

Final Statement of Reasons

The Initial Statement of Reasons is included in the file. The information contained therein is updated as set forth below.

At its June 3, 2004, meeting, the Education Audit Appeals Panel (EAAP) considered regulations to modify the audit guide for K-12 local education agency (LEA) audits for the 2004-05 fiscal year. The Panel adopted emergency regulations and authorized staff to begin the regular rulemaking process for the eventual adoption of permanent regulations.

The Notice of Proposed Rulemaking for the permanent regulations was published in the California Notice Register on June 18, 2004. The public hearing on the proposed permanent regulations was held August 2, 2004; no testimony was given. One written comment was received during the 45-day comment period, at the public hearing.

At its August 30, 2004, meeting, the Panel approved revisions to the regulations in response to the comment received and some staff recommendations for technical changes. The Notice of Modifications to Text of Proposed Regulations and the modified text were then made available to the public from September 1, 2004, through the close of business on September 15, 2004. Three comments were received on the last day of the comment period.

At its September 20, 2004, meeting, the Panel approved further changes to the proposed regulations, and a Second Notice of Modifications to Text of Proposed Regulations was made available, with the modified text, from September 22, 2004, through October 6, 2004. During the Second 15-Day Period, no comments were received.

At its meeting on November 1, 2004, the Panel approved additional changes, and a Third Notice of Modifications to Text of Proposed Regulations was made available, with the modified text, from November 2, 2004, through November 16, 2004. During this comment period, no comments were received. The Panel adopted final 2004-05 audit guide regulations at its meeting on November 29, 2004.

There are no changes to the Initial Statement of Reasons for Sections § 19834 (proposed as § 19835, Proposition 20 Lottery Funds (Cardenas Textbook Act of 2000)), and § 19835 (proposed as § 19836, State Lottery Funds (California State Lottery Act of 1984)).

For the sections listed below, the Initial Statement of Reasons is updated as follows:

Article 2. Audit Reports.

§ 19814. Definitions.

Subdivision (e) was modified to omit State Funded Child Development and the associated number of audit procedures, and to conform the number of audit procedures for other areas to the final version of the adopted regulations.

§ 19814.1. Applicability of Audit Procedures by Audit Year.

Only a conforming change was made to reflect the renumbering of the sections for fiscal year 2004-05 audits.

Article 3. State Compliance Requirements.

§ 19832. State Funded Child Development: Attendance and Parent Fees.

Proposed Section 19832, related to State Funded Child Development, was deleted and the remaining sections were renumbered accordingly.

Subdivision (a) of this proposed regulation was removed because some of the central elements that would necessarily be reviewed in auditing the equivalent of attendance accounting in child development programs have not been defined in statute or regulation and do not therefore qualify for inclusion in an audit regulation. With only limited procedures for auditing parent fees remaining, the proposed regulation was deleted pending probable inclusion of more comprehensive State Funded Child Development audit procedures sometime in the future, following adoption by the Superintendent of Public Instruction or the State Board of Education of additional program regulations.

§ 19832 (proposed as § 19833) School Construction Funds.

In response to comments, modifications were made to clarify that a sample is to be drawn before verifying the appropriate expenditure of bond proceeds (§ 19832(a)(2)), and before verifying expenditures of state school facilities funds (§ 19832(b)(1)).

§ 19833 (proposed as § 19834) Alternative Pension Plans.

This proposed regulation was modified extensively in response to public comments and staff suggestions. Subdivision (b) now includes direction to auditors to interview personnel, because a review of records alone may not reveal whether an LEA offers an alternative pension plan as defined. Because of the variety of ways an alternative pension plan might be organized or denominated, reference to joint ventures was added. Finally, language was added to this subdivision to clarify that both current and former employees of an LEA may be involved in an alternative pension plan as defined.

Rather than presenting the auditor with a list of elements to verify regarding the disclosures related to any alternative pension plan, subdivision (c) now instructs the auditor to determine that the activity has been fully disclosed in the notes to the financial statements.

§ 19836 (proposed as § 19837) California School Age Families Education (Cal-SAFE) Program.

A number of changes were made in the proposed audit procedures for Cal-SAFE, following EAAP staff discussions with staff of the California Department of Education (CDE) and in response to comments received. As explained below, the originally proposed subdivision (a) was modified extensively; and subdivision (b) was ultimately deleted.

The originally proposed subdivision (a) was modified as follows: subparagraph (a)(1) (now (a)) was revised to conform to the style of other regulations included in the audit guide; subparagraph (a)(2) (now (b)) was revised to clarify that a sample is to be selected from each reporting category (line item) on CDE's annual attendance report form, and that for each pupil in each sample the calculation of the pupil's Average Daily Attendance (ADA) is to be verified and traced to supporting documentation. The originally proposed subparagraph (a)(3) was deleted because CDE's annual attendance report form does not allow for reporting pupils who are in

these prohibited categories. Subparagraph (a)(4) was renumbered (a)(3) (now (c)) and revised for clarity. Cal-SAFE pupils may generate ADA in more than one educational program, but Education Code Section 54749(a)(1) provides that not more than one unit of ADA for each pupil may be reported to generate Cal-SAFE support services allowances. A new subparagraph (a)(4) (now (d)) was added to instruct auditors to report as a finding any units of ADA in excess of one unit of ADA for any Cal-SAFE pupil. Subparagraph (a)(5) (now (e)) was revised to clarify the instructions for recalculating the CAL-SAFE claim.

Subparagraphs (a)(6), (7), and (8), as well as and subparagraphs (b)(4) and (5), were deleted. Consistent with statute, those steps had directed verification that Cal-SAFE funds were “maintained in separate accounts”; however, CDE staff determined that all LEAs that receive Cal-SAFE funds are instead “accounting separately” for those funds. CDE will pursue a technical change in the statute.

Subparagraphs (1), (2), and (3) of subdivision (b), regarding child development services for the children of Cal-SAFE pupils, were deleted for the same reasons that proposed Section 19832(a) was removed: some of the central elements that would necessarily be reviewed in auditing the equivalent of attendance accounting in child development programs have not been defined in statute or regulation and do not therefore qualify for inclusion in an audit regulation.

Technical, Theoretical, or Empirical Studies, Reports, or Documents.

In addition to the materials listed in the Initial Statement of Reasons, EAAP referred to Statement No. 14 of the Governmental Accounting Standards Board (GASB), The Financial Reporting Entity (June 1991), in considering the comments regarding proposed Section 19834 (now 19833) Alternative Pension Plans. GASB Statement 14 is available in EAAP’s offices and also may be obtained from GASB for \$15.50 through <http://www.gasb.org>

Request That Regulations Become Effective Upon Filing

EAAP requests that the regulations in the current rulemaking file become effective upon filing. Education Code Section 14502.1 requires EAAP to adopt audit guide regulations pursuant to the rulemaking procedures of the Administrative Procedure Act by July 1 of the fiscal year to be audited. These regulations will replace the emergency audit guide regulations that became effective June 17, 2004. Together with the remainder of Chapter 3, Division 1.5, of Title 5 of the California Code of Regulations, these regulations constitute the audit guide for the audit of the current fiscal year.

Alternatives Determination

The Education Audit Appeals Panel has determined that no alternative would be more effective in carrying out the purpose for which these regulations are proposed or would be as effective and less burdensome than the proposed regulations.

Local Mandate Determination

The proposed regulations do not impose any mandate on local agencies or school districts.

Response to Comments Received During the Public Notice Periods

Initial Notice Period: June 18, 2004, to August 2, 2004

No oral testimony was given at the public hearing on August 2, 2004. The one written comment received during the initial 45-day comment period was submitted by Richard L. Hamilton, on behalf of the California School Boards Association, its Education Legal Alliance, the California Association of School Business Officials, the California County Superintendents Educational Services Association, and the California Society of Certified Public Accountants. Mr. Hamilton noted concerns with the provisions of proposed Section 19832, State Funded Child Development, and proposed Section 19837, California School Age Families Education. Because he knew that EAAP staff had met with staff of the California Department of Education (CDE) and would be proposing extensive changes to those portions of the proposed regulations, he limited his comments to Section 19834. EAAP considered these comments and made changes to the proposed regulations during its August 30, 2004, meeting.

§ 19834. Alternative Pension Plans:

Comment: “With regard to proposed section 19834, Alternative Pension Plans, our recommendation is that this entire section be deleted as unnecessary. Disclosure of such pension plans is already required of local education agencies under generally accepted accounting principles and besides the State already knows that a very few school districts have established alternative pension plans as defined in section 19834 and their identity is known. It is extremely unlikely that any other plans will be established in the next several school years while litigation is pursued with regard to the right to establish these alternative pension plans. It is therefore unnecessary to require all school districts and county offices of education to pay auditors to comply with the requirements of proposed section 19834.”

EAAP Response: The proposed regulation was not deleted as EAAP believes it is appropriate for inclusion in the audit guide.

Comment: “Assuming for purposes of argument that section 19834 remains, section 19834(b) as drafted would miss the mark. In at least one known instance the alternative plan created through joint powers authority was for former permanent, full-time district employees. Clarifying language to include such a situation is recommended.”

EAAP Response: A change was made in subdivision (b) of proposed Section 19834 by inserting the words “current or former” before “permanent, full-time employees” at the end of the sentence.

Comment: “Section 19834(c) requires the auditor to draft note disclosures in the Notes to the Basic Financial Statements. Consistent with generally accepted auditing standards/practices, auditors do not write note disclosures in the Notes to the Basic Financial Statements. These are written by the local education agency and verified by the auditors. Clarifying language is provided.” (The proposed language was interlineated into an attached copy of the proposed regulations: the word “delete” was struck and the phrase “verify that the agency discussed” was inserted.)

EAAP Response: Subdivision (c) was modified by striking “the note disclosure in the Notes to the Basic Financial Statements” and inserting “a comment included in the Findings and Recommendations section of the audit report.”

Comment: “Sections 19834(c)(3), (4) and (6) should be deleted. As written sections (3) and (4) require the auditor to develop the details of the alternative plan (e.g., the number of employees involved, nature of services provided to the district by these “separated employees” and whether the employees involved had a choice of pension plans). In fact, it is well established that in those situations where alternative plans have been identified, the State of California and the State Retirement Systems will conduct their own independent study to develop these details. Under these circumstances requiring auditors to develop this information is unnecessary. If section 19834(c) is revised to require auditor verification of district notes, a considerable, unnecessary requirement is still made of auditors.

“Finally Section 19834(c)(6) ought to be deleted as it requires auditors to make a determination of materiality they are not qualified to make. Auditors are simply not trained to determine whether the provisions of the alternative plan materially exceed their counterpart found in the state retirement systems. Likewise, if section 19834(c) is revised to require auditor verification, auditors still lack the training to verify the materiality requested.”

EAAP Response: Paragraphs (4) and (6) of subdivision (c) of proposed Section 19834 were deleted.

First 15-Day Notice Period: September 1, 2004, to September 15, 2004

The Education Audit Appeals Panel received comments on the modified text from three sources:

- Bruce C. Allen, Director, Government Relations, of the California Society of Certified Public Accountants, writing on behalf of the 28,000 members of the California Society of CPAs
- Thomas M. Gilbert, MBA, CPA, of Gilbert Associates, Inc.
- Richard L. Hamilton, on behalf of the California School Boards Association (CSBA) and its Education Legal Alliance (ELA), the California Association of School Business Officials (CASBO), the California County Superintendents’ Educational Services Association (CCSESA), and the California Society of CPAs, as well as others representing local education agencies involved in audit issues on a statewide basis

EAAP considered these comments and made changes to the proposed regulations during its September 20, 2004, meeting.

§§ 19832 – 19837 in general:

Comment: Mr. Allen: “The audit guide is proposing six new areas to audit without proposing any deletions. You should know that this will increase the cost of audits to local

educational agencies. At some point an evaluation of cost vs. benefit should be undertaken. An audit was never contemplated to be a guarantee of 100% compliance with all statutes and regulations governing the fiscal conduct of any government entity, but rather a reasonable assurance that the agency is following the appropriate accounting principles and has appropriate procedures in place.”

EAAP Response: Education Code Section 14502.1 requires the Controller, in consultation with the Department of Finance and the State Department of Education as well as representatives of specified organizations, to propose the content of an audit guide to promote accountability over public educational funds (Education Code §§ 14503 and 41020). The Controller is to submit proposed content for the audit guide to EAAP. EAAP is to review and possibly amend, and adopt the proposed content, pursuant to the rulemaking procedures of the Administrative Procedure Act, before July 1 of each fiscal year. The Controller proposed six areas for inclusion in the audit guide for the 2004-05 fiscal year.

Comment: Mr. Allen: “One observation that appears throughout the regulations is the use of the term “verify”. This is very confusing and could be problematic. It would be more appropriate to use the language “Using the appropriate auditing procedure, verify...” Use of the term verify unmodified seems to imply that the auditor will test 100% of all transactions and that is simply not feasible.”

EAAP Response: EAAP does not agree with this comment. In the six proposed regulations, all instructions to verify compliance are preceded by an instruction to select a sample, except in those instances in which the verification is to be of 100 percent of the specified transactions (that is, in § 19833(a)(1) and (3); § 19835(a); § 19836(a); § 19837(a)(6) and (7), and (b)(1)¹).

§ 19832. State Funded Child Development: Parent Fees:

Comment: Mr. Hamilton: “As we have previously brought to Panel members [sic] attention, we think that Section 19832, State Funded Child Development: Parent Fees, ought to be deleted in its entirety. At Panel staff’s recommendation, the auditing procedures relating to Attendance have all ready [sic] been eliminated leaving just that portion relating to auditing of Parent Fees. Auditing of State Funded Child Development was proposed by the Department of Finance with the primary focus on Attendance issues. Under these circumstances it is particularly inappropriate to require audit procedures on Parent Fee issues when there is no evidence of significant state revenue issues relating to these fees, and, to the extent that issues are raised with respect to non-payment and notification procedures, there are existing alternatives to determine compliance, e.g. Coordinated Compliance Review.”

Comment: Mr. Gilbert: “No evidence has been submitted to indicate that there are any significant state revenues related to the procedures remaining or any known compliance problems exist. This entire section should be deleted.”

Comment: Mr. Gilbert: “If it remains, (b)(1)(B)&(C) wording should be changed to reflect that the expectation is not a 100% verification. My suggestions are:

¹ So numbered in the Regulations Accompanying 15-Day Notice.

‘(B) Verify for at least one period in the sample selected that the assessed fees were collected...’;

‘(C) Verify for the sample that the fees collected....’”

Comment: Mr. Hamilton: “If the audit procedures for Parent Fees nonetheless remain, Section 19832(b)(2) should be clarified to explain that with respect to applicable fees not collected by the local education agency, the identification in a schedule is only for subsequent determination through a CCR process whether proper delinquency notification procedures are in place and were followed. It should be made clear that the program is not liable for uncollected fees. There is no legal obligation to collect the unpaid fees.”

EAAP Response: EAAP agrees that proposed Section 19832 should be deleted at this time.

§ 19833. School Construction Funds:

Comment: Mr. Gilbert: “Wording should be changed as follows:

(a)(2) ‘...verify that expenditures were only for’;

(b)(1) ‘...verify that expenditures from the account were made only for qualifying school facilities as provided in’.”

Mr. Hamilton concurred with Mr. Gilbert’s comment.

EAAP Response: EAAP agrees in part and disagrees in part with this comment. Proposed Section 19833(a)(2) now reads, “Select a sample of expenditures and verify that bond proceeds were expended only for....” The proposed wording would delete the words “bond proceeds were expended” and substitute “expenditures were.” This change would not improve clarity.

Proposed Section 19833(b)(1) now reads, “Select a sample of expenditures and verify that expenditures of funds from the school district’s account in the county school facilities fund were made only for qualifying school facilities expenditures as provided in subdivision (c) of Education Code Section 17070.43....” The comment suggests deleting the words “of funds” (“verify that expenditures ~~of funds~~ from the school district’s account”). EAAP agrees that these two words should be deleted as they are redundant in this context.

EAAP does not agree that the word expenditures should be deleted (“were made only for qualifying school facilities ~~expenditures~~”). The statute cited in the regulation provides that, “Funds may be expended from the county fund by the recipient school district for qualifying school facilities expenditures set forth in Sections 17072.35 and 17074.25.” (Education Code Section 17070.43(c).) The referenced statutes list the costs for which a grant for new construction may be used and the costs for which a modernization grant may be used, as well as costs for which a modernization grant may not be used. Deleting the word “expenditures” from the regulation would render the regulation inconsistent with the statute.

§ 19834. Alternative Pension Plans:

Comment: Mr. Hamilton concurred with Mr. Gilbert’s comments on proposed Section 19834.

Subdivision (b):

Comment: Mr. Gilbert: “Disclosure is required by generally accepted accounting principles (GAAP), specifically in Governmental Accounting Standards Board Statement No. 14, para. 75. If it must stay, wording should be changed as follows:

‘(b)... has created an entity, joined a joint powers authority, or participates in a joint venture that’;

EAAP Response: Governmental Accounting Standards Board (GASB) Statement 14 provides standards for audits of governmental entities with regard to defining and reporting on the financial reporting entity, and for reporting participation in joint ventures. Paragraph 75, referenced in Mr. Gilbert’s comment, prescribes the disclosures to be made by joint venture participants. GASB Statement 14 defines a joint venture as “A legal entity or other organization that results from a contractual arrangement and that is owned, operated, or governed by two or more participants as a separate and specific activity subject to joint control, in which the participants retain (a) an ongoing financial interest or (b) an ongoing financial responsibility.”

EAAP agrees that it is possible that some local education agencies may provide for an alternative pension plan as defined in the regulation through an arrangement denominated a joint venture and therefore agrees that the term should be added. EAAP proposes the following wording:

§ 19834(b) Interview administrative personnel and determine whether the local education agency has created an entity, ~~or~~ joined a joint powers authority, or entered into a joint venture that provides for an alternative pension plan for its current or former permanent, full-time employees.

Subdivision (c):

Comment: Mr. Allen commented, “Section 19834 related to Alternative Pension Plans-Step c proposes that auditors include in their findings something that appears to be for informational purposes. Findings are by definition items to be considered for correction by the LEA, not verifications. This procedure should be eliminated. If the state would like to collect information on those few districts that have participated in alternative pension plans, it should require the districts to report directly to the Controller and provide the requested information.

Comment: Mr. Gilbert: “If it must stay, wording should be changed as follows: ‘(c) If the local education agency has done so, determine that the activity is properly disclosed in the footnotes to the financial statements, including: the district's financial interest; summary financial information; and the information on the availability of separate financial statements.’ The balance of this section, (c)(1)-(6) is [then] unnecessary. Any disclosures would be misplaced as a "Finding and Recommendation" since this section is for exceptions in internal control and compliance that have the elements as outlined in 19814(j): criteria, condition, effect, cause, recommendation, and corrective action.”

Comment: Mr. Allen: “If the EAAP insists on including the evaluation of the Alternative Pension Plans, the information should be placed in footnotes not in findings.”

EAAP Response: EAAP agrees that any alternative pension plan as defined should be disclosed by the auditee in the notes to the financial statements and that the auditor should verify that the disclosure is properly made. Subdivision (c) has been modified accordingly, and the listing of elements has been deleted.

§ 19837. California School Age Families Education (Cal-SAFE) Program:

Comment: Mr. Hamilton: “With respect to section 19837, the remaining portion of this audit procedure should be eliminated in light of EAAP staff having recommended that procedures regarding attendance should and have been eliminated.”

EAAP Response: EAAP does not agree with this comment. Proposed Section 19837(b) was modified to eliminate reference to auditing attendance in the child development services portion of Cal-SAFE. However, subdivision (b) still provides for the separate verification of appropriate accounting for funds received for child development services for the children of Cal-SAFE participants, and subdivision (a) provides for the audit of funds received for Cal-SAFE supportive services.

Comment: Mr. Hamilton: “If, nonetheless, the provisions remain, the second and third sentences of section 19837(a)(5) (commencing at line 14 through line 19 on page 15) should be deleted. The Step 3 referenced therein has been deleted and thus the correct amount of support services allowances is not determinable.”

EAAP Response: EAAP does not agree with this comment. Subparagraph (a)(3) of the originally-proposed Section 19837 was deleted in the modification of the text circulated for this 15-day comment period. (That subparagraph was eliminated because the Cal-SAFE report form precludes the reporting of these prohibited populations.) Former subparagraph (a)(4) was renumbered (a)(3) and modified. It now directs the auditor to “Determine whether any Cal-SAFE pupils generated Average Daily Attendance in more than one program. Select a representative sample from among such pupils. Verify that not more than a total of one unit of Average Daily Attendance generated by each pupil was included in the report.” A new subparagraph (a)(4) was added, directing the auditor to state in the Findings and Recommendations section of the audit report the total number of excess units of Average Daily Attendance generated by Cal-SAFE pupils, if any.

Subparagraph (a)(5) now directs the auditor to subtract from the total reported to the California Department of Education any inappropriately reported units of Average Daily Attendance identified through steps 1 and 2, and then to subtract any excess units of Average Daily Attendance identified through step 3. The referenced step 3 is the former subparagraph (a)(4). By performing the prescribed subtractions, the auditor can arrive at the correct number of support services allowances and then calculate the dollar value of any inappropriately claimed support services allowances.

Comment: Mr. Hamilton: “In section 19837 references are made in several provisions for determination that monies are maintained in separate accounts. District funds are deposited in one account through county offices of education. This is particularly problematic with (a)(8). The auditors should be looking for funds being ‘separately accounted for.’”

EAAP Response: EAAP does not agree with this comment. As recited in the proposed regulation, the Cal-SAFE law states separately in each of subdivisions (b), (c), and (d) of Education Code Section 54749 that the funds “shall be maintained in a separate account.” To state that the funds are to be “separately accounted for” would be inconsistent with the statute.

Second 15-Day Notice Period: September 22, 2004, to October 6, 2004

EAAP received no comments during the Second 15-Day Notice Period. At its meeting on November 1, 2004, EAAP further revised proposed Section 19836, California School Age Families Education (Cal-SAFE) Program, to delete subparagraphs (a)(6), (7), and (8) and subdivision (b), which had directed verification that Cal-SAFE funds were “maintained in separate accounts.” CDE staff determined that all LEAs that receive Cal-SAFE funds are instead “accounting separately” for those funds. CDE will pursue a technical change in the statute.

Third 15-Day Notice Period: November 2, 2004, to November 16, 2004

EAAP received no comments during the Third 15-Day Notice Period. At its meeting on November 29, 2004, EAAP adopted final regulations for the 2004-05 audit guide.