prior plan were transferred automatically to the new plan. Major elements of the life and disability coverage will continue unchanged for all currently insured Contract of Purchase holders up to age 60. For formerly insured holders of Contracts of Purchase under age 60, 100% of the loan balance is covered. Life insurance coverages at subsidized rates for those currently insured Contract of Purchase holders in the program over age 60 are limited to a maximum of the loan amount or $75,000, if less, reducing in increments every 5 years to a maximum of $5,000 after age 80. Such Contract of Purchase holders can obtain, at actuarial rates, full coverage. Holders of new Contracts of Purchase after February 1, 1998 are covered under a revised insurance plan. The Department continues to require life insurance coverage but in an amount sufficient to cover home payments for five, three or one year(s) depending on the health of the individual loan applicant. All new Contract of Purchase applicants must apply and must be provided the minimum life insurance coverage. Disability coverage for a period up to two years is optional for new Contract of Purchase holders after February 1, 1998, but is a mandatory requirement for Contract of Purchase holders with Contracts of Purchase in existence prior to February 1, 1998. The disability insurance benefit provides home loan protection by paying the participant's monthly loan installment (including insurance premiums) for a maximum benefit period of two years per disability, unless due to a psychiatric condition which would then limit the maximum benefit period to 12 months. Additional, full coverage, life insurance may also be purchased as an option by new Contract of Purchase holders. Spouse life insurance coverage is available as an option. The new plan is an experience rate plan subject to annual rating reviews of insurance claims, expenses, risk charges, profits and premiums. In addition to the new insurance coverages, the Department has established a one-time $5 million rate stabilization reserve, which the Department will retain with interest as part of the 1943 Fund.

THE 1943 FUND

General

The components of the 1943 Fund are (i) proceeds derived from the sale of Revenue Bonds, (ii) proceeds of Veterans G.O. Bonds, (iii) amounts receivable under all Contracts of Purchase and from sales of properties subject to canceled Contracts of Purchase, (iv) temporary investments, cash and funds, and (v) certain other miscellaneous assets. Proceeds of Veterans G.O. Bonds may not be applied to payment of principal of, and interest or any redemption premium on, the Revenue Bonds. The holders of Revenue Bonds are not entitled to compel the sale of Contracts of Purchase and the properties to which they relate, but are entitled to receive payment out of the Revenues derived from those Contracts of Purchase and properties, subject to the prior claims, if any, of the Veterans G.O. Bonds.

In addition to financing Contracts of Purchase and paying or reimbursing of debt service on the Veterans G.O. Bonds and Revenue Bonds, as described below, moneys in the 1943 Fund are used to pay administrative costs of the Department, and to fund certain losses from and reserves for property insurance and life and disability insurance described above in this Appendix B under "THE PROGRAM—Property and Life and Disability Insurance."

While the 1998 Financial Statement for the 1943 Fund reflects an increase in retained earnings, the Program has experienced significant losses during recent fiscal years in the retained earnings in the 1943 Fund. For additional information, see below "Selected Financial Data of the 1943 Fund and Department's Discussion" and also see Exhibit 1 to this Appendix B—"FINANCIAL STATEMENTS OF THE 1943 FUND FOR FISCAL YEARS 1998 AND 1997 AND INDEPENDENT AUDITOR'S REPORT."

The Act and the Veterans Code provide that the undivided interest created by Resolution RB-1 in favor of the holders of Revenue Bonds in the assets of the 1943 Fund is secondary and subordinate to the interest of the people of the State and the holders of Veterans G.O. Bonds. Moneys in the 1943 Fund must be paid, on the debt service payment dates of Veterans G.O. Bonds, to the General Fund in the amount of the principal of (whether at maturity or upon redemption or acceleration), and premium and interest on Veterans G.O. Bonds then due and payable (other than debt service payable from the proceeds of refunding bonds). Debt service on Veterans G.O. Bonds is payable from the General Fund, even if the amount transferred from the 1943 Fund to the General Fund is less than such debt service amount. The balance remaining unpaid must be transferred to the General Fund out of the 1943 Fund as soon thereafter as it becomes available, together with interest thereon at the rate borne by the applicable Veterans G.O. Bonds, compounded semiannually. Until such amounts are repaid to the General Fund, no payments may be made on the Revenue Bonds other than from amounts then in the Bond Reserve Account and the Loan Loss Account. These rights with respect to the 1943 Fund do not grant any lien on the 1943 Fund or the moneys therein to the holders of any Veterans G.O. Bonds.

As of December 31, 1998, there were outstanding $2,835,020,000 aggregate principal amount of Veterans G.O. Bonds and $269,135,000 aggregate principal amount of Revenue Bonds. As of December 31, 1998, $176,835,000 of Veterans G.O. Bonds are authorized but not issued, and the Department may in the future seek voter approval for additional amounts of Veterans G.O. Bonds. The Offered Veterans G.O. Bonds will not use any of such authorized amount. Under the Act, Revenue Bonds in an aggregate principal amount not to exceed $1,500,000,000, at any given time, may be outstanding. The Legislature may increase the amount of Revenue Bonds issuable under the Act or may decrease such amount to an amount not less than the amount of Revenue Bonds then outstanding. See "PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES" for information about the issuance of the Offered Veterans G.O. Bonds. Additional information about outstanding Veterans G.O. Bonds and Revenue Bonds is in Exhibit 2 to this Appendix B—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Veterans G.O. Bonds and Revenue Bonds."

See "THE DEPARTMENT—LAO Reports and Governor's Budget" in this Appendix B for a discussion of suggestions that surplus moneys in the 1943 Fund be applied to finance benefits for veterans outside the Program.

See "PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES" for a discussion of the Department's reductions of the interest rates on existing Contracts of Purchase and the interest rate for new Contracts of Purchase. For additional information regarding the existing interest rates of, and setting interest rates on, Contracts of Purchase, see "THE PROGRAM—Contracts of Purchase" in this Appendix B and Exhibit 2 to this Appendix B—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Contracts of Purchase."

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Selected Financial Data of the 1943 Fund and Department's Discussion

Selected Financial Data of the 1943 Fund

The following selected financial data of the 1943 Fund for fiscal years ended June 30, 1998 and 1997 has been derived from the financial statements of the 1943 Fund audited by Deloitte & Touche LLP, independent auditors, whose report thereon appears in Exhibit 1 to Appendix B in this Official Statement. The following selected financial data of the 1943 Fund for fiscal years ended June 30, 1996, 1995 and 1994 has also been derived from the audited financial statements of the 1943 Fund which are not included herein. This selected financial data should be read in conjunction with the financial statements and notes thereto of the 1943 Fund contained in said Exhibit 1 and the Department's Discussion of Financial Data contained herein.

Beginning with the fiscal year ended June 30, 1998, the financial statements of the 1943 Fund are required to reflect accounting changes required by promulgation of Statement No. 31 by the Governmental Accounting Standards Board ("GASB 31"). GASB 31 requires all investments to be reported at their fair market value (rather than book value) and investment income to be adjusted to reflect the difference between the fair market and book value of investments as either a capital gain or loss. The financial data derived from the financial statements of the 1943 Fund for FY 1994 through FY 1997 and presented in the tables below have been adjusted to reflect the impact of GASB 31 on investments and investment income so as to make such data consistent with the accounting procedures used in preparing the FY 1998 financial statements.

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SELECTED FINANCIAL DATA OF THE 1943 FUND
(Thousands of Dollars)

	June 30, 1998	Restated June 30, 1997	Restated June 30, 1996	Restated June 30, 1995	Restated June 30, 1994
ASSETS AND LIABILITIES RELATED TO LENDING AND FINANCING ACTIVITIES:					
CASH AND INVESTMENTS					
Cash and amounts on Deposit in SMIF	325,321	317,178	295,140	306,269	1,058,832
Guaranteed Investment Contracts	938,888	365,542	475,744	591,449	326,638
Treasury Securities	187,851	347,214	363,426	395,113	53,923
Total	1,452,060	1,029,934	1,134,310	1,292,831	1,439,393
DUE FROM VETERANS DEBENTURE REVENUE FUND	12,686	86,279	137,141	137,166	137,108
OTHER CURRENT ASSETS	13,755	22,596	26,191	25,787	24,819
NET OTHER NON-CURRENT ASSETS	36,406	15,123	15,824	16,600	13,255
CONTRACTS OF PURCHASE					
Performing Contracts	2,035,879	2,154,142	2,231,994	2,356,818	2,185,107
Non Performing Contracts	62,872	75,038	74,268	53,257	40,619
Total	2,098,751	2,229,180	2,306,262	2,410,075	2,225,726
Allowance For Contract Losses	(22,005)	(26,412)	(15,801)	(15,066)	(16,937)
Reduction of REO to Fair Value	(19,003)	(24,003)	(17,113)	(12,334)	0
Total	(41,008)	(50,415)	(32,914)	(27,400)	(16,937)
BONDS PAYABLE					
General Obligation Bonds	(2,947,165)	(2,632,045)	(2,812,810)	(3,002,695)	(2,802,260)
Revenue Bonds	(275,055)	(327,580)	(374,975)	(434,545)	(600,890)
Total	(3,222,220)	(2,959,625)	(3,187,785)	(3,437,240)	(3,403,150)
OTHER CURRENT LIABILITIES	(58,458)	(80,502)	(86,716)	(90,868)	(96,821)
Net Lending & Financing Activities Assets	**291,972**	**292,570**	**312,313**	**326,951**	**323,393**
ASSETS AND LIABILITIES RELATED TO INSURANCE ACTIVITIES:					
LIFE AND DISABILITY COVERAGE					
Deposits with Insurance Administrators	40,823	48,762	56,843	65,246	65,607
Insurance Reserves & Claims Payable	(53,185)	(65,828)	(78,246)	(79,729)	(68,214)
Total	(12,362)	(17,066)	(21,403)	(14,483)	(2,607)
FIRE AND HAZARD COVERAGE					
Net Insurance Reserves & Claims Payable	(1,209)	(1,405)	(2,744)	(5,013)	(3,209)
Net Insurance Activities Liabilities	**(13,571)**	**(18,471)**	**(24,147)**	**(19,496)**	**(5,816)**
RETAINED EARNINGS	**278,401**	**274,099**	**288,166**	**307,455**	**317,577**
SUMMARY INFORMATION					
Total Assets	3,587,000	3,377,000	3,639,000	3,916,000	3,889,000
Total Liabilities	3,309,000	3,103,000	3,351,000	3,609,000	3,571,000
Total Number of Contracts Of Purchase	35,906	39,343	42,650	47,075	48,341

SELECTED FINANCIAL DATA OF THE 1943 FUND
(Thousands of Dollars)

	June 30, 1998	Restated June 30, 1997	Restated June 30, 1996	Restated June 30, 1995	Restated June 30, 1994
NET INCOME FROM LENDING AND FINANCING ACTIVITIES:					
INTEREST INCOME					
Interest on Contracts	162,086	175,186	182,636	181,595	185,040
Interest on Investments	74,077	67,373	79,510	76,846	83,153
Transfers of Interest From Veterans Debenture Revenue Fund	3,317	10,843	11,144	11,164	11,031
Total	239,480	253,402	273,290	269,605	279,224
BOND INTEREST EXPENSE	(218,757)	(230,871)	(245,971)	(252,792)	(274,271)
Net Interest Income(Expense)	**20,723**	**22,531**	**27,319**	**16,813**	**4,953**
GASB 31 ADJUSTMENT	(4,578)	8,420	(12,580)	18,618	1,488
GAIN ON SALE OF SECURITIES	13,460				
RESTRUCTURING EXPENSES	(3,068)				
	5,814	8,420	(12,580)	18,618	1,488
CONTRACTS OF PURCHASES					
PMI	(1,551)				
Net loss on Sale Of REO'S	(3,128)	(8,309)	(5,510)	(2,200)	(945)
Increase In Allowance For Contract Losses	(1,312)	(22,677)	(5,515)	(10,463)	(10,837)
Total	(5,991)	(30,986)	(11,025)	(12,663)	(11,782)
Net Lending/Financing Activities Income (Expense)	**20,546**	**(35)**	**3,714**	**22,768**	**(5,341)**
NET INCOME FROM ADMINISTRATIVE ACTIVITIES					
Operating Revenues	1,891	2,290	1,769	2,768	1,617
Operating Expenses	(20,381)	(20,218)	(18,810)	(17,675)	(18,973)
Net Administrative Activities Expense	**(18,490)**	**(17,928)**	**(17,041)**	**(14,907)**	**(17,356)**
NET INCOME FROM INSURANCE ACTIVITIES					
Life and Disability Coverage	160	3,570	(5,424)	(13,781)	(1,152)
Fire and Hazard Coverage	2,086	326	(538)	(4,202)	3,809
Net Insurance Activities Income (Expense)	**2,246**	**3,896**	**(5,962)**	**(17,983)**	**2,657**
TOTAL DEFICIENCY OF REVENUES AND TRANSFERS OVER EXPENSES	**4,302**	**(14,067)**	**(19,289)**	**(10,122)**	**(20,040)**
RETAINED EARNINGS	278,401	274,099	288,166	307,455	317,577

Department's Discussion of Financial Data

The impact of GASB 31 adjustments over the five-year period reflected in the tables above (including FY 1998) are a cumulative decrease of $11,368,000 in the deficiency of revenues over expenses and cumulative increase of the same amount in retained earnings.

The 1943 Fund, which is the sole operating fund for the Program, reflects a retained earnings balance of $278,401,000 as of June 30, 1998. While this represents a $4,302,000 increase over FY 1997, the balance remains approximately 27.3 percent below the level at year-end FY 1992 when it peaked at $383,148,000. Although retained earnings have decreased in four of the last five years, the overall asset-to-liability ratio for the 1943 Fund has remained nearly constant at approximately 108% during the same period. The excess of revenues over expenses for the Program for FY 1998 was $4,302,000 compared to a deficiency of $14,067,000 in FY 1997. The aggregate net deficiency of revenues for the Program during the five-year period reflected in the tables above was $59,216,000.

As further described below, the Program has experienced significant losses during four of the last five years for three principal reasons: (i) a low interest rate environment that produced high prepayment levels and decreased investment earnings on bond proceeds and other invested funds in the 1943 Fund during FY 1994 through FY 1998; (ii) financial losses associated with the Department's self-insured life and disability and property insurance programs during FY 1994 through FY 1996; and (iii) losses on sale of repossessed properties and allowances for losses associated with the Department's portfolio of Contracts of Purchase during FY 1994 through FY 1998. However, as discussed below, over the last several years the Department has undertaken major initiatives to address each of these areas and expects such actions to have a positive impact on future years' financial performance.

The Program's FY 1998 net interest income (total interest income less bond interest expense) of $20,723,000 was $1,808,000 less than FY 1997. During the first four of the years represented in the table above net interest margin (net interest income divided by average interest bearing assets) improved, reflecting the Department's continuing efforts during the period to reduce debt service cost and increase interest income. These efforts have included, where possible, redemption of outstanding higher interest rate bonds prior to maturity and the transfer of certain invested funds from lower yielding variable rate instruments to higher yielding fixed rate investments. Notwithstanding these recent actions, the Department's net interest margin declined from 0.65% in FY 1997 to 0.60% in FY 1998 and will continue to be adversely affected in future years by the: (i) reduction of the interest rate on existing Contracts of Purchase from 8.00% to 6.95% implemented effective April 1, 1998 (see "PLAN OF FINANCE AND DEPARTMENT'S RECENT PROGRAMMATIC CHANGES—Department's Recent Programmatic Changes"); and (ii) $814,440,000 (as of November 30, 1998) of outstanding Veterans G.O. Bonds issued in series without early redemption provisions, with average interest costs of approximately 9.00% and which cannot be fully retired before the year 2010 (see Exhibit 2 to this Appendix B—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA—Veterans G.O. Bonds and Prior Revenue Bonds").

In addition to GASB 31 adjustments, net lending and financing activities income in FY 1998 was significantly impacted by several new factors. Such income was positively affected by a $13,460,000 gain on the sale of certain securities in conjunction with the issuance of Revenue Bonds and Veterans General Obligation Bonds in 1997 and 1998 (the "1997/1998 Bonds"). Such income was negatively affected by amortizing $3,068,000 of the financing and redemption costs relating to the issuance of the 1997/1998 Bonds and by premium costs of $1,551,000 relating to the purchase of private mortgage insurance with respect to certain Contracts of Purchase—both of which are expected to represent recurring expenses for future years' operations.

Like all loan portfolios, the Program experienced fluctuating levels of prepayments and new originations of Contracts of Purchase primarily influenced by the rates of interest of conventional mortgage financing relative to the Program's interest rates (either 8.00% or 7.75% during the period reflected in the table above until March 31, 1998, and 6.95% thereafter). The net effect of these factors resulted in the outstanding principal balance of Contracts of Purchase declining 5.7% since June 30, 1994. (See Exhibit 2 to this Appendix B—"CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA" for detailed information regarding the history of repayments, prepayments and originations of Contracts of Purchase.) During the first four years of such period, cash and invested funds dropped 28.5% due primarily to the use of such assets to pay bond maturities or redeem bonds and fund new Contracts of Purchase. During FY 1998, cash and investments increased by $422,126,000 primarily as the result of issuance of the 1997/1998 Bonds which provided $353 million of new funds to originate Contracts of Purchase. In aggregate, total Program assets have declined 7.8% since June 30, 1994. The debt structure of the Program, however, accommodated this downward trend in assets through a series of bond redemptions which resulted in a nearly equivalent reduction in the bonds outstanding. Other non-current assets increased by $21,283,000 to $36,406,000 at June 30, 1998 due primarily to the capitalization of financing and redemption costs relating to the 1997/1998 Bonds. Such non-income producing assets will be amortized over the term of the 1997/1998 Bonds and will have a negative effect on net income during such period.

Due to the decline in real estate values in certain California housing sub-markets in the early 1990's and the concentration of the Department's Contract of Purchase portfolio in certain areas of the State which were economically depressed due to military base closures and defense industry employment reductions, the number of repossessed properties ("REOs") and their loss on sale increased significantly between FY 1992 and FY 1997. However, the principal balance of Contracts of Purchase classified as REOs decreased $12,166,000 from June 30, 1997 to June 30, 1998 compared to a $42,738,000 cumulative increase over the preceding four-year period. Beginning in FY 1996, the Department moved aggressively to repossess properties of canceled Contracts of Purchase and dispose of its REOs. In conjunction with this effort, the Department reassessed the adequacy of its loss reserves and, over the four-year period FY 1994 to 1997, took cumulative net charges to its operating income of $49,492,000 to provide for potential losses in the portfolio. During FY 1998, the incremental increase in the Department's loss allowance was reduced from $22,677,000 in FY 1997 to $1,312,000 in FY 1998 due to the adequacy of reserves funded in prior years and improvement in the overall performance of the Contracts of Purchase portfolio. As a result of actual losses realized in the disposition of REO properties and management of the Contracts of Purchase portfolio, accumulated loss reserves decreased $9,407,000 during FY 1998. The remaining loss reserve of $41,008,000 at June 30, 1998, together with the Department's (a) recent purchase of primary mortgage insurance with respect to more than $780 million of existing Contracts of Purchase with high LTV ratios; and (b) imposition of USDVA guaranties for substantially all new Contracts of Purchase originated beginning last year (see "THE PROGRAM—Loan Insurance" in this Appendix B), are expected to provide for future potential REO losses.

Program administrative operating expenses in FY 1998 remained relatively flat after increasing 7.5% in FY 1997 due in large part to consulting expenses and personnel costs relating to identifying and developing strategies to: improve overall Program operations; procure a state-of-the-art integrated mortgage and finance computer system; and complete conversion of the life and disability insurance program to an outside commercial insurer. After taking into account a $399,000 decrease in operating revenue, net administrative operating expenses increased 3.1% over FY 1997 results.

Effective June 1, 1996, the Department's self-insured life and disability coverage plan was transferred to a fully-insured plan underwritten by an outside commercial insurer except for that portion of the program covering existing claims of disabled Contract of Purchase holders for whom the Department continues to provide coverage. Loss reserves for these obligations have been actuarially determined. More than two-thirds of such loss reserves are funded and maintained under a third party administrator agreement. The remaining amount is unfunded, but reserved in the form of an accrued liability. The net effect of these changes resulted in the plan producing positive income in FY 1997 and FY 1998 compared to aggregate losses of $36,373,000 over the four prior fiscal years.

Effective November 1, 1996, a number of changes were made to the Department's fire and hazard insurance coverage, including increasing the deductible, eliminating outdated loss coverages and limiting the claims period. These changes have resulted in stabilized financial operations for the Department's fire and hazard coverage over the last three fiscal years.

Further financial information relating to the 1943 Fund can be located in Exhibit 1 to this Appendix B in this Official Statement.

LAO Reports and Governor's Budget

The Legislative Analyst's Office for the State of California (the "LAO"), on January 16, 1998, issued a report entitled "Rethinking the Cal-Vet Loan Program." On February 16, 1999, the LAO issued an analysis of the proposed Governor's Budget 1999/2000, which analysis included a discussion of the Department. (The report and the analysis are referred to collectively as the "LAO Reports.") The stated purpose of the LAO is to provide analysis and nonpartisan advice to the California Legislature on fiscal and policy issues. The LAO is overseen by the Joint Legislative Budget Committee, a 14-member bipartisan committee composed of an equal number of State Assembly and State Senate members.

In the LAO Reports, the LAO analyzed the historical and recent financial performance and lending activities of the Department and made various recommendations. The LAO Reports described the financial losses experienced by the Department, the increasing rate of repayment of Contracts of Purchase, and the decreased lending activity in recent years. The LAO Reports attributed the decreased lending activity principally to more attractive loan programs available from other sources and to a dwindling population of eligible veterans. The budget analysis stated that the Department's completed and proposed programmatic changes (including changing from the uniform interest rate) have improved borrower demand, although less than the Department had projected, and the Department's bond restructuring program, implemented with the sale of over $1.4 billion of Veterans G.O. Bonds and Revenue Bonds in 1997 and 1998, had improved the Department's financial operations. However, the LAO's analysis of the interests of the State and of the future needs of veterans and funding sources led to several recommendations, which included increased oversight of the Department, ending new loan origination after the year 2007, and use of "surplus" Department moneys for the benefit of veterans and State taxpayers. The 1998 report stated that any redirection of "surplus funds should be accomplished carefully by means that ensure that all obligations of the [S]tate to Bondholders are met." Any further actions on the LAO Reports would result from legislative changes that would be proposed by the Legislature and signed by the Governor. In addition, the LAO budget analysis states that any such use of surplus funds would have to be authorized through a ballot measure.

In his proposed budget for Fiscal Year 1999-2000, Governor Davis cites the 1998 report when discussing the Department, and refers to "a basic dilemma: there is a declining interest or need for home loans and an increasing need for other services for veterans." The Governor listed several steps intended to improve the operation of State programs for veterans. Those most relevant to the Program are (a) appointment of an internal auditor for the Department, (b) a request to the Bureau of State Audits to conduct a fiscal and program compliance audit of the Program, which, with other studies, will lay the groundwork for corrective action, and (c) direction to the Secretary of Veterans Affairs to report within 6 months to the Governor on the need for further restructuring of the Program and on ways that the "surplus funds in the home program" might be redirected to other pressing needs of veterans.

The financial performance of and loan origination by the Department and its recent programmatic changes are discussed elsewhere in this Official Statement. The Department does not believe that either termination of loan originations after 2007 or use of Department moneys to fund other programs, if either or both of these policies were implemented, would have an adverse impact on the Department's ability to pay scheduled principal and purchase price of and interest on any Veterans G.O. Bonds or Revenue Bonds. While the Legislature could enact any or all of the recommendations in the LAO Report, use of moneys in the 1943 Fund for veterans benefits outside of the Program may be subject to approval by the electorate of the State and may also be subject to other legal restrictions.

Litigation

On June 25, 1996, the Department was served with a summons and complaint initiating a lawsuit entitled *John L. Debbs, et al. v. California Department of Veterans Affairs, et al.* (Superior Court of California, County of Los Angeles, Case No. BC 151476). The third amended complaint alleges "fraudulent concealment, declaratory relief, injunctive relief, and damages for monies unlawfully taken from the California Veterans Farm and Home Life and Disability Protection Plan." Plaintiff claims that in 1983, when the Department canceled its contracts with two life insurance companies then responsible for underwriting the life and disability programs, over $100 million was illegally expended by the Department, and that certain transfers from the life and disability reserves to the 1943 Fund were unlawful. The complaint seeks, among other things, that premiums under the life and disability program be reduced to prior levels and the return of the moneys, plus interest, from the 1943 Fund to the life and disability reserves. Plaintiffs' attempts to obtain a preliminary injunction and temporary restraining order from the court have been unsuccessful. Plaintiffs are seeking to convert this action into a class action suit. The court commissioner ordered Plaintiffs' attorney to pay the costs of notifying the class. A hearing on conversion to a class action suit is scheduled in May 1999.

In 1997, John L. Debbs and his wife filed a separate federal court action (entitled *John L. Debbs and Patsy R. Debbs v. Jay Vargas, et al.*) (United States District Court, Eastern District of California, Case No. Civ-S-97-0123). Although the court dismissed most of the defendants, the case is still pending against Pacific Mutual Life Insurance Company and three former Board members. The claims allege violation of constitutional rights, fraud, misappropriation, conspiracy, violation of equal protection, slander, bad faith, breach of fiduciary duty, "arbitrage violations" and other purported misdeeds. The complaint covers a period of approximately twenty years and requested a restraining order, injunctive relief, a receivership of the 1943 Fund and of the Program, criminal relief and general, compensatory, punitive, prospective, consequential, and special damages of over $3,550,000.

In 1998, Mr. and Mrs. Debbs filed an additional federal court action, essentially repeating the charges and damages (albeit for a larger amount) contained in the 1997 action.

On June 1, 1998, the federal district court judge dismissed both of the above-mentioned cases because of lack of a federal question. Plaintiffs have appealed the dismissal of the 1997 case to the Ninth Circuit Court of Appeals. The matter has been briefed, and a response from the Ninth Circuit Court is expected. No appeal was filed in the 1998 case.

The Department is vigorously opposing these lawsuits. While the outcome of any litigation cannot be predicted with certainty, the Department expects ultimately to prevail in these matters. Even if the respective Plaintiffs should prevail in all of these matters, the Department does not expect such outcome to affect its ability to make timely payment of debt service on the Revenue Bonds.

Excess Revenues

The Department has covenanted with the holders of its Revenue Bonds to apply Revenues received with respect to Contracts of Purchase, after payment or reimbursement of debt service on Veterans G.O. Bonds, in a specified order or priority. For this purposes, "Revenues" means all moneys received by or on behalf of the Department representing (i) principal and interest payments on the Contracts of Purchase including all prepayments representing the same and all prepayment premiums or penalties received by or on behalf of the Department in respect to the Contracts of Purchase, (ii) interest earnings received on the investment of amounts to the extent deposited in the revenue account established under the resolution authorizing the issuance of revenue bonds (the "Revenue Bond Resolution"), (iii) amounts transferred to the revenue account from the bond reserve account or the loan loss amount established under the Revenue Bond Resolution, and (iv) any other amounts payable by parties executing Contracts of Purchase or private participants in the Program or related to recoveries on defaulted Contracts of Purchase, including origination and commitment fees, servicing acquisition fees, and liquidation/insurance Proceeds, except to the extent not included as "Revenues" pursuant to the provisions of any resolution authorizing the issuance of a series of Revenue Bonds.

The Department has covenanted with the Revenue Bond holders to administer the 1943 Fund and the Program and perform its obligations to such holders in accordance in all material respects with the then-current Program Operating Procedures. The Program Operating Procedures are operating policies of the Department governing the discretionary activities of the Department under the Revenue Bond Resolution. The Department may amend the Program Operating Procedures. The Program Operating Procedures will affect the Excess Revenues that will become available to redeem the Bonds.

The Department has covenanted with the Revenue Bond holders to apply Revenues in the following order, after paying, or reimbursing for payments of, debt service on Veterans G.O. Bonds, including the costs of liquidity and credit enhancement facilities related thereto, and setting aside moneys as required under the Federal Tax Code to preserve the tax-exempt status of certain Veterans G.O. Bonds and Revenue Bonds, (1) to pay debt service on Revenue Bonds, (2) to pay the costs of liquidity and credit enhancement facilities, if any, for Revenue Bonds, (3) to replenish certain reserve funds established for the Revenue Bonds, (4) if the Department elects, to pay Department expenses, (5) to set aside a monthly accrual of Veterans G.O. Bond debt service, (6) if the Department elects, to finance Contracts of Purchase, and (7) with respect to Excess Revenues and certain tax restricted moneys, to redeem Veterans G.O. Bonds, including the Bonds, and Revenue Bonds. For such purposes:

(a) "Excess Revenues" means, as of any date of calculation, Revenues in excess of Accrued Debt Service;

(b) "Accrued Debt Service" means, as of any date of determination and, as the context requires, with respect to all Revenue Bonds and Veterans G.O. Bonds (including the Offered Veterans G.O. Bonds), the sum of:

(i) the aggregate amount of scheduled interest and principal (except to the extent otherwise to be redeemed pursuant to clause (i) or (ii) below) to become due after such date but on or before the end of the current debt service year, less the product of (i) the number of whole months remaining in the current debt service year and (ii) the Monthly Debt Service Requirement;

(ii) the redemption price of bonds for which notice of redemption has been issued, provided such redemption price is to be paid from amounts on deposit in the revenue account created under the Resolution; and

(iii) the redemption price of bonds that the Department will be obligated to redeem prior to the end of the next succeeding debt service year, to the extent that such obligation arises on account of amounts on deposit in such revenue accounts; and

(c) "Monthly Debt Service Requirements" means, as of any date of termination, one-twelfth of the aggregate amount of scheduled interest and principal to become due during the debt service year in which such date falls, as computed on the first day of such debt service year.

Maintenance of Fund Parity

The Revenue Bond Resolution requires the Department to calculate "Fund Parity" at least annually. "Fund Parity" means (a) an amount equal to the difference between (i) all assets in the 1943 Fund and in the accounts established under the Revenue Bond Resolution, and (ii) the principal amount of all Revenue Bonds and Veterans G.O. Bonds outstanding (plus accrued interest) reduced by (b) defined allowances and reserves for loss coverage on Contracts of Purchase and life and disability coverage on persons obligated under Contracts of Purchase. If any such calculation shall not reflect that Fund Parity at least equals the percentage required by the Revenue Bond Resolution, the Department may be required to expend Excess Revenues to redeem Revenue Bonds until its recalculations of Fund Parity meet the test required by the Revenue Bond Resolution.

EXHIBIT 1

**FINANCIAL STATEMENTS OF THE 1943 FUND
FOR FISCAL YEARS 1998 AND 1997
AND INDEPENDENT AUDITOR'S REPORT**

**VETERANS FARM AND HOME BUILDING FUND OF 1943
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

Financial Statements for the Years Ended June 30, 1998 and 1997 and
Independent Auditors' Report

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Deloitte &
Touche

Deloitte & Touche LLP
Suite 2000
400 Capital Mall
Sacramento, California 95814-4424

Telephone: (916) 498-7100
Facsimile: (916) 444-7963

INDEPENDENT AUDITORS' REPORT

California Veterans Board
State of California
Sacramento, California

We have audited the accompanying balance sheets of the Veterans Farm and Home Building Fund of 1943, Department of Veterans Affairs of the State of California (Fund) as of June 30, 1998 and 1997, and the related statements of revenues, expenses and changes in retained earnings, and of cash flows for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1, the financial statements referred to above present only the Veterans Farm and Home Building Fund of 1943, and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary fund types.

In our opinion, such financial statements referred to above present fairly, in all material respects, the financial position of the Veterans Farm and Home Building Fund of 1943, Department of Veterans Affairs of the State of California as of June 30, 1998 and 1997, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note 1 to the financial statements, in 1998 the Department of Veteran Affairs of the State of California, changed its method of accounting for investments of the Fund to conform with Governmental Accounting Standards Board Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools,* and, retroactively, restated its 1997 financial statements for the change.

Deloitte + Touche LLP

October 9, 1998

Deloitte Touche
Tohmatsu

VETERANS FARM AND HOME BUILDING FUND OF 1943,
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

BALANCE SHEETS
JUNE 30, 1998 AND 1997 (in thousands)

ASSETS	**1998**	**1997 (as restated, see Note 1)**
Cash in State Treasury	$ 6,553	$ 12,773
Investments:		
Unrestricted	571,598	688,770
Restricted	873,909	327,190
Insurance administrators	42,673	50,613
	1,488,180	1,066,573
Total cash and investments	1,494,733	1,079,346
Receivables under contracts of sale, net of allowance for uncollectible contracts of $22,005 and $26,412 in 1998 and 1997, respectively	2,013,874	2,127,730
Due from Veterans Debenture Revenue Fund	12,686	87,479
Interest receivable:		
State of California's Surplus Money Investment Fund	3,101	477
Investments	9,608	17,766
Due from other funds	1,046	4,353
Other real estate owned, net of allowance for losses of $19,003 and $24,003 in 1998 and 1997, respectively	43,869	51,035
Land, improvements and equipment, net of accumulated depreciation of $5,972 and $5.244 in 1998 and 1997, respectively	8,620	7,834
Other	92	976
TOTAL ASSETS	$3,587,629	$3,376,996
LIABILITIES AND RETAINED EARNINGS		
LIABILITIES:		
Accrued interest and other liabilities	$ 58,458	$ 80,502
Bonds payable - net	3,194,526	2,953,312
Insurance claims payable and loss reserves	56,244	69,083
Total liabilities	3,309,228	3,102,897
RETAINED EARNINGS	278,401	274,099
TOTAL LIABILITIES AND RETAINED EARNINGS	$3,587,629	$3,376,996

See notes to financial statements.

VETERANS FARM AND HOME BUILDING FUND OF 1943,
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN RETAINED EARNINGS YEARS ENDED JUNE 30, 1998 AND 1997 (in thousands)

	1998	1997 (as restated, see Note 1)
PROGRAM OPERATIONS:		
Interest revenues:		
Contracts of sale of properties	$ 162,086	$ 175,186
Investments and other	78,621	79,525
Transfers of interest revenue from Veterans Debenture Revenue Fund	8,441	10,843
Total program operations revenues	249,148	265,554
Expenses:		
Interest expense	218,757	230,871
Provision for contract losses	1,312	22,677
Total program operations expenses	220,069	253,548
Excess of program operations revenues and transfers over interest expense and provision for contract losses	29,079	12,006
PROGRAM ADMINISTRATION:		
Revenues:		
Loan servicing fees	1,594	1,385
Other income	297	905
Excess of amounts charged to contract holders over fire and hazard insurance claims and expenses and changes in insurance reserves	2,086	326
Total program administration revenues	3,977	2,616
Expenses:		
Payroll and related costs	11,404	11,342
General expenses	13,596	8,876
Excess of self-insured life and disability insurance claims and expenses and changes in insurance reserves over amounts charged to contract holders	626	162
Total program administration expenses	25,626	20,380
Excess of program administration expenses over program administration revenues	(21,649)	(17,764)
LOSS ON SALE OF REPOSSESSED PROPERTY	(3,128)	(8,309)
EXCESS (DEFICIENCY) OF REVENUES AND TRANSFERS OVER EXPENSES	4,302	(14,067)
RETAINED EARNINGS:		
Beginning of year - as restated	274,099	288,166
End of year	$ 278,401	$ 274,099

See notes to financial statements.

VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 1998 AND 1997 (in thousands)

	1998	1997 (as restated, see Note 1)
CASH FLOWS FROM OPERATING ACTIVITIES:		
Excess (deficiency) of revenues and transfers in over expenses	$ 4,302	$ (14,067)
Adjustments to reconcile to net cash used by operating activities:		
Amortization of bond premiums, discounts and issuance costs	2,494	(46)
Depreciation expense	727	716
Loss on sale of repossessed property	3,128	8,309
Effect of changes in assets and liabilities:		
Interest receivable - State of California's Surplus Money Investment Fund	(2,624)	2,509
Interest receivable - investments	8,158	4,229
Due from other funds	3,307	(5,162)
Other real estate owned	4,038	(2,189)
Other assets	884	144
Accrued interest and other liabilities	(22,044)	(6,214)
Insurance claims payable and loss reserves	(12,839)	(13,757)
Net cash used by operating activities	(10,469)	(25,528)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net decrease in receivables under contracts of sale	113,856	90,778
Net (increase) decrease in investment securities	(421,607)	110,001
Purchase of land, improvements and equipment	(1,513)	(113)
Net cash provided (used) by investing activities	(309,264)	200,666
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from sales of bonds	1,613,366	
Maturities of bonds payable	(1,325,996)	(198,160)
Early redemption of bonds payable	(48,650)	(30,000)
Net change in Due from Veterans Debenture Revenue Fund	74,793	51,681
Net cash provided (used) by financing activities	313,513	(176,479)
DECREASE IN CASH IN STATE TREASURY	(6,220)	(1,341)
CASH IN STATE TREASURY:		
Beginning of year	12,773	14,114
End of year	$ 6,553	$ 12,773

See notes to financial statements.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Description - The California Department of Veterans Affairs (the Department) is a separate legal entity and a Cabinet level agency of the State of California. A seven-member California Veterans Board (the Board) has policy oversight of the operations of the Department. The Board's membership consists of the Department Secretary and six members, all of whom are appointed by the Governor, subject to confirmation by the State Senate. The Veterans Farm and Home Building Fund of 1943 (the Fund) was established under the authority of the California Constitution to provide low-interest, long-term farm and home mortgage loan contracts to veterans living in California. The contract loan program has been continuous since 1922. Proceeds from the sale of general obligation bonds, periodically authorized by the vote of the people of California, and revenue bonds authorized by the Legislature are used for contract loans to veterans. Expenditures are primarily for debt service and administration of the program. The Fund is tax exempt.

The financial statements represent only the activities of the Veterans Farm and Home Building Fund of 1943, and are not intended to present the financial position of the Department of Veterans Affairs of the State of California and the results of its operations and cash flows of its proprietary fund types. The financial statements of the Fund are included in the financial statements of the State of California as the State represents the primary government and has ultimate oversight responsibility for the Fund.

New Accounting Pronouncements - The Governmental Accounting Standards Board (GASB) issued Technical Bulletin No. 98-1 ("GTB 98-1") *Disclosures About Year 2000 Issues*, effective for financial statements on which the auditors' report is dated after October 31, 1998. The provisions terminate for financial statements for periods ending after December 31, 1999 unless systems and other equipment are not year-2000 compliant as of the balance sheet date. GTB 98-1 requires that the financial statements discuss the year 2000 issue as it relates to the Fund. Such disclosure would include a description of the stages of work in process or completed as of June 30, 1999 to make computer systems and other electronic equipment critical to conducting operations year-2000 compliant. Any additional stages of work necessary to make such systems year-2000 compliant would also need to be disclosed.

Use of Estimates in the Preparation of Financial Statements - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Basis of Accounting - The Fund has been classified as a governmental proprietary fund type for accounting purposes. Generally, revenues are recorded when earned and expenses are recognized as incurred.

Cash and Investments - Effective July 1, 1997 the Department adopted GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, with retroactive application as of July 1, 1996 for reporting investments of the Fund. Accordingly, all investments are reported at fair value except for certain nonparticipating fixed interest investment contracts which are valued in accordance with GASB Statement No. 31 using cost based measures. The adoption of GASB Statement No. 31 resulted in an increase in retained earnings of the Fund at July 1, 1996 of $7,526,000 and an increase in investment income for fiscal year ended June 30, 1997 of $8,420,000. The fair value of investments is based on published market prices and quotations from major investment brokers and from the State of California for the Surplus Money Investment Fund. Uncommitted bond proceeds restricted for loans to veterans are reflected in the balance sheet as restricted cash and investments.

Receivables Under Contracts of Sale - Receivables under contracts of sale consist of the remaining contract principal balance plus unpaid interest accrued to date, net of the reserve for uncollectible accounts. The contract balance may also include amounts paid by the Fund for property taxes and insurance pending reimbursement from the contract holder.

Reserve for Uncollectible Accounts - The reserve for uncollectible accounts is established through a provision charged to operations. The reserve is an amount that management believes will be adequate to absorb losses inherent in existing contracts and commitments to extend credit, based on evaluations of the collectibility and prior loss experience of contracts and commitments to extend credit. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, specific problem contracts, commitments, and current and anticipated economic conditions that may affect the borrowers' ability to repay the obligation.

Other Real Estate Owned - Real estate acquired by repossession is carried at the lower of the contract balance or its net realizable value. After repossession, the value of the underlying contract is written down to the estimated fair value of the real estate, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of any related income, are included in other expenses.

On April 1, 1998, the Department instituted a loan guarantee fee on all loans with down payments less than 20%. Such loans are classified as high loan to value loans (HLTV). For eligible borrowers, the fee is used to purchase loan guarantees from the U.S. Department of Veterans Affairs (USDVA). For approximately 5,790 HLTV loans originated prior to purchasing USDVA loan guarantees, the Fund purchased primary mortgage insurance (PMI) from the Commonwealth Mortgage Assurance Company. The PMI provides lifetime coverage on the HLTV loans, not covered by USDVA loan guarantees, subject to a 3% deductible. The Department is responsible for any losses not covered by the USDVA loan guarantees or the PMI.

Insurance Claims Payable and Loss Reserves - Insurance claims payable and loss reserves include unpaid claims, incurred but not reported (INBR) claims and loss reserves for the Fire and Hazard Insurance Plan and the benefits payable under the Department's remaining self-insured life and disability protection plan.

Fire and Hazard Insurance - This insurance program is provided to eligible contract holders as part of the loan program. The difference between premiums charged to contract holders and claims and expenses incurred and the change in loss reserves is included as a net amount in the statement of revenues, expenses and changes in retained earnings.

Self-Insured Life and Disability Protection Plan - From January 1, 1984 to June 1, 1996, the Department operated a self-funded protection plan whereby life and disability insurance was provided to eligible contract holders. The Department's self-insured life and disability protection plan was terminated effective June 1, 1996. The life and disability benefits previously available to these members under the self-insured protection plan continue to be available to those contract holders who were receiving benefits at the time the plan was terminated. Loss reserves to satisfy these obligations of the protection plan which include future disability and life benefits were actuarially determined using a long-term discount rate of 7%. Significant actuarial assumptions and methodologies used to calculate the reserve are interest, mortality, disability and prepayment.

Amortization of Bond Premiums, Discounts and Issuance Costs - Premiums and discounts arising from the issuance of bonds are amortized on a method which approximates the effective interest method. Expenses incurred in connection with the issuance of bonds are capitalized and amortized using the straight-line method.

Retirement Plan - The Department adopted Statement No. 27 of the Governmental Accounting Standards Board, *Accounting for Pensions by State and Local Government Employers*, effective for the fiscal year ended June 30, 1997, and accordingly modified its footnote disclosure regarding its pension plan.

Reclassifications - Certain 1997 amounts have been reclassified to conform with the 1998 presentation.

2. CASH AND INVESTMENTS

Cash in the State Treasury of $6,552,580 and $12,772,900 as of June 30, 1998 and 1997, respectively, represents amounts held in the Fund's general operating accounts with the State Treasury. These monies are pooled with the monies of other State agencies and invested by the State Treasurer's office. These assets are not individually identifiable.

Investment of bond funds is restricted by applicable California law and the various bond resolutions associated with each issuance, generally, to certain types of investments, including direct obligations of the U.S. Government and its agencies, the State of California's Surplus Money Investment Fund, and investment agreements with financial institutions or insurance companies rated within the top two ratings of a nationally recognized rating service. The investments with the insurance administrator, held as a deposit in accordance with a master agreement for the remaining active life and disability insurance program for disabled contract holders, is authorized by California law. In addition, the Department has restricted $5,000,000 plus interest accrued since February 1, 1998, for potential life and disability rate increases after January 31, 2002.

The Fund's four investments in master investment agreements totaling $938,887,843 as of June 30, 1998 are carried at cost. The interest rates on investment agreements are fixed and range from 5.4% to 5.9%. The investment agreements expire from 1999 to 2032.

All of the Fund's investments in U.S. Treasury notes and bonds and the amounts administered by the insurance company are categorized as risk category 1, which is defined by GASB Statement No. 3 as investments that are insured or registered or for which the securities are held by the Fund or its agent in the Fund's name. In accordance with GASB Statement No. 3, the Fund's investments held in the State of California's Surplus Money Investment Fund, the investment agreements and the mutual fund are not categorized as to risk.

The Fund's investments at June 30, 1998 and 1997 are as follows (in thousands):

	1998 Fair Value	1997 Fair Value
Category 1:		
U.S. Treasury notes and bonds	$ 187,851	$ 346,014
Amounts held in trust fund with insurance administrators:		
U.S. Treasury notes	15,331	16,729
Corporate bonds	16,186	21,096
Other	4,378	7,689
Investments Not Subject to Categorization:		
State of California's Surplus Money Investment Fund	318,768	304,405
Investment agreements (at cost)	938,888	365,542
Amounts held in trust fund with insurance administrators:		
Mutual fund	6,778	5,098
	$1,488,180	$1,066,573

3. RECEIVABLES UNDER CONTRACTS OF SALE

The Fund retains title to all real property subject to contracts of sale until the contract is satisfied. The veteran's contracts have original terms of 25-30 years and bear interest at rates of 4.4% to 10.75%, depending on the age and type of contract and the classification of the current contract holder.

4. BONDS PAYABLE

At June 30, 1998 and 1997, bonds payable included the following (in thousands):

	1998	1997
General obligation bonds of the State of California, annual interest rates from 4.1% to 11.0% due in varying annual installments through 2032 (subject to varying redemption provisions)	$2,947,165	$2,632,045
Home purchase revenue bonds, annual interest rates from 3.9% to 5.5%, due in varying annual installments through 2019 (subject to varying redemption provisions)	275,055	327,580
	3,222,220	2,959,625
Discounts	(4,358)	(8,492)
Premiums	214	2,179
Unamortized bond origination costs	(11,454)	
Unamortized bond redemption premiums	(12,096)	
Total	$3,194,526	$2,953,312

Future scheduled bond maturities at June 30, 1998 are as follows (in thousands):

1999	$ 458,395
2000	223,790
2001	120,825
2002	124,660
2003	123,755
Thereafter	2,170,795
	$3,222,220

General obligation bonds of the State of California are payable in accordance with the various veterans bond acts by the State General Fund. The full faith and credit of the State of California is pledged for the payment of both principal and interest. All general obligation bonds have an equal claim against the General Fund of the State of California. These bonds are included as obligations of the Fund when the proceeds from bond sales are received. The repayment for the bonds is the responsibility of the Fund. Authorized and unissued bonds under the Veterans Bond Acts of 1990 and 1996 at June 30, 1998 and 1997 were $176,835,000 and $654,370,000, respectively.

Revenue bonds are special obligations of the Department payable solely from, and by a pledge of, an undivided interest in the assets of the Veterans Farm and Home Building Fund of 1943 and the Veterans Debenture Revenue Fund, a separate fund of the Department. The undivided interest in the net revenues of the 1943 Fund is secondary and subordinate to any interest or right in the 1943 Fund of the people of the State of California and of the holders of general obligation veterans bonds. At any point in time, authorized and unissued revenue bonds equal the $1.5 billion ceiling authorized in 1987 less revenue bonds outstanding at that time. At June 30, 1998 and 1997, authorized and unissued revenue bonds were $1,224,945,000 and $1,172,420,000, respectively.

In December 1997, the Department amended the revenue bond resolution provisions regarding the Bond Reserve Account in the Veterans Debenture Revenue Fund (a separate entity). The revenue bond resolution requires the establishment and maintenance of a Bond Reserve Account in an amount equal to at least three percent of the aggregate outstanding principal amount of all Revenue Bonds with interest rates fixed to maturity. To calculate the reserve requirement, the Ninth Supplemental Resolution established, with respect to the revenue bonds with interest rates fixed to maturity issued pursuant to such resolution (1997 Series A Bonds, 1997 Series B Bonds, and 1998 Series A Bonds), a requirement equal to at least seven percent of the outstanding principal amount of such Revenue Bonds. Amounts in the Bond Reserve Account shall be used solely for the purposes of paying the principal of and the interest on the Revenue Bonds and for making Mandatory Sinking Account Payments on Revenue Bonds. Amounts on deposit in the Bond Reserve Account as of any date, in excess of the bond reserve requirement, may be transferred out of the Veterans Debenture Revenue Fund to the Fund, at the request of the Department. Investment earnings of the Veterans Debenture Revenue Fund are transferred to the Fund. At June 30, 1998 and 1997, the total assets of the Veterans Debenture Revenue Fund are shown as a receivable of the Fund. Complete financial statements of the Veterans Debenture Revenue Fund, Department of Veterans Affairs, State of California can be obtained by contacting the California Department of Veterans Affairs.

5. BOND REFUNDING

During the year ended June 30, 1998, the Department issued General Obligation bonds totaling $1,338,635,000 and Home Purchase Revenue bonds totaling $275,055,000 with an average interest rate of 5.35%. Certain bond proceeds from the bond issue were used to refund previously issued General Obligation bonds of $753,695,000, and Home Purchase Revenue bonds of $234,685,000. The remaining net proceeds are available for new Contracts of Purchase subject to the terms of the bonds.

The refunding of the General Obligation and Home Purchase Revenue bonds is expected to reduce the Department's debt service payments by approximately $213,338,000 over the next 22 years and results in an economic gain based on the present value of the net savings of approximately $132,457,000 as adjusted for issuance costs and redemption premiums.

For those refunded bonds that could not be called for immediate redemption, approximately $310,486,000 was deposited in various escrow accounts held by the State Treasurer, as escrow trustee, to provide for all future debt service payments on the refunded bonds. As a result, these refunded bonds are considered to be defeased and the liability for those bonds has been removed from the Fund's balance sheet.

6. FIRE AND HAZARD INSURANCE

Fire and hazard insurance coverage is provided on behalf of contract holders for substantially all properties subject to contracts of sale. The program is funded by amounts charged to contract holders which are considered appropriate to cover losses incurred, premiums paid for excess insurance coverage and administration fees. From the amounts charged to contract holders, the Department pays losses up to $1,500,000 per occurrence or $12,000,000 per policy year. Coverage in excess of the above amounts is provided under a master policy with an insurance carrier which also administers the program. The loss reserve is based on the third party administrators estimate of incurred but not reported claims based on the historical trends and loss experience within the portfolio.

The excess of premiums charged to contract holders over claims, expenses and change in loss reserves for the year ended June 30, 1998 and 1997 was as follows (in thousands):

	1998	1997
Amounts charged to contract holders	$ 9,788	$ 10,344
(Less) plus:		
Decrease in estimated loss reserve	29	1,339
Claims loss expense	(6,418)	(9,907)
Master policy premium	(532)	(622)
Administrative fees	(781)	(828)
Excess of amounts charged to contract holders over claims and expenses and changes in reserves	$ 2,086	$ 326

7. SELF-INSURED LIFE AND DISABILITY PROTECTION PLAN

The Department was responsible for a self-insured life and disability protection plan for all contract holders until June 1, 1996. At that time, except for contract holders receiving benefits, the self-insured life and disability protection plan was replaced by an interim life and disability insurance plan provided by a commercial insurer, Pacific Mutual Group (PMG). Effective February 1, 1998, PMG was selected to provide a replacement, long-term life and disability plan.

As of June 30, 1998, the Department remains self-insured for approximately 1,249 remaining contract holders. Under the provisions of the self-insured plan benefits continue until the beneficiary returns to active employment, dies or their contract is paid off. Loss reserves for these obligations have been actuarially determined. A portion of the required loss reserves are maintained under a third party administrator (TPA) agreement and are shown in the financial statements as investments with insurance administrators. During the year, the TPA reserves have been used to satisfy benefits payable under the self-insured protection plan. Earnings on investments held by the TPA were $2,976,337 and $3,732,472 in 1998 and 1997, respectively, and are included in interest revenues - investments and other in the financial statements.

The excess of claims expenses, changes in loss reserves, and administrative expenses over plan revenues whose coverages continue as obligations of the self-funded life and disability protection plan for the years ended June 30, 1998 and 1997 was as follows (in thousands):

	1998	1997
Claims expenses:		
Life insurance program	$ (1,836)	$ (1,564)
Disability insurance program	(11,510)	(10,843)
Total claims expenses	(13,346)	(12,407)
Decrease in estimated loss reserves	12,810	12,418
Net claims expenses and change in loss reserves	(536)	11
Plus plan revenues:		
Life insurance program	157	205
Disability insurance program	179	224
Total	336	429
Less administrative fees	(426)	(602)
Excess of net claims expenses, change in loss reserves and administrative fees over plan revenues	$ (626)	$ (162)

8. **COMMITMENTS AND CONTINGENCIES**

As of June 30, 1998 and 1997, the Fund had loan commitments to veterans for the purchase of properties under contracts of sale of approximately $16,017,616 and $14,467,800, respectively.

The Department is a defendant in certain litigation related to the self-insured Life and Disability Protection Plan, formerly operated by the Department, and other matters. The Department, based on the advice of its counsel, believes that the suits are without merit and intends to vigorously defend its position. Management is of the opinion that the potential liability will not have a material adverse effect on the financial statements.

The Fund leases several buildings used as district offices. Rent expense for the years ended June 30, 1998 and 1997 was $462,562 and $482,057, respectively. Lease terms generally range from five to ten years with options to renew for additional periods. As of June 30, 1998, minimum annual rentals under operating leases are as follows (in thousands):

1999	$ 412,241
2000	332,254
2001	278,040
2002	159,000
2003	98,463
Thereafter	36,122
	$1,316,120

9. RETIREMENT PLAN

The Department, through the State of California, contributes to the California Public Employees Retirement System (CalPERS), which includes an agent multiple-employer public employee retirement system and a cost sharing multiple-employee plan that acts as a common investment and administrative agent for participating entities within the State of California. Substantially all full-time employees of the Fund are members of CalPERS. The Plan provides a monthly allowance based on age, years of credited service, and highest average compensation over an established period of time of one to three years. Vesting occurs after five to ten years. The Plan also provides death and disability benefits. The benefits are established by contract with CalPERS in accordance with the provisions of the Public Employees Retirement Law. CalPERS issues a publicly available Comprehensive Annual Financial Report (CAFR) that includes financial statements and required supplementary information for CalPERS. A copy of that report may be obtained by writing to CalPERS, Central Supply, P.O. Box 1802, Sacramento, CA 95812-1802.

Contributions to the Plan are funded by both the Department and the employee, and are actuarially determined by CalPERS based on covered compensation. State employees, with the exception of employees in the second-tier plan, are required to contribute to the fund. The contribution rates of active plan members are based on a percentage of salary over a monthly base compensation amount of $238 to $863. With the exception of employees in the second-tier plan, state employees' required contributions vary from 5% to 8% of their salary over their base compensation amount.

Contributions by the Department to the Plan for the years ended June 30, 1998 and 1997 were approximately $956,000 and $1,042,000, or approximately 8.4% and 9.2% of participants salaries, respectively. Employee contributions to the Plan for the years ended June 30, 1998 and 1997 were approximately $281,000 and $305,000 or approximately 2.5% and 2.7% of participant's salaries, respectively.

For fiscal years ended June 30, 1998 and 1997, the Department's annual pension cost was equal to the Department's required and actual contributions. The required contribution was determined as part of the June 30, 1996 actuarial valuation using the entry age normal actuarial cost method. The actuarial assumptions included (a) 8.5% investment rate of return, and (b) projected salary increases that vary by duration of service. Both (a) and (b) included an inflation component of 4.5%. The actuarial value of the Department's assets was determined using techniques that smooth the effects of short-term volatility in the market value of investments over a five-year period. The underfunded actuarial accrued liability is being amortized as a level percentage of projected payroll on a closed basis. The remaining amortization period at June 30, 1996 was 34 years. Three-year fund trend information is as follows:

Three-Year Fund Trend Information

Fiscal Year-End	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
June 30, 1996	$987,000	100%	$0
June 30, 1997	$1,042,000	100%	$0
June 30, 1998	$956,000	100%	$0

The most recent actuarial valuation of CalPERS indicated that there was an unfunded liability for vested benefits due current employee participants in the plan. The amount of the unfunded liability applicable to each agency or department cannot be determined. Trend information, which presents CalPERS progress in accumulating sufficient assets to pay benefits when due is presented in the June 30, 1997 CalPERS CAFR.

Since all state agencies and departments are considered by CalPERS collectively as a single employer, the actuarial value of plan assets, the actuarial accrued liability, the total unfunded liability, the actuarial value of assets as a percentage of the actuarial accrued liability, and the ratio of unfunded actuarial liability to annual covered payroll attributable to the Department's employees, whose compensation is paid from the Fund, cannot be determined.

10. SUBSEQUENT EVENT

During August 1998, the Fund called approximately $57,600,000 of general obligation bonds pursuant to the terms and early call provisions of the bond agreements.

* * * * * *

EXHIBIT 2

CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA

Contracts of Purchase

Set forth below is certain financial information regarding Contracts of Purchase.

Existing Contracts of Purchase

The following charts describe the current loan to value ratios and geographic distribution of Contracts of Purchase financed under the Program as to November 30, 1998, using proceeds of Veterans G.O. Bonds and Revenue Bonds.

Current Loan-to-Value Ratio of Contracts of Purchase[1]

	Uninsured (000s)	CMAC Insured (000s)	In Process for CMAC Insurance (000s)	VA Guaranteed (000s)	Total (000s)
Single Family Homes					
Less than 30% LTV	$ 111,998	—	—	—	$ 111,998
30-49% LTV	269,590	$ 135	—	$ 55	269,780
50-59% LTV	192,572	—	—	—	192,572
60-69% LTV	222,100	221	—	—	222,321
70-79% LTV	260,540	10,206	—	125	270,871
Sub-total	$1,056,800	$ 10,562	—	$ 180	$1,067,542
80-84% LTV	$ 11,245	$113,915	$ 10,008	$ 1,023	$ 136,191
85-89% LTV	17,076	237,754	18,228	2,678	275,736
90-94% LTV	43,205	310,235	49,852	10,753	414,045
95-97% LTV	5,458	4,802	27,095	15,322	52,677
Sub-total	$ 76,984	$666,706	$105,183	$29,776	$ 878,649
Other High LTV Loans[2]	$ 14,577	$ 1,487	—	—	$ 16,064
Total	$1,148,361	$678,755	$105,183	$29,956	$1,962,255
Other Property Types					
Farms	$ 6,161	—	—	—	$ 6,161
Mobile Homes in Parks	11,154	—	—	—	11,154
Total	$ 17,315	—	—	—	$ 17,315
Special Status Contracts of Purchase					
Real Estate Owned[3]	$ 49,183	$ 1,610	—	—	$ 50,793
Disability Program[4]	41,173	—	—	—	41,173
Total	$ 90,356	$ 1,610	—	—	$ 91,966
Total Portfolio	$1,256,032	$680,365	$105,183	$29,956	$2,071,536

(1) LTV based on current Contracts of Purchase balance (net of accrued interest, advanced taxes and insurance) divided by original appraised value of property.

(2) Consists of Contracts of Purchase where delinquent accrued interest and charges have been added to Contracts of Purchase balance.

(3) Repossessed properties and delinquent Contracts of Purchase carried as REO on financial statements.

(4) Contracts of Purchase where payments are made on behalf of veterans by the Department's life and disability coverage plan.

Geographic Distribution of Contracts of Purchase

County	Approximate Current Contract Balance (000s)
Sacramento	$ 220,585
Los Angeles	161,864
San Bernardino	156,355
San Diego	121,350
Fresno	114,985
Kern	107,757
Riverside	102,026
Orange	96,558
Placer	61,689
San Joaquin	60,583
Solano	55,960
Shasta	51,566
Contra Costa	48,985
Other Northern California Counties	403,137
Other Central California Counties	247,003
Other Southern California Counties	61,133
Statewide—California	$2,071,536

Contracts of Purchase Origination and Principal Repayment Experience

The following tables represent, respectively, a historical picture of Contract of Purchase originations since the 1984-85 fiscal year and selected principal repayments with respect to Contracts of Purchase since the 1977-1978 fiscal year.

New Contracts of Purchase During the Fiscal Year(1)

Fiscal Year Ending June 30	Veterans G.O. Bonds		Unrestricted Funds		Revenue Bonds		Total	
	Number	Amount	Number	Amount	Number	Amount	Number	Amount
1985	4,196	$290,885,900			2,301	$154,244,600	6,497	$445,130,500
1986	3,484	243,955,800			2,401	160,782,200	5,885	404,738,000
1987	1,569	108,789,700			1,160	75,836,800	2,729	184,626,500
1988	2,958	236,054,500			1,397	99,040,900	4,355	335,095,400
1989	3,112	252,796,300			1,154	83,076,100	4,266	335,872,400
1990	2,097	187,445,600			522	38,150,800	2,619	225,596,400
1991	1,927	200,393,500			359	29,189,600	2,286	229,583,100
1992	1,086	111,600,500			388	34,671,600	1,474	146,272,100
1993	740	94,417,100			286	27,443,800	1,026	121,860,900
1994	843	117,213,779			337	34,740,536	1,180	151,954,315
1995	2,109	286,178,376			822	84,860,894	2,931	371,039,270
1996	762	107,751,444			222	22,723,617	984	130,475,061
1997	766	118,344,636			201	21,853,933	967	140,198,569
1998	615	99,224,002	188	17,716,376	164	18,871,066	967	135,811,444
1999(2)	359	59,490,149	260	38,238,379	95	11,446,503	714	109,175,031

(1) Number of new Contracts of Purchase does not include home improvement loans.

(2) 5-month period through November 30, 1998.

Selected Principal Flows with respect to Contracts of Purchase Funded by both Veterans G.O. Bonds and Revenue Bonds

Fiscal Year Ending June 30	Contracts Funded During Year (000s)	Contract Prepayments During Year (000s)	Other Principal Receipts-Losses During Year (000s)	Contract Balance at End of Year (000s)	Average Base Contract Rate	Average of Monthly FHLMC 30-year Conventional Loan Rate	Annual Average Prepayment Rate	Annual Average Origination Rate
	Principal Flows				Rates			
1985	$ 445,131	$ 123,669	$ 88,308	$3,142,526	8.0%	13.8%	4.1%	14.7%
1986	404,738	179,809	94,970	3,272,485	8.0	11.5	5.6	12.6
1987	184,627	261,675	99,569	3,095,868	7.7	9.8	8.2	5.8
1988	335,095	198,396	114,178	3,118,389	7.0	10.5	6.4	10.8
1989	335,872	207,471	105,896	3,140,894	7.3	10.6	6.6	10.7
1990	225,596	232,085	96,639	3,037,766	8.0	10.1	7.5	7.3
1991	229,583	191,895	92,722	2,982,732	8.0	9.9	6.4	7.6
1992	146,272	246,150	92,975	2,789,879	8.0	9.0	8.5	5.1
1993	121,861	273,817	105,629	2,532,294	8.0	8.0	10.3	4.6
1994	151,954	359,749	98,773	2,225,726	8.0	7.3	15.1	6.4
1995	371,039	111,984	74,706	2,410,075	7.8	8.7	4.8	16.0
1996	130,475	141,767	92,521	2,306,262	8.0	7.5	6.0	5.5
1997	140,199	111,254	106,027	2,229,180	8.0	7.9	4.9	6.2
1998	135,812	172,134	94,106	2,098,752	7.7	7.2	8.0	6.3
1999(1)	109,175	75,270	61,121	2,071,536	7.0	6.8	8.7	12.6
	$3,467,429	$2,887,125	$1,418,140					

(1) 5-month period through November 30, 1998.

Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments

The following table shows amounts expected to become available to fund Contracts of Purchase following the expected issuance of the Offered Veterans G.O. Bonds and the Home Purchase Revenue Bonds, 1999 Series B. The table includes bonds issued at short-term rates, the proceeds of which will not become available to finance Contracts of Purchase until the interest rates are adjusted to fixed interest rates to maturity. The universe of veterans eligible to receive Contracts of Purchase financed by the different classifications of available moneys is described under "THE PROGRAM—Qualifying Veteran Status." Additional moneys may become available to finance Contracts of Purchase through the future issuances of Veterans G.O. Bonds and Revenue Bonds. The Department has full discretion to use moneys available from prior, current or future bond issues in any order of priority it chooses. As of November 30, 1998, the Department had 327 pending applications for Contracts of Purchase in the aggregate amount of approximately $51,041,306.

		Respective Series Bond Proceeds Subaccounts				
Bond Series	**Balance as of**	**Unrestricted Moneys[1]**	**Qualified Veterans Mortgage Bond Proceeds[1]**	**Qualified Mortgage Bond Proceeds[1]**	**Investment**	**Investment Rate (%)**
Existing Veterans G.O. Bonds						
Series BG, BH, BK, BL	11/30/98	-0-	$101,435	-0-	Soc Gen[2][3]	5.710
Series BM, BN	11/30/98	$ 164	-0-	-0-	FCMSI[5]	5.620
Series BP	11/30/98	-0-	14,000	-0-	Trinity[6]	5.702
1954 Code G.O. Bond Series Recycling Subaccount	11/30/98	-0-	21,462	-0-	Soc Gen[2][3]	5.710
Unrestricted G.O. Bond Series Recycling Subaccount 1	11/30/98	66,433	-0-	-0-	Trinity[6]	5.702
Total		$ 66,597	$136,897	-0-		
New Veterans G.O. Bonds						
Series BQ/BR[7]	6/1/99	-0-	80,000	-0-	Trinity[7]	5.010
Unrestricted G.O. Bond Series Recycling Subaccount 2[9]	5/4/99	100,000	-0-	-0-	Trinity[9]	5.210
Total		$100,000	$ 80,000	-0-		
Short-Term Veterans G.O. Bonds						
Series BJ 3/4[4]	6/1/99	-0-	100,000	-0-	Trinity[11]	5.030
Series BJ 5/6[4]	6/1/99	-0-	171,500	-0-	BLB[11]	5.163
Total		-0-	$271,500	-0-		
Total with respect to Veterans G.O. Bonds		$166,597	$488,397	-0-		
Existing Revenue Bonds						
143 Revenue Bond Series Recycling Subaccount	11/30/98	-0-	-0-	212,963	Soc Gen[2][8]	5.730
Total		-0-	-0-	$212,963		
New Revenue Bonds						
1999 Series A/B	3/30/99 and 8/1/99	2,725	-0-	-0-	SMIF	Variable
Total		$ 2,725	-0-	-0-		
Short-Term Revenue Bonds						
1997 Series C[4]	3/30/99	-0-	-0-	93,000	NatWest[10]	4.980
Total		-0-	-0-	$ 93,000		
Total with respect to Revenue Bonds		$ 2,725	-0-	$305,963		
Total		$169,322	$488,397	$305,963		

Footnotes are on the following page.

(1) 000s omitted.

(2) On February 1, 1999, Moody's announced that it had placed under review for possible downgrade certain ratings of Societe Generale, including its long-term ratings (senior debts and deposits, currently rated at Aa3 by Moody's) and its bank financial strength rating (currently rated at B by Moody's).

(3) Investment agreement maturing December 1, 2000 with Societe Generale.

(4) Proceeds will become available only with respect to those bonds on which the interest rate has been adjusted to fixed interest rates to maturity.

(5) Investment agreement maturing April 1, 2000 with FGIC Capital Market Services, Inc. ("FCMSI"). The payment obligations of FCMSI under the investment agreement will be guaranteed by General Electric Capital Corporation ("GE Capital").

(6) Investment agreement maturing April 1, 2001 with Trinity Plus Funding Company, LLC ("Trinity"). Under certain circumstances, Trinity will have the benefits of a letter of credit from GE Capital and of a revolving liquidity facility under which GE Capital is a lender (there can be additional lenders under the liquidity facility). However, the aggregate of the amounts available under the letter of credit and the liquidity facility may be significantly less than Trinity's obligations under its investment agreements.

(7) Offered Veterans G.O. Bonds. Expected investment agreement maturing June 1, 2001 with Trinity. Under certain circumstances, Trinity will have the benefits of a letter of credit and a revolving liquidity facility from GE Capital as described in footnote (6).

(8) Investment agreement maturing December 1, 2001 with Societe Generale.

(9) Subaccount to be created upon the issuance of the 1999 Series B Bonds. Expected investment agreement maturing December 1, 2001 with Trinity. Under certain circumstances, Trinity will have the benefits of a letter of credit and a revolving liquidity facility from GE Capital as described in footnote (6).

(10) Investment agreement maturing December 1, 2001 with National Westminster Bank Plc.

(11) Prior to June 1, 1999, proceeds of the Series BJ Bonds are invested in an investment agreement with Societe Generale at an investment rate of 5.52%. On and after June 1, 1999, such proceeds are expected to be invested in new investment agreements as follows: (i) for the Series BJ 3/4 Bonds, with Trinity maturing June 1, 2000, and (ii) for the Series BJ 5/6 Bonds, with Bayerische Landesbank Girozentrale maturing June 1, 2001. Under certain circumstances, Trinity will have the benefits of a letter of credit and a revolving liquidity facility from GE Capital as described in footnote (6).

Cancellations and Delinquencies

Set forth in the table below is a comparative chart of delinquent, cancelled and repossessed Contracts of Purchase and certain comparative information regarding USDVA guaranteed loans during the same period.

	1994(1)	1995(1)	1996(1)	1997(1)	1998(1)	1999(2)
Percentage of Number of Contracts of Purchase						
Delinquent(3)						
30-67 days	0.99%	1.45%	2.90%	1.65%	0.78%	0.76%
68+ days	4.24%	3.12%	2.50%	3.22%	1.99%	2.17%
Cancelled Contracts and Bankruptcies(4)	0.38%	0.64%	0.82%	0.94%	0.82%	0.71%
Repossessed Contracts	0.35%	0.64%	1.07%	0.92%	0.67%	0.58%
USDVA Guaranteed Loans(5)						
Percentages in U.S.						
Delinquent						
30-60 days	4.07%	4.14%	4.59%	4.54%	4.45%	4.71%
60+ days	2.25%	2.21%	2.20%	2.21%	2.35%	2.62%
Foreclosures in inventory	1.44%	1.26%	1.54%	1.81%	1.77%	1.90%
Percentages in California						
Delinquent						
30-60 days	3.42%	4.03%	4.23%	4.30%	4.28%	4.78%
60+ days	2.36%	2.53%	2.36%	2.52%	2.61%	2.98%
Foreclosures in inventory	2.28%	2.31%	3.18%	3.54%	2.92%	2.98%

(1) As of June 18 for Department's and as of June 30 for USDVA data.

(2) Department information as of November 30, 1998. USDVA information currently is not available and is shown as of September 30, 1998.

(3) Time periods conform to Department's record-keeping system.

(4) Bankruptcies are included in cancelled Contracts statistics and do not exceed in any period more than 10% of total cancellations and bankruptcy category. Federal bankruptcy law precludes repossession action of Contracts of Purchase when veteran is in bankruptcy proceedings until the automatic stay is lifted.

(5) Source: National Delinquency Survey published by the Mortgage Bankers Association of America.

Veterans G.O. Bonds and Revenue Bonds

The chart below sets forth certain information regarding Veterans G.O. Bonds and Revenue Bonds, including those expected to be redeemed, defeased or retired as a result of the issuance of the Offered 1999 Revenue Bonds and the 1999 Veterans G.O. Bonds.

Selected Information with Respect to Veterans G.O. Bonds and Revenue Bonds

Series	Bonds Outstanding as of 10/1/98	Bonds Expected to be Outstanding as of 5/4/99	Final Maturity or Mandatory Tender Date of Series	Next Optional Call Date	Call Price on Such Date	Maximum Coupon Subject to Optional Call	Bond Subject to Special Redemption
			Veterans G.O. Bonds Issued Prior to the Mortgage Subsidy Bond Tax Act of 1980				
QQ	$ 9,600,000	$ 4,800,000[2]	February 1, 2000	Non-Callable	N.A.	N.A.	No
YY	42,600,000	— [2]					
ZZ/AB	35,500,000	— [1]					
AC	35,500,000	— [1]					
AD	49,200,000	42,600,000[2]	April 1, 2005	April 1, 2000	100%	6.800%	No
AE	26,240,000	22,720,000[1]	August 1, 2005	August 1, 2000	100%	7.000%	No
AF	39,360,000	34,080,000[1]	August 1, 2005	August 1, 2000	100%	7.300%	No
AG	49,200,000	49,200,000	October 1, 2005	October 1, 2000	100%	8.250%	No
Sub-total	$ 287,200,000	$ 153,400,000					
			Veterans G.O. Bonds Issued to Refund Bonds Issued Prior to the Mortgage Subsidy Bond Tax Act of 1980				
BM	$ 66,600,000	$ 66,600,000	December 1, 2025	—[3]	—[3]	5.450%	Excess Revenues/Unexpended
BN2-4	91,065,000	91,065,000	December 1, 2028	—[3]	—[3]	5.450%	Excess Revenues/Unexpended
	$ 157,665,000	$ 157,665,000					
			Veterans G.O. Bonds Issued as Qualified Veterans Mortgage Bonds under the 1954 Code				
AH	$ 56,000,000	$ 56,000,000	August 1, 2006	August 1, 2001	100%	10.000%	No
AK	13,500,000	12,000,000	April 1, 2007	Non-callable	N.A.	N.A.	No
AL	44,000,000	38,000,000	April 1, 2007	Non-callable	N.A.	N.A.	No
AM	60,000,000	60,000,000	October 1, 2008	Non-callable	N.A.	N.A.	No
AN/AP	91,500,000	90,000,000	April 1, 2009	Non-callable	N.A.	N.A.	No
AQ	90,000,000	90,000,000	October 1, 2008	Non-callable	N.A.	N.A.	No
AR	43,500,000	43,500,000	October 1, 2009	Non-callable	N.A.	N.A.	No
AS	44,000,000	44,000,000	October 1, 2009	Non-callable	N.A.	N.A.	No
AT	207,485,000	194,155,000	February 1, 2010	Non-callable	N.A.	N.A.	No
AU	130,790,000	130,790,000	October 1, 2010	Non-callable	N.A.	N.A.	No
AV	89,665,000	89,665,000	October 1, 2010	Non-callable	N.A.	N.A.	No
Sub-total	$ 870,440,000	$ 848,110,000					
			Veterans G.O. Bonds Issued as Qualified Veterans Mortgage Bonds under the 1986 Code				
BC/BF[4]	$ 338,745,000	$ 320,745,000[10]	February 1, 2027	June 1, 1999	101%	6.550%	Allocated Prepayments[5]
BG/BH	586,355,000	586,355,000	December 1, 2032	—[6]	—[6]	5.600%[6]	Excess Revenues/Unexpended
BJ	300,000,000	271,500,000	—[7]	—[7]	100%	—[7]	Unexpended
BK/BL	280,615,000	255,615,000[10]	December 1, 2012	—[6]	—[6]	5.300%[6]	Excess Revenues/Unexpended
BP/BN1[3]	14,000,000	14,000,000	December 1, 2026	—[3]	—[3]	5.500%[3]	Excess Revenues/Unexpended
BQ/BR[8]	—	80,000,000	December 1, 2029	June 1, 2004	101%	5.300%	Excess Revenues/Unexpended
Sub-total	$1,519,715,000	$1,528,215,000					
TOTAL VETERANS G.O. BONDS	$2,835,020,000	$2,687,390,000					

Series	Bonds Outstanding as of 10/1/98	Bonds Expected to be Outstanding as of 5/4/99	Final Maturity or Mandatory Tender Date of Series	Next Optional Call Date	Call Price on Such Date	Maximum Coupon Subject to Optional Call	Bond Subject to Special Redemption
Revenue Bonds Issued as Qualified Mortgage Bonds under the 1986 Code							
1997 A/B	$ 20,990,000	$ 20,755,000	December 1, 2028	December 1, 2008	101%	5.500%	Excess Revenues/Unexpended
1997 C	100,000,000	100,000,000[9]	December 1, 2001	August 1, 2000	100%	3.65%	Unexpended
1998 A	154,065,000	148,380,000	December 1, 2019	December 1, 2008	101%	5.450%	Excess Revenues/Unexpended
Sub-total	$ 275,055,000	$ 269,135,000					
Revenue Bonds Issued to Refund Bonds Issued Prior to Mortgage Subsidy Bond Tax Act of 1980							
1999 A	—	$ 54,170,000	December 1, 2027	June 1, 2004	101%	5.20%	Excess Revenues/Unexpended
1999 B[9]	—	86,085,000[9]	December 1, 2028	June 1, 2004	101%	5.20%	Excess Revenues/Unexpended
Sub-total	—	$ 140,255,000					
TOTAL REVENUE BONDS	$ 275,055,000	$ 409,390,000					
TOTAL ALL BONDS ...	$3,110,075,000	$3,096,780,000					

(1) Reduction in an amount reflects those Veterans G.O. Bonds expected to be retired following expected sale and delivery of the Home Purchase Revenue Bonds, 1999 Series B on or about May 4, 1999.

(2) Reduction in an amount reflects those Veterans G.O. Bonds retired following delivery of the Home Purchase Revenue Bonds, 1999 Series A on March 30, 1999.

(3) The Series BM Bonds and Series BN Bonds maturing on and before December 1, 2004 are subject to optional redemption at par on and after June 1, 2000. The remaining Series BM Bonds and Series BN Bonds and all of the Series BP Bonds are subject to optional redemption on and after December 1, 2003, initially at 101% of the principal amount thereof, declining to par on and after December 1, 2004.

(4) Includes Series BC, Series BD, Series BE and Series BF.

(5) Subject to redemption at par from a portion of prepayments on all Contracts of Purchase as allocated to Series based on periodically determined ratio of outstanding bonds (including Veterans G.O. Bonds and Revenue Bonds) of Series to all outstanding bonds.

(6) Except as described in the next sentence, the Series BG Bonds, Series BH Bonds, and Series BL Bonds are subject to optional redemption on and after December 1, 2008, initially at 101% of the principal amount thereof, declining to par on December 1, 2009. The Series BH Bonds maturing on December 1, 2018, December 1, 2024, and December 1, 2032 are subject to optional redemption on and after December 1, 2003 at 102% of the principal amount thereof, declining to 101% of the principal amount thereof on and after December 1, 2004, and declining further to par on December 1, 2005. The Series BK Bonds are not subject to optional redemption.

(7) The Series BJ Bonds are expected to be remarketed, in part, at new short term rates to mandatory tender dates on or about April 28, 1999. Upon remarketing, the $100,000,000 aggregate principal amount, Series BJ 3/4 Bonds will have a Latest Mandatory Tender Date of June 1, 2000, will be subject to optional call beginning December 1, 1999, and will have a coupon of 3.20%. Upon remarketing, the $171,500,000 aggregate principal amount Series BJ 5/6 Bonds will have a Latest Mandatory Tender Date of June 1, 2001, will be subject to optional call beginning June 1, 2000, and will have a coupon of 3.60%.

(8) Offered Veterans G.O. Bonds.

(9) Expected to be issued on or about May 4, 1999.

(10) Reduction in an amount reflects those Veterans G.O. Bonds expected to be retired following expected sale and delivery of the Offered Veterans G.O. Bonds.

Additional Investments

In addition to the investments described above under "Contracts of Purchase—Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments," the following investments have been made or will be made with respect to moneys in the 1943 Fund and the Bond Reserve Account which secures the Revenue Bonds:

Fund or Account Designation[1]	Amount	Type of Investment	Investment Provider	Investment Maturity Date	Investment (%)
1997/1998 Bond Reserve Subaccount	$5,251,650	investment agreement	Societe Generale[3]	12/1/28	5.75
	$7,001,992[2]	U.S. Treasury Bond	N.A.	5/15/05	6.50
1999 Bond Reserve Subaccount	$9,817,850	investment agreement	Westdeutsche Landesbank Girozentrale	12/1/28	5.38
1997/1998 Revenue Bond Series Revenue Subaccount and 1997/1998 Revenue Bond Series Restricted Recoveries Subaccount	variable	investment agreement	Societe Generale[3]	12/1/28	5.91
BG, BH, BK, BL G.O. Bond Series Revenue Subaccount and BG, BH, BK, BL G.O. Bonds Series Recycling Subaccount	variable[4]	investment agreement	Societe Generale[3]	12/1/32	5.91
BM, BN G.O. Bond Series Revenue Subaccount	variable	investment agreement	Westdeutsche Landesbank Girozentrale	12/1/28	5.38
BM, BN G.O. Bond Series Recycling Subaccount	variable[5]	investment agreement	Westdeutsche Landesbank Girozentrale	12/1/28	5.38
BP G.O. Bond Series Revenue Subaccount	variable	investment agreement	Westdeutsche Landesbank Girozentrale	12/1/28	5.38
BP G.O. Bond Series Recycling Subaccount	variable[5]	investment agreement	Westdeutsche Landesbank Girozentrale	12/1/28	5.38
1999 A/B Revenue Bond Series Revenue Subaccount and 1999 A/B Revenue Bond Series Recycling Subaccount	variable[6]	investment agreement	Bayerische Landesbank Girozentrale	12/1/28	5.30
BQ/BR G.O. Bond Series Revenue Subaccount and BQ/BR G.O. Bond Series Recycling Subaccount[7]	variable[7]	investment agreement	Westdeutsche Landesbank Girozentrale	12/1/29[7]	5.37

(1) Accounts are established in the resolutions authorizing the issuance of Revenue Bonds.
(2) At cost.
(3) On February 1, 1999, Moody's announced that it had placed under review for possible downgrade certain ratings of Societe Generale, including its long-term ratings (senior debts and deposits, currently rated at Aa3 by Moody's) and its bank financial strength rating (currently rated at B by Moody's).
(4) Maximum permitted amount on deposit under investment agreement at any one time is $250,000,000.
(5) Aggregate maximum permitted amount on deposit under investment agreement for both accounts is $50,000,000.
(6) Aggregate maximum permitted amount on deposit under investment agreement for both accounts is $75,000,000.
(7) Expected investment with respect to the Series BQ Bonds and Series BR Bonds. Expected maximum permitted amount on deposit under investment agreement for both accounts is $35,000,000. If the Series BQ Bonds and Series BR Bonds are redeemed in full prior to December 1, 2029, the investment agreement will terminate on such earlier redemption date.

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APPENDIX C

BOOK-ENTRY SYSTEM

The information in this section concerning DTC and DTC's book-entry only system has been obtained from sources that the Treasurer believes to be reliable, but the Treasurer takes no responsibility for the accuracy thereof. The Beneficial Owners (as defined herein) should confirm the following information with DTC or the DTC Participants.

DTC will act or will continue to act as securities depository for the Offered Veterans G.O. Bonds. The Offered Veterans G.O. Bonds will be issued as fully-registered securities registered in the name of Cede & Co. (DTC's partnership nominee). Fully-registered Offered Veterans G.O. Bonds will be issued and deposited with DTC.

DTC is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds securities that its participants (the "DTC Participants") deposit with DTC. DTC also facilitates the settlement among DTC Participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerized book-entry changes in DTC Participants' accounts, thereby eliminating the need for physical movement of securities certificates. Direct DTC Participants include securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is owned by a number of its Direct DTC Participants and by the New York Stock Exchange, Inc., the American Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others such as securities brokers and dealers, banks and trust companies that clear through or maintain a custodial relationship with a Direct DTC Participant, either directly or indirectly ("Indirect DTC Participants"). The Rules applicable to DTC and its DTC Participants are on file with the Securities and Exchange Commission.

Purchases of the Offered Veterans G.O. Bonds under the DTC system must be made by or through Direct DTC Participants, which will receive a credit for the Offered Veterans G.O. Bonds on DTC's records. The ownership interest of each actual purchaser of each Offered Veterans G.O. Bond (the "Beneficial Owner") is in turn to be recorded on the Direct and Indirect DTC Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchase, but Beneficial Owners are expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect DTC Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Offered Veterans G.O. Bonds are to be accomplished by entries made on the books of DTC Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in the Offered Veterans G.O. Bonds, except in the event that use of the book-entry system for the Offered Veterans G.O. Bonds is discontinued.

To facilitate subsequent transfers, all Offered Veterans G.O. Bonds deposited by DTC Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co. The deposit of Offered Veterans G.O. Bonds with DTC and their registration in the name of Cede & Co. effect no change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Offered Veterans G.O. Bonds; DTC's records reflect only the identity of the Direct DTC Participants to whose accounts such securities are credited, which may or may not be the Beneficial Owners. The DTC Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct DTC Participants, by Direct DTC Participants to Indirect DTC Participants, and by Direct DTC Participants and Indirect DTC Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. The Treasurer will not have any responsibility or obligation to such DTC Participants or the persons for whom they act as nominees with respect to the Offered Veterans G.O. Bonds.

Redemption notices shall be sent to Cede & Co. If less than all of the Offered Veterans G.O. Bonds within a maturity of a Series are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct DTC Participant in such maturity to be redeemed.

The principal, premium and interest payment with respect to the Offered Veterans G.O. Bonds will be made to DTC. DTC's practice is to credit Direct DTC Participants' accounts on payment dates in accordance with their respective holdings shown on DTC's records unless DTC has reason to believe that it will not receive payment on the date payable. Payments by DTC Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such DTC Participant and not of DTC or the Treasurer, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal and interest to DTC is the responsibility of the Treasurer, disbursement of such payments to Direct DTC Participants shall be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners shall be the responsibility of Direct and Indirect DTC Participants.

DTC may discontinue providing its services as securities depository with respect to the Offered Veterans G.O. Bonds at any time by giving reasonable notice to the Treasurer. Under such circumstances, in the event that a successor securities depository is not obtained, certificates are required to be printed and delivered.

The Treasurer may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depository). In that event, securities certificates will be printed and delivered.

SO LONG AS CEDE & CO. IS THE REGISTERED OWNER OF THE OFFERED VETERANS G.O. BONDS, AS NOMINEE OF DTC, REFERENCES HEREIN TO THE OWNERS OF OFFERED VETERANS G.O. BONDS SHALL MEAN CEDE & CO., AS AFORESAID, AND SHALL NOT MEAN THE BENEFICIAL OWNERS OF THE OFFERED VETERANS G.O. BONDS.

NEITHER THE STATE NOR THE TREASURER WILL HAVE ANY RESPONSIBILITY OR OBLIGATION TO DIRECT DTC PARTICIPANTS, INDIRECT PARTICIPANTS, OR TO ANY BENEFICIAL OWNER WITH RESPECT TO (i) THE ACCURACY OF ANY RECORDS MAINTAINED BY DTC, ANY DIRECT DTC PARTICIPANT, OR INDIRECT DTC PARTICIPANT; (ii) THE DELIVERY OF ANY NOTICE THAT IS PERMITTED OR REQUIRED TO BE GIVEN TO THE OWNERS OF THE OFFERED VETERANS G.O. BONDS; (iii) THE PAYMENT BY DTC OR ANY DIRECT DTC PARTICIPANT OR INDIRECT DTC PARTICIPANT OF ANY AMOUNT WITH RESPECT TO THE

PRINCIPAL OR INTEREST DUE WITH RESPECT TO THE OFFERED VETERANS G.O. BONDS; (iv) ANY CONSENT GIVEN OR OTHER ACTION TAKEN BY DTC AS THE REGISTERED OWNER OF OFFERED VETERANS G.O. BONDS; OR (v) ANY OTHER MATTER.

DTC's Year 2000 Efforts

DTC management is aware that some computer applications, systems, and the like for processing data ("Systems") that are dependent upon calendar dates, including dates before, on, and after January 1, 2000, may encounter "Year 2000 problems." DTC has informed its Participants and other members of the financial community (the "Industry") that is has developed and is implementing a program so that its Systems, as the same relate to the timely payment of distributions (including principal and income payments) to security holders, book-entry deliveries, and settlement of trades within DTC ("DTC Services"), continue to function appropriately. This program includes a technical assessment and a remediation plan, each of which is complete. Additionally, DTC's plan includes a testing phase, which is expected to be completed within appropriate time frames.

However, DTC's ability to perform its services properly is also dependent upon other parties, including but not limited to issuers and their agents, as well as third-party vendors from whom DTC licenses software and hardware, and third-party vendors on whom DTC relies for information or the provision of services, including telecommunication and electrical utility service providers, among others. DTC has informed the Industry that is its contacting (and will continue to contact) third-party vendors from whom DTC acquires services to: (i) impress upon them the importance of such services being Year 2000 compliant; and (ii) determine the extent of their efforts for Year 2000 remediation (and, as appropriate, testing) of their services. In addition, DTC is in the process of developing such contingency plans as it deems appropriate.

According to DTC, the foregoing information with respect to DTC has been provided to the Industry for informational purposes only and is not intended to serve as a representation, warranty, or contract modification of any kind.

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APPENDIX D

SUMMARY OF CONTINUING DISCLOSURE CERTIFICATES

STATE TREASURER'S DISCLOSURE CERTIFICATES

The State Treasurer, on behalf of the State, executed a Continuing Disclosure Certificate in connection with the Series BJ Bonds at the time of delivery of the Series BJ Bonds to the original purchasers thereof, and will execute a Continuing Disclosure Certificate (each of such certificates, a "Treasurer's Disclosure Certificate") for the Series BQ Bonds and Series BR Bonds at the time of delivery of the Series BQ Bonds and Series BR Bonds to the purchasers thereof. The following is a summary of the provisions of both of the Treasurer's Disclosure Certificates. Such summary is qualified by reference to each of the complete Treasurer's Disclosure Certificates, which are available from the Office of the State Treasurer.

Definitions

Pursuant to each of the Treasurer's Disclosure Certificates, the following definitions will apply:

"Annual Report" shall mean the Annual Report filed by the State Treasurer pursuant to, and as described in, such Treasurer's Disclosure Certificate.

"Beneficial Owner" shall mean any person which has or shares the power, directly or indirectly, to make investment decisions concerning ownership of any applicable Offered Veterans G.O. Bonds (including persons holding applicable Offered Veterans G.O. Bonds through nominees, depositories or other intermediaries).

"Dissemination Agent" shall mean the State Treasurer, acting in its capacity as Dissemination Agent under such Treasurer's Disclosure Certificate, or any successor Dissemination Agent designated in writing by the State Treasurer.

"Holder" shall mean any person listed on the registration books of the State Treasurer as the registered owner of any applicable Offered Veterans G.O. Bonds

"Listed Events" shall mean any of the events listed below under "Reporting of Significant Events."

"National Repository" shall mean any Nationally Recognized Municipal Securities Information Repository certified by the Securities and Exchange Commission to be the recipient of information of the nature of the Annual Reports required by such Treasurer's Disclosure Certificate.

"Official Statement" shall mean, with respect to the Series BJ Bonds, the official statement relating to the Series BJ Bonds, dated December 10, 1997, and with respect to the Offered Veterans G.O. Bonds, this Official Statement.

"Repository" shall mean each National Repository and the State Repository.

"Rule" shall mean Rule 15c2-12(b)(5) adopted by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as the same may be amended from time to time.

"State" shall mean the State of California.

"State Repository" shall mean any public or private repository or entity within the State created for the purpose of receiving information of the nature of the Annual Reports or reports of material events required by such Treasurer's Disclosure Certificate and recognized as such by the Securities and Exchange Commission. As of the date of this Official Statement, there is no State Repository.

Annual Reports

The State Treasurer on behalf of the State shall, not later than April 1 of each year in which the applicable Offered Veterans G.O. Bonds are outstanding, commencing with the report for the 1998-99 Fiscal Year, provide an Annual Report consistent with the requirements of the applicable Treasurer's Disclosure Certificate (an "Annual Report") to each Repository; provided that the audited financial statements of the State may be submitted separately from the balance of the Annual Report and later than the date required above for the filing of the Annual Report if they are not available by that date. The State Treasurer shall make a copy of any Annual Report available to any person who requests a copy at a cost not exceeding the reasonable cost of duplication and delivery.

If in any year, the State Treasurer does not provide the Annual Report to each Repository by the time specified above, the State Treasurer shall instead file a notice with each Repository stating that the Annual Report has not been timely completed and, if known, stating the date by which the State Treasurer expects to file the Annual Report.

The Annual Report shall contain or include by reference the following:

(1) The audited General Purpose Financial Statements of the State for the fiscal year ended on the previous June 30, prepared in accordance with generally accepted accounting principles promulgated to apply to government entities from time to time by the Governmental Accounting Standards Board. If the State's audited financial statements are not available by the time the Annual Report is required to be filed pursuant to the applicable Treasurer's Disclosure Certificate, the Annual Report shall contain unaudited financial statements in a format similar to the financial statements contained in the applicable final Official Statement, and the audited financial statements shall be filed in the same manner as the Annual Report when they become available.

(2) Financial information relating to the State's General Fund budget for the fiscal year ended on the previous June 30 and information concerning the State budget for the fiscal year in which the Annual Report is issued. Such information shall describe the sources of revenues, the principal categories of expenditures, and changes in fund balances, a summary of expected State revenues and budgeted expenditures, and significant assumptions relating to revenue and expenditure expectations, including updating the following tables which appear under the caption Appendix A— "THE STATE OF CALIFORNIA—Current State Budget" in the applicable Official Statement:

Table Entitled

Summary of State Revenues and Expenditures
Revenue and Expenditure Assumptions

(3) Information concerning the total amount of the State's authorized and outstanding debt, long-term lease obligations and other long-term liabilities as of the end of the most recent June 30, which debt is supported by payments from the State's General Fund and which

includes short-term debt. Such information shall include schedules of debt service for outstanding general obligation bonds and lease-purchase debt. This shall be accomplished by updating the following tables which appear under the caption Appendix A—"THE STATE OF CALIFORNIA —State Indebtedness" in the Official Statement.

Table Entitled

Authorized and Outstanding General Obligation Bonds
Outstanding State Debt

Schedule of Debt Service Requirements for
General Fund General Obligation Bonds

Schedule of Debt Service Requirements for
Enterprise Fund General Obligation Bonds

Schedule of Debt Service Requirements for
Lease-Purchase Debt

State Public Works Board and
Other Lease-Purchase Financing

State Agency Revenue Bonds and
Conduit Financing

The Annual Report may consist of one or more documents. Any or all of the items listed above may be included in the Annual Report by reference to other documents which have been filed by the State with each of the Repositories, including any final official statement (in which case such final official statement must also be available from the Municipal Securities Rulemaking Board). The State Treasurer shall clearly identify in the Annual Report each such document so included by reference.

Reporting of Significant Events

The State Treasurer, on behalf of the State shall give, or cause to be given, prompt notice of the occurrence of any of the following events with respect to the applicable Offered Veterans G.O. Bonds (hereafter referred to as a "Listed Event"), if material:

1. principal and interest payment delinquencies;
2. non-payment related defaults;
3. modifications to rights of Bondholders;
4. optional, contingent or unscheduled bond calls;
5. defeasances;
6. rating changes;
7. adverse tax opinions or event affecting the tax-exempt status of the applicable Offered Veterans G.O. Bonds;
8. unscheduled draws on debt service reserves reflecting financial difficulties;
9. unscheduled draws on credit enhancements reflecting financial difficulties;
10. substitution of credit or liquidity providers, or their failure to perform; or
11. release, substitution or sale of property securing repayment of the applicable Offered Veterans G.O. Bonds.

The State Treasurer shall timely file a notice of each such occurrence, if it is material under applicable federal securities laws, with the Municipal Securities Rulemaking Board and each Repository. The State notes that items 8, 9, 10, and 11 above are not applicable to the Offered Veterans G.O. Bonds.

Other Provisions

Termination of Reporting Obligation. The State's obligations under the applicable Treasurer's Disclosure Certificate shall terminate upon the maturity, legal defeasance, prior redemption or acceleration of all of the applicable outstanding Offered Veterans G.O. Bonds.

Dissemination Agent. The State Treasurer may, from time to time, appoint or engage a Dissemination Agent to assist it in carrying out the obligations under the applicable Treasurer's Disclosure Certificate, and may discharge any such Dissemination Agent, with or without appointing a successor Dissemination Agent. If at any time there is not any other designated Dissemination Agent, the State Treasurer shall be the Dissemination Agent. The initial Dissemination Agent shall be the State Treasurer.

Amendment; Waiver. Notwithstanding any other provision of a Treasurer's Disclosure Certificate, the State Treasurer may amend or waive any provision of such Treasurer's Disclosure Certificate, provided that the following conditions are satisfied:

(a) If the amendment or waiver relates to the provisions of the applicable Treasurer's Disclosure Certificate dealing with the timing or content of the Annual Report or the giving of notice of Listed Events, it may only be made in connection with a change in circumstances that arises from a change in legal requirements, change in law, or change in the identity, nature or status of an obligated person with respect to the applicable Offered Veterans G.O. Bonds, or the type of business conducted;

(b) The undertaking, as amended or taking into account such waiver, would, in the opinion of nationally recognized bond counsel, have complied with the requirements of the Rule at the time of the original issuance of the applicable Offered Veterans G.O. Bonds, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances; and

(c) The amendment or waiver either (i) is approved by the Holders of 60 percent of the Bonds, or (ii) does not, in the opinion of nationally recognized bond counsel, materially impair the interests of the Holders or Beneficial Owners of the applicable Offered Veterans G.O. Bonds.

Additional Information. Nothing in either Treasurer's Disclosure Certificate shall be deemed to prevent the State Treasurer from disseminating any other information, using the means of dissemination set forth in such Treasurer's Disclosure Certificates or any other means of communication, or including any other information in any Annual Report or notice of occurrence of a Listed Event, in addition to that which is required by the Treasurer's Disclosure Certificates. If the State Treasurer chooses to include any information in any Annual Report or notice of occurrence of a Listed Event in addition to that which is specifically required by the Treasurer's Disclosure Certificates, the State Treasurer shall not have any obligation to update such information or include it in any future Annual Report or notice of occurrence of a Listed Event.

Beneficiaries. Each Treasurer's Disclosure Certificate shall inure solely to the benefit of the Holders and Beneficial Owners from time to time of the applicable Offered Veterans G.O. Bonds, and shall create no rights in any other person or entity (except the right of any Bondholder or Beneficial Owner to enforce the provisions of such Treasurer's Disclosure Certificate on behalf of the Bondholders). Neither Treasurer's Disclosure Certificate is intended to create any monetary rights on behalf of any person based upon the Rule.

DEPARTMENT'S DISCLOSURE CERTIFICATE

The Secretary of Veterans Affairs (the "Secretary"), on behalf of the Department, executed a Continuing Disclosure Certificate in connection with the Series BJ Bonds at the time of delivery of the Series BJ Bonds to the original purchasers thereof, and will execute a Continuing Disclosure Certificate (each of such certificates, a "Department's Disclosure Certificate") for the Series BQ Bonds and Series BR Bonds at the time of delivery of the Series BQ Bonds and Series BR Bonds to the purchasers thereof. The following is a summary of the Department's Disclosure Certificates. Such summary is qualified by reference to each of the complete Department's Disclosure Certificates, which are available from the Department.

Certain Definitions

Defined terms used in the Department's Disclosure Certificates and not otherwise defined therein have the meanings set forth elsewhere in this Official Statement.

"**Beneficial Owner**" means a Beneficial Owner of Subject Bonds, as determined pursuant to the Rule.

"**Bondowners**" means the registered owners of the Subject Bonds.

"**Bonds**" means, at any time, all of the State's then Outstanding Offered Veterans G.O. Bonds, collectively.

"**Fiscal Year**" means that period established by the Department with respect to which its, as applicable, Audited Financial Statements or Unaudited Financial Statements are prepared. As of the date of the Department's Disclosure Certificate, the Department's Fiscal Year begins on July 1 and ends on June 30 of the next calendar year.

"**MSRB**" means the Municipal Securities Rulemaking Board established pursuant to Section 15B(b)(1) of the Securities Exchange Act of 1934.

"**Notice**" means written notice, sent for overnight delivery via the United States Postal Service or a private delivery service which provides evidence of delivery.

"**Notice Address**" means with respect to the Department:

State of California Department of Veterans Affairs
1227 O Street
Sacramento, CA 95814
Attention: Bond Finance Division

"**NRMSIR**" means, at any time, a then-existing nationally recognized municipal securities information repository, as recognized from time to time by the SEC for the purposes referred to in the Rule.

"**Official Statement**" means, with respect to the Series BQ Bonds and Series BR Bonds, this Official Statement and, with respect to the Series BJ Bonds means the Official Statement with respect to such Bonds dated December 10, 1997.

"**Participating Underwriter**" means any of the original underwriters of any Subject Bonds required to comply with the Rule in connection with the offering of such Subject Bonds.

"**Rule**" means the applicable provisions of Rule 15c2-12 promulgated by the SEC under the Securities Exchange Act of 1934, as amended (17 CFR Part 240, § 240.15c2-12), as in effect on the date of the Department's Disclosure Certificate, including any official interpretations thereof.

"**SEC**" means the United States Securities and Exchange Commission.

"**Securities Counsel**" means legal counsel expert in Federal securities laws.

"**SID**" means, at any time, a then-existing state information depository, if any, as operated or designated as such by or on behalf of the State and recognized by the SEC for the purposes referred to in the Rule.*

"**Subject Bonds**" means either, as applicable, the Series BQ Bonds and Series BR Bonds, or the Series BJ Bonds and those Veterans G.O. Bonds subject to the same Department's Disclosure Certificate.

Provision of Annual Financial Information

The Department will, not later than the first day of the tenth calendar month after the end of each of the Department's Fiscal Years, commencing with the report for the 1998-1999 Fiscal Year, provide to the State Treasurer and to each NRMSIR and the SID the Annual Financial Information. The audited financial statements of the Department may be submitted separately from the balance of the Annual Financial Information, and later than the date required for the filing of the Annual Financial Information if not available by that date.

Each Department's Disclosure Certificate requires the Department to provide, in a timely manner, notice of any failure by it to provide Annual Financial Information to each NRMSIR and the SID on or before the date described in the first paragraph under this heading, to the SID, to the State Treasurer, and to either (i) each NRMSIR or (ii) the MSRB.

Content of Annual Financial Information

The Department's Annual Financial Information shall contain or include by reference the following:

(a) the audited financial statements of the 1943 Fund for the Fiscal Year ended on the previous June 30, prepared in accordance with generally accepted accounting principles established by the Financial Accounting Standards Board, if available, or unaudited financial statements for such Fiscal Year; and

(b) financial information or operating data of the types included in Exhibit 2 to Appendix B of the applicable Official Statement entitled "Certain Department Financial Information and Operating Data."

If not provided as part of the Annual Financial Information by the date required (as described above under "Provision of Annual Financial Information"), the Department shall provide audited financial statements, when and if available, to the State Treasurer and to each NRMSIR and the SID.

Any or all of the items listed above may be included by specific reference to other documents, including official statements of debt issues of the Department or related public entities, which have been submitted to each NRMSIR and the SID or the SEC. (If such document is an official statement, it must also be available from the MSRB.) Annual Financial Information may be provided in one document or multiple documents, and at one time or in part from time to time.

* As of the date of this Official Statement, there is no SID.

Additional Information

Nothing in either Department's Disclosure Certificate will be deemed to prevent the Department from disseminating any other information, using the means of dissemination set forth in such Department's Disclosure Certificate or any other means of communication, or including any other information in any Annual Financial Information, in addition to that which is required by the Department's Disclosure Certificate. If the Department chooses to include any information in any Annual Financial Information in addition to that which is specifically required by a Department's Disclosure Certificate, the Department will have no obligation under such Department's Disclosure Certificate to update such information or include it in any future Annual Financial Information.

Amendment of Department's Disclosure Certificate

Each Department's Disclosure Certificate may be amended and any provision of such Department's Disclosure Certificate be waived, without the consent of the Bondowners or Beneficial Owners, except as described in clause 4(ii) below, under the following conditions: (1) such amendment or waiver is made in connection with a change in circumstances that arises from a change in legal (including regulatory) requirements, a change in law (including rules or regulations) or in interpretations thereof, or a change in the identity, nature, or status of the Department or the type of business conducted thereby, (2) such Department's Disclosure Certificate as so amended or waived would have complied with the requirements of the Rule as of the date of each primary offering of Subject Bonds affected by such amendment or waiver, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances, (3) the Department shall have obtained an opinion of Securities Counsel, addressed to the Department and the State Treasurer, to the same effect as set forth in clause (2) above, (4) either (i) a party unaffiliated with the Department (such as bond counsel), acceptable to the Department, has determined that the amendment or waiver does not materially impair the interests of the Beneficial Owners, or (ii) the applicable Bondowners consent to the amendment to or waiver of such Department's Disclosure Certificate, and (5) the Department shall have delivered copies of such amendment or waiver to the SID, to the State Treasurer, and to either each NRMSIR or the MSRB.

In addition to the foregoing, the Department may amend a Department's Disclosure Certificate, and any provision of such Department's Disclosure Certificate may be waived, if the Department shall have received an opinion of Securities Counsel, addressed to the Department and the State Treasurer, to the effect that the adoption and the terms of such amendment or waiver would not, in and of themselves, cause the undertakings in such Department's Disclosure Certificate to violate the Rule, taking into account any subsequent change in or official interpretation of the Rule.

Benefit; Enforcement

The provisions of a Department's Disclosure Certificate will inure solely to the benefit of the bondowners and Beneficial Owners from time to time.

Except as described in this paragraph, the provisions of a Department's Disclosure Certificate will create no rights in any other person or entity. The obligation of the Department to comply with the provisions of a Department's Disclosure Certificate are enforceable (i) in the case of enforcement of obligations to provide financial statements, financial information, operating data, and notices, by any Beneficial Owner of Outstanding Subject Bonds, or (ii) in the case of challenges to the adequacy of the financial statements, financial information, and operating data so provided, by the Bondowners of not less than 20% in aggregate principal amount of the Subject Bonds at the time Outstanding.

The right to enforce the provisions of a Department's Disclosure Certificate is limited to a right, by action in mandamus or for specific performance, to compel performance of the Department's obligations under such Department's Disclosure Certificate. Any failure by the Department to perform in accordance with such Department's Disclosure Certificate will not constitute a default or an Event of Default under the Subject Bonds, and the rights and remedies provided by the Subject Bonds upon the occurrence of a default or an Event of Default will not apply to any such failure.

Termination of Reporting Obligation

The Department's obligations under a Department's Disclosure Certificate with respect to the Subject Bonds terminate upon the legal defeasance, prior redemption, or payment in full of all of such Subject Bonds. The Department shall give notice of any such termination to the SID and to either each NRMSIR or the MSRB.

A Department's Disclosure Certificate, or any provision thereof, will be null and void to the extent set forth on the opinion of Securities Counsel obtained by the Department and addressed to the Department and the State Treasurer, to the effect that those portions of the Rule which require the provisions of such Department's Disclosure Certificate, or any of such provisions, do not or no longer apply to the applicable Subject Bonds, whether because such portions of the Rule are invalid, have been repealed, or otherwise, as will be specified in such opinion, and (2) delivers notice to such effect to the State Treasurer, to the SID and to either each NRMSIR or the MSRB.

Governing Law

Each Department's Disclosure Certificate will be construed and interpreted in accordance with the laws of the State, and any suits and actions arising out of such Department's Disclosure Certificate will be instituted in a court of competent jurisdiction in the State, *provided that,* to the extent such Department's Disclosure Certificate addresses matters of Federal securities laws, including the Rule, such Department's Disclosure Certificate will be construed in accordance with such federal securities laws and official interpretations thereof.

APPENDIX E

PROPOSED FORM OF LEGAL OPINION WITH RESPECT TO THE SERIES BQ BONDS AND SERIES BR BONDS

Honorable Philip Angelides
Treasurer of the State of California
915 Capital Mall, Room 110
Sacramento, California 95814

State of California
$80,000,000 Veterans General Obligation Bonds

Dear Mr. Treasurer:

We have acted as Bond Counsel in connection with the issuance by the State of California (the "State") of $80,000,000 aggregate principal amount of bonds, issued in four series, under the Bond Acts, identified in Schedule A hereto, which is incorporated by reference (collectively, the "Bonds"), each of which was approved by the electors of the State. The Bonds are authorized pursuant to the respective bond acts identified in Schedule A (collectively, the "Laws") and are issued pursuant to Part 3 of Division 4 of Title 2 of the California Government Code and to resolutions (the "Resolutions") adopted by the Veterans' Finance Committee of 1943 on February 24, 1999.

In such connection, we have examined the record of proceedings submitted to us relative to the issuance of the Bonds, including the Resolutions, the tax certificate of the State (the "Tax Certificate"), other certifications of the State, and such other documents and matters deemed necessary by us to render the opinions set forth herein, although in doing so, we have not undertaken to verify independently the accuracy of the factual matters represented, warranted or certified therein, and we have assumed the genuineness of all signatures thereto.

The opinions expressed herein are based upon an analysis of existing laws, regulations, rulings and court decisions and cover certain matters not directly addressed by such authorities. Such opinions may be affected by actions taken or omitted or events occurring after the date hereof. We have not undertaken to determine, or to inform any person, whether any such actions are taken or omitted or events do occur or whether any other matters come to our attention after the date hereof. Furthermore, we have assumed compliance with the agreements and covenants contained in the Resolutions and the Tax Certificate, including (without limitation) agreements and covenants compliance with which is necessary to assure that future actions, omissions or events will not cause interest on the Bonds to be included in gross income for federal income tax purposes. We call attention to the fact that the rights and obligations under the Bonds, the Resolutions and the Tax Certificate may be subject to bankruptcy, insolvency, reorganization, arrangement, fraudulent conveyance, moratorium and other laws relating to or affecting creditors' rights, to the application of equitable principles, to the exercise of judicial discretion in appropriate cases, and to the limitations contained in State law regarding legal remedies against the State. Finally, we undertake no responsibility for the accuracy, completeness or fairness of the Official Statement or other offering material relating to the Bonds and express no opinion with respect thereto. Based on and subject to the foregoing, and in reliance thereon, as of the date hereof, we are of the following opinions:

1. The State has lawful authority for the issuance of the Bonds, and the Bonds constitute the legal, valid and binding general obligations of the State payable in accordance with the Laws from the General Fund of the State. The full faith and credit of the State of California are pledged to the punctual payment of the principal of and interest on the Bonds.

2. Interest on the Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from California personal income taxes. Interest on the Series BQ Bonds is not a specific preference item for purposes of calculating the federal individual and corporate alternative minimum taxes, although we observe that it is included in adjusted current earnings in calculating corporate alternative minimum taxable income. Interest on the Series BR Bonds is a specific preference item for purposes of calculating the federal individual or corporate alternative minimum taxes. We express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Bonds.

3. The difference, if any, between the initial offering price to the public (excluding bond houses and brokers) at which a substantial amount of any maturity of the Bonds is sold and the principal amount payable at the maturity thereof constitues "original issue discount" for purposes of federal income taxes and State of California personal income taxes. Original issue discount is treated as interest excluded from gross income for federal income tax purposes and exempt from State of California personal income taxes to the extent properly allocable to each owner thereof.

Very truly yours,

BILL LOCKYER
Attorney General

By
Deputy Attorney General

ORRICK, HERRINGTON & SUTCLIFFE LLP

Per

Schedule A

1. $8,500,000 principal amount of Veterans Bonds, Series BQ, authorized under the Veterans Bond Act of 1980.

2. $29,810,000 principal amount of Veterans Bonds, Series BR1, authorized under the Veterans Bond Act of 1986.

3. $15,230,000 principal amount of Veterans Bonds, Series BR2, authorized under the Veterans Bond Act of 1988.

4. $26,460,000 principal amount of Veterans Bonds, Series BR3, authorized under the Veterans Bond Act of 1990.

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APPENDIX F

LEGAL OPINION DELIVERED WITH RESPECT TO THE SERIES BJ BONDS

December 29, 1997

Honorable Matt Fong
Treasurer of the State of California
915 Capital Mall, Room 110
Sacramento, California 95814

State of California
$886,355,000 Veterans General Obligation Bonds

(Final Opinion)

Dear Mr. Treasurer:

We have acted as Bond Counsel in connection with the issuance by the State of California (the "State") of $886,355,000 aggregate principal amount of bonds, issued in three series, under the Bond Acts, identified in Schedule A hereto, which is incorporated by reference (collectively, the "Bonds"), each of which was approved by the electors of the State. The Bonds are authorized pursuant to the respective bond acts identified in Schedule A (collectively, the "Laws") and are issued pursuant to Part 3 of Division 4 of Title 2 of the California Government Code and to resolutions (the "Resolutions") adopted by the Veterans' Finance Committee of 1943 on November 24, 1997 and December 22, 1997.

In such connection, we have examined the record of proceedings submitted to us relative to the issuance of the Bonds, including the Resolutions, the tax certificate of the State (the "Tax Certificate"), other certifications of the State, and such other documents and matters deemed necessary by us to render the opinions set forth herein, although in doing so, we have not undertaken to verify independently the accuracy of the factual matters represented, warranted or certified therein, and we have assumed the genuineness of all signatures thereto.

The opinions expressed herein are based upon an analysis of existing laws, regulations, rulings and court decisions and cover certain matters not directly addressed by such authorities. Such opinions may be affected by actions taken or omitted or events occurring after the date hereof. We have neither undertaken to determine, or to inform any person, whether any such actions are taken or omitted or events do occur. Furthermore, we have assumed compliance with the agreements and covenants contained in the Resolutions and the Tax Certificate, including (without limitation) agreements and covenants compliance with which is necessary to assure that future actions, omissions or events will not cause interest on the Bonds to be included in gross income for federal income tax purposes. We call attention to the fact that the rights and obligations under the Bonds, the Resolutions and the Tax Certificate may be subject to bankruptcy, insolvency, reorganization, arrangement, fraudulent conveyance, moratorium and other laws relating to or affecting creditors' rights, to the application of equitable principles, to the exercise of judicial discretion in appropriate cases, and to the limitations contained in State law regarding legal remedies against the State. Finally, we undertake no responsibility for the accuracy, completeness or fairness of the Official Statement or other offering material relating to the Bonds and express no opinion with respect thereto. Based on and subject to the foregoing, and in reliance thereon, as of the date hereof, we are of the following opinions:

1. The State has lawful authority for the issuance of the Bonds, and the Bonds constitute the legal, valid and binding general obligations of the State payable in accordance with the Laws from the General Fund of the State. The full faith and credit of the State of California are pledged to the punctual payment of the principal of and interest on the Bonds.

2. Interest on the Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 and is exempt from California personal income taxes. Interest on the Series BG Bonds is not a specific preference item for purposes of calculating the federal individual and corporate alternative minimum taxes, although we observe that it is included in adjusted current earnings in calculating corporate alternative minimum taxable income. Interest on the Series BH Bonds and the Series BJ Bonds is a specific preference item for purposes of calculating the federal individual or corporate alternative minimum taxes. We express no opinion regarding any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Bonds.

3. The difference, if any, between the initial offering price to the public (excluding bond houses and brokers) at which a substantial amount of any maturity of the Bonds is sold and the principal amount payable at the maturity thereof constitutes "original issue discount" for purposes of federal income taxes and State of California personal income taxes. Original issue discount is treated as interest excluded from gross income for federal income tax purposes and exempt from State of California personal income taxes to the extent properly allocable to each owner thereof.

The Bonds are part of a single issue for federal income tax purposes with the Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, 1997 Series A, 1997 Series B, 1997 Series C and 1998 Series A (the "Revenue Bonds"). Hawkins, Delafield & Wood, bond counsel for the Revenue Bonds, has rendered an opinion that interest on the Revenue Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Code, subject to certain conditions, assumptions and restrictions as set forth therein.

In rendering the foregoing tax opinion in respect of the Bonds, we are expressly relying, with such firm's consent, on the opinion of Hawkins, Delafield & Wood, to the extent that the exclusion of interest on the Bonds from federal gross income is affected by the exclusion of interest on the Revenue Bonds from federal gross income.

Very truly yours,

ORRICK, HERRINGTON & SUTCLIFFE LLP

Per /s/ Robert P. Feyer

DANIEL E. LUNGREN
Attorney General

By /s/ Carol Hunter
Deputy Attorney General
Bond Counsel

By /s/ Shellyanne W.L. Chang
Deputy Attorney General
Tax Counsel

Schedule A

1. $2,370,000 principal amount of Veterans Bonds, Series BG1, authorized under the Veterans Bond Act of 1996;

2. $93,000,000 principal amount of Veterans Bonds, Series BG2, authorized under the Veterans Bond Act of 1986; and

3. $206,210,000 principal amount of Veterans Bonds, Series BH1, authorized under the Veterans Bond Act of 1986.

4. $149,900,000 principal amount of Veterans Bonds, Series BH2, authorized under the Veterans Bond Act of 1988.

5. $15,265,000 principal amount of Veterans Bonds, Series BH3, authorized under the Veterans Bond Act of 1990.

6. $23,980,000 principal amount of Veterans Bonds, Series BH4, authorized under the Veterans Bond Act of 1996.

7. $85,630,000 principal amount of Veterans Bonds, Series BH5, authorized under the Veterans Bond Act of 1996.

8. $69,610,000 principal amount of Veterans Bonds, Series BJ1, authorized under the Veterans Bond Act of 1988.

9. $230,390,000 principal amount of Veterans Bonds, Series BJ2, authorized under the Veterans Bond Act of 1990.

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