

**ITEM 3**  
**INCORRECT REDUCTION CLAIM**  
**PROPOSED DECISION**

Former Education Code Section 72246 (Renumbered as 76355)<sup>1</sup>  
Statutes 1984, Chapter 1 (1983-1984 2nd Ex. Sess.) (AB2X 1); and  
Statutes 1987, Chapter 1118 (AB 2336)

*Health Fee Elimination*

Fiscal Years 2002-2003, 2003-2004, 2004-2005, 2005-2006, and 2006-2007

10-4206-I-35

San Mateo County Community College District, Claimant

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**EXECUTIVE SUMMARY**

**Overview**

This analysis addresses reductions of \$781,934 made by the State Controller's Office (Controller) to San Mateo County Community College District's (claimant's) reimbursement claims for fiscal years 2002-2003 through 2006-2007 under the *Health Fee Elimination* program. The following issues are in dispute:

- The statutory deadlines applicable to the audit of the 2002-2003 and 2003-2004 reimbursement claims;
- Reduction in service and supply costs, based on the assertions that some costs claimed go beyond the scope of the mandate and are not reimbursable;
- Reduction of costs claimed as a bad debt expense resulting from uncollected student health fees;
- Reduction of costs claimed based on the claimant's development and application of indirect cost rates; and
- The amount of offsetting revenue to be applied from health service fee authority.

**Health Fee Elimination Program**

Prior to 1984, former Education Code section 72246 authorized community college districts that voluntarily provided health supervision and services, direct and indirect medical and hospitalization services, or operation of student health centers to charge almost all students a health service fee not to exceed \$7.50 for each semester or \$5 for each quarter or summer

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<sup>1</sup> Statutes 1993, chapter 8.

session, to fund these services.<sup>2</sup> In 1984, the Legislature repealed the community colleges' fee authority for health services.<sup>3</sup> However, the Legislature also reenacted section 72246, to become operative on January 1, 1988, to reauthorize the fee, at \$7.50 for each semester (or \$5 per quarter or summer session).<sup>4</sup>

In addition to temporarily repealing community college districts' authority to levy a health services fee, the 1984 enactment required any district that provided health services during the 1983-1984 fiscal year, for which districts were previously authorized to charge a fee, to maintain health services at the level provided during the 1983-1984 fiscal year for every subsequent fiscal year until January 1, 1988.<sup>5</sup> As a result, community college districts were required to maintain health services provided in the 1983-1984 fiscal year without any fee authority for this purpose until January 1, 1988.

In 1987, the Legislature amended former Education Code section 72246, operative January 1, 1988, to incorporate and extend the maintenance of effort provisions of former Education Code section 72246.5, which became inoperative by its own terms as of January 1, 1988.<sup>6</sup> In addition, Statutes 1987, chapter 1118 restated that the fee would be reestablished at not more than \$7.50 for each semester, or \$5 for each quarter or summer session.<sup>7</sup> As a result, beginning January 1, 1988, all community college districts were required to maintain the same level of health services they provided in the 1986-1987 fiscal year each year thereafter, with limited fee authority to offset the costs of those services. In 1992, section 72246 was amended to provide that the health fee could be increased by the same percentage as the Implicit Price Deflator whenever that calculation would produce an increase of one dollar.<sup>8</sup>

### **Procedural History**

The claimant signed and dated its reimbursement claims to the Controller for the 2002-2003 and 2003-2004 fiscal years on January 10, 2005 and submitted the claims with a cover letter dated January 12, 2005.<sup>9</sup> The claimant signed and dated its 2004-2005 fiscal year claim on

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<sup>2</sup> Former Education Code section 72246 (Stats. 1981, ch. 763). Low-income students, students that depend upon prayer for healing, and students attending a college under an approved apprenticeship training program, were exempt from the fee.

<sup>3</sup> Statutes 1984, 2nd Extraordinary Session, chapter 1, section 4, repealing Education Code section 72246.

<sup>4</sup> Statutes 1984, 2nd Extraordinary Session, chapter 1, section 4.5.

<sup>5</sup> Education Code section 72246.5 (Stats. 1984, 2d. Ex. Sess., ch. 1, § 4.7).

<sup>6</sup> Education Code section 72246 (as amended, Stats. 1987, ch. 1118). See also former Education Code section 72246.5 (Stats. 1984, 2d Ex. Sess., ch. 1, § 4.7).

<sup>7</sup> Education Code section 72246 (as amended, Stats. 1987, ch. 1118).

<sup>8</sup> Education Code section 72246 (as amended, Stats. 1992, ch. 753). In 1993, former Education Code section 72246, was renumbered as Education Code section 76355 (Stats. 1993, ch. 8).

<sup>9</sup> Exhibit A, IRC, Claimant's Reimbursement Claim for FY 2002-2003 and 2003-2004, pages 118, 119.

January 10, 2006 and submitted it with a cover letter dated January 12, 2006.<sup>10</sup> The claim for the 2005-2006 fiscal year was signed and dated on December 20, 2017 and submitted with a cover letter dated December 21, 2007.<sup>11</sup> The claim for the 2006-2007 fiscal year was signed and dated January 17, 2008 and was submitted with a cover letter dated January 25, 2008.<sup>12</sup> On September 8, 2008, the Controller conducted an audit entrance conference for the claims for all five fiscal years.<sup>13</sup> On September 23, 2009, the Controller issued its final audit report.<sup>14</sup>

Claimant filed this Incorrect Reduction Claim (IRC) on November 29, 2010.<sup>15</sup> The Controller filed late comments on the IRC on December 2, 2014.<sup>16</sup> Commission on State Mandates (Commission) staff issued the Draft Proposed Decision on March 17, 2017.<sup>17</sup> On March 24, 2017, the Controller filed comments agreeing with the Draft Proposed Decision.<sup>18</sup> On April 6, 2017, the claimant filed comments on the Draft Proposed Decision, agreeing with the finding that the reduction of indirect costs for fiscal year 2004-2005 is incorrect as a matter of law. However, the claimant continues to disagree with the remaining findings. In addition, the claimant clarified the amount reduced by the Controller in Finding 1, and asked for those numbers to be corrected.<sup>19</sup>

### **Commission Responsibilities**

Government Code section 17561(d) authorizes the Controller to audit the claims filed by local agencies and school districts and to reduce any claim for reimbursement of state-mandated costs that the Controller determines is excessive or unreasonable.

Government Code Section 17551(d) requires the Commission to hear and decide a claim that the Controller has incorrectly reduced payments to the local agency or school district. If the Commission determines that a reimbursement claim has been incorrectly reduced, section 1185.9 of the Commission's regulations requires the Commission to send the decision to the Controller and request that the costs in the claim be reinstated.

The Commission must review questions of law, including interpretation of parameters and guidelines, de novo, without consideration of conclusions made by the Controller in the context of an audit. The Commission is vested with exclusive authority to adjudicate disputes over the existence of state-mandated programs within the meaning of article XIII B, section 6 of the

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<sup>10</sup> Exhibit A, IRC, Claimant's Reimbursement Claim for FY 2004-2005, pages 128, 129.

<sup>11</sup> Exhibit A, IRC, Claimant's Reimbursement Claim for FY 2005-2006, pages 138,139.

<sup>12</sup> Exhibit A, IRC, Claimant's Reimbursement Claim for FY 2006-2007, pages 148, 149.

<sup>13</sup> Exhibit B, Controller's Late Comments on the IRC, page. 15.

<sup>14</sup> Exhibit A, IRC, page 63.

<sup>15</sup> Exhibit A, IRC.

<sup>16</sup> Exhibit B, Controller's Late Comments on the IRC.

<sup>17</sup> Exhibit C, Draft Proposed Decision.

<sup>18</sup> Exhibit D, Controller's Comments on the Draft Proposed Decision.

<sup>19</sup> Exhibit E, Claimant's Comments on the Draft Proposed Decision. The amount reduced by the Controller in Finding 1 has been corrected.

California Constitution.<sup>20</sup> The Commission must also interpret the Government Code and implementing regulations in accordance with the broader constitutional and statutory scheme. In making its decisions, the Commission must strictly construe article XIII B, section 6 and not apply it as an “equitable remedy to cure the perceived unfairness resulting from political decisions on funding priorities.”<sup>21</sup>

With regard to the Controller’s audit decisions, the Commission must determine whether they were arbitrary, capricious, or entirely lacking in evidentiary support. This standard is similar to the standard used by the courts when reviewing an alleged abuse of discretion of a state agency.<sup>22</sup>

The Commission must also review the Controller’s audit in light of the fact that the initial burden of providing evidence for a claim of reimbursement lies with the claimant.<sup>23</sup> In addition, sections 1185.1(f)(3) and 1185.2(c) of the Commission’s regulations requires that any assertions of fact by the parties to an IRC must be supported by documentary evidence. The Commission’s ultimate findings of fact must be supported by substantial evidence in the record.<sup>24</sup>

### **Claims**

The following chart provides a brief summary of the claims and issues raised and staff’s recommendation.

<b>Issue</b>	<b>Description</b>	<b>Staff Recommendation</b>
Whether the audit of the fiscal year 2002-2003 and 2003-2004 reimbursement claims was timely initiated and completed within the deadlines required by Government Code section 17558.5.	<p>The claimant alleges that the Controller failed to timely commence the audit of the fiscal year 2002-2003 and 2003-2004 reimbursement claims.</p> <p>The Controller alleges that the audit was timely.</p> <p>Government Code section 17558.5 requires a valid audit to</p>	<i>The audit is timely initiated and timely completed</i> – The 2002-2003 and 2003-2004 reimbursement claims were filed January 12, 2005, and the audit entrance conference took place on December 8, 2008. However, the claimant did not receive a payment for the 2002-2003 reimbursement claim until October 25, 2006, and had not

<sup>20</sup> *Kinlaw v. State of California* (1991) 54 Cal.3d 326, 331-334; Government Code sections 17551, 17552.

<sup>21</sup> *County of Sonoma v. Commission on State Mandates*, (2000) 84 Cal.App.4th 1264, 1281, citing *City of San Jose v. State of California* (1996) 45 Cal.App.4th 1802, 1817.

<sup>22</sup> *Johnston v. Sonoma County Agricultural Preservation and Open Space District* (2002) 100 Cal.App.4th 973, 983-984. See also *American Bd. of Cosmetic Surgery, Inc. v. Medical Bd. of California* (2008) 162 Cal.App.4th 534, 547.

<sup>23</sup> *Gilbert v. City of Sunnyvale* (2005) 130 Cal.App.4th 1264, 1274-1275.

<sup>24</sup> Government Code section 17559(b), which provides that a claimant or the state may commence a proceeding in accordance with the provisions of section 1094.5 of the Code of Civil Procedure to set aside a decision of the Commission on the ground that the Commission’s decision is not supported by substantial evidence in the record.

	<p>be initiated no later than three years after the date the reimbursement claim is filed or last amended. However, the section also provides that <i>if no funds are appropriated or no payment is made</i> “to a claimant for the program for the fiscal year for which the claim is filed, the time for the Controller to initiate an audit shall commence to run from the date of initial payment of the claim.”</p>	<p>received payment for the fiscal year 2003-2004 when the audit was initiated. Therefore, the Controller’s initiation of the audit with the entrance conference on December 8, 2008, was timely. In addition, the audit was timely completed. The final audit report was issued September 23, 2009, prior to the expiration of the two year deadline on December 8, 2010.</p>
<p>Reduction of costs claimed for unallowable services and supplies for gift certificates, food, and other promotional items distributed during health fairs.</p>	<p>The claimant argues that the costs of promotional items for a student health fair are within the scope of the mandate.</p>	<p><i>Correct</i> – The plain language of the Parameters and Guidelines allows reimbursement to conduct health fairs in order to provide information to students regarding various health issues, <i>to the extent</i> they were conducted in fiscal year 1986-1987. Thus, if the promotional items were not provided by the district in the base year, these costs go beyond the scope of the mandate. The claimant has not argued or submitted any evidence, as required by the Parameters and Guidelines, that it provided these promotional items in the base year as an integral part of its health fairs. Thus, the reduction is correct as a matter of law, and is not arbitrary, capricious, or entirely lacking in evidentiary support.</p>
<p>Reduction of costs claimed as a bad debt expense resulting from uncollected student health fees.</p>	<p>The claimant argues that the bad debt expense for uncollectible health service fees is reimbursable, arguing that “[a]s a practical matter, college districts do not incur this cost as a discretionary activity, the cost is forced upon the districts by those students who do not pay their fees.” The claimant further states that it reported gross student health service fee income as offsetting revenue and the</p>	<p><i>Correct</i> – The Parameters and Guidelines authorize reimbursement for the costs of providing health supervision and services and direct and indirect medical and hospitalization services to students, and the operation of student health centers, to the extent the community college provided these services in fiscal year 1986-1987. Health service fees authorized by statute to be charged, but remain uncollectible, are not</p>

	uncollected amounts as an expense; “an appropriate application of generally accepted accounting principles.”	costs identified in the Parameters and Guidelines as eligible for reimbursement.
Reduction of costs claimed based on the claimant’s development and application of indirect cost rates.	<p>The district claimed indirect costs for all fiscal years based on a federally approved rate of 30 percent, developed using “a base of ‘Direct salaries and wages including all fringe benefits.’” For fiscal years 2002-2003 and 2003-2004, the Controller found that the claimant overstated indirect costs because it incorrectly applied the indirect cost rate to a base of total direct costs, rather than to a base of salaries and benefits only, as approved by the federal government. This resulted in a reduction of \$21,298 for the two fiscal years.</p> <p>For fiscal years 2004-2005, 2005-2006, and 2006-2007, the Controller adjusted indirect costs because the claiming instructions, beginning for the fiscal year 2004-2005 reimbursement claims, do not allow the use of a federally approved rate to claim indirect costs unless specifically approved in the Commission’s Parameters and Guidelines. The Parameters and Guidelines for the <i>Health Fee Elimination</i> program provide only that “indirect costs may be claimed in the manner described by the State Controller in his claiming instructions.” The Controller recalculated indirect costs using the FAM-29C methodology, resulting in a reduction of \$4,896 for fiscal year 2004-2005, and an</p>	<p><i>Partially Correct</i> – The reduction of indirect costs in fiscal years 2002-2003 and 2003-2004 is correct as a matter of law. Section H(2)(e) of the OMB Circular A-21 requires the rate to be applied only to direct salaries and wages. Thus, the claimant did not comply with the OMB Circular A-21 or the negotiated agreement with the federal government and, instead, applied the rate to all direct costs. Moreover, there is no evidence that the Controller’s recalculation of indirect costs is arbitrary, capricious, or entirely lacking in evidentiary support.</p> <p>The reduction for fiscal year 2004-2005, however, is incorrect as a matter of law. The Controller’s new indirect cost rate rule is included in the Controller’s Mandated Cost Manual, “updated December 27, 2005,” which applied to the fiscal year 2004-2005 reimbursement claims due to be filed by January 15, 2006, just two weeks later. However, the Parameters and Guidelines may validly incorporate manuals and other documents by reference as long the incorporated document is adequately identified and available for comment. If the manual or document that is incorporated by reference later changes without notice or opportunity for comment, then the new rule may become an invalid underground regulation. There is no evidence in the record, such as a proof of service or</p>

	<p>increase of \$25,303 for fiscal years 2005-2006 and 2006-2007.</p>	<p>certificate of mailing, that the Controller provided notice of the change in the rule to the claimant, or an opportunity to comment. Even if the updated Mandated Cost Manual was, in fact, issued to community college districts on December 27, 2005 (the date of the manual), the claimant would not have had sufficient notice or an opportunity to comment before the 2004-2005 reimbursement claim was due on January 15, 2006.</p> <p>Since the Controller's adjustment to indirect costs in fiscal years 2005-2006 and 2006-2007 does not result in a reduction, the Commission has no jurisdiction under Government Code section 17551(d) to review the Controller's audit adjustment for those fiscal years.</p>
<p>Reductions based on understated offsetting student health fee authority.</p>	<p>The claimant asserts that the Controller incorrectly reduced costs claimed based on fees authorized to be charged, rather than the fee revenue actually collected.</p>	<p><i>Correct</i> – This issue has been conclusively decided by <i>Clovis Unified School District v. Chiang</i> (2010) 188 Cal.App.4th 794, in which the court held that local government is required to identify and deduct the full amount of fees authorized to be charged, and not only the fee revenue actually collected. Therefore, this reduction is correct as a matter of law. In addition, the Controller's calculation of authorized health service fees, based on student enrollment and BOGG recipient data from the Chancellor's Office is not arbitrary, capricious, or entirely lacking in evidentiary support.</p>

### **Staff Analysis**

#### **A. The Audit of the 2002-2003 and 2003-2004 Reimbursement Claims Was Timely Initiated and Timely Completed.**

Government Code section 17558.5 requires a valid audit to be initiated no later than three years after the date the reimbursement claim is filed or last amended. However, section 17558.5 also

provides that *if no funds are appropriated or no payment is made* “to a claimant for the program for the fiscal year for which the claim is filed, the time for the Controller to initiate an audit shall commence to run from the date of initial payment of the claim.”

Here, the 2002-2003 and 2003-2004 reimbursement claims were filed on or about January 12, 2005, and the audit entrance conference took place on December 8, 2008. However, the claimant did not receive a payment for the 2002-2003 reimbursement claim until October 25, 2006, and had not received payment for the fiscal year 2003-2004 when the audit was initiated. Therefore, the Controller’s initiation of the audit with the entrance conference on December 8, 2008, was timely.

In addition, the audit was timely completed. The final audit report was issued September 23, 2009, prior to the expiration of the two year deadline on December 8, 2010.

**B. The Controller’s Reduction of Costs for Gift Certificates, Health Fair Food, and Other Promotional Items Is Correct as a Matter of Law and Is Not Arbitrary, Capricious, or Entirely Lacking in Evidentiary Support.**

The Controller’s reduction of costs for gift certificates, food, and other promotional items distributed during health fairs is correct as a matter of law, and is not arbitrary, capricious, or without evidentiary support. The Parameters and Guidelines authorize reimbursement for the costs to provide health services to students in the claim year, including the costs for health fairs to distribute information to students, *to the extent* the district provided the service in fiscal year 1986-1987.<sup>25</sup> Thus, to the extent that these promotional items were not provided by the district in the base year, these costs go beyond the scope of the mandate. Here, the record contains invoices supporting the costs incurred in the claim year for gift certificates, food, and other promotional items distributed during health fairs.<sup>26</sup> However, claimant has not argued or submitted any evidence, as required by the Parameters and Guidelines, that it provided these promotional items in the base year as an integral part of its health fairs.

**C. The Controller’s Reduction of Costs Claimed as a Bad Debt Expense for Uncollected Student Health Fees Is Correct as a Matter of Law.**

The Controller’s reduction of costs claimed as a bad debt expense resulting from uncollected student health fees is correct as a matter of law. The Parameters and Guidelines authorize reimbursement for the costs of providing health supervision and services and direct and indirect medical and hospitalization services to students, and the operation of student health centers, to the extent the community college provided these services in fiscal year 1986-1987. Health service fees authorized by statute to be charged, but uncollectible, are not costs identified in the Parameters and Guidelines as eligible for reimbursement.

**D. The Controller’s Reduction of Indirect Costs for Fiscal Years 2002-2003, 2003-2004, and 2004-2005 Is Partially Correct; and the Commission Does Not Have Jurisdiction to Review the Controller’s Adjustment of Indirect Costs That Resulted in Increased Reimbursement in Fiscal Years 2005-2006 and 2006-2007.**

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<sup>25</sup> Exhibit A, IRC, page 40, emphasis added.

<sup>26</sup> Exhibit B, Controller’s Late Comments on the IRC, pages 89-109.

The Controller's reduction of indirect costs is partially correct. The district claimed indirect costs for all fiscal years under the OMB Circular A-21 based on a federally approved rate of 30 percent, developed using a base of "Direct salaries and wages including all fringe benefits."<sup>27</sup> For fiscal years 2002-2003 and 2003-2004, the Controller found that the claimant overstated indirect costs because it incorrectly applied the indirect cost rate to a base of total direct costs, rather than to a base of salaries and benefits only, as approved by the federal government. This reduction is correct as a matter of law. Section H(2)(e) of the OMB Circular A-21 requires the rate to be applied only to direct salaries and wages.<sup>28</sup> Thus, the claimant did not comply with the OMB Circular A-21 or the negotiated agreement with the federal government and, instead, applied the rate to all direct costs. Moreover, there is no evidence that the Controller's recalculation is arbitrary, capricious, or entirely lacking in evidentiary support.

The reduction for fiscal year 2004-2005, however, is incorrect as a matter of law. The Controller adjusted indirect costs based solely on the ground that the claiming instructions were changed beginning with the fiscal year 2004-2005 reimbursement claims, to not allow the use of a federally approved rate to claim indirect costs unless specifically approved in the Commission's Parameters and Guidelines. The Controller's new indirect cost rate rule is included in the Controller's Mandated Cost Manual, "updated December 27, 2005," which applied to the fiscal year 2004-2005 reimbursement claims due to be filed by January 15, 2006, just two weeks later.<sup>29</sup> Although the new rule allows the use of the federal OMB Circular A-21 "if specifically allowed by a mandated program's Ps & Gs," the Parameters and Guidelines for the *Health Fee Elimination* Program do not contain that language and, thus, the Controller's change to the rule effectively prohibits the use of the federal method for calculating indirect costs for this program for fiscal year 2004-2005. Parameters and guidelines are regulatory in nature and may validly incorporate manuals and other documents by reference as long the incorporated document is adequately identified and available for comment.<sup>30</sup> However, if the manual or document that is incorporated by reference later changes without notice or opportunity for comment, then the new rule or standard of general application in the incorporated document may become an invalid underground regulation.<sup>31</sup> There is no evidence in the record, such as a proof of service or certificate of mailing, that the Controller provided notice of the change in the rule to the claimant. Even if the updated Mandated Cost Manual was, in fact, issued to community college districts on December 27, 2005 (the date of the manual), the claimant would not have had sufficient notice or opportunity to comment before the 2004-2005 reimbursement claim was due on January 15, 2006. Thus, the Commission finds that the Controller's reduction of indirect

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<sup>27</sup> Exhibit A, IRC, pages 13, and 109 and 120 (federal approval letter of indirect cost rate, dated March 11, 2003, and effective for the period of July 1, 2003, through June 30, 2008); Exhibit B, Controller's Late Comments on the IRC, pages 48-51 (federal approval letter of indirect cost rate, dated February 4, 1999, and effective for the period of July 1, 1999 through June 30, 2004).

<sup>28</sup> Exhibit F, OMB Circular A-21, page 39 (emphasis added).

<sup>29</sup> Exhibit F, Mandated Cost Manual updated December 27, 2005; Government Code section 17560, as amended by Statutes 1998, chapter 681.

<sup>30</sup> *Clovis Unified School Dist. v. Chiang* (2010) 188 Cal.App.4th 794, 799; *Kings Rehabilitation Center Inc. v. Premo* (1999) 69 Cal.App.4th 215, 220.

<sup>31</sup> *Kings Rehabilitation Center Inc. v. Premo* (1999) 69 Cal.App.4th 215, 219-220.

costs in fiscal year 2004-2005, based solely on the Controller's change to the claiming instructions and its use of the new indirect cost rate rule, without evidence that notice and an opportunity for comment was provided to the claimant, is an invalid underground regulation and the costs reduced should be reinstated to the claimant.

Since the Controller's adjustment to indirect costs in fiscal years 2005-2006 and 2006-2007 does not result in a reduction, the Commission has no jurisdiction under Government Code section 17551(d) to review the Controller's audit adjustment for those fiscal years.

**E. The Controller's Reduction for Understated Offsetting Revenues Is Correct as a Matter of Law, and Not Arbitrary, Capricious, or Entirely Lacking in Evidentiary Support.**

The Controller's reduction based on the claimant's unreported offsetting fee authority is correct as a matter of law, and is not arbitrary, capricious, or entirely lacking in evidentiary support. This issue has been conclusively decided in *Clovis Unified School District*,<sup>32</sup> in which the court held that local government is required to identify and deduct the total amount of fees authorized to be charged, and not only the fee revenue actually collected. The court stated that local government could choose not to exercise statutory fee authority to its maximum extent, but not at the state's expense. The Commission further finds that the Controller's calculation of the claimant's authorized offsetting fee revenue is not arbitrary, capricious, or entirely lacking in evidentiary support, since the Controller used the enrollment data available and reported by the claimant. The Controller obtained student enrollment and Board of Governors Grant (BOGG) recipient data from the California Community College's Chancellor's Office and calculated the authorized health service fees using the authorized rates approved by the Chancellor's Office for the fiscal years at issue.<sup>33</sup>

**Conclusion**

Staff concludes that the Controller's reduction of indirect costs of \$4,896 for fiscal year 2004-2005, based solely on the change to the claiming instructions and its use of the new indirect cost rate rule, without evidence that notice and opportunity for comment was provided to the claimant, is incorrect as a matter of law and should be reinstated to the claimant.

Staff further finds that the remaining reductions are correct as a matter of law and not arbitrary, capricious, or entirely lacking in evidentiary support.

**Staff Recommendation**

Staff recommends that the Commission adopt the Proposed Decision to partially approve the IRC and request, pursuant to Government Code section 17551(d) and section 1185.9 of the Commission's regulations, that the Controller reinstate costs to the claimant. Staff further recommends that the Commission authorize staff to make any technical, non-substantive changes following the hearing.

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<sup>32</sup> *Clovis Unified School District v. Chiang* (2010) 188 Cal.App.4th 794.

<sup>33</sup> Exhibit A, IRC, page 80.

BEFORE THE  
COMMISSION ON STATE MANDATES  
STATE OF CALIFORNIA

**IN RE INCORRECT REDUCTION CLAIM  
ON:**

Former Education Code Section 72246  
(Renumbered as 76355)<sup>34</sup>

Statutes 1984, Chapter 1 (1983-1984 2nd Ex.  
Sess.) (AB2X 1); and Statutes 1987, Chapter  
1118 (AB 2336)

Fiscal Years 2002-2003, 2003-2004, 2004-  
2005, 2005-2006, and 2006-2007

San Mateo County Community College  
District, Claimant

Case No.: 10-4206-I-35

*Health Fee Elimination*

DECISION PURSUANT TO  
GOVERNMENT CODE SECTION 17500  
ET SEQ.; CALIFORNIA CODE OF  
REGULATIONS, TITLE 2, DIVISION 2,  
CHAPTER 2.5. ARTICLE 7

*(Adopted May 26, 2017)*

**DECISION**

The Commission on State Mandates (Commission) heard and decided this Incorrect Reduction Claim (IRC) during a regularly scheduled hearing on May 26, 2017. [Witness list will be included in the adopted Decision.]

The law applicable to the Commission's determination of a reimbursable state-mandated program is article XIII B, section 6 of the California Constitution, Government Code section 17500 et seq., and related case law.

The Commission [adopted/modified] the Proposed Decision to [approve/partially approve/deny] the IRC by a vote of [vote count will be included in the adopted Decision].

<b>Member</b>	<b>Vote</b>
Lee Adams, County Supervisor	
Ken Alex, Director of the Office of Planning and Research	
Richard Chivaro, Representative of the State Controller, Vice Chairperson	
Mark Hariri, Representative of the State Treasurer	
Sarah Olsen, Public Member	
Eraina Ortega, Representative of the Director of the Department of Finance, Chairperson	
Carmen Ramirez, City Council Member	

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<sup>34</sup> Statutes 1993, chapter 8.

## **Summary of the Findings**

This Decision addresses the IRC filed by San Mateo County Community College District (claimant) regarding reductions made by the State Controller's Office (Controller) to reimbursement claims for fiscal years 2002-2003 through 2006-2007 under the *Health Fee Elimination* program. Over the five fiscal years in question, the Controller reduced costs totaling \$781,934, of which \$732,846 is in dispute. The Controller made reductions based on its findings of unallowable costs for services and supplies (gift certificates, food, and other promotional items distributed during health fairs); unallowable costs for uncollected student health fees as a bad debt expense; overstated indirect costs; and understated health fees authorized to be collected.

The Commission finds that the Controller timely initiated the audit of the fiscal year 2002-2003 and 2003-2004 reimbursement claims pursuant to Government Code section 17558.5, since payment on the 2002-2003 reimbursement claim was made within three years of the date the audit was initiated, and no payment had been made for the 2003-2004 claim at the time the audit was initiated. The audit was complete for all reimbursement claims before the two-year deadline.

On the merits, the Commission finds as follows:

- The Controller's reduction of costs for gift certificates, food, and other promotional items distributed during health fairs is correct as a matter of law, and is not arbitrary, capricious, or without evidentiary support. The Parameters and Guidelines authorize reimbursement for the costs to provide health services to students in the claim year, including the costs for health fairs to distribute information to students, *to the extent* the district provided the service in fiscal year 1986-1987.<sup>35</sup> Thus, to the extent that these promotional items were not provided by the district in the base year, these costs go beyond the scope of the mandate. Here, the record contains invoices supporting the costs incurred in the claim year for gift certificates, food, and other promotional items distributed during health fairs.<sup>36</sup> However, claimant has not argued or submitted any evidence, as required by the Parameters and Guidelines, that it provided these promotional items in the base year as an integral part of its health fairs.
- The Controller's reduction of costs claimed as a bad debt expense resulting from uncollected student health fees is correct as a matter of law. The Parameters and Guidelines authorize reimbursement for the costs of providing health supervision and services and direct and indirect medical and hospitalization services to students, and the operation of student health centers, to the extent the community college provided these services in fiscal year 1986-1987. Health service fees authorized by statute to be charged, but uncollectible, are not costs identified in the Parameters and Guidelines as eligible for reimbursement.
- The Controller's reduction of indirect costs is partially correct. The district claimed indirect costs for all fiscal years under the OMB Circular A-21 based on a federally approved rate of 30 percent, developed using a base of "Direct salaries and wages

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<sup>35</sup> Exhibit A, IRC, page 40, emphasis added.

<sup>36</sup> Exhibit B, Controller's Late Comments on the IRC, pages 89-109.

including all fringe benefits.”<sup>37</sup> For fiscal years 2002-2003 and 2003-2004, the Controller found that the claimant overstated indirect costs because it incorrectly applied the indirect cost rate to a base of total direct costs, rather than to a base of salaries and benefits only, as approved by the federal government. This reduction is correct as a matter of law. Section H(2)(e) of the OMB Circular A-21 requires the rate to be applied only to direct salaries and wages.<sup>38</sup> Thus, the claimant did not comply with the OMB Circular A-21 or the negotiated agreement with the federal government and, instead, applied the rate to all direct costs. Moreover, there is no evidence that the Controller’s recalculation is arbitrary, capricious, or entirely lacking in evidentiary support.

The reduction for fiscal year 2004-2005, however, is incorrect as a matter of law. The Controller adjusted indirect costs based solely on the ground that the claiming instructions were changed beginning with the fiscal year 2004-2005 reimbursement claims, to not allow the use of a federally approved rate to claim indirect costs unless specifically approved in the Commission’s Parameters and Guidelines. The Controller’s new indirect cost rate rule is included in the Controller’s Mandated Cost Manual, “updated December 27, 2005,” which applied to fiscal year 2004-2005 reimbursement claims to be filed by January 15, 2006, just two weeks later.<sup>39</sup> Although the new rule allows the use of the federal OMB Circular A-21 “if specifically allowed by a mandated program’s Ps & Gs,” the Parameters and Guidelines for the *Health Fee Elimination* Program do not contain that language and, thus, the Controller’s change to the rule effectively prohibits the use of the federal method for calculating indirect costs for this program in fiscal year 2004-2005. Parameters and guidelines are regulatory in nature and may validly incorporate manuals and other documents by reference as long the incorporated document is adequately identified and available for comment.<sup>40</sup> However, if the manual or document that is incorporated by reference later changes without notice or opportunity for comment, then the new rule or standard of general application in the incorporated document may become an invalid underground regulation.<sup>41</sup> There is no evidence in the record, such as a proof of service or certificate of mailing, that the Controller provided notice of the change in the rule to the claimant or that the Claimant received the updated Mandated Cost Manual prior to filing its 2004-2005 reimbursement claim. Even if the updated Mandated Cost Manual was, in fact, issued to community college districts on December 27, 2005 (the date of the manual), the claimant would not have had sufficient notice or opportunity to comment before the 2004-2005

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<sup>37</sup> Exhibit A, IRC, pages 13, and 109 and 120 (federal approval letter of indirect cost rate, dated March 11, 2003, and effective for the period of July 1, 2003, through June 30, 2008); Exhibit B, Controller’s Late Comments on the IRC, pages 48-51 (federal approval letter of indirect cost rate, dated February 4, 1999, and effective for the period of July 1, 1999 through June 30, 2004).

<sup>38</sup> Exhibit F, OMB Circular A-21, page 39 (emphasis added).

<sup>39</sup> Exhibit F, Mandated Cost Manual updated December 27, 2005; Government Code section 17560, as amended by Statutes 1998, chapter 681.

<sup>40</sup> *Clovis Unified School Dist. v. Chiang* (2010) 188 Cal.App.4th 794, 799; *Kings Rehabilitation Center Inc. v. Premo* (1999) 69 Cal.App.4th 215, 220.

<sup>41</sup> *Kings Rehabilitation Center Inc. v. Premo* (1999) 69 Cal.App.4th 215, 219-220.

reimbursement claim was due on January 15, 2006. Thus, the Commission finds that the Controller's reduction of indirect costs in fiscal year 2004-2005, based solely on the Controller's change to the claiming instructions and its use of the new indirect cost rate rule, without evidence that notice and an opportunity for comment was provided to the claimant, is an invalid underground regulation and the costs reduced should be reinstated to the claimant.

Since the Controller's adjustment to indirect costs in fiscal years 2005-2006 and 2006-2007 does not result in a reduction, the Commission has no jurisdiction under Government Code section 17551(d) to review the Controller's audit adjustment for those fiscal years.

- The Controller's reduction based on the claimant's unreported offsetting fee authority is correct as a matter of law, and is not arbitrary, capricious, or entirely lacking in evidentiary support. This issue has been conclusively decided in *Clovis Unified School District*,<sup>42</sup> in which the court held that local government is required to identify and deduct the total amount of fees authorized to be charged, and not only the fee revenue actually collected. The court stated that local government could choose not to exercise statutory fee authority to its maximum extent, but not at the state's expense. The Commission further finds that the Controller's calculation of the claimant's authorized offsetting fee revenue is not arbitrary, capricious, or entirely lacking in evidentiary support, since the Controller used the enrollment data available and reported by the claimant. The Controller obtained student enrollment and Board of Governors Grant (BOGG) recipient data from the California Community College's Chancellor's Office and calculated the authorized health service fees using the authorized rates approved by the Chancellor's Office for the fiscal years at issue.<sup>43</sup>

The Commission, therefore, partially approves this IRC and requests that the Controller reinstate \$4,896 to the claimant.

## **COMMISSION FINDINGS**

### **I. Chronology**

- 01/10/2005     Claimant signed and dated its reimbursement claims for fiscal years 2002-2003 and 2003-2004. The claims were submitted with a cover letter dated January 12, 2005.<sup>44</sup>
- 01/10/2006     Claimant signed and dated its reimbursement claim for fiscal year 2004-2005. The claim was submitted with a cover letter dated January 12, 2006.<sup>45</sup>

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<sup>42</sup> *Clovis Unified School District v. Chiang* (2010) 188 Cal.App.4th 794.

<sup>43</sup> Exhibit A, IRC, page 80.

<sup>44</sup> Exhibit A, IRC, Claimant's Reimbursement Claim for FY 2002-2003 and 2003-2004, pages 117, 118.

<sup>45</sup> Exhibit A, IRC, Claimant's Reimbursement Claim for FY 2004-2005, pages 128,129.

10/25/2006 The Controller issued a payment of \$307,148 for fiscal year 2002-2003.<sup>46</sup>

12/20/2007 Claimant signed and dated its reimbursement claim for fiscal year 2005-2006. The claim was submitted with a cover letter dated December 20, 2007.<sup>47</sup>

01/17/2008 Claimant signed and dated its reimbursement claim for fiscal year 2006-2007. The claim was submitted with a cover letter dated January 25, 2007.<sup>48</sup>

09/08/2008 The entrance conference for the audit of the 2002-2003, 2003-2004, 2004-2005, 2005-2006, and 2006-2007 reimbursement claims was held.<sup>49</sup>

07/22/2009 The Controller issued the draft audit report.

08/07/2009 Claimant submitted comments on the draft audit report.<sup>50</sup>

09/23/2009 The Controller issued the final audit report.<sup>51</sup>

11/29/2010 Claimant filed this IRC.<sup>52</sup>

12/02/2014 Controller filed late comments on the IRC.<sup>53</sup>

03/17/2017 Commission staff issued the Draft Proposed Decision.<sup>54</sup>

03/24/2017 The Controller filed comments on the Draft Proposed Decision.<sup>55</sup>

04/06/2017 Claimant filed comments on the Draft Proposed Decision.<sup>56</sup>

## II. Background

### A. The Health Fee Elimination Program

Prior to 1984, former Education Code section 72246 authorized community college districts that voluntarily provided health supervision and services, direct and indirect medical and hospitalization services, or operation of student health centers to charge almost all students a health service fee not to exceed \$7.50 for each semester or \$5 for each quarter or summer

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<sup>46</sup> Exhibit A, IRC, page 36.

<sup>47</sup> Exhibit A, IRC, Claimant's Reimbursement Claim for FY 2005-2006, pages 138, 139.

<sup>48</sup> Exhibit A, IRC, Claimant's Reimbursement Claim for FY 2006-2007, page 148.

<sup>49</sup> Exhibit B, Controller's Late Comments on the IRC, page. 15.

<sup>50</sup> Exhibit A, IRC, page 91-97.

<sup>51</sup> Exhibit A, IRC, page 63.

<sup>52</sup> Exhibit A, IRC.

<sup>53</sup> Exhibit B, Controller's Late Comments on the IRC.

<sup>54</sup> Exhibit C, Draft Proposed Decision.

<sup>55</sup> Exhibit D, Controller's Comments on the Draft Proposed Decision.

<sup>56</sup> Exhibit E, Claimant's Comments on the Draft Proposed Decision.

session, to fund these services.<sup>57</sup> In 1984, the Legislature repealed the community colleges' fee authority for health services.<sup>58</sup> However, the Legislature also reenacted section 72246, to become operative on January 1, 1988, to reauthorize the fee at \$7.50 for each semester (or \$5 per quarter or summer session).<sup>59</sup>

In addition to temporarily repealing community college districts' fee authority, Statutes 1984, chapter 1 required any district that provided health services during the 1983-1984 fiscal year, for which districts were previously authorized to charge a fee, to maintain the health services at the level provided during the 1983-1984 fiscal year for every subsequent fiscal year until January 1, 1988.<sup>60</sup> As a result, community college districts were required to maintain health services provided in the 1983-1984 fiscal year without any fee authority for this purpose until January 1, 1988.

In 1987,<sup>61</sup> the Legislature amended former Education Code section 72246, operative January 1, 1988, to incorporate and extend the maintenance of effort provisions of former Education Code section 72246.5, which became inoperative by its own terms as of January 1, 1988.<sup>62</sup> In addition, Statutes 1987, chapter 1118 restated that the fee would be reestablished at not more than \$7.50 for each semester, or \$5 for each quarter or summer session.<sup>63</sup> As a result, beginning January 1, 1988, all community college districts were required to maintain the same level of health services they provided in the 1986-1987 fiscal year each year thereafter, with a limited fee authority to offset the costs of those services.<sup>64</sup> In 1992, section 72246 was amended to provide that the health fee could be increased by the same percentage as the Implicit Price Deflator whenever that calculation would produce an increase of one dollar.<sup>65</sup>

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<sup>57</sup> Former Education Code section 72246 (Stats. 1981, ch. 763). Low-income students, students that depend upon prayer for healing, and students attending a college under an approved apprenticeship training program, were exempt from the fee.

<sup>58</sup> Statutes 1984, 2nd Extraordinary Session 1984, chapter 1, section 4, repealing Education Code section 72246.

<sup>59</sup> Statutes 1984, 2nd Extraordinary Session 1984, chapter 1, section 4.5.

<sup>60</sup> Education Code section 72246.5 (Stats. 1984, 2d. Ex. Sess., ch. 1, § 4.7).

<sup>61</sup> Statutes 1987, chapter 1118.

<sup>62</sup> Education Code section 72246 (as amended, Stats. 1987, ch. 1118). See also former Education Code section 72246.5 (Stats. 1984, 2d Ex. Sess., ch. 1, § 4.7).

<sup>63</sup> Education Code section 72246 (as amended, Stats. 1987, ch. 1118).

<sup>64</sup> In 1992, section 72246 was amended to provide that the health fee could be increased by the same percentage as the Implicit Price Deflator whenever that calculation would produce an increase of one dollar. (Education Code section 72246 (as amended, Stats. 1992, ch. 753). In 1993, former Education Code section 72246, was renumbered as Education Code section 76355 (Stats. 1993, ch. 8).

<sup>65</sup> Education Code section 72246 (as amended, Stats. 1992, ch. 753). In 1993, former Education Code section 72246, was renumbered as Education Code section 76355 (Stats. 1993, ch. 8).

On November 20, 1986, the Commission determined that Statutes 1984, chapter 1 imposed a reimbursable state-mandated new program upon community college districts. On August 27, 1987, the Commission adopted the Parameters and Guidelines for the *Health Fee Elimination* program. On May 25, 1989, the Commission adopted amendments to the Parameters and Guidelines to reflect amendments made by Statutes 1987, chapter 1118.

The Parameters and Guidelines generally provide that eligible community college districts shall be reimbursed for the costs of providing a health services program, and that only services specified in the Parameters and Guidelines and provided by the community college district in the 1986-1987 fiscal year may be claimed.

B. Controller's Audit and Summary of the Issues

The Controller reduced \$781,934 from the costs claimed for fiscal years 2002-2003, 2003-2004, 2004-2005, 2005-2006, and 2006-2007, \$732,846 of which is in dispute as follows:

- Reduction of \$61,288 for unallowable services and supplies. This finding includes a reduction of \$7,976 for health fair promotional items, including food, rental fees for a popcorn cart, and other promotional items (mood lamps, curling ribbons, and tattoo bracelets). The Controller states that these are not expenditures the district is required to make in order to maintain the base-year level of health services.<sup>66</sup> This finding also includes a reduction of \$53,312 claimed as a bad debt expense resulting from uncollected student health fees, which the Controller found was beyond the scope of the mandate and not reimbursable.<sup>67</sup>
- Reductions for overstated indirect costs. The district claimed indirect costs for all fiscal years based on a federally approved rate of 30 percent, developed using "a base of "Direct salaries and wages including all fringe benefits."<sup>68</sup> For fiscal years 2002-2003 and 2003-2004, the Controller found that the claimant overstated indirect costs because it incorrectly applied the indirect cost rate to a base of total direct costs, rather than to a base of salaries and benefits only, as approved by the federal government. This resulted in a reduction of \$21,298 for these two fiscal years.

The claimant used the same methodology for claiming indirect costs for fiscal years 2004-2005, 2005-2006, and 2006-2007.<sup>69</sup> However, the Controller adjusted indirect costs in these years because the claiming instructions, beginning for fiscal year 2004-2005 reimbursement claims, do not allow the use of a federally approved rate to claim indirect costs unless specifically approved in the Commission's Parameters and Guidelines (which is not the case here). The Controller, therefore, recalculated indirect

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<sup>66</sup> Exhibit A, IRC, page 72.

<sup>67</sup> Exhibit A, IRC, page 74.

<sup>68</sup> Exhibit A, IRC, pages 13, and 109 and 120 (federal approval letter of indirect cost rate, dated March 11, 2003, and effective for the period of July 1, 2003, through June 30, 2008); Exhibit B, Controller's Late Comments on the IRC, pages 48-51 (federal approval letter of indirect cost rate, dated February 4, 1999, and effective for the period of July 1, 1999 through June 30, 2004).

<sup>69</sup> Exhibit A, IRC, pages 13 and 128-156 (reimbursement claims for fiscal years 2004-2005, 2005-2006, and 2006-2007).

costs based on the FAM-29C methodology, the only method allowed, resulting in a reduction of \$4,896 for fiscal year 2004-2005, and an increase of \$25,303 for fiscal years 2005-2006 and 2006-2007.<sup>70</sup>

- Reduction of \$694,471 for understated offsetting health service fee authority.<sup>71</sup>

The Controller also reduced \$49,088 for miscellaneous revenue that was incorrectly reported as authorized health service fees,<sup>72</sup> and \$74,372 for understated offsetting savings and reimbursements.<sup>73</sup> The claimant does not dispute these reductions.<sup>74</sup>

Finally, the claimant contends that the Controller did not timely initiate the audit of the 2002-2003 and 2003-2004 reimbursement claims and, thus asserts that the Controller's audit of those reimbursement claims is void.

### **III. Positions of the Parties**

#### **A. San Mateo County Community College District**

The claimant contends that the Controller did not timely initiate the audit of the 2002-2003 and 2003-2004 reimbursement claims. The claimant asserts that it filed these reimbursement claims on January 12, 2005 and, pursuant to Government Code section 17558.5, the Controller had until January 12, 2008 to audit. However, the audit entrance conference for all fiscal year claims did not take place until September 8, 2008, after the three-year deadline. The claimant contends that the clause in Government Code section 17558.5 that delays the commencement of the time to audit to the date of initial payment is impermissibly vague and, therefore, void.<sup>75</sup>

The claimant contends that the Controller's reductions are incorrect and should be reinstated. The claimant argues that food and promotional expenditures are reimbursable and included in the costs for health fairs, which is a reimbursable activity. The claimant states that the purpose of health fairs is to effectively communicate health information to the student population in general, which requires that students attend. Promotional materials are intended to promote attendance at the health fair.<sup>76</sup>

The claimant also contends that bad debt expense for uncollectible health service fees is reimbursable, arguing that "[a]s a practical matter, college districts do not incur this cost as a discretionary activity, the cost is forced upon the districts by those students who do not pay their fees."<sup>77</sup> The claimant further contends that it reported gross student health service fee income as

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<sup>70</sup> Exhibit A, IRC, pages 74-76.

<sup>71</sup> Exhibit A, IRC, page 80.

<sup>72</sup> Exhibit A, IRC, pages 78-79.

<sup>73</sup> Exhibit A, IRC, page 83.

<sup>74</sup> Exhibit A, IRC, pages 19 and 26.

<sup>75</sup> Exhibit A, IRC, pages 30-33.

<sup>76</sup> Exhibit A, IRC, pages 10-12.

<sup>77</sup> Exhibit A, IRC, pages 10-11.

offsetting revenue and the uncollected amounts as an expense; “an appropriate application of generally accepted accounting principles.”<sup>78</sup>

The claimant argues that the Controller’s reduction of indirect costs is incorrect, and amounts to an underground regulation. The claimant contends that the Parameters and Guidelines do not contain any limitation or direction to apply the federally approved rate only to salaries and benefits. The claimant further states that the Controller simply stopped accepting federally approved rates, retroactively beginning fiscal year 2004-2005, with no justification or opportunity for public comment.<sup>79</sup>

Finally, the claimant contends that it is only required to report as offsetting revenues, the fee revenue actually collected.<sup>80</sup>

On April 6, 2017, the claimant filed comments on the Draft Proposed Decision, agreeing with the finding that the reduction of indirect costs for fiscal year 2004-2005 is incorrect as a matter of law. However, the claimant disagrees with the remaining findings for the same reasons originally asserted in the IRC. In addition, the claimant clarified the amount reduced by the Controller in Finding 1, and asked for those numbers to be corrected.<sup>81</sup>

#### **B. State Controller’s Office**

The Controller argues that, pursuant to Government Code section 17558.5, it timely conducted the audit of the fiscal year 2002-2003 and 2003-2004 reimbursement claims. The Controller also contends that it correctly reduced costs. The Controller argues that the claimed costs reduced for services and supplies did not relate to the mandated program. The Controller further contends that the claimant did not correctly calculate its indirect cost rate. The Controller also asserts that the correct calculation of offsetting revenue is all offsetting health service fee revenue authorized by statute, rather than the amount collected. Thus, the Controller urges the Commission to deny the IRC.<sup>82</sup>

On March 24, 2017, the Controller filed comments agreeing with the Draft Proposed Decision.<sup>83</sup>

### **IV. Discussion**

Government Code section 17561(d) authorizes the Controller to audit the claims filed by local agencies and school districts and to reduce any claim for reimbursement of state mandated costs that the Controller determines is excessive or unreasonable.

Government Code Section 17551(d) requires the Commission to hear and decide a claim that the Controller has incorrectly reduced payments to the local agency or school district. If the Commission determines that a reimbursement claim has been incorrectly reduced, section 1185.9

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<sup>78</sup> Exhibit A, IRC, page 11.

<sup>79</sup> Exhibit A, IRC, pages 14-19.

<sup>80</sup> Exhibit A, IRC, pages 19-26.

<sup>81</sup> Exhibit E, Claimant’s Comments on the Draft Proposed Decision. The amount reduced by the Controller in Finding 1 has been corrected.

<sup>82</sup> Exhibit B, Controller’s Late Comments on the IRC.

<sup>83</sup> Exhibit D, Controller’s Comments on the Draft Proposed Decision.

of the Commission's regulations requires the Commission to send the decision to the Controller and request that the costs in the claim be reinstated.

The Commission must review questions of law, including interpretation of the parameters and guidelines, *de novo*, without consideration of legal conclusions made by the Controller in the context of an audit. The Commission is vested with exclusive authority to adjudicate disputes over the existence of state-mandated programs within the meaning of article XIII B, section 6 of the California Constitution.<sup>84</sup> The Commission must also interpret the Government Code and implementing regulations in accordance with the broader constitutional and statutory scheme. In making its decisions, the Commission must strictly construe article XIII B, section 6 and not apply it as an "equitable remedy to cure the perceived unfairness resulting from political decisions on funding priorities."<sup>85</sup>

With regard to the Controller's audit decisions, the Commission must determine whether they were arbitrary, capricious, or entirely lacking in evidentiary support. This standard is similar to the standard used by the courts when reviewing an alleged abuse of discretion of a state agency.<sup>86</sup> Under this standard, the courts have found that:

When reviewing the exercise of discretion, "[t]he scope of review is limited, out of deference to the agency's authority and presumed expertise: 'The court may not reweigh the evidence or substitute its judgment for that of the agency. [Citation.]'" ... "In general ... the inquiry is limited to whether the decision was arbitrary, capricious, or entirely lacking in evidentiary support. . . ." [Citations.] When making that inquiry, the " "court must ensure that an agency has adequately considered all relevant factors, and has demonstrated a rational connection between those factors, the choice made, and the purposes of the enabling statute." [Citation.]' "<sup>87</sup>

The Commission must also review the Controller's audit in light of the fact that the initial burden of providing evidence for a claim of reimbursement lies with the claimant.<sup>88</sup> In addition, sections 1185.1(f)(3) and 1185.2(c) of the Commission's regulations require that any assertions of fact by the parties to an IRC must be supported by documentary evidence. The Commission's ultimate findings of fact must be supported by substantial evidence in the record.<sup>89</sup>

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<sup>84</sup> *Kinlaw v. State of California* (1991) 54 Cal.3d 326, 331-334; Government Code sections 17551, 17552.

<sup>85</sup> *County of Sonoma v. Commission on State Mandates* (2000) 84 Cal.App.4th 1264, 1281, citing *City of San Jose v. State of California* (1996) 45 Cal.App.4th 1802, 1817.

<sup>86</sup> *Johnston v. Sonoma County Agricultural Preservation and Open Space District* (2002) 100 Cal.App.4th 973, 983-984. See also *American Bd. of Cosmetic Surgery, Inc. v. Medical Bd. of California* (2008) 162 Cal.App.4th 534, 547.

<sup>87</sup> *American Bd. of Cosmetic Surgery, Inc., v. Medical Bd. of California*, 162 Cal.App.4th 534, 547-548.

<sup>88</sup> *Gilbert v. City of Sunnyvale* (2005) 130 Cal.App.4th 1264, 1274-1275.

<sup>89</sup> Government Code section 17559(b), which provides that a claimant or the state may commence a proceeding in accordance with the provisions of section 1094.5 of the Code of Civil

A. The Audit of the 2002-2003 and 2003-2004 Reimbursement Claims Was Timely Initiated and Timely Completed.

The claimant argues that the audit of the 2002-2003 and 2003-2004 reimbursement claims was not timely initiated. Section 17558.5 requires an audit to be initiated no later than three years after the date the reimbursement claim is filed or last amended. However, section 17558.5 also provides that *if no funds are appropriated or no payment is made* “to a claimant for the program for the fiscal year for which the claim is filed, the time for the Controller to initiate an audit shall commence to run from the date of initial payment of the claim.”<sup>90</sup> “In any case,” section 17558.5 requires the audit to be completed no later than two years after it is commenced.<sup>91</sup>

*1. The Audit Was Timely Initiated.*

The claimant asserts that the audit of the 2002-2003 and 2003-2004 reimbursement claims was not timely initiated based on the date that it asserts that the claims were filed (January 12, 2005), and the date that the audit entrance conference took place (December 8, 2008). However, the Controller points out that the claimant did not receive a payment for the 2002-2003 reimbursement claim until October 25, 2006, and had not received payment for the fiscal year 2003-2004 when the audit was initiated. Therefore, the Controller’s initiation of the audit with the entrance conference on December 8, 2008, was timely.<sup>92</sup>

Government Code section 17558.5 states that “[a] reimbursement claim for actual costs filed by a local agency or school district pursuant to this chapter is subject to the initiation of an audit by the Controller no later than three years after the date that the actual reimbursement claim is filed or last amended ....” However, if funds are not appropriated or no payment is made to the claimant for a given year, section 17558.5 states the “time for the Controller to initiate an audit shall commence to run from the date of initial payment of the claim.”<sup>93</sup>

The claimant argues that this provision “is void because it is impermissibly vague,” and that “the only specific and enforceable time limitation to commence an audit is three years from the date the claim was filed.”<sup>94</sup> However, article III, section 3.5 of the California Constitution states that an administrative agency has no power “[t]o declare a statute unenforceable, or refuse to enforce a statute, on the basis of it being unconstitutional unless an appellate court has made a determination that such statute is unconstitutional...”<sup>95</sup> Thus, the statute is presumed constitutional and must be followed.

Here, the fiscal year 2002-2003 and 2003-2004 reimbursement claims were filed on January 12, 2005. But, the record shows that payment on the 2002-2003 reimbursement claim

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Procedure to set aside a decision of the Commission on the ground that the Commission’s decision is not supported by substantial evidence in the record.

<sup>90</sup> Government Code section 17558.5 (as amended, Stats. 2002, ch. 1128 (AB 2834)).

<sup>91</sup> Government Code section 17558.5 (as amended, Stats. 2004, ch. 890 (AB 2856)).

<sup>92</sup> Exhibit A, IRC, page 88; Exhibit B, Controller’s Late Comments on the IRC, page 32.

<sup>93</sup> Government Code section 17558.5 (as amended, Stats. 2002, ch. 1128 (AB 2834)).

<sup>94</sup> Exhibit A, IRC, page 30.

<sup>95</sup> California Constitution, article III, section 3.5 (added June 6, 1978, by Proposition 5).

was not made until October 25, 2006,<sup>96</sup> and no payment had been made for the 2003-2004 claim when the audit entrance conference took place on December 8, 2008.<sup>97</sup> Therefore, pursuant to the plain language of Government Code section 17558.5, the audit of the 2002-2003 claim had to be initiated no later than October 25, 2009. Since the Controller initiated the audit for all fiscal years on December 8, 2008, with the audit entrance conference, the audit was timely initiated.

## *2. The Audit Was Timely Completed.*

Government Code section 17558.5 also prescribes the time in which an audit must be completed: “In any case, an audit shall be completed not later than two years after the date that the audit is commenced.”<sup>98</sup> As indicated above, the audit was initiated no later than December 8, 2008, the date of the entrance conference and, thus, had to be completed no later than December 8, 2010. An audit is completed when the Controller issues the final audit report to the claimant. The final audit report constitutes the Controller’s final determination on the subject claims and provides written notice of the claim components adjusted, the amounts adjusted, and the reasons for the adjustment, as required by Government Code section 17558.5(c), allowing the claimant to thereafter file an IRC. Here, the final audit report was issued September 23, 2009, more than a year prior to the expiration of the two year deadline on December 8, 2010.

Based on the foregoing, the Commission finds that the Controller’s audit was timely completed in accordance with Government Code section 17558.5.

### B. The Controller’s Reduction of Costs for Gift Certificates, Health Fair Food, and Other Promotional Items Is Correct as a Matter of Law and Is Not Arbitrary, Capricious, or Entirely Lacking in Evidentiary Support.

The Controller reduced \$7,976 claimed for health fair promotional items, including food, rental fees for a popcorn cart, and other promotional items (mood lamps, curling ribbons, and tattoo bracelets). The Controller states that these are not expenditures the district is required to make in order to maintain the base-year level of health services.<sup>99</sup>

The claimant contends that since the Commission has determined that health fair activities are reimbursable, then these costs are necessary and reimbursable. The claimant further contends that the Controller has not determined that these costs are excessive or unreasonable. The intent of the promotional items, the claimant asserts, is to induce attendance at the health fair in order for interested students to receive the information.<sup>100</sup>

Based on the evidence in the record, the Commission finds that the reduction is correct as a matter of law, and is not arbitrary, capricious, or entirely lacking in evidentiary support.

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<sup>96</sup> Exhibit A, IRC, page 36 (adjustment letter dated October 28, 2009, for fiscal year 2002-2003 showing prior payment for that fiscal year of \$307,148 on October 25, 2006).

<sup>97</sup> Exhibit A, IRC, page 37 (adjustment letter dated October 28, 2009, for fiscal year 2003-2004, showing no payments for that fiscal year).

<sup>98</sup> Government Code section 17558.5 (Stats. 2004, ch. 890).

<sup>99</sup> Exhibit A, IRC, page 72.

<sup>100</sup> Exhibit A, IRC, page 12.

The Parameters and Guidelines for the *Health Fee Elimination* program authorize reimbursement for the costs of providing health supervision and services and direct and indirect medical and hospitalization services to students, and the operation of student health centers, *to the extent* the community college provided these services in fiscal year 1986-1987. Section V. lists the types of services and costs that are eligible for reimbursement to the extent they were provided in fiscal year 1986-1987, including “health talks or fairs – information,” as follows:

#### HEALTH TALKS OR FAIRS – INFORMATION

- Sexually Transmitted Disease
- Drugs
- Aids
- Child Abuse
- Birth Control/Family Planning
- Stop Smoking
- Etc.
- Library – videos and cassettes

Section VI.B.2 of the Parameters and Guidelines, which governs Claim Preparation for services and supplies, states that “[o]nly expenditures which can be identified as a direct cost of the mandate can be claimed.”

And, Section VII. governs the supporting data for the claim, which states the following:

For auditing purposes, all costs claimed must be traceable to source documents and/or worksheets that show evidence of the validity of such costs. *This would include documentation for the fiscal year 1986-87 program to substantiate a maintenance of effort.* These documents must be kept on file by the agency submitting the claim for a period of no less than three years from the date of the final payment of the claim pursuant to this mandate, and made available on the request of the State Controller of his agent.<sup>101</sup>

The plain language of the Parameters and Guidelines allows reimbursement to provide health talks and fairs to distribute information to students regarding various health issues, but is silent regarding reimbursement for the cost of promotional items given away by the district to encourage attendance. However, the Parameters and Guidelines do specify that approved cost items listed in section V.B. “are reimbursable *to the extent* they were provided by the community college district in fiscal year 1986-87.”<sup>102</sup> Thus, to the extent that these promotional items were not provided by the district in the base year, these costs go beyond the scope of the mandate. Here, the record contains invoices supporting the costs incurred in the claim year for food and promotional items distributed during health fairs.<sup>103</sup> However, the claimant has not argued or provided any evidence, as required by the Parameters and Guidelines, that it provided these promotional items in the base year as an integral part of its health fairs.

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<sup>101</sup> Exhibit A, IRC, pages 42-48.

<sup>102</sup> Exhibit A, IRC, page 43, emphasis added.

<sup>103</sup> Exhibit B, Controller’s Late Comments on the IRC, pages 89-109.

Accordingly, the Controller's reduction of costs for gift certificates, health fair food, and other promotional items is correct as a matter of law and not arbitrary, capricious, or entirely lacking in evidentiary support.

C. The Controller's Reduction of Costs Claimed as a Bad Debt Expense for Uncollected Student Health Fees Is Correct as a Matter of Law.

The Controller reduced \$53,312 claimed as a bad debt expense resulting from uncollected student health fees, on the ground that these costs go beyond the scope of the mandate and are not reimbursable.<sup>104</sup> Claimant contends that the bad debt expense for uncollectible health service fees is reimbursable, arguing that "[a]s a practical matter, college districts do not incur this cost as a discretionary activity, the cost is forced upon the districts by those students who do not pay their fees."<sup>105</sup> The claimant further states that it reported gross student health service fee income as offsetting revenue and the uncollected amounts as an expense; "an appropriate application of generally accepted accounting principles."<sup>106</sup>

The Commission finds that reduction is correct as a matter of law. The Parameters and Guidelines for the *Health Fee Elimination* program authorize reimbursement for the costs of providing health supervision and services and direct and indirect medical and hospitalization services to students, and the operation of student health centers, to the extent the community college provided these services in fiscal year 1986-1987. Health service fees authorized by statute to be charged, but remain uncollectible, are not costs identified in the Parameters and Guidelines as eligible for reimbursement.

Therefore, the Controller's reduction of these costs is correct as a matter of law.

D. The Controller's Reduction of Indirect Costs for Fiscal Years 2002-2003, 2003-2004, and 2004-2005 Is Partially Correct; and the Commission Does Not Have Jurisdiction to Review the Controller's Adjustment of Indirect Costs That Resulted in Increased Reimbursement in Fiscal Years 2005-2006 and 2006-2007.

The district claimed indirect costs for all fiscal years based on a federally approved rate of 30 percent, developed using "a base of 'Direct salaries and wages including all fringe benefits.'"<sup>107</sup> For fiscal years 2002-2003 and 2003-2004, the Controller found that the claimant overstated indirect costs because it incorrectly applied the indirect cost rate to a base of total direct costs,

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<sup>104</sup> Exhibit A, IRC, page 74.

<sup>105</sup> Exhibit A, IRC, pages 10-11.

<sup>106</sup> Exhibit A, IRC, page 11.

<sup>107</sup> Exhibit A, IRC, pages 13, and 109 and 120 (federal approval letter of indirect cost rate, dated March 11, 2003, and effective for the period of July 1, 2003, through June 30, 2008); Exhibit B, Controller's Late Comments on the IRC, pages 48-51 (federal approval letter of indirect cost rate, dated February 4, 1999, and effective for the period of July 1, 1999 through June 30, 2004).

rather than to a base of salaries and benefits only, as approved by the federal government. This resulted in a reduction of \$21,298 for the two fiscal years.<sup>108</sup>

For fiscal years 2004-2005, 2005-2006, and 2006-2007, the Controller adjusted indirect costs because the claiming instructions, beginning for the fiscal year 2004-2005 reimbursement claims, do not allow the use of a federally approved rate to claim indirect costs unless specifically approved in the Commission's Parameters and Guidelines. The Parameters and Guidelines for the *Health Fee Elimination* program provide only that "indirect costs may be claimed in the manner described by the State Controller in his claiming instructions."<sup>109</sup> The Controller recalculated indirect costs using the FAM-29C methodology, resulting in a reduction of \$4,896 for fiscal year 2004-2005, and an increase of \$25,303 for fiscal years 2005-2006 and 2006-2007.<sup>110</sup>

Since the Controller's adjustment to indirect costs for fiscal years 2005-2006 and 2006-2007 does not result in a reduction, the Commission has no jurisdiction to review the Controller's audit adjustment for those fiscal years. Government Code section 17551(d), which requires the Commission to hear and decide IRCs, applies only to claims that the Controller incorrectly *reduced* payments to the claimant as follows:

The commission, pursuant to the provisions of this chapter, shall hear and decide upon a claim by a local agency or school district filed on or after January 1, 1985, that the Controller has incorrectly reduced payments to the local agency or school district pursuant to paragraph (2) of subdivision (d) of Section 17561.

As described below, the Commission finds that the Controller's reduction of indirect costs for fiscal years 2002-2003 and 2003-2004 is correct as a matter of law. However, the Controller's reduction of indirect costs for fiscal year 2004-2005 is incorrect as a matter of law.

1. *The Controller's reduction of indirect costs for fiscal years 2002-2003 and 2003-2004 is correct as a matter of law.*

The Controller reduced indirect costs for fiscal years 2002-2003 and 2003-2004 because the claimant applied its federally approved indirect cost rate of 30 percent to total direct costs, instead of to salaries and benefits only as approved by the federal government. The claimant contends that this reduction is incorrect, arguing that neither the Parameters and Guidelines nor the claiming instructions restrict the application of the rate only to salaries and benefits.<sup>111</sup> The Controller responds as follows:

The district implies that it may apply its federally approved rate to whatever direct cost base that it chooses. The district draws a distinction between federal approvals of the rate itself versus the allocation base. There is no such distinction. The federal approval letter (Tab 6) defines both the rate and the applicable base;

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<sup>108</sup> Exhibit A, IRC, pages 74-76; Exhibit B, Controller's Late Comments on the IRC, pages 48-51 (federal approval letter of indirect cost rate, dated February 4, 1999, and effective for the period of July 1, 1999 through June 30, 2004).

<sup>109</sup> Exhibit A, IRC, page 47.

<sup>110</sup> Exhibit A, IRC, pages 74-76.

<sup>111</sup> Exhibit A, IRC, page 15.

they are inseparable. Government Code section 17561, subdivision (d)(2)(B), states that the SCO may reduce any excessive or unreasonable claim. It is clearly unreasonable to calculate mandate-related indirect costs by applying a federally approved rate to a direct cost base other than the base used to calculate the rate.<sup>112</sup>

The Commission finds that the Controller's reduction of indirect costs for these fiscal years is correct as a matter of law.

The Parameters and Guidelines provide that "indirect costs may be claimed in the manner described by the State Controller in his claiming instructions."<sup>113</sup> The claiming instructions specific to the *Health Fee Elimination* mandate, are found in the Community Colleges Mandated Cost Manual which contains claiming instructions applicable to all school and community college mandated programs. The cost manual issued by the Controller's Office in September 2003 governs the reimbursement claim filed for fiscal year 2002-2003.<sup>114</sup> This cost manual provides two options for claiming indirect costs by either using the federal OMB Circular A-21, or the FAM-29C:

A community college has the option of using a federally approved rate, utilizing the cost accounting principles from *Office of Management and Budget Circular A-21* "Cost Principles for Educational Institutions," or the Controller's methodology outlined in the following paragraphs.

The Controller allows the following methodology for use by community colleges in computing an indirect cost rate for state mandates. The objective of this computation is to determine an equitable rate for use in allocating administrative support to personnel that performed the mandated cost activities claimed by the community college. This methodology assumes that administrative services are provided to all activities of the institution in relation to the direct costs incurred in the performance of those activities. *Form FAM-29C* has been developed to assist the community college in computing an indirect cost rate for state mandates. . . .

[¶]

The [FAM-29C] computation is based on total expenditures as reported in "California Community Colleges Annual Financial and Budget Report, Expenditures by Activity (CCFS-311)." Expenditures classified by activity are segregated by the function they serve. Each function may include expenses for salaries, fringe benefits, supplies, and capital outlay. OMB Circular A-21 requires expenditures for capital outlays to be excluded from the indirect cost rate computation.<sup>115</sup>

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<sup>112</sup> Exhibit B, Controller's Late Comments on the IRC, page 18.

<sup>113</sup> Exhibit A, IRC, page 44.

<sup>114</sup> Exhibit B, Controller's Late Comments on the IRC, page 35.

<sup>115</sup> Exhibit B, Controller's Late Comments on the IRC, page 35.

The cost manual issued by the Controller's Office in September 2004 for fiscal year 2003-2004 costs contains the same language.<sup>116</sup>

In this case, the claimant used a federally approved indirect cost rate under the OMB Circular A-21. The OMB Circular A-21 establishes principles for determining costs applicable to grants, contracts, and other agreements between the federal government and educational institutions. Sections G(11) and H of the OMB Circular A-21 govern the determination of indirect cost rates and require the federal approval of a proposed rate by the "cognizant federal agency," which is normally either the federal Department of Health and Human Services or the Department of Defense's Office of Naval Research.<sup>117</sup> If a claimant chooses to use the OMB Circular A-21 methodology, the claimant must obtain federal approval of the rate calculated through formal negotiation, an informal correspondence process, or a simplified method which sets the indirect cost rate using a salaries and wage base.<sup>118</sup> Section H(2) governs the simplified method using a salaries and wage base, which the claimant used here, and which resulted in an indirect cost rate of 30 percent.<sup>119</sup> The letter issued by the federal Department of Health and Human Services containing the negotiated agreement with the claimant, effective from July 1, 1999 to June 30, 2004, shows the 30 percent rate with a base of "Direct salaries and wages including all fringe benefits" for all programs.<sup>120</sup> Section H(2)(e) of the OMB Circular A-21 then directs the community college district to "apply the F&A cost rate *to direct salaries and wages* for individual agreements to determine the F&A costs allocable to such agreements."<sup>121</sup> Thus, the OMB Circular A-21 itself requires the rate to be applied only to direct salaries and wages. Here, the claimant did not comply with the OMB Circular A-21 or the negotiated agreement with the federal government and, instead, applied the rate to all direct costs.

Accordingly, the Controller's reduction of indirect costs in fiscal years 2002-2003 and 2003-2004 is correct as a matter of law. Moreover, there is no evidence that the Controller's recalculation of indirect costs arbitrary, capricious, or entirely lacking in evidentiary support. Therefore, the reduction of indirect costs in fiscal years 2002-2003 and 2003-2004 is correct.

2. *The Controller's reduction of indirect costs for fiscal year 2004-2005, based solely on the Controller's change to the claiming instructions without notice or opportunity to comment, is incorrect as a matter of law.*

For fiscal year 2004-2005, the Controller reduced indirect costs because the claiming instructions, beginning with the fiscal year 2004-2005 reimbursement claims, do not allow the

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<sup>116</sup> Exhibit B, Controller's Late Comments on the IRC, pages 42-43.

<sup>117</sup> Exhibit F, OMB Circular A-21.

<sup>118</sup> Exhibit F, OMB Circular A-21, pages 37-39.

<sup>119</sup> Exhibit F, OMB Circular A-21, pages 38-39, which describes the calculation of the "simplified procedure – salaries and wages base" as subtracting from the total amount of salaries and wages paid to all employees of the institution, the expenditures for general administration, operation and maintenance of the physical plant, the library, and department administration expenses.

<sup>120</sup> Exhibit B, Controller's Late Comments on the IRC, pages 48-49.

<sup>121</sup> Exhibit F, OMB Circular A-21, page 39 (emphasis added).

use of the federally approved rate developed under the OMB Circular A-21 to claim indirect costs unless specifically approved in the Commission's parameters and guidelines. The Parameters and Guidelines for the *Health Fee Elimination* program provides only that "indirect costs may be claimed in the manner described by the State Controller in his claiming instructions."<sup>122</sup> Thus, the Controller recalculated indirect costs using the FAM-29C methodology, resulting in a reduction of \$4,896 for fiscal year 2004-2005.

The claiming instructions specific to the *Health Fee Elimination* mandate are found in the Controller's Mandated Cost Manual. The Mandated Cost Manual for fiscal year 2004-2005 claims, dated December 27, 2005, for the first time changed the indirect cost rate language to prohibit the use of the federal OMB Circular A-21 unless specifically allowed by the Parameters and Guidelines:

A CCD may claim indirect costs using the Controller's methodology (FAM-29C), outlined in the following paragraphs. If specifically allowed by a mandated program's Ps & Gs, a district may alternately choose to claim indirect costs using either (1) a federally approved rate prepared in accordance with Office of Management and Budget (OMB) Circular A-21, *Cost Principles for Educational Institutions*; or (2) a flat 7% rate.<sup>123</sup>

At that time, Government Code section 17560 required annual reimbursement claims to be filed by January 15.<sup>124</sup> In this case, the claimant's fiscal year 2004-2005 reimbursement claim was signed on January 10, 2006, and was mailed to the Controller's Office on January 12, 2006, approximately two weeks after the date on the December 27, 2005 revised claiming instructions.<sup>125</sup>

The claimant contends that the reduction is incorrect, and that the Controller simply stopped accepting federally approved rates, retroactively beginning fiscal year 2004-2005, with no justification or opportunity for public comment and in violation of the Administrative Procedures Act.<sup>126</sup>

The Controller relies on the plain language of the Parameters and Guidelines to contend that the reduction is correct as a matter of law. The Controller states the following:

We disagree with the district's interpretation of the parameters and guidelines, which are clear and unambiguous. They state, "Indirect costs may be claimed *in the manner described by the State Controller in his claiming instructions*." [Emphasis in original.] In this case, the parameters and guidelines specifically identify the claiming instructions as authoritative criteria for indirect costs. The phrase "may be claimed" simply permits the district to claim indirect costs. If the district chooses to claim indirect costs, then the parameters and guidelines require

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<sup>122</sup> Exhibit A, IRC, page 47.

<sup>123</sup> Exhibit F, Mandated Cost Manual updated December 27, 2005; Exhibit B, Controller's Late Comments on the IRC, page 17.

<sup>124</sup> As last amended by Statutes 1998, chapter 681.

<sup>125</sup> Exhibit A, IRC, pages 30 and 128.

<sup>126</sup> Exhibit A, IRC, pages 14-19.

that it comply with the SCO's claiming instructions. If the district believes that the program's parameters and guidelines are deficient, it should initiate a request to amend the parameters and guidelines pursuant to Government Code section 17557, subdivision (d). However, any such amendment would not apply to this audit period.

The district states that it "claimed these indirect costs 'in the manner' described by the Controller." The district did *not* claim indirect costs in accordance with the SCO's claiming instructions.<sup>127</sup>

For the reasons below, the Commission finds that the Controller's reduction is incorrect as a matter of law.

As indicated above, the Parameters and Guidelines state that "indirect costs may be claimed in the manner described by the State Controller in his claiming instructions." Parameters and guidelines are regulatory in nature and may validly incorporate manuals and other documents by reference as long as the incorporated document is adequately identified and available for comment.<sup>128</sup> This is consistent with the Administrative Procedures Act (APA), which requires public notice of all proposed rules that apply generally, and that implement, interpret, or make the specific the law.<sup>129</sup> The purpose of the APA is to ensure that those persons or entities affected by a regulation have a voice in its creation, as well as notice of the law's requirements so that they can conform their conduct accordingly.<sup>130</sup> Thus, if the manual or document that is incorporated by reference later changes without notice or opportunity for comment, then the new rule or standard of general application in the incorporated document may become an invalid underground regulation.<sup>131</sup>

For example, the case of *Union of American Physicians & Dentists v. Kizer* addressed regulations adopted by the Department of Health Services, which incorporated by reference separate bulletins and a provider manual setting forth *current* documentation requirements for reimbursement claims filed by providers under the Medi-Cal program.<sup>132</sup> The Department acknowledged that it "used the manual to evaluate whether a provider's progress notes satisfy the appropriateness and quality of medical services requirements."<sup>133</sup> The court determined that the documentation requirements in the manual were standards of general application to providers statewide, which interpreted or made specific the law enforced by the Department, and were therefore invalid underground regulations.<sup>134</sup>

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<sup>127</sup> Exhibit B, Controller's Late Comments on the IRC, pages 18-19 (emphasis in original).

<sup>128</sup> *Clovis Unified School Dist. v. Chiang* (2010) 188 Cal.App.4th 794, 799; *Kings Rehabilitation Center Inc. v. Premo* (1999) 69 Cal.App.4th 215, 220.

<sup>129</sup> Government Code sections 11346, et seq.

<sup>130</sup> *Tidewater Marine Western, Inc. v. Bradshaw* (1996) 14 Cal.4th 557, 570.

<sup>131</sup> *Kings Rehabilitation Center Inc. v. Premo* (1999) 69 Cal.App.4th 215, 219-220.

<sup>132</sup> *Union of American Physicians & Dentists v. Kizer* (1990) 223 Cal.App.3d 490, 495.

<sup>133</sup> *Union of American Physicians & Dentists* (1990), 223 Cal.App.3d 490, 501.

<sup>134</sup> *Union of American Physicians & Dentists* (1990), 223 Cal.App.3d 490, 506.

Similarly, in *California Association of Nursing Homes v. Williams*, the court addressed a class action challenge by nursing homes to the validity of regulations adopted by the Department of Health Care Services, which incorporated by reference a pamphlet (“State Schedule of Maximum Allowances”) published by the Department of Finance, to reimburse nursing and convalescent homes based on the schedule of allowances in effect at the time services were provided. Based on the language, the regulation attempted to incorporate future changes in reimbursement standards adopted by the Department of Finance.<sup>135</sup> The court found that the Schedule of Maximum Allowances “appears to be the result of ex parte studies by staff personnel of the Department of Finance,” and changes were made “without public or judicial access.”<sup>136</sup> The court concluded that the documentation requirements in the manual were invalid underground regulations.<sup>137</sup>

In 2010, the Third District Court of Appeal in the *Clovis Unified School District* case, addressed the Controller’s contemporaneous documentation rules contained in the Controller’s claiming instructions. The court determined that the claiming instructions are non-regulatory, and that any rule requiring additional documentation that is contained in the claiming instructions that did not go through the regulatory process required by the APA, but was used by the Controller in an audit to reduce costs, invalidates the audit to the extent the Controller used the underground rule to reduce costs.<sup>138</sup>

Based on the cases cited above, the Commission finds that the Controller’s reduction of indirect costs, based solely on the Controller’s change to the claiming instructions and its use of the new indirect cost rate rule, without evidence that notice and an opportunity for comment was provided to the claimant, is an invalid underground regulation.

The Controller’s new indirect cost rate rule is included in the Controller’s Mandated Cost Manual, “updated December 27, 2005,” which applied to the fiscal year 2004-2005 reimbursement claims due to be filed just two weeks later. Although the new rule allows the use of the federal OMB Circular A-21 “if specifically allowed by a mandated program’s Ps &Gs,” the Parameters and Guidelines for the *Health Fee Elimination* Program do not contain that language and, thus, the Controller’s change to the rule effectively prohibits the use of the federal method for calculating indirect costs for this program in fiscal year 2004-2005. There is no evidence in the record, such as a proof of service or certificate of mailing, that the Controller provided notice of the change in the rule to the claimant. The claimant asserts that it received no notice for the fiscal years in question and, in fact, it continued to calculate indirect costs using the federal method as it had for the previous two fiscal years.<sup>139</sup> The record also shows that the claimant was first made aware of the change in the rule when the Controller’s draft audit report was received by the claimant for this matter on July 27, 2009.<sup>140</sup> By this time, the claimant

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<sup>135</sup> *California Assn. of Nursing Homes v. Williams* (1970) 4 Cal.App.3d 800, 808.

<sup>136</sup> *California Assn. of Nursing Homes* (1970) 4 Cal.App.3d 800, 813-814.

<sup>137</sup> *California Assn. of Nursing Homes* (1970) 4 Cal.App.3d 800, 816.

<sup>138</sup> *Clovis Unified School Dist.* (2010) 188 Cal.App.4th 794, 799, 805.

<sup>139</sup> Exhibit A, IRC, pages 17.

<sup>140</sup> Exhibit A, IRC, pages 91 and 93 [claimant’s response to draft audit report, where claimant states the following: “In prior years, federally approved indirect cost rates have been accepted

could not have filed a request to amend the Parameters and Guidelines to specifically allow the use of the federal OMB method for the fiscal year 2004-2005 reimbursement claim, as suggested by the Controller. Government Code section 17557(d) states that “[a] parameters and guidelines amendment filed more than 90 days after the claiming deadline for initial claims . . . and on or before the claiming deadline following a fiscal year, shall establish reimbursement eligibility for that fiscal year.” Thus, even if the claimant filed a request to amend the Parameters and Guidelines on July 27, 2009 (the day the notice was received) and the Commission approved the request, the amendment would only apply to fiscal year 2008-2009 claims.

Moreover, if the updated Mandated Cost Manual was, in fact, issued to community college districts on December 27, 2005 (the date of the manual), the claimant would not have had sufficient notice or an opportunity to comment before the 2004-2005 reimbursement claim was due on January 15, 2006. Due process requires that a claimant have reasonable notice of any change that affects the substantive rights and liabilities of the parties.<sup>141</sup> Under similar circumstances, when parameters and guidelines are amended, the Government Code requires notice of an extra 120 days after the revised claiming instructions are issued to local government before annual reimbursement claims are due.<sup>142</sup> Thus, in those cases, a full regulatory hearing is conducted to amend the parameters and guidelines *and* claimants are provided an additional four months before claims are due. In this case, if the Controller issued notice on December 27, 2005, notice, if it was actually provided at all, was at most only two weeks during the holiday season when most community colleges are not in session and many employees are on vacation.

Accordingly, under these circumstances, the Commission finds that the Controller’s reduction of indirect costs in fiscal year 2004-2005, based solely on the Controller’s change to the calculation of indirect cost rates, is incorrect as a matter of law.<sup>143</sup>

E. The Controller’s Reduction for Understated Offsetting Revenues Is Correct as a Matter of Law, and Not Arbitrary, Capricious, or Entirely Lacking in Evidentiary Support.

The Controller reduced costs by \$694,471 because the claimant understated its offsetting health service fee authority. In each fiscal year, the claimant reported only those health service fees actually collected, and not the total amount of fees authorized to be charged. Using enrollment

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by the Controller. The draft audit report contains no explanation as to why suddenly federally approved rates are no longer permissible.”].

<sup>141</sup> *In re Cindy B.* (1987) 192 Cal.App.3d 771, 783-784.

<sup>142</sup> Government Code section 17560(c).

<sup>143</sup> The facts of this case are distinguishable from the Commission’s decision in *Health Fee Elimination*, 08-4206-I-17 (Santa Monica Community College; adopted December 3, 2015). In the Santa Monica IRC, the Controller reduced indirect costs in 2003-2004, 2004-2005, and 2005-2006 because the claimant used the federal OMB Circular A-21, but did not obtain federal approval for its indirect cost rate proposals as required by the OMB Circular. In this case, the only reason for the reduction of indirect costs in 2004-2005 was the Controller’s change to the claiming instructions.

and BOGG exemption data, the Controller calculated the health fees that the claimant was authorized to charge, which resulted in a reduction of costs claimed.<sup>144</sup>

The claimant contends that it is only required to report as offsetting revenues, the fee revenue actually collected.<sup>145</sup>

The Commission finds that the correct calculation and application of offsetting revenue from student health fees has been resolved by the *Clovis Unified* decision, and that a reduction to the extent of the fee *authority*, rather than fee revenue actually collected, is correct as a matter of law.<sup>146</sup>

After the claimant filed its IRC, the court in *Clovis Unified* specifically addressed the Controller's practice of reducing claims of community college districts by the maximum fee amount that districts are statutorily authorized to charge students, whether or not districts choose to impose those fees. As expressed by the court, the "Health Fee Rule" states in pertinent part:

Eligible claimants will be reimbursed for health service costs at the level of service provided in the 1986/87 fiscal year. The reimbursement will be reduced by the amount of student health fees authorized per the Education Code [section] 76355.<sup>147</sup> (Underline in original.)

The Health Fee Rule relies on Education Code section 76355(a), which provides in relevant part:

(a)(1) The governing board of a district maintaining a community college may require community college students to pay a fee in the total amount of not more than ten dollars (\$10) for each semester, seven dollars (\$7) for summer school, seven dollars (\$7) for each intersession of at least four weeks, or seven dollars (\$7) for each quarter for health supervision and services, including direct or indirect medical and hospitalization services, or the operation of a student health center or centers, or both.

(a)(2) The governing board of each community college district may increase [the health service fee] by the same percentage increase as the Implicit Price Deflator for State and Local Government Purchase of Goods and Services. Whenever that calculation produces an increase of one dollar (\$1) above the existing fee, the fee may be increased by one dollar (\$1).<sup>148</sup>

Pursuant to the plain language of Education Code section 76355(a)(2), the fee authority given to districts automatically increases at the same rate as the Implicit Price Deflator; when that calculation produces an increase of one dollar above the existing fee, the fee may be increased by

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<sup>144</sup> Exhibit A, IRC, page 80.

<sup>145</sup> Exhibit A, IRC, pages 19-26.

<sup>146</sup> *Clovis Unified School Dist.* (2010) 188 Cal.App.4th 794.

<sup>147</sup> *Clovis Unified School Dist.* (2010) 188 Cal.App.4th 794, 811.

<sup>148</sup> Education Code section 76355(d)(2) (Stats. 1993, ch. 8 (AB 46); Stats. 1993, ch. 1132 (AB 39); Stats. 1994, ch. 422 (AB 2589); Stats. 1995, ch. 758 (AB 446); Stats. 2005, ch. 320 (AB 982)) [Formerly Education Code section 72246(e) (Stats. 1987, ch. 118)].

one dollar.<sup>149</sup> The Chancellor of the California Community Colleges issues a notice to the governing boards of all community colleges when a fee increase is triggered. Accordingly, the court in *Clovis Unified* upheld the Controller’s use of the Health Fee Rule to reduce reimbursement claims based on the fees districts are *authorized* to charge. The court held that:

To the extent a local agency or school district “has the authority” to charge for the mandated program or increased level of service, that charge cannot be recovered as a state-mandated cost.<sup>150</sup>

The court also noted that, “this basic principle flows from common sense as well. As the Controller succinctly puts it, ‘Claimants can choose not to require these fees, but not at the state’s expense.’”<sup>151</sup> Additionally, in responding to the claimant’s argument that, “since the Health Fee Rule is a claiming instruction, its validity must be determined *solely* through the Commission’s P&G’s,”<sup>152</sup> the court held:

To accept this argument, though, we would have to ignore, and so would the Controller, the fundamental legal principles underlying state-mandated costs. We conclude *the Health Fee Rule is valid*.<sup>153</sup> (Italics added.)

Since the *Clovis* case is a final decision of the court addressing the merits of the issue presented here, the Commission, under principles of stare decisis, is required to apply the rule set forth by the court.<sup>154</sup> In addition, the *Clovis* decision is binding on the claimant under principles of collateral estoppel.<sup>155</sup> Collateral estoppel applies when (1) the issue necessarily decided in the previous proceeding is identical to the one that is currently being decided; (2) the previous proceeding terminated with a final judgment on the merits; (3) the party against whom collateral estoppel is asserted is a party to or in privity with a party in the previous proceeding; and (4) the party against whom the earlier decision is asserted had a full and fair opportunity to litigate the issue.<sup>156</sup> The claimant was a party to the *Clovis* action.

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<sup>149</sup> See Education Code section 76355 (Stats. 1995, ch. 758 (AB 446)). The Implicit Price Deflator for State and Local Purchase of Goods and Services is a number computed annually (and quarterly) by the United States Department of Commerce as part of its statistical series on measuring national income and product, and is used to adjust government expenditure data for the effect of inflation.

<sup>150</sup> *Clovis Unified School Dist.* (2010) 188 Cal.App.4th 794, 812.

<sup>151</sup> *Ibid.*

<sup>152</sup> *Ibid.* Italics in original.

<sup>153</sup> *Clovis Unified School Dist.* (2010) 188 Cal.App.4th 794, 812.

<sup>154</sup> *Fenske v. Board of Administration* (1980) 103 Cal.App.3d 590, 596.

<sup>155</sup> The petitioners in the *Clovis* case included Clovis Unified School District, El Camino Community College District, Fremont Unified School District, Newport-Mesa Unified School District, Norwalk-La Mirada Unified School District, Riverside Unified School District, San Mateo County Community College District, Santa Monica Community College District, State Center Community College District, and Sweetwater Union High School District.

<sup>156</sup> *Roos v. Red* (2006) 130 Cal.App.4th 870, 879-880.

The Commission further finds that the Controller's calculation of the claimant's authorized offsetting fee revenue is not arbitrary, capricious, or entirely lacking in evidentiary support, since the Controller used the enrollment data available and reported by the claimant. The Controller obtained student enrollment and Board of Governors Grant (BOGG) recipient data from the California Community Colleges Chancellor's Office and calculated the authorized health service fees using the authorized rates that the Chancellor's Office noticed during the fiscal years at issue.<sup>157</sup>

Therefore, the Commission finds that the Controller's reduction of \$694,471 based on the claimant's unreported offsetting fee authority is correct as a matter of law, and is not arbitrary, capricious, or entirely lacking in evidentiary support.

## **V. Conclusion**

Based on the foregoing, the Commission partially approves this IRC. The Commission finds that the Controller's reduction of indirect costs of \$4,896 for fiscal year 2004-2005, based solely on the change to the claiming instructions and its use of the new indirect cost rate rule, without evidence that notice and an opportunity for comment was provided to the claimant, is incorrect as a matter of law and requests, pursuant to Government Code section 17551(d) and section 1185.9 of the Commission's regulations, that the Controller reinstate costs to the claimant.

The Commission further finds that the remaining reductions are correct as a matter of law and not arbitrary, capricious, or entirely lacking in evidentiary support.

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<sup>157</sup> Exhibit A, IRC, page 80.