



AGENDA ITEM: 7
DATE OF MEETING: October 23, 2014
ACTION: X
INFORMATION: _____

STATE BOARD OF EQUALIZATION AUDIT

SUMMARY

Due to concerns with the State Board of Equalization's (BOE) expenditures of First 5 California (F5CA) funds over the 15 years since the passage of the California Children and Families Act (the Act), it has been proposed that an independent audit of BOE be authorized and funded F5CA.

BACKGROUND

Proposition 10 allows BOE to be reimbursed for the expenses incurred in its administration and collection of taxes delineated by the Act. As has been reported to the Commission, BOE's expenses charged against F5CA have consistently, and at times dramatically, increased since Proposition 10 was passed. BOE's administrative costs have increased by more than 600 percent over the last 10 years.

While BOE's expenses have significantly increased over time, F5CA's revenue has decreased by approximately 25 percent over the last 10 years.

PAST ATTEMPTS TO CLARIFY BOE EXPENDITURES

Over the years, efforts have been taken to better understand BOE's expenditures. As outlined below, although some clarity has been provided by BOE, for the most part, F5CA has been unsatisfied with the explanations.

Passage of Assembly Bill (AB) 71 and Subsequent BOE Budget Change

In 2003, BOE received broad, new authority with the passage of AB 71 to create a licensing and enforcement program to track the sale of cigarettes and tobacco products in California. To support this new level of enforcement, AB 71 imposed a one-time fee on retailers, distributors/wholesalers, and manufacturers of tobacco products.

In 2006, BOE submitted a budget request for approval to reimburse the costs of the licensing program from the General Fund and three special funds – Breast Cancer, Proposition 99, and Proposition 10. The request stated the shortfall was the result of declining revenue from the initial license fee established by AB 71. BOE made this change in the funding stream to support the AB 71 program without new legislative authorization

and created a new cost allocation methodology between the General Fund and special funds that exists to this day.

On-Going Meetings with BOE

BOE has been working with F5CA and the First 5 county commissions to shed light on BOE's expenditures over the years. Numerous cross-agency meetings have occurred and significant information has been shared. BOE has provided F5CA with documentation explaining its cost allocation methodology, which pivots on the Cigarette Tax Rate, or percentage of tax revenue received per pack of cigarettes. F5CA currently receives \$0.50 of the total \$0.87 tax per pack, equating to 57.5 percent of all cigarette and tobacco tax revenue. The costs to administer the Cigarette and Tobacco Products Tax Program and Cigarette and Tobacco Products Licensing Program are allocated to the recipient entities based on the rate described above. Historically, BOE has not charged F5CA our full share of costs to administer the programs, or 57.5 percent; F5CA was allocated 50.8 percent of the costs to administer the programs in Fiscal Year (FY) 2013–14.

The existing Proposition 10 language does not cap the amount BOE can charge F5CA to administer the programs. Based on BOE's existing cost allocation methodology, costs can increase continually, while cigarette and tobacco tax revenue steadily decreases, and be appropriate provided the percentage charged to F5CA is 57.5 percent or less.

DOF Audit

In 2012, the Department of Finance, in its independent audit report of First 5 California, noted the following: "The BOE does not have written cost allocation procedures (CAP) for program and administrative costs allocated to the various funds it administers." The report further recommended the BOE be required, per applicable Government Code and the State Administrative Manual, to maintain documentation of CAP with detailed information required for the costs being allocated, allocation methodology, frequency of allocation, and the rationale for the allocation base. In response to the observation, BOE provided a CAP to DOF in 2013 that was considered acceptable and, therefore, not mentioned in the subsequent audit.

Enforcement Revenue

F5CA staff has asked for the amount of revenue generated resulting from BOE enforcement activities to ensure the investment in this area has been fully recovered. Unfortunately, BOE cannot provide this data as they currently do not track revenue at this level of detail. Dollars resulting from compliance and enforcement activities (including the cigarette tax stamp) are recorded as a whole, and not tracked by specific function area. According to BOE, these activities protect program revenue and it can be difficult associating a dollar amount to the potential losses. However, BOE did report tax loss associated with untaxed tobacco products (excluding cigarettes) would have increased to \$369 million by 2014 from \$109 million of losses accounted for during the period of 2004 through 2009. Additionally, as of FY 2012–13, seizures of contraband cigarettes have declined by 90 percent as a result of the cigarette tax stamp.

2014 LEGISLATIVE ACTION

Due primarily to the efforts of First 5 Los Angeles and the Children and Families Commission of Orange County, the Legislature specifically addressed the BOE administrative costs during the last legislative session. At a May 21, 2014, Assembly Subcommittee Hearing, the Assembly recommended the California Department of Public Health convene a stakeholder meeting with the agencies that administer the Breast Cancer fund and Proposition 99, First 5 California, BOE, the Department of Justice, the Legislative Analyst's Office, and tobacco industry to examine BOE's administrative cost allocation and develop a funding plan for the administration of AB 71. They required a policy plan to be developed by December 1, 2014.

The Assembly also requested the following supplemental reporting from BOE to address its F5CA administrative expenditures:

- 1) By October 15, 2014, BOE shall submit to the Joint Legislative Budget Committee and to the fiscal subcommittees of the Legislature a report that provides:
 - A detailed breakdown of BOE's expenditures on the Cigarette and Tobacco Products Tax Program and on the Cigarette and Tobacco Products Licensing Program for the most recent fiscal year for which information is available. This breakdown shall include the number of hours by classification as well as a description of the activities undertaken by personnel in each classification.
 - A step-by-step explanation of the methods used to allocate costs for the Cigarette and Tobacco Products Tax Program and for the Cigarette and Tobacco Products Licensing Program among various funds, including, but not limited to, the California Children and Families First Trust Fund.
- 2) By February 1, 2015, BOE shall convene a stakeholder meeting to discuss potential approaches for future funding of the Cigarette and Tobacco Products Licensing Program, and by April 1, 2015, BOE shall submit a report describing at least three alternative approaches for future funding of the Cigarette and Tobacco Products Licensing Program. At least one of these alternatives shall provide for increasing the share of costs covered by licensing fees and another shall include increasing the share of costs covered by the General Fund.

REQUEST FOR AUDIT AND FUNDING

In light of BOE's inability to adequately justify how it uses F5CA funds, an independent audit of BOE is being requested. The audit should address F5CA's general concerns regarding BOE's expenditures, as well as specifically address BOE's justification of its enforcement costs in relation to its return on investment, and how F5CA is specifically benefited.

The funds allocated for the independent audit will come from the Administration Account, Fund 0638, and shall not exceed \$100,000.