

**STATE OF CALIFORNIA  
CALIFORNIA STATE AUDITOR'S OFFICE  
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**TITLE 2, DIVISION 10, CALIFORNIA CODE OF REGULATIONS  
ADOPT SECTIONS 61100 TO 61140, INCLUSIVE, REGARDING HIGH RISK LOCAL  
GOVERNMENT AGENCY AUDIT PROGRAM**

**INITIAL STATEMENT OF REASONS**

**INTRODUCTION**

The California State Auditor (“State Auditor” or the “office”) proposes to amend the California Code of Regulations, title 2, division 10, to add regulations relating to the State Auditor’s authority to implement Government Code section 8546.10, relating to high risk local government agency audits. Government Code<sup>1</sup> section 8546.10 was enacted in 2011 (Stats. 2011, ch. 451) and subsequently amended in 2012 to reflect the agency’s name change from Bureau of State Audits to the California State Auditor’s Office (Stats. 2012, ch. 281). Section 8546.10 authorizes the State Auditor to establish a high risk local government agency audit program for the purpose of identifying, auditing, and issuing reports on any local government agency that the California State Auditor identifies as being at high risk for the potential of waste, fraud, abuse, or mismanagement or that has major challenges associated with its economy, efficiency, or effectiveness.

Prior to the enactment of section 8546.10, the State Auditor had broad authority to conduct financial and performance audits of local government agencies as directed by the Joint Legislative Audit Committee (“audit committee”) or as prescribed by statute. Section 8546.10 expands on this authority by creating an additional source of legal authority for the State Auditor. Section 8546.10 authorizes the State Auditor to use the expertise and experience of the office to identify a local government agency that is at high risk, as prescribed by section 8546.10, to inform the audit committee of that determination, and to conduct an audit of a high-risk local government agency upon the audit committee’s approval.

In developing these proposed regulations, the office has consulted with stakeholders, including organizations that represent the interests of local government agencies. The office also conducted pre-rulemaking informational sessions with interested parties and has incorporated the perspectives of those entities here.

These proposed regulations recognize and respect the unique status of local government agencies in California. The California Constitution requires the Legislature to prescribe uniform procedures for the formation of cities (Cal. Const., art. XI, § 2), but once formed, a city may

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<sup>1</sup> All subsequent code section references are to the Government Code, unless otherwise indicated.

make and enforce within its limits all local, police, sanitary, and other ordinances and regulations not in conflict with general laws (Cal. Const., art XI, § 7). Thus, cities may assist the State in providing government services but are only subject to general laws of the State (See, e.g. *Arques v. City of Sausalito* (1954) 126 Cal.2d 403, 406). The California Constitution also allows for the formation of charter cities, which have even greater independence from state control than do non-charter cities (Cal. Const., art. XI, § 3 (a)). California is organized into 58 counties. Counties are expressly designated as political subdivisions of the State in the California Constitution (See Cal. Const., art XI, § 1(a)), and a major function of counties is to assist the State in administering state programs (See *County of Marin v. Superior Court* (1960) 53 Cal.2d 633, 638). Special districts, which also fall within the purview of section 8546.10, are public entities formed to perform particular governmental functions within a limited territory, such as flood control, fire protection, sewer, or power service. Regardless of the specific purpose of the special district, it has only those limited powers specified in law (*Turlock Irrig. Dist. v. Hetrick* (1999) 71 Cal. App.4th 948, 952, 953). Finally, school districts also fall within the definition of a local government agency for purposes of section 8546.10 (*Hall v. City of Taft* (1956) 47 Cal.2d 177, 181).

These proposed regulations recognize the degree of self-governance afforded to local government agencies and their relationship to the State. These proposed regulations also recognize the importance of promoting effective and efficient local government, and are informed by the following key principles:

- 1. Preventing fiscal distress is a key component of promoting local government health:** In proposing these regulations, the State Auditor is guided by the principle that preventing fiscal distress is essential to effective and efficient local government. A recent study by the PEW Foundation titled, *The State Role in Local Government Financial Distress*, highlights the value of acting proactively to prevent fiscal distress at the local level. Prevention requires having robust systems in place for managing financial activities and an effective process for taking action as soon as warning signs of fiscal distress emerge. The process prescribed by these regulations, whereby the State Auditor will identify local governments that are potentially at high risk and that will encourage local government agencies to take immediate and effective action that will allow them to demonstrate that they should not be subject to an audit that may confirm their high risk status, aligns with this key concept of taking effective preventative measures to avoid fiscal or other types of crises.
- 2. A Collaborative and Positive Partnership Between the State Auditor and Local Government Agencies Can Result in Greater Efficiency and Effectiveness at the Local Level and Have Statewide Benefits:** The State Auditor has extensive experience auditing the performance of local government

agencies throughout California. Coupled with the broad state-level expertise of the office, the State Auditor is well poised to assist local government agencies in identifying areas of risk and taking appropriate action to remedy the difficult problems that confront California's local government agencies. Especially now, when most, if not all, local government agencies face fiscal constraints and unprecedented challenges, this program is needed more than ever and is intended to assist local governments in a positive and collaborative way that fosters the effective and efficient use of local government agency resources.

- 3. Local Government Functions Best When Good Ideas are Shared:** Although no two local government agencies are the same, local government agencies throughout California have much in common and face many of the same financial pressures and constraints. A central tenet of the State Auditor's high risk local government agency audit program is that the solutions to the problems local government agencies face should be shared with other local governments that confront the same or similar issues. To that end, these regulations require the State Auditor to make specific recommendations directed at high-risk local government agencies, to work collaboratively with those agencies when developing those recommendations, and to make the solutions to the problems faced by local agencies (corrective action plans) publicly available.

### **Proposed Regulations**

Section 8546.10 does not define the phrase "high risk for the potential of waste, fraud, abuse or mismanagement or has major challenges associated with its economy, efficiency, or effectiveness." Section 8546.10 also does not provide guidance on the particulars of how the high risk local government agency audit program will operate. These proposed regulations make specific the meaning of the quoted phrase above and provide additional specificity regarding the process of identifying a local government agency that is potentially high risk. These regulations also prescribe the process for performing an audit of that local government agency to confirm whether it is high risk, and re-designating that local government agency so that it is no longer considered high risk. Further, these regulations also provide clarity to affected local government agencies and the general public regarding how the high risk local government agency audit program will function.

### **SPECIFIC PURPOSE OF EACH SECTION—GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(1)**

This regulatory proposal would adopt the following sections in California Code of Regulations, title 2, division 10.

The specific purpose of each adoption, and the rationale for the determination that each adoption is reasonably necessary to carry out the purpose for which it is proposed, together with a description of the public problem, administrative requirement, or other condition or circumstance that each adoption or amendment is intended to address, is as follows:

**Proposed Section 61100** sets forth a general statement regarding the purpose of section 8546.10 and provides a general description of the matters to be made specific by these regulations: the definition of key terms; the process by which the State Auditor will identify risk, initiate a high risk local government agency audit, conduct an audit, and perform post-audit follow-up measures to ensure that the recommendations made as a result of the audit are implemented and are effective at improving local government. This proposed regulation is necessary to inform the Legislature, local government agencies, and the general public, and it furthers the purposes of section 8546.10.

**Proposed Section 61101** names the program which will be administered by the State Auditor pursuant to section 8546.10 and these proposed regulations. The name reflects the statute and is intended to convey the core purpose of the high risk local government agency audit program, which is to evaluate the effectiveness of local government and to improve its performance. This proposed regulation is necessary to inform the Legislature, local government agencies, and the general public and furthers the purposes of section 8546.10.

**Proposed Section 61102** defines the term “abuse” in a manner consistent with the generally accepted government auditing standards adopted by the Comptroller General of the United States. This proposed regulation is necessary to provide clarity to the Legislature, local government agencies, and the general public.

**Proposed Section 61103** identifies the Joint Legislative Audit Committee of the Legislature as the “audit committee.” The Joint Legislative Audit Committee is expressly identified in section 8546.10 as the committee that must approve a high risk local government agency audit before it can be conducted by the State Auditor. This proposed regulation is necessary to provide clarity to the Legislature, local government agencies, and the general public.

**Proposed Section 61104** defines the term “fraud” in a manner that is consistent with the generally accepted government auditing standards adopted by the Comptroller General of the United States. This proposed regulation is necessary to provide clarity to the Legislature, local government agencies, and the general public.

**Proposed Section 61105** defines the phrase “high risk” for purposes of section 8546.10. Giving meaning to the terms used in the quoted phrase is very significant because this definition, along with the risk factors specific in section 61121, will inform the Legislature, local government agencies, and the general public of the specific factors that will be used to determine whether a local government agency will be considered potentially high risk, and, therefore, potentially subject to a high risk local government agency audit. This definition will also inform the

Legislature and the general public regarding the operation of this high risk local government agency audit program and furthers the purposes of section 8546.10.

**Proposed section 61106** defines the phrase “local government agency.” The definition contained in the proposed regulation furthers the intent of the Legislature as expressed in section 8546.10. The proposed regulation is necessary to clarify and inform the Legislature, local government agencies, and the general public.

**Proposed section 61107** establishes and defines the term “risk factors” to describe the specific criteria that will be used by the State Auditor to determine whether a local government agency should be identified as being potentially at high risk or at high risk. The proposed regulation furthers the intent of section 8546.10 and provides clarity to the Legislature, local government agencies, and the general public.

**Proposed section 61108** provides clarity by indicating that the California State Auditor, the state official charged with administering section 8546.10 and these regulations, will be known as the “State Auditor.”

**Proposed section 61109** defines “waste” in a manner consistent with the generally accepted government auditing standards adopted by the Comptroller General of the United States. This proposed regulation is necessary to provide clarity to the Legislature, local government agencies, and the general public.

**[Sections 61110 to 61119, inclusive, are reserved.]**

**Proposed section 61120** would prescribe the process by which the State Auditor would identify a high-risk local government agency. Identifying a local government agency that is potentially high risk would be a prerequisite to notifying the audit committee of that determination and proposing to conduct an audit of that agency. This proposed regulation informs and provides clarification and furthers the purposes of section 8546.10.

**Proposed section 61121** would specify the risk factors that the State Auditor may use to identify a local government agency as being potentially at high risk, or at high risk, of potential for waste, fraud, abuse or mismanagement or that has major challenges associated with its economy, efficiency, or effectiveness. Specifying the risk factors that may be used for this purpose is essential to providing transparency and clarity to local government agencies throughout California so that they will understand what characteristics of their operations are likely to result in being designated as a high-risk local government agency.

**Proposed section 61122** would specify that, after identifying a local government agency as having potential risk for waste, fraud, abuse, or mismanagement or major challenges associated with its economy, efficiency, or effectiveness, the State Auditor has the authority to develop an audit proposal.

**[Sections 61123 to 61129, inclusive, are reserved.]**

**Proposed section 61130** would specify that, prior to conducting an audit of a high-risk local government agency, the State Auditor shall obtain approval from the audit committee, and would prescribe related matters, including the information that would be required to be included in an audit proposal submitted to the audit committee. The proposed regulation furthers the purposes of section 8546.10 and provides information and clarity to the Legislature, local government agencies, and the general public.

**Proposed section 61131** would specify, consistent with generally accepted rules of statutory construction, that a high risk local government agency audit conducted pursuant to section 8546.10 would also be governed by the State Auditor's general enabling statutes. This proposed regulation would further the intent of section 8546.10 and provide clarity to the Legislature, local government agencies, and the general public.

**Proposed section 61132** would specify that, prior to publishing a high risk local government agency audit report, the State Auditor would be required to provide the local government agency five business days within which to respond, in writing, to the confidential draft report. This proposed regulation informs and provides clarity to the Legislature, local government agencies, and the general public.

**[Sections 61133 to 61139, inclusive, are reserved.]**

**Proposed section 61140** would specify the manner in which a local government agency would be removed from the high risk local government agency audit program. This proposed regulation is necessary to provide clarity and certainty to local government agencies and to inform the Legislature and the general public. It also furthers the purposes of section 8546.10

**[Sections 61141 to 61149, inclusive, are reserved.]**

**OTHER REQUIRED SHOWINGS–GOVERNMENT CODE SECTION 11346.2, SUBDIVISIONS (b)(2)-(4)**

**Studies, Reports, or Documents Relied Upon-Government Code section 11346.2, subdivision (b)(2):**

- Brown, Ken W., *The 10-Point Test of Financial Condition: Toward an Easy-to-Use Assessment Tool for Smaller Cities* (December 1993), Government Finance Review.
- State of Florida Auditor General, *Financial Condition Assessment Procedures and Appendix A* (Fiscal Year ending September 30, 2013).

- Nollenberger, Karl (Revised; original text by Sanford M. Groves and Maureen Godsey Valente), *Evaluating Financial Condition: A Handbook for Local Government* (ICMA 2003).
- Maher, Craig S. and Karl Nollenberger, *Revisiting Kenneth Brown's "10-Point Test"* (October 2009), Government Finance Review.
- Ohio Auditor of State, *Financial Health Indicators* (2013).
- State of Oregon, Secretary of State Audit Report, *Oregon's Counties: 2012 Financial Condition Review* (May 2012).
- The PEW Charitable Trusts, *The State Role in Local Government Financial Distress* (July 1, 2013).

**Reasonable Alternatives Considered—Government Code section 11346.2, subdivision (b)(3)(A):** The State Auditor considered various alternatives when drafting these proposed regulations. The alternatives included those alternatives presented by interested persons during informal, pre-rulemaking sessions held in 2014.

**Reasonable Alternatives That Would Lessen the Impact on Small Businesses—Government Code section 11346.2, subdivision (b)(3)(B):** The proposed regulations do not impact small business.

**Evidence Relied Upon to Support the Initial Determination that the Regulations Will Not Have a Significant Adverse Economic Impact on Business—Government Code section 11346.2, subdivision (b)(4):** The proposed regulations further implement and make specific Government Code section 8546.10, relating to high risk local government agency audits. Because of the limited scope of these regulations, the State Auditor determined that none of the regulations would have a significant adverse impact on business.