

**STATE OF CALIFORNIA
CALIFORNIA STATE AUDITOR'S OFFICE
621 CAPITOL MALL, SUITE 1200
SACRAMENTO, CA 95814**

**TITLE 2, DIVISION 10, CALIFORNIA CODE OF REGULATIONS
ADOPT SECTIONS 61200 TO 61240, INCLUSIVE, REGARDING THE
CALIFORNIA HEALTHCARE, RESEARCH AND PREVENTION TOBACCO TAX
ACT OF 2016**

FINAL STATEMENT OF REASONS

**UPDATE OF INITIAL STATEMENT OF REASONS AND SUMMARY AND
RESPONSE TO COMMENTS RECEIVED DURING RULEMAKING – GOVERNMENT
CODE SECTION 11346.9**

Proposed Section¹ 61200

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed section 61200 declares the intention of the proposed regulations in California Code of Regulations, title 2, division 10, chapter 4 as being to interpret the provisions of Revenue and Taxation Code sections 30130.56 and 30130.57, requiring the California State Auditor (“State Auditor” or “office”) to conduct at least biennially an independent financial audit of the state and local agencies receiving funds pursuant to the Act and to promulgate the regulations required by Revenue and Taxation Code section 30130.57 defining administrative costs for purposes of the California Healthcare, Research and Prevention Tobacco Tax Act of 2016 (“Act”). This proposed regulation is necessary to inform the Legislature, state and local government agencies, and the general public of the purpose of the proposed regulations, and furthers the purposes of Revenue and Taxation Code sections 30130.56 and 30130.57.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the first 15-day public comment period.

¹ Unless otherwise indicated, (such as by an express reference to the California Revenue and Taxation Code) any use of the term “section” in this statement is a reference to a section or proposed section of the California Code of Regulations.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the third 15-day public comment period.

Proposed Section 61201

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed section 61201 defines a variety of terms, each of which is described in more detail below. This proposed regulation is necessary to establish terms and give each term a particular meaning so as to provide clarity and allow for easy reference to a state agency or local agency subject to the proposed regulations. Further, establishing definitions helps to avoid ambiguity in the proposed regulations.

Comments Received During the 45-Day, the First 15-Day, the Second 15-Day, and the Third 15-Day Public Comment Periods

The State Auditor received comments during all four of the public comment periods regarding specific subdivisions of this proposed regulation. Because the comments pertained to specific subdivisions of this proposed regulation, we are summarizing and responding to each comment within the discussion regarding each applicable subdivision.

Proposed Section 61201, subdivision (a)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (a) defines the term “Act” to mean that portion of Proposition 56 adopted by the voters on November 8, 2016 at the statewide general election that was added as Article 2.5 (commencing with section 30130.50) of Chapter 2 of Part 13 of Division 2 of the Revenue and Taxation Code (“Proposition 56”) and is consistent with the terms of Proposition 56. By establishing this term and giving it a particular meaning, the proposed subdivision allows easy reference to a state agency or local agency receiving revenues pursuant to the Act and helps to avoid ambiguity in the proposed regulations.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (a) during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (a) during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (a) during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (a) during the third 15-day public comment period.

Proposed Section 61201, subdivision (b)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (b) defines the term “administrative cost” as used in the proposed regulations. By establishing this term and giving it a particular meaning, the proposed subdivision allows easy reference to a state agency or local agency receiving revenues pursuant to the Act and helps to avoid ambiguity in the proposed regulations. In the way the term is defined by the proposed regulation, the proposed regulation makes clear that what constitutes an administrative cost with respect to the Act for each state or local agency will be based on particular criteria set forth with respect to that particular agency. It also makes clear that the definition of administrative costs is only applicable to funds received by any state agency or local agency pursuant to Revenue and Taxation Code sections 30130.55, 30130.56, or 30130.57.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (b) during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (b) during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (b) during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (b) during the third 15-day public comment period.

Proposed Section 61201, subdivision (c)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (c) defines the term “applicable funds” as moneys received by any state agency or local agency pursuant to Revenue and Taxation Code sections 30130.55, 30130.56, or 30130.57. This is necessary as, in accordance with Revenue and Taxation Code section 30130.54, a portion of the revenues generated by Proposition 56 will be used to backfill the Cigarette and Tobacco Products Surtax Fund created by Revenue and Taxation Code section 30122 [Proposition 99 as approved by the voters at the November 8, 1988 statewide general election (“Proposition 99”)], the Breast Cancer Fund created by Revenue and Taxation Code section 30461.16, the California Children and Families Trust Fund created by Revenue and Taxation Code section 30131 [Proposition 10 as approved by the voters at the November 3, 1998 statewide general election (“Proposition 10”)], and the revenues derived from Revenue and Taxation Code section 30101, to address revenue declines that result from the additional tax authorized by Proposition 56. Each of the backfilled programs set forth in Revenue and Taxation Code section 30130.54 was established prior to the approval of Proposition 56 and each state or local agency participating in a backfilled program has a pre-established method for charging administrative costs with respect to those backfilled programs. Limiting the scope of these regulations to the funds received by any state agency or local agency pursuant to Revenue and Taxation Code sections 30130.55, 30130.56, or 30130.57 eliminates the ambiguity of the possible impact of these proposed regulations on the backfilled programs.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (c) during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (c) during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (c) during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (c) during the third 15-day public comment period.

Proposed Section 61201, subdivision (d)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (d) defines the term “audit” and interprets and makes specific the provisions of Revenue and Taxation Code section 30130.56, subdivisions (a) and (b) and Revenue and Taxation Code section 30130.57, subdivision (b), requiring the State Auditor to conduct at least biennially an independent financial audit of the state and local agencies receiving funds pursuant to the Act; review (at a minimum) the administrative costs expended by the state agencies that receive revenues generated by the Act; provide public transparency with respect to revenues generated by the Act; ensure that revenues generated by the Act are used for healthcare, tobacco use prevention, and research; and make recommendations for improvements. Government Code section 8546.1 requires the State Auditor to conduct financial and performance audits as directed by statute and to complete any audit pursuant to the “Government Auditing Standards” published by the Comptroller General of the United States (“Audit Standards”). Under Audit Standards, a financial audit provides an independent assessment of whether an entity’s reported financial information is presented fairly in accordance with recognized criteria. Under Audit Standards, a performance audit provides objective analysis to assist management and those charged with governance and oversight by using audit recommendations to improve program performance and operations, initiate corrective action, and contribute to public accountability. While Revenue and Taxation Code section 30130.56, subdivision (a) uses the term financial audit, the reviews, purposes, and recommendations required suggest that the State Auditor conduct a performance audit. Therefore it is necessary to clarify the type of audits that the State Auditor shall conduct as required by the Act. The way the term is defined by the proposed regulation, it makes it clear that an audit conducted by the State Auditor pursuant to Revenue and Taxation Code section 30130.56, subdivisions (a) and (b) and Revenue and Taxation Code section 30130.57 may consist of elements of a financial audit, a performance audit, or both.

Comments Received During the 45-Day Public Comment Period

A group of nonprofit organizations (hereinafter referred to as the “Nonprofits”)² and the Tobacco Education & Research Oversight Committee (“TEROC”) objected to this proposed subdivision (d) on the grounds that it improperly included performance audit work as a valid audit activity. The Nonprofits opined that TEROc has both oversight and performance audit authority over tobacco programs, that TEROc has statutory authority to make recommendations regarding program effectiveness and to provide advice on how to improve based on scientific evidence, and that if the State Auditor were to conduct performance audits over the use of these funds, such audit work would be duplicative and counterproductive to TEROc’s role. TEROc made similar comments regarding its oversight authority and the duplicative nature of the State Auditor’s audit

² The group of nonprofit organizations consists of the American Cancer Society Cancer Action Network, the American Heart Association, the American Stroke Association, and the American Lung Association in California all of whom submitted joint comments throughout the rulemaking process.

work, though it did not go so far as to suggest that it conducts performance audits. Further, the Nonprofits and TEROC asserted that the State Auditor's inclusion of performance audit work as a valid audit activity was both contrary to the Act's plain language and to the intent of the Act's authors. TEROC further opined that the State Auditor's inclusion of performance audit work as a valid audit activity was contrary to the intent of the voters. Finally, both the Nonprofits and TEROC asserted that the State Auditor should limit its work to financial audit activities in order to most effectively and efficiently utilize the State Auditor's limited \$400,000 annual reimbursement cap for actual audit costs. We declined to modify this proposed subdivision (d) to address these comments for the following reasons:

First, we acknowledge that TEROC was created for the purpose of advising the California Department of Public Health ("Public Health"), the California Department of Education ("Education"), and the University of California ("University") with respect to the tobacco use prevention programs set forth in Health and Safety Code sections 104350 – 104495. However, this advisory oversight role is limited to a relatively small portion of the funds passing under the Act. Specifically, TEROC's authority is limited to the funds passing to these entities as a result of Revenue and Taxation Code section 30130.55 (b)(1), (b)(2), and (c), which equates to only 18% of the Act's funds that remain *after* (1) specific amounts are allocated to various state agencies for other purposes (amounts which total to more than \$118,400,000.00) and (2) certain Proposition 10 and Proposition 99 backfills are made pursuant to Revenue and Taxation Code section 30130.54. Thus, TEROC does not conduct any form of advisory oversight activity for a vast majority of the funds passing under the Act, nor does it conduct advisory oversight activities of all the funds Public Health or the University receive under the Act. Therefore, it is necessary that the State Auditor have the authority to conduct the necessary and appropriate audit activities in order to ensure that the revenues generated by the Act are used appropriately as required by the voters. In completing its work, the State Auditor, in accordance with Audit Standards, may need to engage in audit activities that consist of elements of a financial audit, a performance audit, or both.

Second, the Nonprofits' assertion that TEROC conducts performance audits is erroneous. TEROC does not have statutory authority to conduct audits. While TEROC's activities include evaluating the tobacco use prevention programs set forth in Health and Safety Code sections 104350 – 104495; making recommendations regarding the most appropriate criteria for the selection of, standards of the operation of, and the types of such programs to be funded; and submitting a master plan regarding such programs to the Legislature biennially – these activities do not constitute audit work. Moreover, unlike the State Auditor, TEROC is not required to conduct its work in conformity with Audit Standards and, therefore, does not follow the auditing rigors required by Auditing Standards. Further, unlike the State Auditor, TEROC does not have an independent, unfettered right of access to the books, accounts, files, or other records pertaining to the programs it oversees. Rather TEROC's statutory authority states that, in order to evaluate tobacco education, research, and cessation programs, TEROC must depend upon the cooperation and assistance of various state and local agencies in order to fulfill its mandate. This dependence on the cooperation

of the reviewed agency is contrary to Auditing Standards nor does it provide the assurances that the voters were likely seeking. In contrast, the State Auditor has the statutory authority and responsibility of conducting audits under both state law and the Act, is required to follow Auditing Standards when conducting its work, has an unfettered right of access, and has the requisite independence needed to properly conduct audit work. Thus, the State Auditor is the appropriate entity to conduct the necessary and appropriate audit activities as required by the Act and the voters.

None of the foregoing two paragraphs is intended to negate the importance of TEROC's role with respect to the tobacco use prevention programs set forth in Health and Safety Code sections 104350 – 104495. It is simply to clarify that its work as an advisory oversight committee is materially distinct from the audit work to be performed by the State Auditor, as the voters enacted.

Third, we do not agree that if the State Auditor were to conduct performance audit activities, such activities would be duplicative of the work undertaken by TEROC. For the reasons described above, the audit work performed by the State Auditor is materially distinct from TEROC's advisory oversight activities. Even if one were to assume that the respective responsibilities were materially similar, Auditing Standards addresses this issue. For example, when planning an audit, Auditing Standards require that the State Auditor ask management of the audited entity to identify previous audits, attestation engagements, or other studies that directly related to the objectives of the audit. Auditing Standards also require that the State Auditor use this information in assessing risk and determining the nature, timing, and extent of current audit work, including the testing of the implementation of recommendations made by others. Thus, in accordance with Auditing Standards, the State Auditor would be cognizant of TEROC's work when developing an appropriate audit plan and would not duplicate it in the absence of justified reasons.

Fourth, we do not agree that the plain language of the Act requires the State Auditor to conduct only financial audits of the funds passing to state and local agencies pursuant to the Act. Under the rules of statutory construction, “[t]he meaning of a statute may not be determined from a single word or sentence; the words must be construed in context, and provisions relating to the same subject matter must be harmonized to the extent possible. [Citation.] Literal construction should not prevail if it is contrary to the...intent apparent in the statute.” (*People v. King* (1993) 5 Cal.4th 59, 69). As noted above in the Initial Statement of Reasons, Revenue and Taxation Code section 30130.57, subdivision (b), requires the State Auditor to (1) conduct at least biennially an independent financial audit of the state and local agencies receiving funds pursuant to the Act; (2) review (at a minimum) the administrative costs expended by the state agencies that receive revenues generated by the Act; (3) provide public transparency with respect to revenues generated by the Act; (4) ensure that revenues generated by the Act are used for healthcare, tobacco use prevention, and research; and (5) make recommendations for improvements. While Revenue and Taxation Code section 30130.56, subdivision (a) uses the term financial audit, the reviews, purposes, and recommendations required suggest that the State Auditor conduct a performance audit. Therefore, in order to harmonize all of the applicable language and to give meaning to all

the requirements of the Act, it is necessary to clarify that an audit conducted by the State Auditor pursuant to Revenue and Taxation Code section 30130.56, subdivisions (a) and (b) and Revenue and Taxation Code section 30130.57 may contain elements of a financial audit, a performance audit, or both.

Fifth, we do not agree that the State Auditor's inclusion of performance audit work as a valid audit activity was contrary to the intent of the voters. Further, we do not agree that the authors' intent is determinative. Case law makes clear that initiative measures should be interpreted as to give effect to the intent of the electorate and that it is appropriate to consider indicia of the voter's intent including the analysis and arguments contained in the official ballot pamphlet (*Legislature v. Eu* (1991) 54 Cal.3d 492, 505; *Hill v. National Collegiate Athletic Assn.* (1994) 7 Cal.4th 1, 16). Thus, it is the voters' intent that is relevant – not the authors' intent. As indicated above, the reviews, purposes, and recommendations required by the Act suggest that the State Auditor conduct a performance audit. Further, the analysis of the initiative measure by the Legislative Analyst states that “the State Auditor would conduct *audits* of agencies receiving funds from the new taxes at least every other year. The Auditor, who provides independent assessments of the California government's financial *and operational activities*, would receive up to \$400,000 annually to cover costs incurred from conducting these *audits*.” (Proposition 56, Analysis, p. 50, *emphasis added*). The analysis, like the language of the measure itself, references both financial and performance audit work – again supporting the conclusion that the voters intended the State Auditor conduct audits that may include more than just financial audit activities, but also performance audit activities.

Sixth, we decline both the Nonprofits' and TEROC's comments that the State Auditor should limit its work to financial audit activities in order to most effectively and efficiently utilize the State Auditor's limited \$400,000 annual reimbursement cap for actual audit costs. We decline this suggestion as we have the experience, knowledge, and skill to plan our audits appropriately and in accordance with Auditing Standards. We have every expectation that we can complete all of our audit responsibilities within the \$400,000 maximum annual budget allocated for this purpose.

Separately, TEROC asserted that proposed subdivision (b)(5) (which pertains to auditing the performance of a contract) should be eliminated. We cannot accept this comment as to do so would limit our statutory authority to audit the performance of a contract under Government Code section 8546.7. Our authority to audit the performance of a contract exists whenever the State Auditor conducts an audit, irrespective of whether the audit is a financial audit or performance audit.

On a separate note, the University requested that the proposed definition of “audit” be modified to limit any audit we conduct pursuant to the Act to only the information available from the state and local agencies receiving the Act's funds. The purposes of this request was to ensure that any such audit would be limited to information collected and maintained by the administering agency and not the grantee organization. We cannot accept this comment as it conflicts with our statutory rights of access as set forth in Government Code sections 8545.2 and 8546.7.

Comments Received During the First 15-Day Public Comment Period

TEROC submitted the same letter during the first 15-day public comment period that it submitted to our office during the 45-day public comment period, effectively making the exact same comments. We declined to accept TEROC's comments as resubmitted during the first 15-day public comment period for the same reasons articulated above.

The Nonprofits again commented that this proposed subdivision (d) improperly included performance audit work as a valid audit activity. The Nonprofits again noted that TEROC has oversight authority and the requisite experience to conduct performance audit work, that performance audit work would be contrary to the plain language of the Act, and that the Nonprofits hoped that we would not duplicate TEROC's efforts. Since these comments are materially similar to comments the Nonprofits made above, we declined to accept the Nonprofit's comments for the same reasons articulated above. Last, the Nonprofits opined that the definition of financial and performance audit activities as provided for in this proposed subdivision (d) did not match the description of financial and performance audits as set forth on our website. We declined to modify this proposed regulation subdivision on this basis as the description of these activities on our website is not applicable to this regulatory rulemaking.

Comments Received During the Second 15-Day Public Comment Period

TEROC again commented to this proposed regulation subdivision citing the same reasons as it provided during the 45-day public comment period and the first 15-day public comment period. We declined to accept TEROC's comments for the same reasons articulated above. TEROC also commented that if the State Auditor conducts an audit that includes performance audit activities, such audit work would be a usurpation of TEROC's mandate. We declined to accept this comment because as explained above, the mandates, rights of access, and scope of authority of TEROC and the State Auditor are different and each entity operates independently of the other. Therefore, the requested change is unnecessary.

Public Health commented on this proposed subdivision (d) stating that it improperly included performance audit work as a valid audit activity, asserting that TEROC has oversight authority over Public Health's tobacco control programs; that performance audit work would be contrary to the plain language of the Act and the intent of the authors and voters; that the State Auditor should limit its work to financial audit activities in order to most effectively and efficiently utilize the State Auditor's limited \$400,000 annual reimbursement cap for actual audit costs; and that the State Auditor should eliminate not only reference to performance audit activities but also eliminate reference to auditing the performance of a contract. We declined to accept these comments for the reasons stated above.

The California Department of Health Care Services (“Health Care Services”) commented that this proposed subdivision (d) is ambiguous regarding which activities will be subject to audit. Health Care Services noted that this proposed subdivision (d) did not specify the activities of those agencies to be examined or the scope of compliance to be evaluated and that the language, as drafted, implied that audits may be conducted for any activities undertaken by agencies receiving funds under the Act or for compliance with programmatic requirements unrelated to the Act. Health Care Services proposed adding certain language to this subdivision to clarify that an audit would pertain to the expenditure of funds from the Act and ensuring compliance with Revenue and Taxation Code sections 30130.55 and 30130.57.

We substantially accepted this comment. While we did not use the language proposed by Health Care Services, we revised this proposed subdivision (d) to clarify the scope of an audit that our office would conduct pursuant to the Act. Specifically, we directly incorporated the Act’s language regarding the purposes of such audits into proposed subdivision (d). In making these revisions, we clarified the scope of the audits to be conducted by the State Auditor pursuant to the Act.

Comments Received During the Third 15-Day Public Comment Period

The Nonprofits indicated their approval of the revisions we made to this proposed subdivision (d) but still requested that we remove reference to performance audits in the proposed regulation subdivision. For the reasons stated above, we declined to accept this comment.

Education objected to this revised proposed subdivision (d) on the grounds that it improperly included performance audit work as a valid audit activity by asserting that TEROC has oversight authority over its tobacco control programs; that performance audit work would be contrary to the plain language of the Act; and that the State Auditor should eliminate not only reference to performance audit activities but also eliminate reference to auditing the performance of a contract. We declined to accept these comments for the reasons articulated above.

Education also requested that we eliminate subdivision (d)(3) regarding compliance audit activities because it believes that compliance audit activities constitutes performance audit activities. We declined to accept this comment because under Auditing Standards, both financial and performance audits have compliance audit activities.

Proposed Section 61201, subdivision (e)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (e) defines the term “capital outlay” as used in the proposed regulations. This term defines a category of expenditures included as part of the criteria for determining what constitutes an administrative cost for a number of state agencies receiving applicable funds under the Act. The definition is based on the definition provided by the

Department of Finance in its *Finance Glossary of Accounting and Budgeting Terms*, which reflects how this term is used in the Governor’s Budget, the Governor’s Budget Summary, and the annual Budget. By establishing this term and giving it a particular meaning, the proposed regulation provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (e) during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (e) during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (e) during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (e) during the third 15-day public comment period.

Proposed Section 61201, subdivision (f)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (f) defines the term “department central services costs” as used in the proposed regulations. This term defines a category of expenditures included as part of the criteria for determining what constitutes an administrative cost for a number of state agencies receiving applicable funds under the Act. The definition is based on a definition provided by the *State Administrative Manual*. By establishing this term and giving it a particular meaning, the proposed regulation provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (f) during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (f) during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (f) during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (f) during the third 15-day public comment period.

Proposed Section 61201, subdivision (g)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (g) defines the term “department direct costs” as used in the proposed regulations. This term defines a category of expenditures included as part of the criteria for determining what constitutes an administrative cost for a number of state agencies receiving applicable funds under the Act. The definition is based on a definition provided by the *State Administrative Manual*. By establishing this term and giving it a particular meaning, the proposed regulation provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (g) during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (g) during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (g) during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (g) during the third 15-day public comment period.

Proposed Section 61201, subdivision (h)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (h) defines the term “department indirect costs” as used in the proposed regulations. This term defines a category of expenditures included as part of the criteria for determining what constitutes an administrative cost for a number of state agencies receiving applicable funds under the Act. The definition is based on a definition provided by the *State Administrative Manual*. By establishing this term and giving it a particular meaning, the proposed regulation provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (h) during the 45-day public comment period. We made a non-substantial change to subdivision (h) of the proposed regulation to correct a typographical error.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (h) during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (h) during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (h) during the third 15-day public comment period.

Proposed Section 61201, subdivision (i)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (i) defines the term “financial audit” as used in the proposed regulations. While Revenue and Taxation Code section 30130.56, subdivision (a) uses the term “financial audit”, the reviews, purposes, and recommendations required by Revenue and Taxation Code section 30130.56, subdivisions (a) and (b) and Revenue and Taxation Code section 30130.57, subdivision (b) suggest that the State Auditor conduct a performance audit. Therefore it is necessary to clarify the types of audits that the State Auditor shall conduct as required by the Act. The way the term is defined by the proposed regulation, in conjunction with the way the term “audit” is defined above, makes it clear that an audit conducted by the State Auditor pursuant to Revenue and Taxation Code section 30130.56, subdivisions (a) and (b) and Revenue and Taxation

Code section 30130.57 may consist of elements of a financial audit, a performance audit, or both. By establishing this term and giving it a particular meaning, the proposed regulation allows easy reference to a state agency or local agency and helps avoid ambiguity in the proposed regulations.

Comments Received During the 45-Day Public Comment Period

TEROC referenced this proposed subdivision (i) in its comments to proposed subdivision (d) as described above. However, TEROC did not request any change to this proposed subdivision (i) nor did it direct any specific comment to this proposed subdivision (i). Thus, we described and addressed all of TEROC's comments in the section pertaining to proposed subdivision (d) above.

Comments Received During the First 15-Day Public Comment Period

TEROC referenced this proposed subdivision (i) in its comments to proposed subdivision (d) as described above. However, TEROC did not request any change to this proposed subdivision (i) nor did it direct any specific comment to this proposed subdivision (i). Thus, we described and addressed all of TEROC's comments in the section pertaining to proposed subdivision (d) above.

Comments Received During the Second 15-Day Public Comment Period

TEROC referenced this proposed subdivision (i) in its comments to proposed subdivision (d) as described above. However, TEROC did not request any change to this proposed subdivision (i) nor did it direct any specific comment to this proposed subdivision (i). Thus, we described and addressed all of TEROC's comments in the section pertaining to proposed subdivision (d) above.

Public Health requested that the definition of financial audit as set forth in this subdivision (i) not be expanded to include performance audit activities for the same reasons it objected to proposed subdivision (d) as described above. We declined to accept this comment for the reasons described above in proposed subdivision (d).

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (i) during the third 15-day public comment period.

Proposed Section 61201, subdivision (j)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (j) defines the term "Fund" as used in the proposed regulations. By establishing this term and giving it a particular meaning, the proposed regulation provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (j) during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (j) during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (j) during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (j) during the third 15-day public comment period.

Proposed Section 61201, subdivision (k)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (k) defines the phrase “local agency” as used in the proposed regulations. It limits the term “local agency” to local public entities and makes clear that the definition of local agency does not include any privately created entities. As a result, insofar as the proposed regulations pertain to local agencies, they are applicable only to local government agencies and are not applicable to privately created entities. This proposed regulation also maintains consistency as to how this term is defined for purposes of all of the State Auditor’s regulations, including regulations pertaining to the High Risk Local Government Agency Audit Program. By establishing this term and giving it a particular meaning, the proposed regulation allows easy reference to a state agency or local agency and helps avoid ambiguity in the proposed regulations.

Comments Received During the 45-Day Public Comment Period

Public Health requested that the definition of “local agency” as set forth in this proposed subdivision (k) be revised to explicitly exclude community-based organizations, not for profit universities, tribes, tribal governments, and tribal government organizations from the definition. We declined to adopt this comment as it is unnecessary. As drafted, proposed subdivision (k) maintains consistency as to how this term is defined for purposes all of the State Auditor’s regulations by referencing section 61106, which clearly describes what constitutes a local agency. Further, other state agencies receiving funds pursuant to the Act may be authorized to distribute applicable funds to private entities other than community-based organizations, not for profit universities, tribes, tribal governments, and tribal government organizations. Thus, including

reference to only these types of entities, while not identifying all potential recipients of applicable funds, might create confusion.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (k) during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (k) during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (k) during the third 15-day public comment period.

Proposed Section 61201, subdivision (l)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (l) defines the phrase “local assistance” as used in the proposed regulations. This term defines a category of expenditures included as part of the criteria for determining what constitutes an administrative cost for a number of state agencies receiving applicable funds under the Act. The definition is based on the definition provided by the Department of Finance in its *Finance Glossary of Accounting and Budgeting Terms*, which reflects how this term is used in the Governor’s Budget, the Governor’s Budget Summary, and the annual Budget. By establishing this term and giving it a particular meaning, the proposed regulation provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (l) during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (l) during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (l) during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (l) during the third 15-day public comment period.

Proposed Section 61201, subdivision (m)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (m) defines the term “state agency” as used in the proposed regulations. This proposed regulation maintains consistency as to how this term is defined for purposes of all of the State Auditor’s regulations, including regulations pertaining to the State High-Risk Government Agency Audit Program. By establishing this term and giving it a particular meaning, the proposed regulation allows easy reference to a state agency or local agency and helps avoid ambiguity in the proposed regulations.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (m) during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (m) during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (m) during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (m) during the third 15-day public comment period.

Proposed Section 61201, subdivision (n)

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61201, subdivision (n) defines the term “state operations” as used in the proposed regulations. This term defines a category of expenditures included as part of the criteria for determining what constitutes an administrative cost for a number of state agencies receiving applicable funds under the Act. The definition is based on the definition provided by the Department of Finance in its *Finance Glossary of Accounting and Budgeting Terms*, which reflects how this term is used in the Governor’s Budget, the Governor’s Budget Summary, and the annual Budget. By establishing this term and giving it a particular meaning, the proposed regulation

provides clarity, allows easy reference to a state agency or local agency, and helps avoid ambiguity in the proposed regulations.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (n) during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (n) during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (n) during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed subdivision (n) during the third 15-day public comment period.

[Sections 61202 to 61209, inclusive, are reserved.]

Proposed Section 61210

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61210 identifies which of Education’s expenditures constitutes an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

Revenue and Taxation Code section 30130.55, subdivision (b)(2) directs Education to use any funds it receives pursuant to the Act for school programs to prevent and reduce the use of tobacco and nicotine products by young people. According to the Governor’s Proposed Budget for fiscal year 2017-2018, 95 percent of the funds Education receives pursuant to the Act are classified as local assistance and the remaining five percent are classified as state operations. According to Education, the funds classified as local assistance represent program costs to be spent entirely on the program’s competitive grants and the funds classified as state operations represents Education’s administrative costs. According to the *State Administrative Manual*, unless statutory

language specifically allows otherwise, once classified as either a state operation, local assistance, or capital outlay expenditure, a program or activity must follow that classification's expenditure rules. While the Governor's Proposed Budget for fiscal year 2017-2018 does not contain a line item for capital outlay with respect to the funds Education receives pursuant to the Act, the proposed regulation provides for this potentiality. This proposed regulation defines what expenditures constitute an administrative cost for Education with respect to funds it receives pursuant to the Act by taking Education's unique circumstances into account.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the third 15-day public comment period.

Proposed Section 61211

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61211 identifies which of Health Care Services' expenditures constitutes an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

Revenue and Taxation Code section 30130.55, subdivision (a) directs Health Care Services to use any funds it receives pursuant to the Act to increase funding for certain existing healthcare programs and services. According to the Governor's Proposed Budget for fiscal year 2017-2018, 100 percent of the funds Health Care Services will receive pursuant to the Act is classified as local assistance and will be used to provide medical care benefits and services. According to the *State*

Administrative Manual, unless statutory language specifically allows otherwise, once classified as either a state operation, local assistance, or capital outlay expenditure, a program or activity must follow that classification's expenditure rules. Since local assistance funds will be spent entirely for the support of local government or other locally administered activities, they do not constitute administrative costs for Health Care Services. While the Governor's Proposed Budget for fiscal year 2017-2018 does not contain a line item for state operations or capital outlay with respect to the funds Health Care Services receives pursuant to the Act, the proposed regulation provides for this potentiality and characterizes any such expenditures to be administrative costs as such costs would be administrative in nature. This proposed regulation defines what expenditures constitute administrative costs for Health Care Services with respect to funds it receives pursuant to the Act by taking Health Care Services' unique circumstances into account.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the third 15-day public comment period.

Proposed Section 61212

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61212 identifies which of the California Department of Justice's ("Justice") expenditures constitutes an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

Revenue and Taxation Code section 30130.57, subdivision (e)(1) directs Justice to distribute any funds it receives pursuant this subdivision to local law enforcement agencies to support and hire front-line law enforcement peace officers for programs, including, but not limited to, enforcement of state and local laws related to the illegal sales and marketing of tobacco to minors, and increasing investigative activities and compliance checks to reduce illegal sales of cigarettes and tobacco products to minors and youth. According to the Governor's Proposed Budget for fiscal year 2017-2018, 100 percent of the funds Justice will receive pursuant to this subdivision are classified as local assistance. According to the *State Administrative Manual*, unless statutory language specifically allows otherwise, once classified as either a state operation, local assistance, or capital outlay expenditure, a program or activity must follow that classification's expenditure rules. Since local assistance funds will be spent entirely for the support of local government or other locally administered activities, the funds Justice receives pursuant this subdivision do not constitute administrative costs for Justice. Further, since the funds Justice receives pursuant this subdivision are required to be distributed to local law enforcement agencies, none of these funds may be used for state operations or capital outlay.

However, Revenue and Taxation Code section 30130.57, subdivision (e)(4) directs Justice to directly use the funds it receives pursuant to this subdivision for certain activities the California Attorney General conducts, including but not limited to, enforcing laws that regulate the distribution and sale of cigarettes and other tobacco products. According to the Governor's Proposed Budget for fiscal year 2017-2018, 100 percent of these funds are classified as state operations and are not set aside for local assistance. In this context Justice is directly engaging in program activities. Generally, when an agency directly engages in program activities, some of its expenditures will be specific to the program and some of its expenditures will not be specific to the program. Costs that solely benefit the specific program are department direct costs and costs that do not solely benefit the specific program include both department indirect costs and department central services costs. Because department indirect costs and department central services costs are not specific to the program, they constitute administrative costs. This proposed regulation defines what expenditures constitute an administrative cost for Justice with respect to funds it receives pursuant to the Act by taking Justice's unique circumstances into account.

Comments Received During the 45-Day Public Comment Period

Justice requested that we revise this proposed regulation to account for the fact that it will need a portion of the funds it will receive pursuant to Revenue and Taxation Code section 30130.57, subdivision (e)(1) to conduct activities to support, administer, and oversee the local assistance grant program contemplated by Revenue and Taxation Code section 30130.57, subdivision (e)(1). Justice stated that while the Governor's 2017-2018 Budget allocated 100% of the Revenue and Taxation Code section 30130.57, subdivision (e)(1) funds solely to local assistance, the allocation of the entirety of this amount to local assistance was an error. Justice stated that the Department of Finance has indicated that it intends to correct this error in future budgets by including a separate

state operations line item for administrative costs associated with Revenue and Taxation Code section 30130.57, subdivision (e)(1). Justice concluded its request by asking that any such revision be amended such that the definitions of administrative costs would be consistent between Revenue and Taxation Code section 30130.57, subdivision (e)(1) and Revenue and Taxation Code section 30130.57, subdivision (e)(4).

We partially accepted this comment. We revised the proposed regulation to define any state operation or capital outlay expenditure that Justice incurs with respect to any funds transferred to Justice pursuant to Revenue and Taxation Code section 30130.57, subdivision (e)(1) as an administrative cost. We also revised the proposed regulation to maintain consistency between the treatment of local assistance expenditures that are funded by either Revenue and Taxation Code section 30130.57, subdivision (e)(1) or Revenue and Taxation Code section 30130.57, subdivision (e)(4).

However, we did not agree that the definition of administrative costs for funds Justice receives pursuant to Revenue and Taxation Code section 30130.57, subdivision (e)(1) should be fully consistent with how administrative costs are defined for funds Justice receives pursuant to Revenue and Taxation Code section 30130.57, subdivision (e)(4). As explained above, Justice will be directly engaging in program activities with respect to the funds it receives pursuant to Revenue and Taxation Code section 30130.57, subdivision (e)(4). In contrast, the funds Justice receives pursuant to Revenue and Taxation Code section 30130.57, subdivision (e)(1) are to be distributed to local law enforcement agencies. In this context, Justice is administering a program rather than engaging in direct programmatic responsibilities. Therefore, all state operation or capital outlay expenditures (irrespective of whether they constitute a department direct cost or a department indirect cost) pertaining to any funds transferred to Justice pursuant to Revenue and Taxation Code section 30130.57, subdivision (e)(1) constitute administrative costs.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the third 15-day public comment period.

Proposed Section 61213

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61213 identifies which of Public Health's expenditures constitutes an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

Revenue and Taxation Code section 30130.55, subdivision (b)(1) and Revenue and Taxation Code section 30130.57, subdivision (d) direct Public Health to use any funds it receives pursuant to these subdivisions in part for local assistance. According to the Governor's Proposed Budget for fiscal year 2017-2018, 95 percent of the funds Public Health receives pursuant to these subdivisions is classified as local assistance and the remaining five percent is classified as state operations. According to the *State Administrative Manual*, unless statutory language specifically allows otherwise, once classified as either a state operation, local assistance, or capital outlay expenditure, a program or activity must follow that classification's expenditure rules. Since local assistance funds will be spent entirely for the support of local government or other locally administered activities, they do not constitute administrative costs for Public Health. Funds Public Health receives pursuant to these subdivisions that are classified as state operations constitute administrative costs. While the Governor's Proposed Budget for fiscal year 2017-2018 does not contain a line item for capital outlay with respect to the funds Education receives pursuant to the Act, the proposed regulation provides for this potentiality.

Revenue and Taxation Code section 30130.55, subdivision (e)(3) directs Public Health to both provide local assistance and to engage in program administration. According to the Governor's Proposed Budget for fiscal year 2017-2018, 62 percent of these funds are classified as local assistance and 38 percent are classified as state operations. According to the *State Administrative Manual*, expenditures for the support of state government include both department direct costs, department indirect costs, and department central service costs. Since local assistance funds will be spent entirely for the support of local government or other locally administered activities, they do not constitute administrative costs for Public Health. However, with respect to the remaining 38 percent that is appropriated as state operations, Public Health is directly engaging in program activities. Generally, when an agency directly engages in program activities, some of its expenditures will be specific to the program and some of its expenditures will not be specific to the program. Costs that solely benefit the specific program are department direct costs and costs that do not solely benefit the specific program include both department indirect costs and department central services costs. Because department indirect costs and department central

services costs are not specific to the program, they constitute administrative costs. This proposed regulation clarifies that with respect to any funds Public Health receives pursuant this subdivision that are classified as state operations costs and that constitute a department indirect cost or department central service cost are administrative costs.

Comments Received During the 45-Day Public Comment Period

Public Health and the Nonprofits requested we revise this proposed regulation to account for the fact that programs funded under Revenue and Taxation Code section 30130.55, subdivision (b)(1) and Revenue and Taxation Code section 30130.57, subdivision (d) include state operations costs that are direct costs. These direct state operations costs are analogous to the direct state operations costs of programs funded under Revenue and Taxation Code section 30130.57, subdivision (e)(3) which are excluded from the definition of administrative cost in the proposed regulations. As such, the proposed regulation should exclude these direct costs from the definition of administrative costs.

Public Health also commented that while the Governor's Proposed Budget for fiscal year 2017 - 2018 designated 95 percent of the funds Public Health receives pursuant to Revenue and Taxation Code section 30130.55, subdivision (b)(1) and Revenue and Taxation Code section 30130.57, subdivision (d) to local assistance, this was subsequently corrected in the approved budget for fiscal year 2017-2018 to designate a smaller percentage of these funds for local assistance and a larger percentage of these funds for state operations. This correction reflects the fact that Public Health will be engaging in direct programmatic activities when it administers the funds it receives pursuant to these code sections.

TEROC made the same request as Public Health and the Nonprofits, but limited the scope of its request to the funds Public Health receives under Revenue and Taxation Code section 30130.55, subdivision (b)(1).

We agreed with these comments and revised the proposed regulation to account for the fact that programs funded under Revenue and Taxation Code section 30130.55, subdivision (b)(1) and Revenue and Taxation Code section 30130.57, subdivision (d) include state operations costs that are direct costs. Specifically, we excluded state operations expenditures and capital outlay expenditures that constitute department direct costs from the definition of administrative costs.

Comments Received During the First 15-Day Public Comment Period

The Nonprofits and TEROc indicated their approval of the revisions we made to this proposed regulation. The State Auditor did not receive any other comments regarding this proposed regulation during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the third 15-day public comment period.

Proposed Section 61214

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61214 defines actual costs incurred for audits conducted by the State Auditor pursuant to the Act and states that actual costs incurred shall not constitute an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). By its nature, the State Auditor does not engage in program activities as the office does not administer any programs. Thus, all of State Auditor's costs are administrative. However, unlike other state or local agencies receiving funds pursuant to the Act, the State Auditor's receipt of such funds is limited to the amount needed to reimburse the State Auditor annually for actual audit costs incurred or \$400,000, whichever is less. Thus, the State Auditor will not be receiving funds in excess of the State Auditor's actual audit costs incurred and the risk that the State Auditor will spend the funds the office receives pursuant to the Act for purposes unrelated to the required audits is mitigated. Therefore, to give full effect to the language of Revenue and Taxation Code section 30130.57, subdivision (b), actual audit costs incurred does not constitute an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). The calculation of actual costs incurred uses the same methodology that the State Auditor uses when it directly bills state agencies for other audit costs pursuant to Government Code section 8544.5. This proposed regulation takes the State Auditor's unique circumstances into account.

Comments Received During the 45-Day Public Comment Period

Public Health commented that, as part of the Act, Revenue and Taxation Code section 30130.57, subdivision (f) provides for a five percent administrative cost cap on state or local agencies receiving funds pursuant to the Act. Public Health then opined that while it agrees it is appropriate for the State Auditor to exempt itself from the five percent administrative cost cap for services directly related to conducting audits, the Act does not exempt the State Auditor from the five percent administrative cost cap for expenses such as departmental overhead.

We declined to modify the proposed regulation as requested by Public Health. First, as Public Health noted, it is appropriate for the State Auditor to exempt itself from the five percent administrative cost cap for services directly related to conducting audits. The proposed regulation limits the State Auditor's reimbursements to the actual audit costs incurred, namely, the number of personnel hours performed multiplied by the State Auditor's standard rate of reimbursement, the costs of travel expenses, and the costs of any agents hired to perform work on the applicable audit. Personnel hours, travel expenses and the costs of any hired agents are all costs directly

related to conducting the required audits. Thus, by Public Health’s own measure, each of these costs are appropriate and should be exempted from the five percent administrative cost cap. In calculating the value of personnel hours, the proposed regulation follows the same methodology established by the California Legislature in Government Code section 8544.5 and that applies to the calculation of costs pertaining to any audit undertaken by the State Auditor, namely the use of the standard rate of reimbursement. Further, as noted above in the Initial Statement of Reasons, unlike other state or local agencies receiving funds pursuant to the Act, the State Auditor’s receipt of such funds is limited to the amount needed to reimburse the State Auditor annually for actual audit costs incurred or \$400,000, whichever is less. Thus, the State Auditor will not be receiving any funds in excess of the State Auditor’s actual audit costs incurred.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the third 15-day public comment period.

Proposed Section 61215

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61215 identifies which of the California State Board of Equalization’s or any successor entity (“Board of Equalization”) expenditures constitutes an administrative cost for purposes of Revenue and Taxation Code section 30130.57, subdivision (f). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

The Board of Equalization has a specific methodology that it uses to apportion the Board of Equalization’s personal services and operating expenditures to the various tax and fee programs administered by it, including its Cigarette and Tobacco Products Program and its Cigarette and Tobacco Products Licensing Program. According to the Governor’s Proposed Budget for fiscal year 2017-2018, all of the funds transferred to the Board of Equalization pursuant to the Act will be used to for the Cigarette and Tobacco Products Program. The Board of Equalization’s

methodology for apportioning expenditures to the various tax and fee programs is done in two phases. The first phase takes the expenditures as entered into Board of Equalization's financial accounting system and then distributes those expenditures to the Board of Equalization's payroll units. The second phase allocates those distributed costs to the various tax and fee programs. To accomplish this, the payroll units are separated into three categories: direct program, indirect program support, and distributed administration (overhead). Direct program units are those units that work directly on programs. Indirect support units are those units without primary program responsibility but that have a specific method to allocate their costs to the various tax programs. Examples of these units include legal, investigations, and cashiers because these units use methods such as time reporting or cashier transactions that allow for specific allocation of the expenditure to a specific program. Distributed administration (overhead) units are those units that support the Board of Equalization and that do not have a distinct method for allocating their costs. Examples of these units include the board members' offices, the executive director's office, accounting, human resources, administrative support, external affairs, and outreach services.

With respect to any funds transferred to the Board of Equalization pursuant to the Act, this proposed regulation follows the Board of Equalization's cost allocation approach with respect to how it allocates its expenditures to the various tax and fee programs administered by Board of Equalization. Because expenditures allocated to direct program units and indirect support units have a distinct method for allocating their costs to a specific program, these units costs are not administrative costs. However, distributed administration (overhead) unit costs do not have a distinct method for allocating their costs to a specific program. Thus, any such costs constitute an administrative cost. This proposed regulation defines what expenditures constitute an administrative cost for the Board of Equalization with respect to funds it receives pursuant to the Act by taking the Board of Equalization's unique circumstances into account.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the 45-day public comment period; however, we made changes to this proposed regulation account for the restructuring of the Board of Equalization that occurred after the commencement of 45-day public comment period. Effective July 1, 2017, the Taxpayer Transparency and Fairness Act of 2017 (Stats. 2017, ch. 16) restructured the California State Board of Equalization. While the State Board of Equalization will continue in existence, it will handle only those duties assigned to it by the California Constitution. The California Department of Tax and Fee Administration ("CDTFA") will perform those statutory duties formerly assigned to the California State Board of Equalization. Because the Act adopted statutory provisions affecting the Revenue and Taxation Code, CDTFA is the public entity that will now be administering, calculating, and collecting the tax imposed by the Act. Therefore, we revised the heading of proposed regulation and changed the description of the "California State Board of Equalization", "successor entity", "any successor entity", or "BOE" to reference CDTFA. Further, since the CDTFA does not have board members,

reference to the board members' offices as an example of an overhead unit was no longer applicable. Therefore we removed this reference from the proposed regulation. Finally, we made a non-substantial change to subdivision (c) of the proposed regulation to correct a grammatical error.

Comments Received During the First 15-Day Public Comment Period

CDTFA commented that this proposed regulation should be revised to account for the fact that with respect to the funds it receives pursuant to Revenue and Taxation Code section 30130.57, subdivision (a), CDTFA is to be reimbursed for all expenses incurred in the administration, calculation, and collection of the tax imposed as a result of the Act, irrespective of whether they are direct or indirect expenditures. CDTFA then proposed a change to this proposed regulation that would not only effectuate this change, but would also result in all expenditures it incurs pursuant to Revenue and Taxation Code section 30130.57, subdivision (e)(2) constituting administrative costs.

We partially accepted this comment. We revised the proposed regulation to state that each of CDTFA's expenditures constitutes an administrative cost with respect to any funds transferred to the CDTFA from the Fund pursuant to Revenue and Taxation Code section 30130.57, subdivision (a).

However, we did not revise the proposed regulation to define all of the expenditures CDTFA incurs pursuant to the funds it receives under Revenue and Taxation Code section 30130.57, subdivision (e)(2) as administrative costs. The broad language providing for full reimbursement of administrative costs set forth in Revenue and Taxation Code section 30130.57, subdivision (a) is limited to the activities described in subdivision (a). The enforcement activities set forth in Revenue and Taxation Code section 30130.57, subdivision (e)(2) are distinct from the administrative activities set forth in Revenue and Taxation Code section 30130.57, subdivision (a). Therefore, with respect to the funds it receives under Revenue and Taxation Code section 30130.57, subdivision (e)(2), this proposed regulation follows CDTFA's cost allocation approach and defines only distributed administration (overhead) unit costs as administrative costs.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the third 15-day public comment period.

Proposed Section 61216

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61216 identifies which of the University's expenditures constitutes an administrative cost for purposes of Revenue and Taxation Code section 30130.55, subdivision (c) and Revenue and Taxation Code section 30130.57, subdivisions (c). Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

With respect to any funds transferred to the University from the California Healthcare, Research and Prevention Tobacco Tax Act of 2016 Fund pursuant to Revenue and Taxation Code section 30130.55, subdivision (c), this proposed regulation follows the University's cost allocation approach with respect to its Research Grants Program. First, the proposed regulation excludes local agencies that receive applicable funds through grants or contracts awarded because, according to the University, it will administer these funds in accordance with the Tobacco-Related Disease Research Program as set forth in Health and Safety Code sections 104500 through 104545. Health and Safety Code sections 104500 through 104545 provide that any local agencies receiving funds pursuant to these code sections shall be reimbursed their full direct and indirect costs. Thus, there cannot be a cap on direct or indirect costs for any grants or contracts awarded pursuant to these code sections and neither type of cost is considered to be an administrative cost for any local agency recipient. Second, personnel costs and University recharges directly associated with research evaluation program activities and for dissemination program activities do not constitute administrative costs. Third, any other expenditure of these funds by the University constitutes an administrative cost. This methodology is generally consistent with the accounting methodology that the University uses with respect to other research programs administered by the University.

With respect to any funds transferred to the University from the California Healthcare, Research and Prevention Tobacco Tax Act of 2016 Fund pursuant to Revenue and Taxation Code section 30130.57, subdivision (c), this proposed regulation identifies indirect and recharge costs as administrative costs. These types of costs are to be determined according to the University's policies and procedures. These funds are to be used to provide funding to the University for the purpose of increasing the number of certain physicians in California. In this context the University is directly engaging in program activities. Generally, when an agency directly engages in program activities, some of its expenditures will be specific to the program and some of its expenditures will not be specific to the program. Costs that solely benefit the specific program are direct costs and costs that do not solely benefit the specific program include both indirect costs and recharges. Because indirect costs and recharges are not specific to the program, they constitute administrative costs. This proposed regulation defines what expenditures constitute an administrative cost for the

University with respect to funds it receives pursuant to the Act by taking the University's unique circumstances into account.

Comments Received During the 45-Day Public Comment Period

The University made three comments during the 45-day public comment period regarding this proposed regulation.

First, the University requested that subdivision (a)(1) of the proposed regulation be modified to replace the term "local agency" with the phrase "individuals or entities" because, with respect to any funds transferred to the University from the California Healthcare, Research and Prevention Tobacco Tax Act of 2016 Fund pursuant to Revenue and Taxation Code section 30130.55, subdivision (c), the University may issue awards by contract or grant to individuals or entities that do not fall within the definition of "local agency". Thus, the University wanted subdivision (a)(1) of this proposed regulation to be modified to clarify that there is to be a consistent treatment of administrative costs for all Health and Safety Code sections 104500 through 104545 recipients, regardless of type of entity.

We declined to make this modification because it is unnecessary. As noted above, Health and Safety Code sections 104500 through 104545 provide that it is the intent of the Legislature that any recipient receiving awards pursuant to these code sections shall be reimbursed their full direct and indirect costs. The scope of these proposed regulations is limited to defining what constitutes administrative costs for state and local agencies that receive funds pursuant to the Act. Therefore, it is only necessary to address the interplay between Health and Safety Code sections 104500 through 104545 and the Act with respect to state or local agencies as they are defined by these proposed regulations. Since proposed regulation section 61201, subdivision (k) excludes individuals or non-public entities from the definition of "local agency", it is not necessary to address the interplay between Health and Safety Code sections 104500 through 104545 and the Act for such recipients.

Second, the University proposed that the word "expenses" be added to subdivision (a)(2)(C) of the proposed regulation in order to allow for the other direct costs incurred for the research evaluation and research development activities. The University requested this change because not all costs are recharge in nature, some are paid directly and not on a recharge basis.

We accepted this comment and made the corresponding change.

Third, the University proposes modification to subdivision (a)(3)(B) of the proposed regulation to make it clear that any amounts it awards by contract or grant to individuals or entities from funds pursuant to Revenue and Taxation Code section 30130.57, subdivision (c) shall not constitute an administrative cost for either the University or the individual or entity in receipt of such funds.

We declined to make this modification. Funds transferred to the University pursuant to Revenue and Taxation Code section 30130.57, subdivision (c) are to be used to provide funding to the University for the purpose of increasing the number of certain physicians in California. In this context the University is directly engaging in program activities. Generally, when an agency directly engages in program activities, some of its expenditures will be specific to the program and some of its expenditures will not be specific to the program. Costs that solely benefit the specific program are direct costs and costs that do not solely benefit the specific program include both indirect costs and recharges. Because indirect costs and recharges are not specific to the program, they constitute administrative costs.

To the extent that the University issues awards of these funds by contract or grant to a local agency, such awards will be subject to proposed regulation section 61217 because, unlike awards the University issues pursuant to Revenue and Taxation Code section 30130.55, subdivision (c), there are no statutes indicating that it is the intent of the Legislature that awardees of funds the University issues pursuant to Revenue and Taxation Code section 30130.57, subdivision (c) are to be reimbursed their full direct and indirect costs. Further, because the scope of these proposed regulations is limited to defining what constitutes administrative costs for state and local agencies that receive funds pursuant to the Act, it is not necessary to define what would constitute an administrative cost for individuals or non-public entities that do not fall within the definition of a “local agency”.

Comments Received During the First 15-Day Public Comment Period

The University again requested that subdivision (a)(1) of the proposed regulation be modified to replace the term “local agency” with the phrase “individuals or entities”. However, the University’s proposed language for this subdivision differed from its request by suggesting we revise this subdivision by replacing the term “local agency” with “local agency and other agencies”.

We declined to do so for the same reasons explained above in our response to comments received during the 45-day public comment period above.

Comments Received During the Second 15-Day Public Comment Period

The University commented that in addition to local agencies, the University itself, the California State University, and other state agencies might be awarded contracts or grants with respect to funds the University receives pursuant to Revenue and Taxation Code section 30130.55, subdivision (c). Thus, the University requested that we modify subdivision (a)(1) of this proposed regulation to clarify that any amounts the University awards by contract or grant pursuant to Health and Safety Code sections 104500 through 104545 do not constitute an administrative cost for the state or local agencies in receipt of such funds.

We accepted this comment and made the corresponding change.

Comments Received During the Third 15-Day Public Comment Period

The University indicated their approval of the revisions we made to this proposed regulation. The State Auditor did not receive any other comments regarding this proposed regulation during the third 15-day public comment period.

Proposed Section 61217

Specific Purpose as Stated in the Initial Statement of Reasons

Proposed Section 61217 identifies which costs incurred by a local agency constitute an administrative cost for purposes of Revenue and Taxation Code sections 30130.55, 30130.56, and 30130.57. Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to promulgate regulations defining administrative costs for purposes of the Act, including for local agencies. When defining administrative costs, Revenue and Taxation Code section 30130.57, subdivision (g) requires the State Auditor to take into account the differing nature of the agencies or departments receiving funds pursuant to the Act.

This proposed regulation excludes local agencies that receive applicable funds through grants or contracts awarded pursuant to Health and Safety Code sections 104500 through 104545 from its terms. As noted above, these code sections provide that any local agencies receiving funds pursuant to these code sections shall be reimbursed their full direct and indirect costs. Thus, there cannot be a cap on direct or indirect costs and neither is considered an administrative cost. With respect to any other applicable funds passing to a local agency from a state agency, administrative costs means the indirect costs allowed by the terms of the applicable grant or contract. This general language is necessary as local agencies will be receiving applicable funds from a variety of different healthcare, research, and tobacco prevention related programs. Each program is subject to its own terms and conditions. This language allows for a consistent means of determining administrative costs for local agencies receiving applicable funds, while still allowing the unique terms that govern each program to remain in effect.

Comments Received During the 45-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the 45-day public comment period.

Comments Received During the First 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the first 15-day public comment period.

Comments Received During the Second 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the second 15-day public comment period.

Comments Received During the Third 15-Day Public Comment Period

The State Auditor did not receive any comments regarding this proposed regulation during the third 15-day public comment period.

[Sections 61218 to 61240, inclusive, are reserved.]

We made a nonsubstantive change that was solely typographical in nature to this reserved line by changing the sections referenced from “sections 61217 to 61240” to “sections 61218 to 61240”.

LOCAL MANDATE

This proposal does not impose a mandate on local agencies or school districts.

ALTERNATIVES CONSIDERED

The State Auditor has determined that no reasonable alternative considered by the State Auditor or that has otherwise been identified and brought to the attention of the State Auditor would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost-effective to affected private persons and equally effective in implementing the statutory policy or other provisions of law.