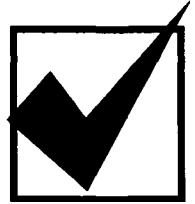


Bureau of State Audits

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Created by SB 37 (Maddy) (Chapter 12, Statutes of 1993), the Bureau of State Audits (BSA) is an auditing and investigative agency which operates under the administrative oversight of the Milton Marks Commission on California State Government Organization and Economy (also known as the "Little Hoover Commission"). In Government Code section 8543 *et seq.*, SB 37 delegates to BSA most of the duties previously performed by the Auditor General's Office, such as examining and reporting annually upon the financial statements prepared by the executive branch of the state, performing other related assignments (such as performance audits) that are mandated by statute, and administering the Reporting of Improper Governmental Activities Act, Government Code section 8547 *et seq.* BSA is also required to conduct audits of state and local government requested by the Joint Legislative Audit Committee (JLAC) to the extent that funding is available. BSA is headed by the State Auditor, appointed by the Governor to a four-year term from a list of three qualified individuals submitted by the JLAC.

Major Projects

The Cost of the PUC's Regulation of Transportation Companies

In *California Public Utilities Commission: It Does Not Know Its True Costs of Regulating Transportation Companies* (No. 98021; December 1998), BSA examined the fees collected by the Public Utilities Commission (PUC) from privately-owned freight railroad and passenger transportation companies (transportation companies), and found they may not sufficiently cover the costs of regulating these companies. As a result, the PUC's other fee-payers, such as trucking and utility companies, may subsidize freight railroad and passenger transportation regulation. Because its former accounting system did not isolate expenditures for the Commission's various funds, the PUC does not know the true cost of transportation regulation during fiscal year 1997-98. Consequently, its other fee-payers may have subsidized up to \$919,000 for these costs.

In addition, fees received from railroad corporations did not cover all of the Commission's corresponding expenses because the Public Utilities Code limits the amount and types of costs for which the Commission can use such moneys. Nonetheless, the PUC spent approximately \$2.9 million on allowed railroad costs—\$119,000 less than the \$3 million cap established by the Code. Finally, the PUC installed a new accounting system in July 1998 that allows it to separate costs by fund. However, in determining which costs it should allocate to its various funds, the PUC excluded \$5.1 million in overhead expenses for facilities. Unless it properly allocates

all relevant costs on the new accounting system, the Commission will continue to be unable to determine the true costs of providing services to transportation companies and other fee-payers.

BSA recommended that the PUC, to ensure that its other fee-payers are not subsidizing railroad safety regulation, press for legislation allowing it to use railroad corporation fees to pay a fair share of its overhead costs. To determine its true costs of regulating utility and transportation companies, BSA suggested that the Commission equitably allocate all relevant overhead costs, including rent for its headquarters building, to its various funds.

Auditor Criticizes OSHPD's Cal-Mortgage Loan Insurance Program

In *Office of Statewide Health Planning and Development: The Cal-Mortgage Program Does Not Minimize the State's Financial Risk When Insuring Health Facility Debt* (No. 97108; October 1998), BSA evaluated the Cal-Mortgage Loan Insurance Program (Cal-Mortgage) administered by the Office of Statewide Health Planning and Development (OSHPD). Cal-Mortgage insures loans for health facility construction in California, including hospitals, primary care clinics, and elderly care facilities. Many of Cal-Mortgage's clients are high-risk borrowers that could not obtain loans without this insurance because their projects are deemed too risky. Accordingly, the likelihood of default for Cal-Mortgage clients is significantly higher than it is for clients of larger, private insurers. When its borrowers default and are unable to continue payment on their debt, Cal-Mortgage must pay off the insured debt. Although the very nature of dealing with high-risk borrowers increases the likelihood of defaults, BSA found that Cal-Mortgage further increases its risk of client defaults with its ineffectual application process, vague guidelines, and incomplete and inconsistent monitoring.

BSA's audit revealed that Cal-Mortgage does not adequately screen applicants because it does not adhere to objective guidelines in its application process. It does not use all available information or standard procedures to assess its applicants' financial viability, nor has it established procedures for determining its maximum level of risk when insuring a client. Due to this inadequate process, Cal-Mortgage has insured a number of financially unstable applicants, some of which have defaulted on their loans. Cal-Mortgage does not consistently require that borrowers submit information about their financial condition, and it does not consistently conduct timely or structured site visits with borrowers. As a result, Cal-Mortgage may have little notice of financial difficulties before a borrower defaults on its debt. Weaknesses in its monitoring include inconsistent methods to oversee borrowers, a lack of formal procedures for this oversight, and insufficient supervision by Cal-Mortgage management.

Moreover, Cal-Mortgage cannot effectively monitor the risk in its borrower portfolio because the portfolio database is unreliable, contains numerous errors, and is not properly maintained. Finally, because Cal-Mortgage does not have benchmarks or standard criteria for identifying problem borrowers that require executive management intervention, the director of the OSHPD, which oversees this insurance program, may not be fully aware of the risk present in Cal-Mortgage's portfolio.

To improve consistency and minimize the risk of financial loss to the state, BSA recommended that Cal-Mortgage develop a more rigorous process to determine the financial viability of applicants, and define a maximum level of risk that it will accept when insuring a borrower. BSA also suggested that the legislature consider changing the law to require that Cal-Mortgage develop a maximum level of insurance risk acceptable for loan insurance approval. The new law should ensure that Cal-Mortgage sets the risk level to minimize the potential of loan defaults and the resulting default payments from the Health Facilities Construction Loan Insurance Fund, while still being able to accomplish its statutory mission. To ensure that Cal-Mortgage adequately oversees its borrowers and is sufficiently warned of those experiencing financial difficulties, BSA recommended that it establish a standard monitoring system for tracking and analyzing borrowers' financial information. To improve its management information for monitoring and oversight, Cal-Mortgage should periodically review the portfolio database for errors and develop procedures for maintaining and ensuring the integrity of the database. Finally, Cal-Mortgage should develop benchmarks and standard criteria for calling an at-risk borrower's financial status to OSHPD's attention, to ensure that OSHPD management has the information necessary to assess the level of risk in the portfolio.

State Agency Readiness for The Year 2000

In Year 2000 Computer Problem: Progress May Be Overly Optimistic and Certain Implications Have Not Been Addressed (No. 98023; August 1998), BSA examined the progress of state agencies in fixing their computer systems to recognize the year 2000. Thousands of critical state computer systems must be adapted in order to allow the continued delivery of essential products and services to Californians. To address this important issue, Governor Wilson designated the Department of Information Technology (DOIT) to oversee, coordinate, and report on efforts agencies are making to ensure that over 2,700 of the state's computer systems are fixed to recognize the year 2000. These efforts involve repairing and testing or replacing components to recognize both the 20th and 21st centuries. The DOIT requires agencies, departments, boards, and commissions under its purview to report the status of their information technology systems and associated remediation efforts on a monthly basis; at the end of each quarter, DOIT in turn reports to the administration and the legislature.

BSA surveyed 39 state agencies which report to DOIT and have critical computer systems, and concluded that almost 700 of the state's critical computer projects may not be

as far along as reported by DOIT in its April 1998 quarterly report to the administration and legislature. Furthermore, many state agencies have not addressed all facets of the year 2000 problem and, therefore, may not actually be ready for the next millennium.

Specifically, agencies are prematurely declaring their critical projects complete that have not been thoroughly tested. Critical projects are those so important that their failure would cause a significant negative impact on the health and safety of Californians, on the fiscal or legal integrity of state operations, or on the continuation of essential state agency programs. Thus far, none of the agencies reporting on completed critical projects to the DOIT have rigorously tested their information-technology systems, comprised of one or more critical projects, in an isolated environment where the computer's internal clock is set to dates in the next century to make sure the systems will continue to function after the year 2000. Moreover, several agencies responsible for remediating large, complex systems have yet to even schedule such tests at either of the state's two data centers. While all critical projects may not need this type of testing, the fact that none of the ten agencies reporting completed critical projects to the DOIT has used such testing on those projects caused BSA concern. Moreover, in many cases the amount of time agencies are allocating to test their critical projects falls far short of the 50%-70% of total project time and resources that others in the industry have spent on testing.

In addition, many of the state's critical computer projects and systems depend on data exchanges with other entities, such as counties and the federal government. Yet not all agencies have completed the necessary steps to ensure that data transmitted through these interfaces will work seamlessly with the state's computer systems into the next century. Even if agencies successfully fix their own critical computer systems, they still may not be able to deliver expected products and services in the next millennium if their data-exchange partners' systems are not year 2000-ready.

Finally, the managers of most state agencies have yet to ensure that their agencies have established appropriate business continuation plans in the event of failures or delays caused by the year 2000 problem. Agencies appear to be focusing exclusively on fixing critical computer systems and choosing not to involve the individuals responsible for program delivery in determining what to do if critical systems do not work as intended or are delayed. However, rather than using staff involved with remediation, BSA believes the managers responsible for the agencies' core business processes should establish work groups of program staff and dedicate sufficient resources to develop business continuation plans to ensure that the agencies maintain the delivery of essential products and services in the event of year 2000-induced failures or delays.

To ensure uninterrupted delivery of essential products and services to Californians, BSA recommended that the Governor's Office ensure that all state agencies take the following steps: (1) provide DOIT with accurate information about the status of their year 2000 remediation efforts—spe-

cifically, the estimated completion dates for each phase of remediation, including final completion, should reflect the agency's best estimate for the actual completion dates and should be updated whenever circumstances affecting a project's status change; (2) thoroughly and comprehensively test the remediation for each critical project; for larger, complex projects associated with systems that support the delivery of services to Californians where interruption would be unacceptable, agencies should also consider testing the system in an isolated computer environment using a time machine; moreover, prior to declaring a project complete, tests of any internal interdependencies, external data exchanges, 20th and 21st century date recognition, and the impacts from embedded systems such as desktop computers, should be complete and the project acceptance tested and approved by agency managers responsible for the business functions; (3) protect their computer systems from missing or corrupted data supplied by external parties—specifically, agencies should identify their data-exchange partners, develop schedules for testing and implementing new date formats, and thoroughly test data supplied by external parties; and (4) establish business continuation planning groups, made up of managers from major business units, experts in relevant functional areas, business continuation and disaster recovery specialists, operational analysts, and contract specialists; these planning groups should then follow a structured approach to develop a business continuation plan for each core business process and infrastructure component affected by the year 2000 problem.

In addition, to ensure that the administration and the legislature have accurate information about state agencies' progress toward fixing their critical projects and systems threatened by year 2000 problems, BSA recommended that DOIT continue to collect and analyze information state agencies provide on their overall progress. If, after analyzing the reported information, something appears anomalous—such as too little test time—DOIT should contact the agency for an explanation. DOIT should also continue to collect information from agencies on their data-exchange partners. In addition, it should take appropriate follow-up action if it appears that agencies are not testing their interfaces with data-exchange partners. DOIT should require agencies, as part of their monthly reporting, to indicate whether they have business continuation plans that ensure that each core business function will continue uninterrupted if the critical computer systems supporting those functions fail to work or are delayed because of year 2000 problems.

The High Cost of Incarcerating Inmates

In *California Department of Corrections: The Cost of Incarcerating Inmates in State-Run Prisons Is Higher Than the Department's Published Cost* (No. 97125; September 1998), BSA analyzed the Department of Corrections' calculation of its costs of incarcerating 146,000 criminals. Each fiscal year, the Department calculates and publishes the amount of incarceration costs per inmate. The Department's calculation focuses primarily on those operating costs directly related to housing and supporting inmates, such as food, cloth-

ing, health care, and inmate activities. For fiscal year 1996–97, the Department calculated annual incarceration costs at \$21,012 per inmate. BSA reviewed the Department's calculation and found that, although it appropriately reflects many of the operating costs, it does not include all costs incurred by the state. When BSA included all of the costs, it found that annual incarceration costs were \$24,807 per inmate for fiscal year 1996–97, \$3,795 higher per inmate than the Department's published figure. The total difference of costs to incarcerate inmates between the Department's calculation and BSA's estimate is \$517 million. The primary reason for this difference is the Department's calculation does not include capital costs, such as lease-purchase payments, debt service costs for new construction, and costs of improving and renovating existing prisons. The Department's calculation also does not include reimbursements to local governments for transportation costs, court fees, and county charges related to state inmates. Finally, the Department's calculation does not include its share of state central-service costs, such as costs of various accounting functions performed by the State Controller's Office for other state departments.

BSA calculated the annual incarceration costs per inmate for each of the 32 state-run prisons operating during fiscal year 1996–97, as well as the statewide cost per inmate. BSA's calculation includes all operating and capital costs. BSA found that annual incarceration costs per inmate vary significantly from one prison to another, depending on each prison's security levels, facility types, and age. Annual costs per inmate for the 32 prisons ranged from \$18,562 to \$38,554 per year.

BSA recommended that, to accurately determine the relevant cost of prison operations, the Department should include all operating and capital costs in its calculation of how much the state pays annually to incarcerate criminals.

Millions Spent on Incomplete Los Angeles Courthouse Projects

In *Los Angeles County: Millions Spent on Courthouse Projects That May Never Be Built* (No. 97119; July 1998), BSA found that since 1988, Los Angeles County has spent \$79 million on eight incomplete courthouse construction projects financed through its Robbins Courthouse Construction Fund. Five of these courthouse projects have scant chance of being built, yet the County spent \$18.6 million on them—\$9.9 million for planning and design, money from which it will derive no benefit, and \$8.7 million for land that now sits idle.

Following approval of its master courthouse construction program in 1988, the County started eight courthouse projects. However, it predicated its ambitious program on revenue projections that, because of subsequent changes in law, proved to be overly optimistic and cost projections that were too low. In addition, the County failed to perform comparative needs assessments and did not prioritize the courthouse projects to determine where construction funds could be most effectively spent. To compound these problems, the courthouse projects have been plagued by significant delays. Some of the delays, such as those caused by the Northridge earthquake and relocation of one courthouse, were out of the

control of the County. Other delays have resulted from the County's poor control over the projects. Three years into the program, an outside consultant warned the County that it could not finance the entire courthouse construction program, but the County continued to purchase land and develop plans for all eight projects. The County was finally forced to defer six projects in 1994 due to insufficient funding. Had the County reacted promptly to the consultant's warning, it could have prevented spending as much as \$7.8 million of the \$9.9 million it spent on planning and designing projects it eventually deferred, and \$8.6 million on unnecessary land purchases.

Until revenues increased recently, the County lacked sufficient funding to complete any of the projects it deferred. However, the County now projects that if the current revenue levels continue, it will have sufficient funding to complete one of the deferred projects—the Antelope Valley courthouse. BSA recommended that the county proceed with caution. These revenues are subject to sudden changes, and even small decreases in revenues or increases in costs could jeopardize the County's ability to fund the project. Unfortunately, the County has not identified the factors that account for the recent increase in revenue. Thus, it has no assurance its projections are based on realistic assumptions. As a result, BSA believes the County risks repeating its past mistakes by spending money on projects it cannot complete.

Nonetheless, the County has taken steps to improve its project development process. In 1995, the County reorganized some duties and in 1997 it adopted a capital projects management process. Although these actions appear to address its main problems, the changes are too recent to evaluate in practice.

To ensure that the County maximizes scarce resources for courthouse construction, BSA recommended that the County conduct a countywide comparative needs assessment and continue projects based on the greatest need. To ensure project funding is realistic, the County should monitor factors that will affect revenues or costs, revise cash flow projections, and recommend changes to the courthouse construction program whenever warranted.

The Proper Agency to Regulate Managed Care

In *Department of Corporations: To Optimize Health Plan Regulation, This Function Should Be Moved to the Health and Welfare Agency* (No. 97118.1; May 1998), BSA examined the regulation of managed care by the Department of Corporations (DOC) within the Business, Transportation and Housing Agency. BSA noted that DOC regulates three unique types of businesses: health care service plans, securities and franchise investments, and financial lenders. As to health plans, DOC administers the Knox-Keene Health Care Service Plan Act of 1975. While health plan enrollment has increased significantly in the past 20 years, BTH devotes only 1% of its 39,000 employees, and only 5% of its \$8 billion budget, to DOC's Health Plan Division (Division). Further,

BSA concluded that the regulation of health plans belongs within the Health and Welfare Agency.

BTH's primary interest is in business and transportation regulation, rather than the delivery of health care. According to BSA, "given the current health plan environment and because health care holds a minority interest within the overall operations of the agency, it seems unlikely that the state would again decide today to have this agency regulate health plans."

At the request of the Joint Legislative Audit Committee, BSA evaluated the "fit" of other state agencies to take over the regulation of managed care. During its review, BSA analyzed the skills, expertise, and focus of the Department of Consumer Affairs, the Department of Health Services, and the Department of Insurance; BSA did not attempt to ascertain the efficiency and effectiveness of operations at these departments nor at DOC. BSA found that all three departments perform, to varying degrees, the types of functions necessary to regulate health plans; however, BSA concluded that—of the three—the Department of Health

Services within the Health and Welfare Agency offers the most suitable environment for the Division.

Additionally, BSA noted that the state also has the option of creating an entirely new entity that would perform the required regulatory functions. Regardless of whether the state moves the Division to an existing department or creates a new entity, BSA concluded that the regulation of health plans belongs within the Health and Welfare Agency. In locating health plan oversight in this agency, the state can capitalize on the agency's expertise and its focus on health care matters.

Other Reports

BSA also issued the following reports between July 1 and December 31, 1998: *Los Angeles Metropolitan Transportation Authority: Creating a Separate San Fernando Valley Authority Would Take a Split of Assets, Revenue, and Debt* (No. 98107; July 1998); *South Coast Air Quality Management District: The District Should Establish a More Equitable Emission Fee Structure and Process Permits More Promptly* (No. 97114; July 1998); *Department of Health Services: Drug Treatment Authorization Requests Continue to Increase* (No. 98012; August 1998); *Cajon Valley Union School District: The District Needs to Improve Its Managerial Oversight and Accountability* (No. 97124; August 1998); *Marks-Roos Bond Act Borrowings: Several Cities Misused the Program and Some Financed Risky Projects Which May Result in Investor Losses* (No. 97127; September 1998); *Prison Industry Authority: Its Outside Purchase of Goods and Services is Neither Well Planned nor Cost Effective* (No. 98102; September 1998); *State Contracting: The State Can Do More to Save Money When Acquiring Goods and Services* (No. 97015; October 1998); *Los Angeles County Metropolitan Transportation Authority: Its Plan for Managing Debt is Reasonable* (No. 98119; October 1998); *Lahontan Regional Water Quality Control Board: Has Not Accomplished All of Its Regulatory Work and Has Not Always Vigorously Acted*

Against Water Quality Violations (No. 97123; November 1998); *State of California: Statement of Securities Accountability of the State Treasurer's Office (June 30, 1998)* (No. 98008; November 1998); *Automated Child Support System: Selection of Interim System Appears Reasonable* (No. 98025; November 1998); *Department of Transportation: Seismic Retrofit Expenditures Comply with the Bond Act* (No. 98022; December 1998); *Forensic Laboratories: Many Face Challenges Beyond Accreditation to Assure the Highest Quality Services* (No. 97025; December 1998); *California Drinking Water: State and Local Agencies Need to Provide Leadership to Address Contamination of Groundwater by Gasoline Components and Additives* (No. 98112; December 1998); *Los Angeles Community College District: Proposed Reforms Have Not Fully Addressed Past Problems and Create a New Set of Challenges* (No. 97107; December 1998); and *State of California: Financial Report Year Ended June 30, 1998* (No. 98001; December 1998).

Legislation

AB 2067 (Cuneen), as amended August 17, requires BSA to submit a report to the legislature by June 30, 1999 making recommendations for changes in the structure of the fees which generators of hazardous waste are required to pay to the State Board of Equalization. This bill was signed by the Governor on September 26 (Chapter 880, Statutes of 1998).

Litigation

In a case of first impression, *Braun v. Bureau of State Audits*, 67 Cal. App. 4th 1382 (Nov. 23, 1998), the First District Court of Appeal held that statements made by BSA in an investigative audit report are absolutely privileged under Civil Code 47(b), such that plaintiff's tort claims against the Bureau were properly dismissed by the trial court.

In early 1994, pursuant to allegations submitted under the Reporting of Improper Governmental Activities Act, Government Code section 8547 *et seq.*, BSA began an investigative audit of the Center for Pre-hospital Research and Training (CPRT), an activity within the University of California at San Francisco's (UCSF) School of Medicine which supported emergency medical services in the community. Plaintiff/appellant Odelia Braun was the medical director of the CPRT. BSA's 73-page November 1994 report of its audit found that plaintiff, who was not identified by name in the report, and UCSF had "grossly mismanaged" the CPRT, and accused plaintiff of "numerous improprieties." [15:1 CRLR 22-23] As a result of the report and publicity which ensued, plaintiff lost her job and the CPRT was closed. Plaintiff sued BSA in tort for compensatory and punitive damages; BSA demurred on grounds that its report was absolutely privileged under Civil Code section 47, subdivisions (a) (publication in the discharge of official duty) and (b) (publication

in official proceeding authorized by law). The trial court sustained BSA's demurrer; plaintiff appealed.

On appeal, the First District held that plaintiff's tort claims were properly dismissed under Civil Code section 47(b), which immunizes from civil action "a privileged publication or broadcast," including one made in the course of a legislative proceeding, a judicial proceeding, or "in any other official proceeding authorized by law." The Reporting Act expressly authorizes the State Auditor to investigate allegations of improper governmental activity; under Government Code section 8547(a), if the Auditor determines that there is reasonable cause to believe that an employee or state agency has engaged in any improper governmental activity, "he or she shall report the nature and details of the activity to the head of the employing agency, or the appropriate authority. If appropriate, the State Auditor shall report this information to the Attorney General, the policy committees of the Senate and Assembly having jurisdiction over the subject matter, and to any other authority that the State Auditor determines appropriate." Under section 8547.7(b), the head of the employing agency or appropriate appointing authority must then report monthly to the State Auditor until "final action has been taken" on the report.

The court noted that its holding is consistent with numerous cases which have reached the same conclusion with respect to statements made in or about other types of governmental investigations, and other cases which have reasoned that "a communication to an official administrative agency, which communication is designed to prompt action by that agency, is as much a part of the 'official proceeding' as a communication made after the proceedings have commenced." The court also stated that "one policy underlying

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the absolute privilege for statements made in governmental investigations and reports of misconduct 'is to assure utmost freedom of communication between citizens and public authorities whose responsibility is to investigate and remedy wrongdoing.'

This consideration is especially

pertinent here because the express purpose of the Reporting Act is to foster such communications."

The court rejected appellant's argument that nothing in the Reporting Act authorizes BSA to make its audit reports public. "Although the statute does not expressly refer to the release of investigative audit reports and findings to the public, the State Auditor submits that this is the statute's intent." The court examined the language of section 8547.7(c) ("[e]very investigative audit shall be kept confidential, except that the State Auditor may issue any report of an investigation that has been substantiated, keeping confidential the identity of the individual or individuals involved, or release any findings resulting from an investigation conducted pursuant to this article that is deemed necessary to serve the interests of the state"), and found support for the Auditor's interpretation.