



May 2016



The State Bar of California

Its Lack of Transparency Has Undermined Its Communications With Decision Makers and Stakeholders

Report 2015-047

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Elaine M. Howle State Auditor
Doug Cordiner Chief Deputy

May 12, 2016

2015-047

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As required by Business and Professions Code section 6145, the California State Auditor presents this audit report concerning the State Bar of California's (State Bar) financial operations and management practices. This report concludes that the State Bar's financial-related reports lacked transparency and contained errors, limiting stakeholders' ability to understand the State Bar's operations and the Legislature's ability to ensure the appropriateness of the State Bar's fees.

The State Bar has not clearly informed stakeholders of the amounts it estimates it will pay to reimburse members of the public who suffer financial losses because of dishonest attorneys. By the end of 2015, the State Bar estimated it would pay about \$18.9 million from its Client Security Fund for such reimbursements. Unfortunately, the Client Security Fund had approximately \$2.2 million available by that time, severely limiting the State Bar's ability to pay these claims. However, beginning in 2012, the State Bar eliminated from its financial statements any disclosure of Client Security Fund claims it expected to pay, reporting instead that the fund's balance had improved. This impeded stakeholders' ability to assess the financial condition of the Client Security Fund. After we discussed this issue with the State Bar, it revised its 2015 financial statements to disclose the amount of the Client Security Fund's estimated payouts.

We identified other instances in which the State Bar's reports lacked transparency. For example, the State Bar reported the balance in two of its funds as unrestricted—or available for general use—when, in fact, that money could only be used for specific purposes. The State Bar also has not clearly reported its budget assumptions to the Legislature, despite the fact that the Legislature relies on that budget to ensure the reasonableness of the State Bar's fees. In addition, the State Bar recently pledged its member fee revenue when it entered into a loan agreement without informing the Legislature, even though the pledge might have restricted the Legislature's ability to lower the State Bar's fees. After we discussed our concern regarding this loan provision with the State Bar, it replaced this provision with a \$7 million debt service reserve. The State Bar also created and used a nonprofit foundation without sufficient oversight of its Board of Trustees (board), and recently used almost \$14,800 from its general fund to eliminate the foundation's fund deficit without its board's knowledge or approval.

Finally, the State Bar has continued to provide its executives significantly more in salaries and benefits than that of state government executives in comparable positions. Although the State Bar is currently conducting a compensation and benefits study, it did not initially include state government executive branch salaries or benefits in its evaluation. After we raised this issue, the State Bar added state government executives to its evaluation. Overall, we believe that increased oversight and improved financial processes could reduce the risk that the State Bar will face similar problems in the future.

Respectfully submitted,

ELAINE M. HOWLE, CPA
State Auditor

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Summary

Results in Brief

State law requires that every person licensed to practice law in California belong to the State Bar of California (State Bar), a public corporation within the State's judicial branch. Supported primarily by member fees, the State Bar's duties include regulating the conduct of attorneys through its attorney discipline system as well as administering the California Bar exam. State law requires the State Bar to provide its stakeholders with various reports detailing its financial situation. However, in recent years, the State Bar's financial reports have contained errors and lacked transparency, and these weaknesses have limited stakeholders' ability to understand the State Bar's operations and the Legislature's ability to ensure the appropriateness of the State Bar's fees.

For example, the State Bar has not taken critical steps to ensure that it has the funds necessary to reimburse members of the public who suffer financial losses because of dishonest attorneys, nor has the State Bar clearly informed stakeholders of the amounts related to such claims that it estimates it will pay. Specifically, the primary purpose of the State Bar's Client Security Fund is to compensate victims of dishonest attorneys through a claims process. However, the number of claim applications to the Client Security Fund program soared beginning around 2009, in large part because many Californians had become victims of loan modification schemes. By the end of 2015, the State Bar indicated it had about 5,500 applications either in process or awaiting payment, and it estimated that it would pay a total of about \$18.9 million related to those claims. Unfortunately, the available balance in the Client Security Fund had dropped to approximately \$2.2 million by that time; this lowered balance thus severely reduced the State Bar's ability to pay these claims.

Although the State Bar recognized the impending shortfall in its Client Security Fund at least as early as 2011, not only did it fail to take steps to address the problem or to communicate the fund's true financial situation, it did the opposite: In 2012 the State Bar eliminated from its financial statements any disclosure of future amounts it expected to pay related to the Client Security Fund, reporting instead that the fund's balance had improved. Further, because the State Bar lacked the funds necessary to pay claims, it slowed its claims processing from about 18 months to about 36 months, potentially harming victims who needed these resources. It has recently taken some steps toward a solution, such as transferring \$2 million from other funds to the Client Security Fund. However, unless the State Bar takes additional significant actions, victims of dishonest attorneys will continue to have to wait years for their claims to be paid.

Audit Highlights . . .

Our audit of the State Bar of California's (State Bar) financial operations and management practices revealed the following:

- » *The State Bar's financial reports have contained errors and lack transparency, limiting the ability of stakeholders to fully understand its financial operations and the Legislature's ability to set appropriate State Bar fees.*
 - *In 2015 the Client Security Fund's balance had only \$2.2 million available to pay nearly \$19 million in estimated claims.*
- » *The State Bar has not clearly informed stakeholders that it lacks the funding necessary to pay victims of attorney misconduct.*
- » *The State Bar reported the balance in two of its funds as unrestricted—or available for general use—when, in fact, that money could only be used for specific purposes.*
- » *The State Bar did not adequately document or communicate to the Legislature the assumptions and methodology used in its budget process.*
- » *After we stated our concern, the State Bar modified provisions in its loan agreements that might have otherwise restricted the Legislature's ability to lower the State Bar fees.*
- » *The State Bar created and used a nonprofit foundation without sufficient oversight of its Board of Trustees.*
 - *It charged more than \$22,000 in inappropriate expenses to the foundation.*
 - *It used \$14,800 from its general fund to eliminate the nonprofit foundation's fund deficit.*
- » *The State Bar's salaries and benefits for its executives continue to be significantly higher than those of state government executives in comparable positions.*

We identified a number of other instances in which the State Bar's reports lacked transparency or contained errors, and these problems undercut the reports' usefulness for the decision makers and stakeholders who rely on them. For example, because the State Bar failed to establish a reasonable process for allocating the costs of information technology projects, it identified the balance in its Technology Improvement Fund as unrestricted—or available for general use—when, in fact, that money could only be used for specific purposes. Similarly, the State Bar inaccurately identified its Legal Services Trust Fund balance as unrestricted, even though state law restricts the fund to awarding grants to entities that provide free legal services to low-income Californians. In addition, over the past five years, the State Bar has repeatedly changed the way it presents indirect costs in its financial statements, creating apparent fluctuations in its funds' year-to-year spending and reducing a stakeholder's ability to compare one year to another.

In February 2016, the State Bar established a new reserve policy for its funds, and our review found that its most significant funds now comply with that policy. However, we have a number of concerns about the State Bar's budgeting process. Specifically, the State Bar lacks a clear, documented methodology for establishing its budget forecasts. In fact, it was unable to provide us with documentation of either its budget assumptions or its methodology. Further, the State Bar has not reported its budget assumptions and methodology to the Legislature, despite the fact that the Legislature relies on that budget to ensure the reasonableness of the State Bar's fees. Finally, after we raised concerns about one of the provisions in its building loans, the State Bar modified the provision which might have otherwise restricted the Legislature's ability to lower the State Bar's fees.

Our audit further found that in the absence of oversight, the State Bar has made some questionable or inappropriate financial decisions. For example, in 2013 the State Bar created a nonprofit foundation to purportedly collect money from donors and to administer activities benefiting two of its programs. Although state law allows the State Bar to create nonprofit organizations for the purpose of generating revenue for its operations, about \$22,000 of the \$33,000 in expenses the State Bar recorded in the foundation's fund from 2013 through 2015 were for purposes unrelated to the two programs the foundation was established to support. In fact, the State Bar incurred nearly \$4,800 of these expenses for a dinner and hotel stay it charged to the foundation that took place two months before the foundation was even created. Moreover, in December 2015, without the knowledge or approval of its board of trustees, the State Bar transferred from its general fund almost

\$14,800 to eliminate a deficit in the foundation's fund. Lacking proper oversight, the State Bar could create a similar nonprofit in the future and use it for questionable purposes.

Finally, the State Bar has continued to provide its executives significantly more generous salaries and benefits than those received by other executives in comparable positions in state government. In fact, the salary ranges for the State Bar's 13 top executives exceed the salary of the governor. If the State Bar capped all of its executive staff salaries below the position level of chief operations officer (operations officer) at the highest level allowed for similar state positions, it could save as much as \$428,000 annually. Although the State Bar is conducting a comprehensive compensation and benefits study, it had not included in its evaluation the data for salaries or benefits of the state government's executive branch. After we raised this issue, the State Bar added state executive branch salary and benefit comparisons to its compensation study covering staff involved in its disciplinary activities. According to the State Bar's operations officer, the State Bar also plans to include comparisons to state executive branch salaries and benefits in its agency-wide compensation study.

In the past year, the State Bar's management team has undergone significant turnover. Given the magnitude of those changes, we are optimistic that the State Bar may improve the clarity of its financial communications and that its financial decisions may reflect better judgment. However, we also believe that increased oversight and improved financial processes could reduce the risk that the State Bar will face similar problems in the future.

Recommendations

To reduce the length of time that victims of dishonest lawyers must wait for reimbursement from the Client Security Fund, the State Bar should continue to explore fund transfers, member fee increases, and operating efficiencies that would increase resources available for payouts.

To reduce the risk of errors in its financial reporting, the State Bar should update its procedures to include detailed steps that staff should take to prepare financial statements and to ensure that the statements are accurate and complete.

To increase the transparency and comparability of its financial information, the State Bar should do the following:

- Limit significant changes in its indirect cost reporting.
- Clearly disclose any changes in its accounting practices.

- Disclose the reasons for any significant changes to program costs.

To ensure that it accounts appropriately for information technology project costs and their related funding sources, the State Bar should do the following:

- Develop a reasonable method for allocating information technology project costs.
- Apply this new cost-allocation method to the costs of its Technology Improvement Fund.

To make certain that it informs stakeholders of conditions that may affect its policy and programmatic decisions, the State Bar should document the assumptions and methodology underlying its budget estimates. It should present such assumptions and methodology concisely in the final budget document it provides to its board and the Legislature.

To make certain that the Legislature is not limited in its ability to set member fees, the Legislature should require the State Bar to notify or seek its approval when the State Bar plans to pledge its revenue for a period that exceeds 12 months or that overlaps fiscal years.

To ensure that it retains appropriate supervision and control over the State Bar's financial affairs, the board should establish a policy that includes the following:

- A description of the parameters for the creation of nonprofit organizations that limits such organizations to the purposes consistent with the law and the State Bar's mission.
- A description of the board's oversight role in relation to the State Bar's nonprofit organizations.
- Requirements that the State Bar develop policies and procedures to prevent the mingling of its funds and any nonprofit organization's funds.

To improve its oversight of the State Bar's financial affairs, the Legislature should require the State Bar to disclose the creation of and use of nonprofit organizations, including the nonprofits' annual budgets and reports on their financial conditions explaining the sources and uses of the nonprofits' funding.

To ensure that the compensation it provides its executives is reasonable, the State Bar should include in the comprehensive salary and benefits study it plans to complete by October 2016 the data for salaries and benefits for comparable positions in the state government's executive branch.

Agency Comments

The State Bar of California generally agrees with the recommendations in our report, and indicated that it has already begun implementing some of them; however, it expressed concerns about certain report headings.

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Introduction

Background

The State Bar of California (State Bar) is a public corporation within the judicial branch of the State of California. State law requires that every person admitted and licensed to practice law in California belong to the State Bar, unless the individual holds office as a judge in a court of record. State law establishes public protection as the highest priority of the State Bar and its board of trustees (board) in exercising their licensing, regulatory, and disciplinary functions. The State Bar's primary responsibilities are listed in the text box.

The State Bar's Governance and Oversight Structure

States may use one of two models to establish their bars: the *unified bar model* or the *voluntary bar model*. Characteristics of a unified bar model, which California's bar follows, include mandatory membership and the payment of an annual fee by each attorney licensed to practice law in the State.¹ The bar's functions under this model include discipline, admissions, and education. A unified bar also provides member services, such as annual meetings and social functions; political lobbying related to the administration of justice; and member discounts on insurance and other goods and services. Like California, Texas and Florida operate under the unified bar structure.

Under the voluntary bar model, a state supreme court creates boards, commissions, or agencies that are responsible for overseeing the state's legal disciplinary systems; thus, the state bar performs only member-service functions. States that operate under the voluntary bar structure include New York and Illinois. Boards govern the bars in both unified and voluntary models. However, the voluntary bars in New York and Illinois also have assemblies—large authoritative bodies—that set the policies that the boards administer.

State Bar of California's Primary Responsibilities

- Regulating the conduct of attorneys through an attorney discipline system
- Administering the exam for admission to the California State Bar
- Regulating mandatory continuing legal education
- Administering an Attorney Diversion and Assistance Program
- Expanding access to and improving the quality of free or low cost legal services in civil matters for indigent citizens
- Administering a Client Security Fund to mitigate losses caused by the dishonest conduct of attorneys

Source: *Business and Professions Code, Division 3, Chapter 4.*

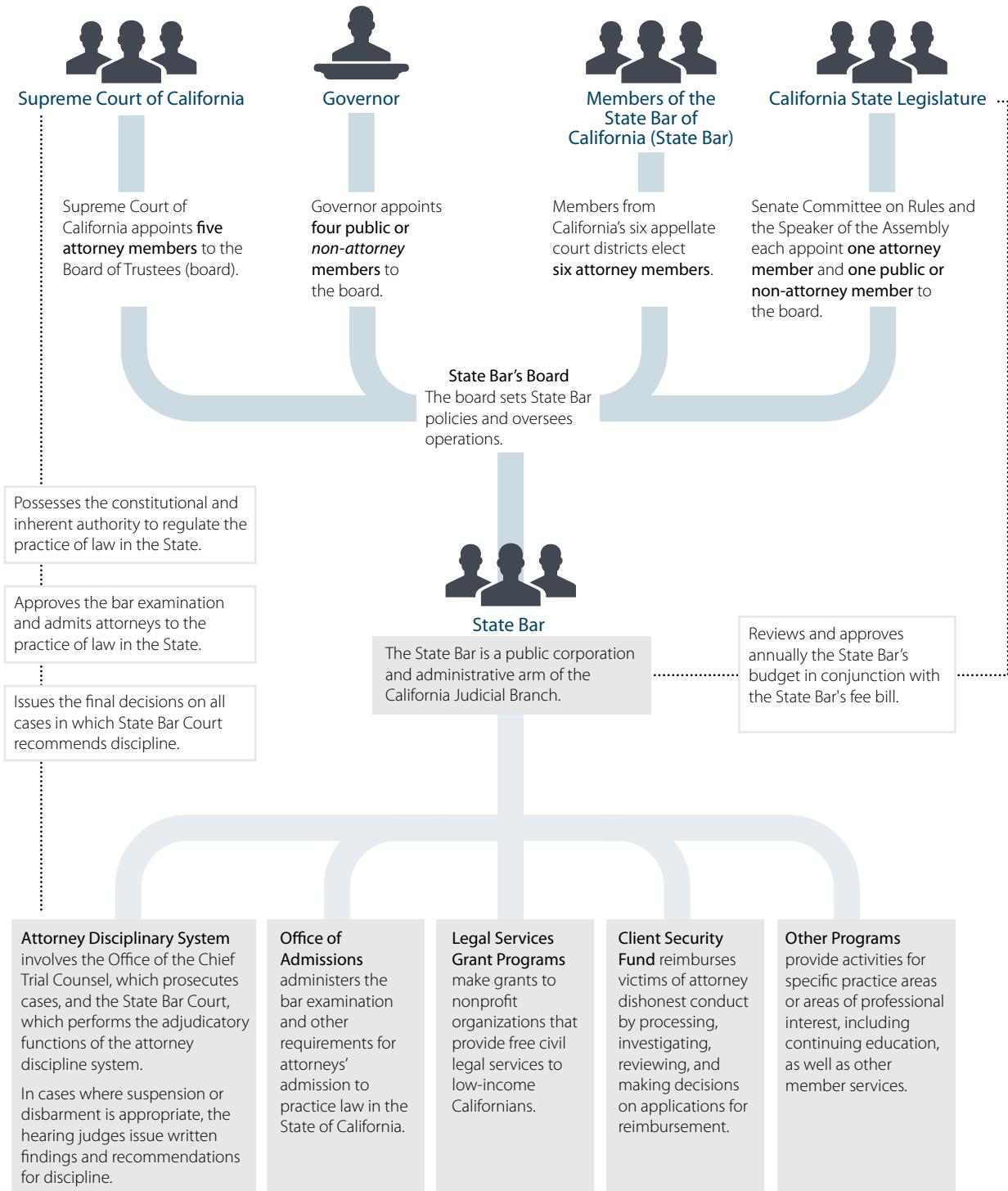
¹ States that require their practicing attorneys to be members of those states' bars refer to their bars as *unified, integrated, or mandatory*. In this report, we refer to this type of bar as *unified*.

Typically a 19-member board that meets formally six to eight times per year governs the State Bar. As Figure 1 shows, 13 of its trustees are lawyers: members of the State Bar elect six of these 13, and the California Supreme Court (Supreme Court) and the Legislature appoint the other seven. Six members are public members who are not attorneys: the governor appoints four, and the Legislature appoints two members. Each of these six public members is subject to confirmation by the Senate and must never have been a member of the State Bar or admitted to practice in any court in the United States. California's State Bar board members serve three-year terms and may be reelected. As of March 2016, the longest-serving trustee had been on the board since 2009, and another had served since 2010.

The State Bar has experienced significant turnover and a restructuring of its executive management since 2014. All of the state bars we reviewed employ executive directors to execute the policies and directives of their boards. In California, the executive director serves at the pleasure of the board. On November 7, 2014, after procuring an independent investigation of wide-ranging allegations that several of the State Bar's high-level employees had raised, the State Bar's board voted to end the former executive director's employment. Additionally, five other executives left the State Bar between November 2014 and November 2015. The former executive director subsequently filed a lawsuit. In January 2016, a Los Angeles County Superior Court judge appointed an arbitrator to assist the State Bar and the former executive director in resolving the litigation. The arbitrator dismissed all claims in the lawsuit in April 2016. According to a State Bar press release, should the former executive director amend his complaint, the State Bar will again challenge it.

The State Bar hired a new executive director and a new chief operations officer (operations officer), who assumed their responsibilities in September 2015, and a new general counsel, who began her employment in October 2015. Under the new leadership, the State Bar restructured its executive management team by eliminating the positions of deputy executive director, chief financial officer, and chief communications officer, among others. As of March 2016, the State Bar employed 534 people, and it had offices in San Francisco and Los Angeles.

Figure 1
The State Bar of California's Governance Structure



Sources: Various Business and Professions Code sections and State Bar organization charts and documents.

The State Bar's Accounting Processes for Revenue and Expenses

In 2015 the State Bar accounted for its various revenue and expenses by recording individual transactions across 22 program funds and its general fund. As shown in Table 1, these funds are designed for specific purposes, such as accounting for mandatory fee revenue and expenses related to administering the bar exam or for voluntary donations to provide grants to nonprofit legal aid organizations. Some of the State Bar's funds are restricted; therefore, the money within those funds can only be used in accordance with special regulations, restrictions, or limitations. In 2015 the State Bar consolidated eight of its funds into its general fund for financial reporting and budgeting purposes. However, the State Bar still tracks revenue and expenses of these eight funds separately in its accounting system.

Table 1
The State Bar of California's Fund Structure as of October 2015

Consolidated General Fund*	
Main operating fund	General Fund —Used to account for membership fees and resources of the State Bar of California (State Bar) not related to other fund activities; these fees include those assessed on law corporations and continuing education providers. Also used to account for voluntary and nonfee operating revenue of the State Bar not related to other fund activities, including revenue from continuing education fees and investment income. The general fund supports various State Bar programs, including Discipline and Adjudication, Administration of the Profession, and Program Development.
Capital asset funds	<p>Building Fund—Used to account for revenue from rental income the State Bar generates from leasing space to third parties at its facility in San Francisco. The Building Fund also accounts for capital asset purchases, including construction, equipment, furnishings, land, and buildings not accounted for in the Fixed Assets Fund or in the Los Angeles Facilities Fund.</p> <p>Fixed Assets Fund—Used to account for capital assets not accounted for in the Building Fund and in the Los Angeles Facilities Fund. This fund does not receive revenue.</p> <p>Los Angeles Facilities Fund—Used to account for rental income the State Bar generates from leasing space to third parties at its facility in Los Angeles. This Fund also accounts for all expenses, such as capital asset purchases, loan payments, and building maintenance activities related to the State Bar's Los Angeles facility.</p>
Reserve funds	<p>Benefits Reserve Fund—Used to account for resources set aside by the State Bar to fund the future costs of postemployment benefits other than pensions. Resources in this fund are provided by other State Bar funds in proportion to their salary expenses.</p> <p>Public Protection Fund—Used to account for reserve funding set aside to ensure the continuity of the State Bar's disciplinary system and its other essential public protection programs.</p>
Other program and administrative funds	<p>Legal and Education Development Fund—Used to account for revenue from royalties, marketing contributions, investment income, and programs it offers to members, such as life insurance and discounts on products. The Legal and Education Development Fund supports competency-based education programs for attorneys that are aimed at reducing the severity and frequency of professional liability claims.</p> <p>Technology Improvement Fund—Used to account for expenses related to technology projects. This fund receives resources from the State Bar's other funds—such as the Information Technology Assessment Fund, the Admissions Fund, and the general fund—to finance its technology projects.</p> <p>Support and Administration Fund—Used to account for the State Bar's indirect costs that are not accounted for by the program areas in the State Bar's other funds. The Support and Administration Fund does not receive revenue.</p>
Restricted funds	Admissions Fund —Used to account for mandatory fee revenue and expenses related to administering the bar examination and other requirements for admission to the practice of law in the State of California. This fund is also used to account for voluntary and nonfee operating revenue of the State Bar not related to other fund activities, including penalties and various continuing legal education fees.

Restricted funds	<p>Client Security Fund—Used to account for mandatory membership fees and expenses of the Client Security Fund program. The State Bar is required by law to administer the Client Security Fund program to reimburse individuals who incur losses resulting from dishonest conduct by attorneys.</p>
	<p>Elimination of Bias and Bar Relations Fund—Used to account for annual voluntary membership fees and expenses that support activities with voluntary bar associations and programs that address concerns of access and bias in the legal profession. The State Bar includes a voluntary fee in its annual membership fee bill; however, members who do not wish to fund these activities have the option to reduce their annual fee payment by \$5. This fund is also used to account for various voluntary fees related to the State Bar's sponsored events and programs, as well as grant revenue.</p>
	<p>Equal Access Fund—Used to account for funding from the Judicial Council of California that the State Bar uses to provide grants to approximately 100 nonprofit legal aid organizations to provide free legal services to indigent Californians.</p>
	<p>Information Technology Special Assessment Fund—Used to account for a \$10 mandatory fee the State Bar collected from its members from 2011 through 2013 for the purpose of upgrading the State Bar's information technology systems, including the purchase and maintenance of computer hardware and software.</p>
	<p>Justice Gap Fund—Used to account for voluntary donations the State Bar uses to provide grants to nonprofit legal aid organizations offering free legal services to low-income Californians. The State Bar includes an option on its annual membership fee bill for members to make donations to this program.</p>
	<p>Lawyer's Assistance Fund—Used to account for mandatory member fees the State Bar uses to fund education, remedial, and rehabilitative programs for those members who need assistance as a result of disabilities related to substance abuse or mental illness.</p>
	<p>Legal Services Trust Fund—Used to account for revenue primarily from interest earned on certain client trust accounts held by California attorneys to fund free legal services for indigent people. State law requires attorneys who hold client funds in trust to remit interest earned on those accounts to the State Bar. After the State Bar deducts its administrative costs, it distributes the remaining funds as grants to nonprofit legal aid organizations. In addition, this fund receives voluntary membership fees that the State Bar also uses to fund these grants. The State Bar includes a voluntary fee for this fund in its annual membership fee bill; however, members who do not wish to fund these activities have the option to reduce their annual fee payment by \$40. This fund is also used to account for tax refund revenue intercepted from resigned or disbarred members who have outstanding debts with the State Bar.</p>
	<p>Legal Specialization Fund—Used to account for voluntary application fees, certification fees, recertification fees, and annual membership fees and expenses of the State Bar's Legal Specialization Program.</p>
	<p>Legislative Activities Fund—Used to account for voluntary member fees the State Bar uses for lobbying and other related activities deemed outside of the parameters established in Keller vs. the State Bar. The State Bar includes a voluntary fee for this fund in its annual membership fee bill; however, members who do not wish to fund these activities have the option to reduce their annual fee payment by \$5.</p>
	<p>Sections Fund—Used to account for voluntary membership fees and expenses restricted by law related to the activities of 16 sections, which consist of specific practice areas or areas of professional interest. The Sections Fund also receives revenue from seminars and workshops, advertising, sales of various pamphlets and publications, and grants.</p>
Other funds	<p>Annual Meeting Fund—Used to account for voluntary registration fees and expenses of the State Bar's annual meeting. The Annual Meeting Fund allocates its revenue and expenses among itself, the Sections Fund, and the Conference of Delegates of California Bar Associations, which operates as an independent entity. This fund is also used to account for advertising revenue and other miscellaneous revenue generated from hosting the annual meeting.</p>
	<p>Grants Fund—Used to account for corporate sponsorships and grant revenue the State Bar uses to support various program expenses and special projects.</p>
	<p>State Bar Access and Education Foundation Fund—Used to account for the activities of the State Bar's nonprofit organization, the State Bar Access and Education Foundation.</p>

Sources: The State Bar's 2014 financial report and accounting documents, policies of the State Bar's board of trustees, and the California Business and Professions Code.

* The funds in the consolidated general fund are reported as one fund in the State Bar's financial statements beginning in fiscal year 2015; however, the State Bar continues to report restricted funds and other funds separately.

The State Bar's budget serves as its primary fiscal control and contains its anticipated income and expenses. The State Bar uses its budget to present its plans for its programs, the cost of those plans, and the estimated income sources it intends to use to finance the costs. The State Bar's Office of Finance prepares and submits the annual budget to the board for approval. State law requires the board to complete and implement five-year strategic plans, which provide the framework for its annual budget process. In its most recent update of its strategic plan in 2014, the State Bar included such initiatives as modernizing its information technology, improving its physical facilities, and streamlining its programs and processes.

The State Bar's fiscal year ends on December 31, and its expense cycle begins when the board uses the annual budget process to approve expense amounts for its programs. State Bar policy requires various levels of management approval to authorize all expenses based on board-approved budget or agenda items. For example, certain employees may approve amounts up to \$1,000, managers may approve amounts up to \$5,000, and senior executive staff members may approve amounts up to \$50,000. Only the State Bar's executive director or operations officer may approve amounts more than \$50,000. State Bar policy further emphasizes that each department's procurement of goods and services must be based on its approved budget regardless of the amount of the purchase.

The State Bar also has formal processes in place to ensure that its staff record revenue and expenses in the appropriate funds and accounts. For example, its policies and procedures for cash receipts describe the steps necessary to prepare, review, and approve transactions and to record them in its accounting system.

The State Bar's Revenue Sources

The State Bar maintains, operates, and supports its discipline system and general operations primarily through mandatory fees that it charges its members. Nearly 49 percent of the revenue the State Bar received from 2013 through 2015 was restricted either by statute or by its board. As shown in Table 2, the State Bar's largest types of revenue were mandatory member fees, admissions fees, and revenue from the Judicial Council of California (Judicial Council) used for grants. In 2015 mandatory member and admissions fees totaled \$91.7 million, or 61 percent of the State Bar's overall revenue. Judicial Council revenue totaled about \$14.2 million, or 9 percent of its overall revenue.

Table 2
The State Bar of California's Revenue by Type and Restriction Level
From 2013 Through 2015
(Dollars in Thousands)

	REVENUE TYPE	2013			2014			2015		
		RESTRICTED	UNRESTRICTED	TOTAL	RESTRICTED	UNRESTRICTED	TOTAL	RESTRICTED	UNRESTRICTED	TOTAL
Category 1: Mandatory fees and other charges	Mandatory member fees	\$11,357	\$59,236	\$70,593	\$7,597	\$64,811	\$72,408	\$7,709	\$65,784	\$73,993
	Admissions fees	17,939	17,939	17,939	17,487	17,487	18,223	17,487	18,223	18,253
	Legal specialization fees	2,388	2,388	2,019	2,019	2,019	2,538	2,019	2,538	2,538
	Law corporation fees	1,338	1,338	1,338	1,355	1,355	1,410	1,355	1,410	1,410
	Continuing education fees	293	136	429	311	137	448	280	156	436
	Law school fees	139	139	126	126	126	125	126	125	125
	Other mandatory charges	173	723	896	194	848	1,042	227	869	1,096
	Category 1 total	32,289	61,433	93,722	27,734	67,151	94,885	29,132	68,219	97,351
Category 2: Voluntary fees and charges, and donations	Donations	5,893	5,893	7,395	7,395	7,395	8,912	7,395	8,912	8,912
	Sections fees	4,951	4,951	5,428	5,428	5,428	5,891	5,428	5,891	5,891
	Continuing education fees	1,025	226	1,251	1,029	170	1,199	810	278	1,088
	Other voluntary fees and charges	3,216	628	3,844	3,388	795	4,183	3,653	682	4,335
Category 2 total		15,085	854	15,939	17,240	965	18,205	19,266	960	20,226
Category 3: Nonfee operating revenue	Judicial Council of California revenue	16,145	23	16,168	14,512	5	14,517	14,200	25	14,225
	Settlement grants							6,085		6,085
	Mandatory collection of interest on lawyer trust accounts	4,989	4,989	5,226	5,226	5,226	5,332	5,226	5,332	5,332
	Penalties, late fees, and miscellaneous charges	509	2,562	3,071	460	2,374	2,834	476	2,530	3,006
	Insurance program revenue		1,867	1,867		1,650	1,650	2,143	2,143	2,143
	Advertising income	17	126	143	35	140	175	57	159	216
	Royalties and sales of member information		136	136		115	115	188	188	188
	Collections from tax intercepts				178		178	99	99	99
	Sales of publications	77	38	115	65	45	110	57	24	81
	Other revenue		4	4		4	4	4	4	4
Category 3 total		21,737	4,756	26,493	20,476	4,333	24,809	26,506	5,073	31,579
Category 4: Other nonoperating revenue	Rental income		1,034	1,034		1,879	1,879		1,814	1,814
	Investment income	134	128	262	102	127	229	109	76	185
	Category 4 total	134	1,162	1,296	102	2,006	2,108	109	1,890	1,999
Grand total		\$69,245	\$68,205	\$137,450	\$65,552	\$74,455	\$140,007	\$75,013	\$76,142	\$151,155

Source: California State Auditor's analysis of the State Bar of California's JD Edwards EnterpriseOne data.

Member Fees, Admissions Fees, and Donations

In recent years, the State Bar's mandatory member fees revenue ranged from \$70.6 million in 2013 to \$73.5 million in 2015 because of a 4.3 percent increase in membership. Historically, annual legislation has authorized the State Bar to impose a membership fee; however, in 1997 the governor vetoed the annual fee bill because he had concerns that the State Bar had become overly political, unresponsive to its members, and inefficient. As a result, the State Bar was unable to impose annual membership fees for 1998 and 1999. The Supreme Court adopted an emergency interim measure in 1998 and imposed a mandatory fee on all active members for a special attorney discipline fund.

In past years, state law also authorized the State Bar to charge members additional mandatory fees for specific purposes. For example, from 2008 through 2013, state law authorized the State Bar to collect an additional \$10 from each active member to pay for upgrades to its information technology (IT) systems. State law also authorized the State Bar to collect an additional \$10 from each member from 2009 through 2013 to pay for the cost of financing, constructing, purchasing, or leasing facilities to house State Bar staff in Southern California. Additionally, admission fees support the State Bar's admission program. State law requires applicants to pay these fees if they wish to take the bar exam and register to practice law in the State. The State Bar received between \$17.5 and \$18.3 million annually in admissions fees from 2013 to 2015.

On the other hand, some of the membership fees the State Bar collects are voluntary. For example, members may choose not to pay the State Bar's \$5 fee for lobbying and related activities. As shown in Table 3, State Bar members each could pay a maximum of \$50 in voluntary membership fees for 2015 and 2016. State law restricted to specific purposes the State Bar's use of \$45 of each \$50 voluntary fee payment, while the board restricted the other \$5. For example, members can pay a voluntary \$40 fee to the Legal Services Trust Fund, which specifically supports nonprofit organizations that provide free legal services to people of limited means. The State Bar collected more than \$20.2 million in total voluntary fees, donations, and charges in 2015. Of this amount, the State Bar received nearly \$5.9 million in voluntary sections fees—revenue dedicated to voluntary organizations of attorneys and associates who share an area of interest. The Sections help their members maintain knowledge in various fields of law, expand their professional contacts, and serve the profession, the public, and the legal system. The State Bar received the remaining \$14.3 million of the \$20.2 million in donations and other voluntary fees and charges to provide legal aid to low-income Californians, to address concerns of bias in the legal profession, to offer support services for local bar associations, and to oversee providers of continuing education.

Table 3**The State Bar of California's Allocation of Annual Member Fees by Fund for 2013 Through 2016**

FEE ALLOCATION BY FUND	2013		2014		2015		2016	
	ACTIVE MEMBER FEE	INACTIVE MEMBER FEE	ACTIVE MEMBER FEE	INACTIVE MEMBER FEE	ACTIVE MEMBER FEE	INACTIVE MEMBER FEE	ACTIVE MEMBER FEE	INACTIVE MEMBER FEE
Funds receiving mandatory fees	General Fund	\$285	\$ 45	\$305	\$65	\$305	\$ 65	\$305
	Client Security Fund	40	10	40	10	40	10	40
	General Fund—discipline activity	25	25	25	25	25	25	25
	Lawyers Assistance Fund	10	5	10	5	10	5	10
	Building Special Assessment Fund	10	10	—	—	—	—	—
	Information Technology Special Assessment Fund	10	—	—	—	—	—	—
Mandatory fee allocation total		380	95	380	105	380	105	380
Funds receiving voluntary fees	Legal Services Trust Fund	20	20	30	30	40	40	40
	Legislative Activities Fund	5	5	5	5	5	5	5
	Elimination of Bias and Bar Relations Fund	5	5	5	5	5	5	5
Voluntary fee allocation total		30	30	40	40	50	50	50
Grand total		\$410	\$125	\$420	\$145	\$430	\$155	\$430
Grand total								
\$155								

Sources: California State Auditor's review of California Business and Professions Code and of State Bar of California documents.

Revenue for Grants

The Judicial Council contracts with the State Bar to administer grants through its Equal Access Fund. In 2015 the Equal Access Fund received more than \$14.4 million in revenue for the State Bar to award to qualified legal services projects and support centers that provide legal services to indigent people. The State Bar also receives interest on lawyer trust accounts for the same purpose. Further, the State Bar received \$6 million from a national mortgage settlement in 2015 to provide grants for organizations helping California families dealing with foreclosures and community redevelopment legal assistance. The State Bar's Legal Services Trust Fund Commission awards these grants.

Other Revenue

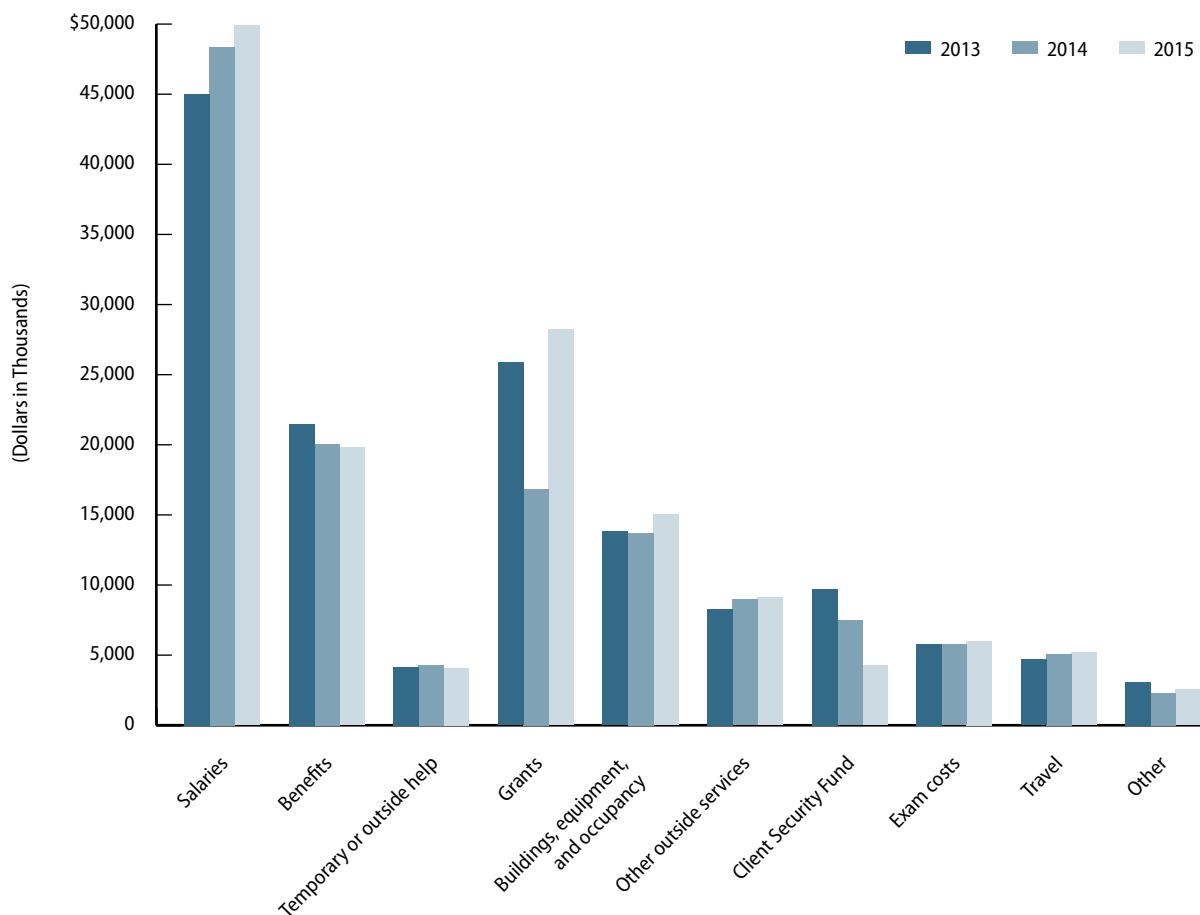
From 2013 to 2015, the State Bar collected between \$6.6 and \$7.7 million annually from other sources, including insurance program revenue, rental income, and penalties and late fees. Insurance program revenue accounted for \$2.1 million in 2015. Although revenue from these sources is not legally restricted, the board may set it aside during its annual budget process for specific purposes or programs. For example, the board designated insurance program revenue to provide financial support for legal service programs in 2015. The State Bar also deposited its 2015 rental income of \$1.8 million—proceeds from leasing to other organizations the unused space in its San Francisco and Los Angeles facilities—into its general fund to support facility-related expenses, such as construction, equipment, and furnishings.²

The State Bar's Expenses

The State Bar's largest expenses included salaries, benefits, and grants. As shown in Figure 2, salaries accounted for the State Bar's largest expense and increased by nearly \$4.9 million between 2013 and 2015. Grants, like those previously mentioned for legal services for indigent people, accounted for the State Bar's next largest expense. The State Bar reported a decrease in its grant expenses in 2014 because it adjusted its grants cycle to coincide with the calendar year. As a result, it reported only six months of grant activities in its 2014 financial statements. Finally, as Figure 2 shows, the Client Security Fund's expenses decreased each year from 2013 through 2015. We discuss this decrease in the Audit Results.

² During 2013 and 2014, the State Bar deposited its rental income into its Building Fund and its Los Angeles Facilities Fund. As previously discussed, the State Bar consolidated these funds into its general fund beginning in 2015.

Figure 2
The State Bar of California's Expenses
From 2013 Through 2015



Source: California State Auditor's analysis of the State Bar of California's JD Edwards EnterpriseOne data.

Prior Audit by the California State Auditor

Our June 2015 audit titled *State Bar of California: It Has Not Consistently Protected the Public Through Its Attorney Discipline Process and Lacks Accountability*, Report 2015-030, included eight recommendations to the State Bar related to the efficiency and effectiveness of its discipline system and seven recommendations related to improving its financial practices. Specifically, we found that the State Bar's efforts to align with its mission the staffing for its discipline system had fallen short. In 2011 it employed contractors, shifted staffing resources, and authorized a significant amount of overtime to reduce its backlog of attorney discipline cases, but it discontinued these operational changes shortly thereafter. Its backlog subsequently increased by 25 percent between 2011 and 2014.

State Bar of California's Workforce Plan

The State Bar of California (State Bar) contracted in 2016 with the National Center for State Courts to review the State Bar's staffing levels and make recommendations for improving the efficiency and effectiveness of its programs and business processes. The contract requires the following:

- Identify the desired performance level.
- Identify current staffing, including temporary or contract staffing.
- Make recommendations for business process reengineering that could increase the efficiency of each department reviewed.
- Develop a workforce plan that identifies performance-level metrics and objectives, recommended business processes, and recommended staffing levels, including staff type.
- Develop an implementation timeline and approach.
- Prepare a written report of its recommendations, including the methods, techniques, and data it used to develop its proposed performance metrics, workload planning, and business process reengineering.

Source: The State Bar's contract with National Center for State Courts, February 2016.

To better align its staffing with its mission, we recommended that the State Bar engage in workforce planning for its discipline system. In October 2015, the governor signed Senate Bill 387 (SB 387), which—among other things—requires the State Bar to submit a workforce plan to the Legislature by May 15, 2016, and to implement this plan by December 31, 2016. In response, the State Bar contracted with the National Center for State Courts, a nonprofit organization, to complete the workforce plan by April 29, 2016. The text box shows the tasks named in the contract. State law requires the State Bar to set a goal for its disciplinary system to complete complaint processing within six months from the receipt of complaints and to ensure that it provides appropriate resources to its disciplinary functions. The State Bar expects the workforce plan will result in a reallocation of resources to the discipline system.

We also recommended that the State Bar conduct an analysis of its operating costs and develop a biennial spending plan that includes an analysis of its plans to spend excessive fund balances. SB 387 also requires that the State Bar conduct a thorough analysis of its operating costs and develop a spending plan to determine a reasonable amount for the annual membership fee by May 15, 2016. The State Bar's operations officer said that the State Bar anticipates

finalizing its analysis of its priorities and necessary operating costs by the statutory deadline.

Additionally, SB 387 requires that the State Bar conduct a public sector compensation and benefits study (compensation study) to reassess the numbers and classifications of staff required to conduct its disciplinary activities. We discuss the compensation study in the Audit Results.

Our June 2015 audit also found that in 2012 the State Bar transferred \$12 million among its various funds to facilitate the purchase of a building in Los Angeles, despite the fact that its board had restricted some of this money for other purposes. We recommended that the State Bar implement policies and procedures to restrict its ability to transfer money between funds that its board or state law designated for specific purposes. We also recommended that the State Bar implement a policy requiring it to develop and present to its board accurate cost-benefit analyses for purchases exceeding a certain dollar level. We advised that these cost-benefit analyses should compare

relevant cost estimates and be clear about the sources of funding the State Bar intends to use to pay for the purchases. In response to our recommendation, the State Bar developed related policies in July 2015.

Scope and Methodology

The Business and Professions Code requires the State Bar to contract with the California State Auditor to conduct an in-depth financial audit of the State Bar, including an audit of its financial statements, internal controls, and relevant management practices. The law requires the audit to examine the revenue, expenses, and reserves of the State Bar, including all fund transfers. We list the objectives we developed and the methods we used to address them in Table 4.

Table 4
Audit Objectives and the Methods Used to Address Them

AUDIT OBJECTIVE	METHOD
1 Identify rules and regulations significant to the audit objectives.	<ul style="list-style-type: none"> • Identified criteria related to audit standards used to meet the intent of Senate Bill 387 and the concerns of stakeholders. • Reviewed the working papers and schedule of internal controls testing of the financial statement auditor for the State Bar of California (State Bar) to prevent duplication of effort. • Reviewed qualifications and standing of the State Bar's financial statement auditor.
2 Assess the State Bar's financial condition for a selection of its funds as well as its plans to establish reasonable reserves.	<ul style="list-style-type: none"> • Reviewed the State Bar's financial statements for 2013, 2014, and 2015. • Assessed the State Bar's financial condition for significant funds based on trends in revenue, expenses, and net position. Determined net positions restricted by legislation, the State Bar's Board of Trustees (board), or other external parties. • Evaluated the financial risks involved in the State Bar's long-term debt obligations, including restrictions on cash and other assets related to debt covenants. • Determined the extent to which the board exercised oversight regarding debt decisions. • Evaluated the reasonableness of the State Bar's new fund reserve policies and its plan to implement those policies. • Reviewed the State Bar's 2015 consultant report on its use of fund accounting. <ul style="list-style-type: none"> - Asked management to determine how it addressed any findings and recommendations in the report. - Determined the extent to which the board exercised oversight regarding these findings and recommendations. • Reviewed the State Bar's budget documents from 2013 through 2015 and asked management regarding plans to address financial risks identified in its fiscal forecasts. • Obtained an understanding and determined the reasonableness of the assumptions the State Bar uses in its budget projections. • Verified the status of the State Bar's development of a biennial spending plan used to determine the amounts of member fees. Determined the reasonableness of the State Bar's actions to reduce costs.

AUDIT OBJECTIVE	METHOD
3 Determine and evaluate how the State Bar records its revenues to ensure proper use and reporting.	<ul style="list-style-type: none"> • Identified the various sources and purposes of fee and nonfee revenue the State Bar collected during 2013, 2014, and 2015. • Gained an understanding of the State Bar's processes for ensuring it properly accounts for and records revenue. • Identified and assessed the design and operating effectiveness of the State Bar's internal controls over receiving and accounting for revenue. • Determined whether the State Bar's internal controls over key functions were operating effectively by observing or testing the process. • Selected 34 revenue transactions and determined whether they were recorded appropriately in the correct fund and revenue accounts. • Obtained an understanding of the State Bar's process for classifying and presenting revenues in its financial reports. • Determined the amounts of revenue—grouped by sources and funds—that the State Bar received during 2013, 2014, and 2015. Identified each source as a mandatory fee, voluntary fee, or nonfee revenue, and identified each source as restricted or nonrestricted. • Assessed the impacts of the State Bar's new fund reporting structure on the budgeting, accounting, and reporting of significant revenue. Also, determined the extent to which the board exercised oversight of this change.
4 Determine whether the State Bar's interfund transfers are appropriate and consistent with legal restrictions on funds and consistent with generally accepted accounting principles.	<ul style="list-style-type: none"> • Identified and assessed the design and operating effectiveness of the State Bar's internal controls over transfers and interfund activity. Efforts included obtaining and evaluating policies and procedures and determining the extent to which the board exercises oversight. • Selected 29 transfers that occurred during 2013, 2014, and 2015 and tested operating effectiveness of key internal controls. • For a selection of 10 transactions classified as interfund activity, determined the purpose of the transactions and whether the State Bar posted the transactions to the appropriate accounts. • For all interfund loans, assessed whether they were for appropriate purposes, properly authorized, and repaid within reasonable amounts of time.
5 Determine whether the State Bar's expenses are appropriate, reasonable, and correctly assigned to programs and funds.	<ul style="list-style-type: none"> • Identified and assessed the design and operating effectiveness of the State Bar's internal controls over authorizing, monitoring, and accounting for expenses. • Determined—by observing or testing the processes—whether the State Bar's internal controls over key functions were operating effectively. • Assessed trends in major categories of expenses during 2013, 2014, and 2015. Reviewed trends related to travel expenses. • Selected 34 expenses and determined whether they were allowable, reasonable, and consistent with the purposes of the related funds, any restrictions, and the mission of the State Bar. • Evaluated and determined whether the State Bar's expenses related to lobbying activities were reasonable and paid from appropriate revenue sources. • Determined the amount and reasonableness of administrative expenses, which included professional services and indirect costs, from the Legal Services Trust Fund program during 2013, 2014, and 2015. • Obtained and evaluated the reasonableness of the State Bar's indirect cost allocations for 2015 and determined the status of the review by the State Bar's consultant of the State Bar's indirect cost allocations. • Assessed the State Bar's use of employees contracted for professional services, such as attorneys.
6 Determine the effectiveness of the State Bar's efforts to recover disciplinary costs and Client Security Fund payments to victims by evaluating the effectiveness of the State Bar's corrective actions related to recommendations the State Auditor made in previous audits.	<ul style="list-style-type: none"> • Asked management for and obtained an understanding of the State Bar's cost recovery processes. • Evaluated the State Bar's corrective actions related to prior audit recommendations for its cost recovery process. • Analyzed the effectiveness and efficiency of the State Bar's process for billing, accounting for, and monitoring amounts owed to it. • Evaluated the effectiveness and efficiency of the State Bar's various collection methods by analyzing debt outstanding, collection rates by method, number of money judgments enforced, and numbers of cases and amounts associated with debts uncollected within 12 months of beginning collection efforts. Also examined whether any debts passed the statutes of limitations for collection during 2013, 2014, and 2015. • Selected 10 court-ordered debts, including those with restitution or Client Security Fund payments, and determined whether the State Bar took reasonable steps to collect the debts.

AUDIT OBJECTIVE	METHOD
7 Determine whether the State Bar's current compensation levels for its executive management are commensurate with the duties and responsibilities of comparable entities.	<ul style="list-style-type: none"> Evaluated the scope of the State Bar's ongoing classification and compensation study. Obtained the State Bar's most current salary and wage schedules and compared the salary ranges for a selection of executive and management positions at the State Bar with the salary ranges for equivalent positions at state agencies. Reviewed the State Bar's practices relating to cost-of-living adjustments, longevity pay, and merit salary increases. Compared the benefit packages that the State Bar offers its executive management with the benefits offered by state agencies. Reviewed changes the State Bar made to salary ranges for key management positions in 2013, 2014, and 2015. Reviewed employment contracts for a selection of the State Bar's former and current executives.
8 Determine whether the State Bar's current governance structure and board composition promote sound operational and financial practices. Identify the board's oversight of the State Bar's financial and administrative operations.	<ul style="list-style-type: none"> Obtained an understanding of the different types of governance structures for State Bars in the United States. Compared the State Bar's governance structure, oversight structure, and legal restrictions with those of four other large states: Texas (unified), Florida (unified), New York (voluntary), and Illinois (voluntary). Determined whether there have been any recent reviews of the four comparison State Bars' governance structures, and reviewed any related reports. To the extent possible, compared the financial reporting requirements and level of detail reported for the four comparison states to those of the State Bar of California. Determined the amount of turnover in the State Bar's executive management and board since 2013.
9 Determine the appropriateness of the formation and use of the State Bar's Access and Education Fund and the extent of the Board of Trustees' oversight.	<ul style="list-style-type: none"> Reviewed use by the State Bar's Sections' of the State Bar Access and Education Foundation (foundation) to support its events. Determined whether the State Bar reported its relationship with the foundation appropriately and classified the foundation's fund appropriately in its financial reports. Determined the amount of the foundation's revenue and expenses for 2013, 2014, and 2015. Learned the sources of funding used to support the foundation's expenses and whether it used its funding appropriately. Determined whether the State Bar accounted for the foundation's fund revenue and expenses appropriately. Ascertained whether the State Bar's use of the foundation was consistent with state law and the purpose for which the foundation was created. Determined the extent to which the board oversaw the State Bar's creation and use of the foundation.

Sources: California State Auditor's analysis of state law, planning documents, and information and documentation identified in the table column titled *Method*.

Assessment of Data Reliability

In performing this audit, we obtained electronic data files extracted from the information system listed in Table 5 on the following page. The U.S. Government Accountability Office, whose standards we are statutorily required to follow, requires us to assess the sufficiency and appropriateness of computer-processed information that we use to support our findings, conclusions, or recommendations. Table 5 describes the analyses we conducted using the data from this information system, our methods for testing it, and the result of our assessment.

Table 5
Methods Used to Assess Data Reliability

INFORMATION SYSTEM	PURPOSE	METHODS AND RESULTS	CONCLUSION
State Bar of California (State Bar)	To make selections of expense, revenue, and transfer transactions from January 1, 2013, through December 31, 2015.	<ul style="list-style-type: none"> We performed data-set verification procedures and electronic testing of key data elements and did not identify any issues. 	Sufficiently reliable for these audit purposes.
JD Edwards EnterpriseOne (JDE) data	To categorize and total expense and revenue transactions from January 1, 2013, through December 31, 2015.	<ul style="list-style-type: none"> To test the accuracy of the State Bar's JDE data, we traced key data elements to supporting documentation for a selection of 34 expense, 34 revenue, and 29 transfer transactions from January 1, 2013, through December 31, 2015, and found no errors. 	
Accounting data as of January 26, 2016		<ul style="list-style-type: none"> To test the completeness of the State Bar's JDE data, we traced the total amounts of the expense, revenue, and transfer transactions to the State Bar's 2013 and 2014 audited financial statements. Because we found this accounting data to be complete for 2013 and 2014, we have reasonable assurance that expense, revenue, and transfer transactions for 2015 are also complete. 	

Sources: California State Auditor's analysis of various documents, interviews, and data obtained from the State Bar.

Audit Results

The State Bar of California Has Not Ensured That Its Financial Reports Clearly Communicate Its Financial Situation

State law requires the State Bar of California (State Bar) to produce various financial-related reports. The purpose of these reports is to present information necessary for stakeholders to understand the State Bar's operations and for the Legislature to set its annual fees. However, in recent years, the State Bar's reports have lacked the transparency necessary for the reports' users to fully understand the State Bar's financial situation. For example, the primary purpose of the State Bar's Client Security Fund is to reimburse members of the public who suffer financial losses because of dishonest attorneys. However, for the past several years the State Bar has slowed its processing of many of these individuals' claims because the Client Security Fund lacks the funds necessary to pay them. Rather than report this shortfall to stakeholders, in 2012 the State Bar decided to eliminate from its financial statements any disclosure of future amounts it estimated it would pay related to Client Security Fund claims that it had not yet approved. After we raised this issue with the State Bar, it added a disclosure in the notes to its 2015 financial statements noting this fund's estimated payouts of \$18.9 million.

We also identified a number of other instances in which the State Bar's reporting lacked transparency. For example, because the State Bar failed to establish a reasonable process for allocating the costs of information technology (IT) projects, it identified the *net position*—the balance of assets less liabilities (balance)—in its Technology Improvement Fund as unrestricted, or available for general use, when in fact it was statutorily restricted to specific purposes. Further, the State Bar's frequent changes in its presentation of indirect costs decreased its financial statements' comparability and transparency. The State Bar also inaccurately identified its Legal Services Trust Fund as unrestricted when state law restricts the fund to awarding grants to entities that provide free legal services to low-income Californians.

The State Bar Has Not Clearly Informed Stakeholders That It Lacks the Funding Necessary to Pay Victims of Attorney Misconduct

The Client Security Fund helps protect consumers of legal services by alleviating losses resulting from the dishonest conduct of attorneys. To protect the public, it reimburses money or property lost up to \$100,000 related to any individual attorney. The fund's primary source of revenue is an annual fee of \$40 for active members and \$10 for

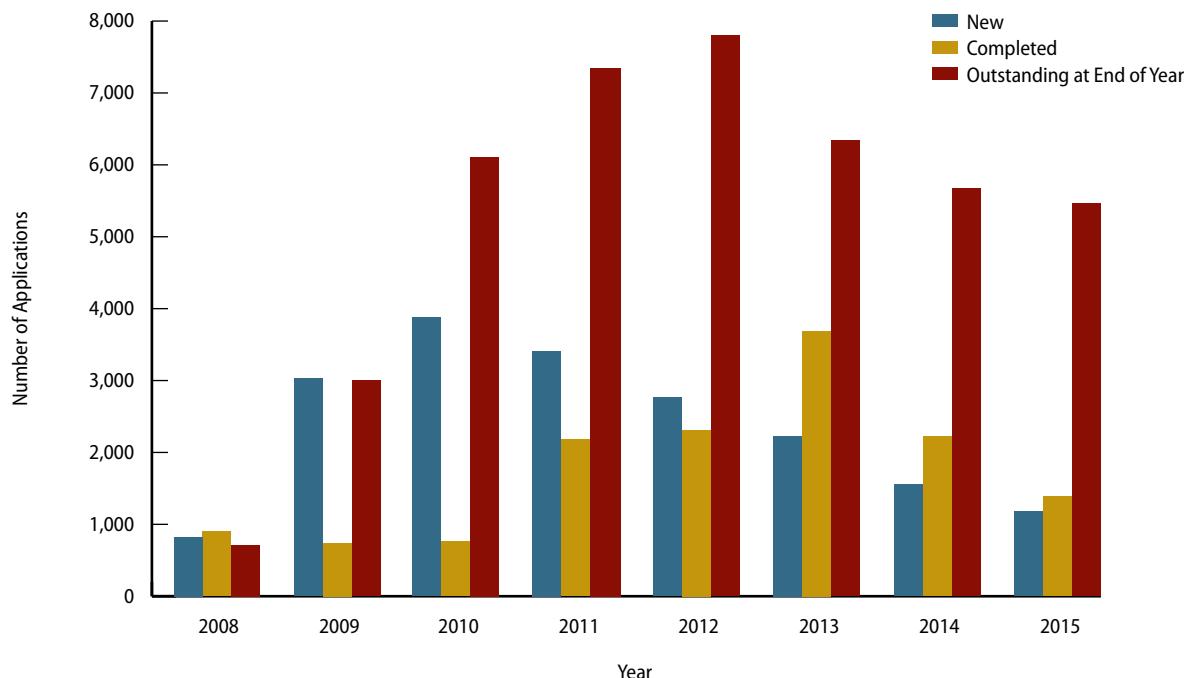
Stakeholders have lacked the information necessary to recognize that the Client Security Fund does not have the resources necessary to serve its primary purpose of protecting the public.

inactive members. Another source of revenue is recovery payments from the dishonest attorneys who have caused the State Bar to reimburse their clients. However, disbarred attorneys rarely pay the State Bar the money they owe, and the low level of recovery payments causes the State Bar to rely almost entirely on annual member fees to continue paying reimbursements from the Client Security Fund.

Since 2010, estimated future payouts to consumers have far outstripped the amount of money in the Client Security Fund available for payments. Because the State Bar did not take sufficient action when it first identified this potential problem, it is currently unable to make timely reimbursements to victims of dishonest attorneys. Further, in 2012 it changed its financial statements so that they no longer identify any of the State Bar's estimated payouts related to such reimbursements. Consequently, stakeholders have lacked the information necessary to recognize that the Client Security Fund does not have the resources necessary to serve its primary purpose of protecting the public.

A 2015 report by the State Bar to its board of trustees (board) noted an unprecedented increase in claim applications for its Client Security Fund program beginning in 2009, with about half of the fund's pending claims as of July 2015 related to loan modification schemes. In 2009 the number of new claim applications nearly tripled, as shown in Figure 3. The State Bar's reports show that applications it received peaked at 3,900 in 2010, compared to only 800 applications in 2008. By the end of 2012, pending applications totaled 7,800. The Client Security Fund's administrative costs rose as it employed temporary help and authorized overtime in 2013 and 2014 to help reduce the large inventory of pending applications, but at the end of 2015 the State Bar indicated it still had about 5,500 applications in process or awaiting payment, compared to only 710 applications at the end of 2008. The Client Security Fund currently has 11 staff, including three attorneys, who process the applications.

Client Security Fund applicants can experience significant delays in obtaining reimbursement for their claims in part because the State Bar has to wait to complete the processing of most applications until the California Supreme Court (Supreme Court) orders that the attorney in question be disciplined, as Figure 4 on page 26 illustrates. The State Bar reported that in 2014 the median total time from its receipt of a complaint to the final decision by the Supreme Court was 505 days. Further, in March 2016, the State Bar reported that 1,100 claims filed during 2009 and 2010 against one attorney for loan modification schemes were still awaiting completion of the discipline process. Once the Supreme Court orders that an attorney be disciplined, the State Bar can pay the related claims from the fund if it has money available.

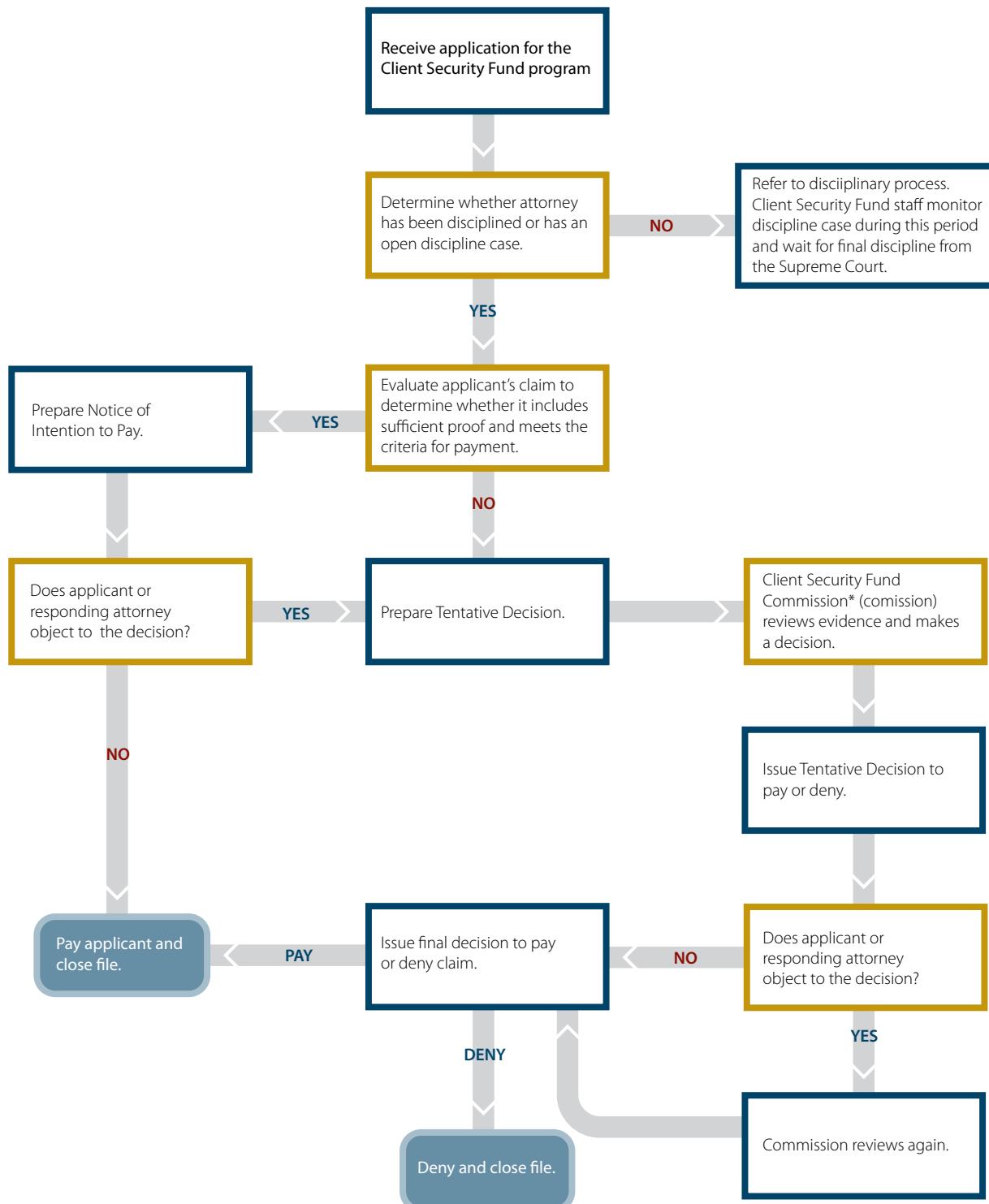
Figure 3**Number and Status of Applications to the State Bar of California's Client Security Fund Program**

Source: Activities reports for State Bar of California's Client Security Fund, 2008 through 2015.

Nevertheless, even when the Supreme Court has disciplined attorneys involved in dishonest conduct, the State Bar has delayed processing applications because the Client Security Fund lacks the money necessary to make the payments. The State Bar's report to its board in March 2016 stated that the current process to pay claims takes about 36 months after an attorney is disciplined because the Client Security Fund does not have the necessary funds. The State Bar has reported that historically it has paid applications 12 to 18 months after the discipline decision. Consequently, victims of dishonest attorneys can potentially wait four to five years from the time they submit their applications until the time they receive their payments. The State Bar's long delays in paying claims harm the people who are waiting and who may be counting on these resources to meet basic needs. Moreover, the State Bar has commented to its board that long delays may cause it to lose track of applicants if they lose their homes or move without informing the State Bar of their new addresses.

Figure 4

The State Bar of California's Review Process for Applications to Its Client Security Fund Program



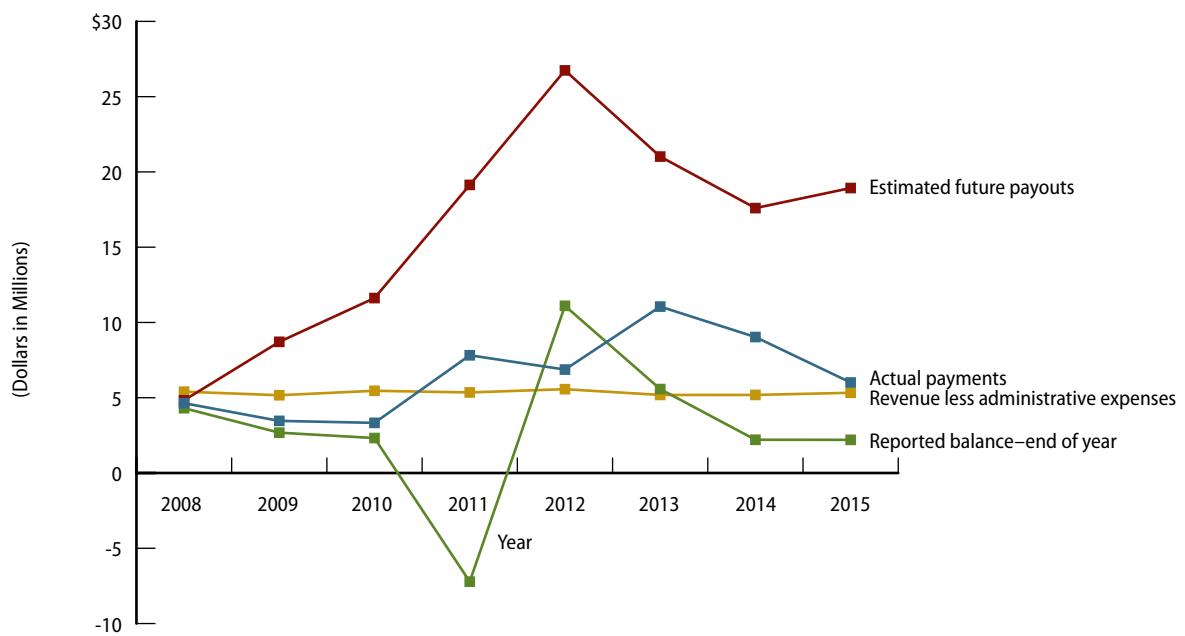
Source: State Bar of California's Client Security Fund Workflow and Client Security Fund Purpose and Process Summary.

* The commission is comprised of 7 volunteer members—four attorneys and three nonattorneys—appointed by the State Bar of California's board of trustees

At the end of 2015, the amount of the State Bar's estimated Client Security Fund payments far exceeded the amount of funds available, as shown in Figure 5. The State Bar estimates the amount it will pay in future years by using a ratio based on the amount the fund has historically paid for every dollar requested. At the end of 2015, the State Bar estimated that the payouts for its backlog of nearly 5,500 pending applications was \$18.9 million; this backlog included about 270 approved applications awaiting payment of \$1.3 million. Nonetheless, it had only \$2.2 million available in its Client Security Fund at that time. In other words, the fund's likely future payouts outstripped its assets by \$16.7 million. To address its decreasing balance, between 2013 and 2015, the State Bar reduced the number of claims completed and the amount it paid in claims each year. In 2015 it paid only slightly more than it received in revenue, less administrative expenses.

Figure 5

Total Claims Paid by and Balances for the State Bar of California's Client Security Fund From 2008 to 2015



Source: State Bar of California's financial statements and Client Security Fund Ten-Year Comparison schedule.

Further, between 2012 and 2014 the State Bar did not include information in its financial statements that inform stakeholders of its inability to pay claims. Specifically, in its 2012 financial statements, the State Bar disclosed that it had updated its legal analysis of rules governing the Client Security Fund and determined that it should not record a liability in its financial statements related

to its estimated claim payments. The State Bar stated that until it had approved applications, it had not incurred a financial obligation related to them. Thus, by delaying its processing of the applications, it could effectively defer payments on those applications—and it could also defer informing users of its financial statements about the amounts that it expected to pay. This approach caused the \$15.6 million deficit that the State Bar would have reported in 2012 to turn into a positive \$11.1 million balance. Further, it allowed the State Bar to report that the fund's net position—the difference between its assets and liabilities—remained constant at \$2.2 million between 2014 and 2015, even though its estimated payouts actually rose to \$18.9 million. Although the State Bar's rationale for avoiding the reporting of its potential liability is defensible, we believe that it should have disclosed in the notes to its financial statements that it had a commitment related to a large, continuing estimated payout. After we discussed this issue with the State Bar it disclosed the fund's estimated payout of 18.9 million in the notes to its 2015 financial statements.

In addition, the State Bar could have done more to communicate the Client Security Fund's difficulties and offer proposed solutions sooner. In its 2013 budget submitted to its board, the State Bar stated that it might need to increase the fee it charged to members to maintain the Client Security Fund's balance. However, it did not then include such an increase in its 2013 budget to the Legislature. Further, its 2016 budget submitted to the board and Legislature, did not discuss the strain on the Client Security Fund or propose any solutions. The State Bar's lobbyist stated that the State Bar has discussed the shortage of money in the Client Security Fund with the Legislature for a number of years and has explored solutions with legislators, including a fee increase. She said that although a fee increase has been discussed, it has never made it into the State Bar's fee bill. Despite discussions with individual legislators, we believe that it is important to present ongoing challenges and potential solutions in budget documents that are available to a wider audience of decision makers and stakeholders.

In March 2016, however, the board approved a transfer of \$2 million to the Client Security Fund from the Lawyers Assistance Fund and the Legislative Activities Fund, making additional payouts possible.³ The State Bar's chief operations officer (operations officer) said the State Bar is also considering requesting a three-year fee augmentation to clear the Client Security Fund backlog and a permanent increase to support the program in the future. Further, she said that the board is also considering permanently redirecting half of the Lawyer Assistance Program fee to the Client Security

The State Bar's 2016 budget submitted to the board and Legislature did not discuss the strain on the Client Security Fund.

³ The Lawyer's Assistance Fund receives mandatory member fees, and the Legislative Activities Fund receives voluntary member fees.

Fund in order to reduce the level of proposed Client Security Fund fee increases. According to the State Bar's estimates, such efforts would provide enough money to reduce the time to pay pending claims to eighteen months, once discipline is complete and the unit begins its evaluation of the related applications.

The need to augment the Client Security Fund fee is partly due to the fact that the State Bar has had little success in recovering costs from resigned or disbarred attorneys, who have little incentive to pay. State law allows the State Bar to recover costs from attorneys related to payments it makes from its Client Security Fund. The State Bar makes the vast majority of Client Security Fund payments because of misconduct by attorneys who later resign or are disbarred. At the end of 2015, the State Bar was owed approximately \$91 million in outstanding debts associated with attorney misconduct, of which \$74 million related to the Client Security Fund, on accounts open since 2003. However, between 2013 and 2015, the Client Security Fund reported recovering only about \$910,000. Attorneys paid most of this amount through timely response to billings, but the State Bar recovered the rest through other efforts.

The State Bar uses four primary methods to pursue recoveries for Client Security Fund payouts, as shown in the text box. However, none of these methods has resulted in significant success. For example, collection agencies have generally been able to collect only small amounts from resigned or disbarred attorneys, and the State Bar has also received approximately \$300,000 through the Franchise Tax Board's intercept program over the past two years. However, state law requires that these funds go to the Legal Services Trust Fund to provide legal services to low-income Californians rather than to the Client Security Fund.⁴

As the text box explains, the State Bar may pursue money judgments against attorneys who are delinquent on paying their debts. However, because

Methods of Pursuing Reimbursement for Client Security Fund Applications Payments

State Bar billing: The State Bar of California (State Bar) notifies disciplined attorneys when it makes payments from the Client Security Fund. Attorneys must reimburse the fund to continue practicing law, or in the case of disbarred attorneys, to return to the practice of law. Such payments accounted for about \$818,000 of Client Security Fund recoveries during the past three years.

Collection agencies: For resigned and disbarred attorneys, the State Bar pursues debts through collection agencies. The State Bar stated that it has worked with three collection agencies in the last 10 years and that the latest agency chose not to renew its contract due to the difficulty in collecting these debts. Since 2013 the State Bar has collected \$18,000 through this method.

Franchise Tax Board's intercept program: For resigned and disbarred attorneys, the State Bar also sends the debtor accounts to a tax intercept program. This program reduces state tax refunds by the amount individuals owe government agencies. Since 2014 the State Bar has collected approximately \$300,000. However, state law requires that the State Bar—rather than reimbursing the Client Security Fund—allocate money it receives through the tax intercept program to the Legal Services Trust Fund.

Money judgments: The State Bar files money judgments on court ordered debts it has deemed uncollectible by other means. However, because the court must have ordered the attorney to pay restitution to the Client Security Fund applicant, only certain cases meet the criteria for the State Bar to file money judgments. Since 2013 the State Bar has collected \$74,000 through this method.

Sources: Business and Professions Code, sections 6034 and 6140.5; the State Bar's *CSF Payment Summary Report* and *Discipline Payments Received Report*; and the Franchise Tax Board's website.

⁴ In rejecting the State Bar's request to participate in the tax intercept program in 2001, the Senate Judiciary Committee's analysis concluded that ensuring that attorneys pay their debts in order to reduce annual bar dues does not rise to the same level of public service as collecting unpaid child support, for example. After 2014 the Legislature permitted the State Bar to use the tax intercept program under the condition that it give recovered money to the Legal Services Trust Fund.

the State Bar does not include all victims of an attorney's misconduct as complaining witnesses for the discipline case against the attorney, the court does not order restitution for all victims. Only victims with restitution orders can receive money judgments. In cases without restitution orders, the statute of limitations to recover Client Security Fund payouts is three years rather than 10 years.

The State Bar is currently working through a backlog of outstanding debts that are eligible for money judgments. According to an assistant general counsel, the State Bar did not file money judgments between 2012 and 2013 because it had determined that the effort was not cost-effective and because it had chosen to focus on the use of collection agencies. However, as of April 2016, the general counsel said it had filed approximately 375 money judgments totaling about \$3.8 million. She stated that the State Bar is reviewing the remaining 1,200 debts, totaling approximately \$7.6 million, and that it should file money judgments by September 2016 for all eligible cases completed before December 2015. Although the rate of payment on money judgments is low, the cost to process and file them is also low, so the State Bar says it will continue to seek money judgments.

The State Bar Has Not Accurately Reported Certain Restricted Funds Because It Lacks a Reasonable Process for Allocating Costs of Information Technology Projects

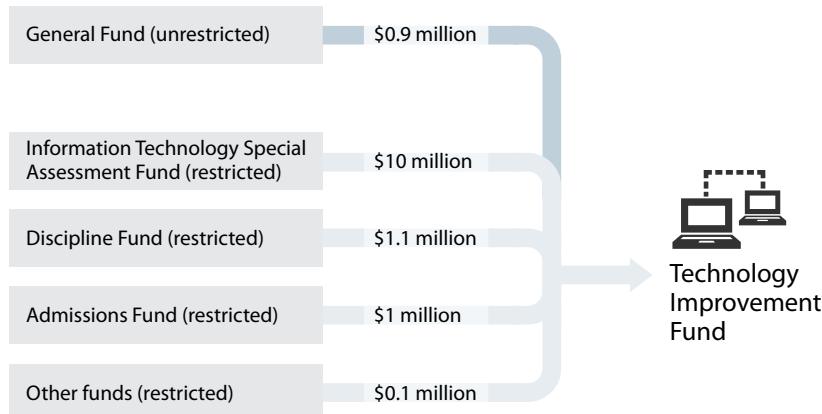
In 2013 and 2014, the State Bar reported that the balance in the Technology Improvement Fund was unrestricted, when, in fact, most of the money came from restricted sources and thus was limited to specific purposes.

The State Bar has failed to establish a reasonable process for allocating the costs of IT projects; therefore, it has not ensured that it always identifies funds that are restricted to certain purposes by law. Specifically, in 2013 and 2014, it reported that the balance in its Technology Improvement Fund was unrestricted—or available for general purposes—when, in fact, most of the money making up the balance came from restricted sources and thus was limited to specific purposes.

According to the State Bar's financial reports, it established the Technology Improvement Fund to pay for IT projects that it had previously paid for through its general fund. Although it reported the ending balance in the Technology Improvement Fund as unrestricted in 2013 and 2014, only \$944,000 of the \$13.4 million that the State Bar transferred into the fund from 2008 through 2015 originated from unrestricted funds, as Figure 6 shows. The remaining money came from restricted sources, such as the IT Special Assessment Fund, the Admissions Fund, and the Discipline Fund. Consequently, in 2014 the State Bar overreported to stakeholders its level of funds available for general purposes by \$4.6 million.

Figure 6

**The State Bar of California's Transfers To the Technology Improvement Fund
From 2008 Through 2015**



Source: State Bar of California's Technology Improvement Fund reconciliation.

Note: Transfer amounts are rounded to the nearest hundred thousand. Actual amount transferred totaled \$13.4 million.

According to the State Bar's director of finance (finance director), the State Bar initially set up the Technology Improvement Fund to track IT project expenses, which would then be reimbursed by the State Bar's other funds that benefit from the projects. However, the State Bar did not have a reasonable process for distributing IT project costs; and so lacked a solid basis to make transfers from other funds. In fact, the State Bar transferred more money into the fund than it needed to reimburse its costs, leaving a balance of \$3.6 million in predominately restricted funds at the end of 2015. For example, according to the State Bar's IT strategic plan for 2014 to 2018, the State Bar planned to use \$1 million from its Admissions Fund to replace the admissions IT system. In 2012 the State Bar did transfer \$1 million from this fund to the Technology Improvement Fund; nevertheless, the State Bar's fund reconciliation indicates that it had only incurred about \$173,000 in admissions project costs through 2015.

Because of the mix of restricted and unrestricted money in the Technology Improvement Fund, the State Bar cannot be certain which portion of the ending balance it should have reported as restricted. This problem will continue until the State Bar devises a reasonable method for allocating IT project costs that align project benefits with allocated amounts and matches the timing of expenses with incoming transfers.

In October 2015, the State Bar consolidated into its general fund the Technology Improvement Fund, along with seven other funds that account for building projects, indirect costs of the State Bar's operations, retirement related resources, and unrestricted revenue. Our review found that this consolidation appears appropriate. Further, the State Bar accurately reported the fund's remaining \$3.6 million as restricted in its 2015 financial statements, despite the fund's consolidation into the State Bar's general fund.

The State Bar Has Frequently Changed How It Presents Certain Costs in Its Financial Statements, Causing the Statements to Lose Comparability

Multiple times over the past five years, the State Bar's financial statements have lacked comparability of costs at the program level because the State Bar repeatedly changed the way it presented entity-wide indirect costs that it allocated among its various funds. The text box lists the State Bar's major sources of indirect costs. Because the State Bar has twice changed the way it reported these indirect costs since 2011, the general and administration expenses it reported have fluctuated significantly, as shown in Figure 7. Specifically, in 2012 and 2013, the State Bar allocated indirect costs at the fund level, thus grouping many of these costs into the general and administration expense line. In 2011, 2014, and 2015, the State Bar allocated indirect costs to a more detailed cost-center level, allowing the State Bar to record these indirect costs in various other program expense lines rather than in the general and administration expense line.

The State Bar of California's Indirect Costs Include Costs Related to the following:

- General counsel
- Member billing
- Finance
- Human resources
- Information technology
- Administration and support

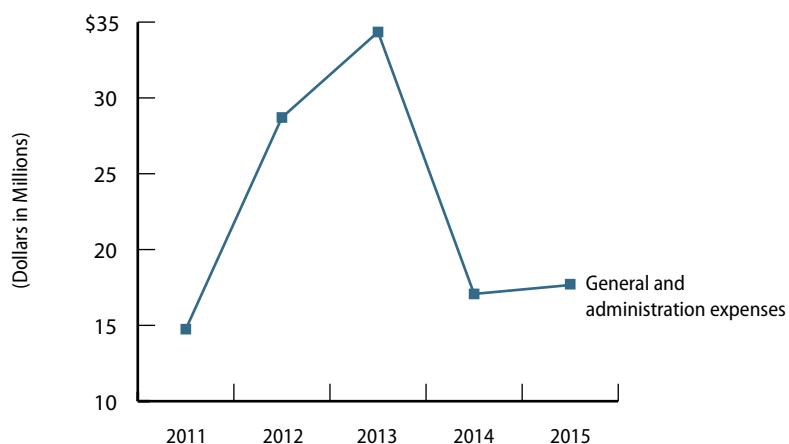
Source: State Bar of California's indirect cost allocation methodology.

As shown in Figure 7, these frequent changes reduce the comparability of expenses from year to year. In the Management's Discussion and Analysis section of its 2012 financial statements, the State Bar highlighted the change in its presentation of indirect costs. However, the State Bar did not provide a similar explanation when it changed its presentation of indirect costs again in 2014, leaving stakeholders without the information necessary to understand the apparent cost fluctuations.

Expenses in the State Bar's 2016 financial reports may lack comparability with expenses of previous years because the State Bar board has decided once again to change the way it allocates indirect costs. The State Bar will once more allocate indirect costs at a less-detailed fund level, grouping many costs into the general and administration expense line. Although the State Bar's revised methodology for allocating indirect costs is reasonable, we believe that the State Bar's decision to make significant changes in

accounting methodologies every few years reduces the usefulness and transparency of its financial reports. The State Bar could improve the comparability and understandability of these reports if it limited significant changes to its methodologies and if it highlighted any such changes when it chooses to implement them.

Figure 7
The State Bar of California's General and Administration Expenses
2011 Through 2015



Source: State Bar of California's annual audited financial statements from 2011 through 2015.

The State Bar Misclassified the Legal Services Trust Fund as Unrestricted and Did Not Report Its Administrative Expenses Accurately

The State Bar's Legal Services Trust Fund Program makes grants to approximately 100 nonprofit organizations that provide free civil legal services to low-income Californians. The program receives revenue from three different revenue sources: membership fees, donations, and interest on lawyer trust accounts recorded in the Legal Services Trust Fund; voluntary member donations recorded in the Justice Gap Fund; and filing fee revenue from the Judicial Council of California (Judicial Council) recorded in the Equal Access Fund.

Resources in the Legal Services Trust Fund are restricted to providing free legal services to low-income Californians. However, the State Bar misclassified the balance in the Legal Services Trust Fund as unrestricted in its 2013 and 2014 financial statements, thus indicating that the State Bar could use these funds for other purposes. As a result, the State Bar misreported that it had \$20.2 million available in unrestricted funds in 2014, when in fact \$4.6 million of that amount represented the balance in the

Legal Services Trust Fund and was restricted. According to the finance director, the State Bar classified this fund as unrestricted in those two years based on an analysis she performed in consultation with the State Bar's Office of General Counsel and its external auditors. However, she could not explain the reasoning behind her analysis. The State Bar correctly classified this fund's balance as restricted in its 2015 financial statements.

Further, because the State Bar incorrectly reported the costs of this fund, administrative costs for the Legal Services Trust Fund appeared to double in its 2014 financial statements when they actually changed only slightly. In 2013 and 2014, the Equal Access Fund experienced a \$1.1 million shortfall in revenue due to a drop in filing fees. According to the managing director of the Legal Services Trust Fund, to minimize harm to grantees and to ensure the timely and full distribution of grants, the State Bar approved a \$1.1 million interfund transfer from the Legal Services Trust Fund to the Equal Access Fund. This transfer was appropriate given that the two funds provide grants to the same recipients. However, the State Bar did not display this transaction as a transfer in its 2014 financial statements. Instead, it increased the Legal Services Trust Fund's administrative costs by \$1.1 million and decreased those of the Equal Access Fund by a similar amount. The former's administrative costs thus appeared nearly to double from \$1.3 million in 2013 to \$2.4 million in 2014, while the latter's administration costs went from a positive \$604,000 in 2013 to negative \$650,000 in 2014.

We found that the State Bar lacks sufficiently detailed procedures to guide its staff in preparing financial statements and to guide its management in reviewing and approving them.

According to the Legal Services Trust Fund's managing director, the State Bar correctly recorded the \$1.1 million transaction in its general ledger system but inadvertently presented it in the audited financial statements under administrative expenses. We found that the State Bar lacked sufficiently detailed procedures to guide its staff in preparing financial statements and to guide its management in reviewing and approving them. The State Bar's procedures did not include steps staff must take to ensure accounting data is accurately and completely presented in the financial statements. Further, these procedures did not describe management's process for reviewing and approving the financial statements. Without such procedures, the State Bar risks making similar errors in its financial reports in the future.

The State Bar's Compliance With a New Accounting Standard Caused It to Change the Way It Reports Pension Liabilities in Its Financial Statements

The State Bar recently implemented a new accounting standard that requires it to report a pension liability on the face of its financial statements. Specifically, in 2015 the State Bar implemented a new accounting standard, Government Accounting Standards Board 68 (GASB 68). As a result, for 2015 the State Bar

reported a net pension liability of \$31.2 million, representing the difference between its total pension liability and the assets it has set aside for the pension plan. Because of this change and the combined total of \$9.2 million that the State Bar had misclassified as unrestricted balances in its Technology Improvement Fund and Legal Services Trust Fund (as previously discussed), the State Bar's unrestricted balance appeared to fall precipitously from \$20.2 million in 2014 to a deficit of \$20.6 million in 2015.

However, the amount of the State Bar's pension-related liability did not change significantly; rather, the State Bar reported that amount differently. Specifically, GASB 68 requires governmental organizations to report on the face of their financial statements a net pension liability related to future benefit payouts as soon as their employees earn them. Under past accounting practices, such a liability was only disclosed in the notes to the financial statements. In the State Bar's case, it reported a pension-related liability of \$27.3 million for 2013 in the notes to its 2014 financial statements.⁵ When it implemented GASB 68 in 2015, the State Bar reported an \$18.8 million net pension liability for 2014 and a \$31.2 million liability for 2015 on the face of its financial statements. Although GASB 68 changed the way organizations report pension liabilities, it did not require changes in the way organizations such as the State Bar fund their pension obligations. In fact, according to the State Bar's financial statements, it has had enough assets set aside to fund 90 percent or more of its pension-related liability in each year since 2012. Compared to the State of California, which had enough resources set aside to fund 74 percent of its pension liability in 2014, the State Bar's pension plan is relatively well funded. Further, the State Bar paid 100 percent of its required annual pension contribution to the California Public Employees' Retirement System from 2013 through 2015, a practice that it did not change as the result of implementing GASB 68. Thus, while the State Bar reported pension liabilities on the face of its financial statements in 2015 rather than in notes to the statements, this change did not significantly affect its financial situation.

While the State Bar reported pension liabilities on the face of its financial statements in 2015 rather than in notes to the statements, this change did not significantly affect its financial situation.

Although the State Bar's Reserves Are Generally Reasonable, It Has Not Adequately Communicated the Assumptions Underlying Its Budget

In our June 2015 report, we found that the State Bar had maintained excessively high balances in a number of its funds, and we recommended that it develop a plan to spend those balances. In response, the State Bar implemented a new fund reserve policy in February 2016. The general fund and Admissions Fund reserves

⁵ Reported pension information may be up to one year old depending primarily on the timing of actuarial valuations.

appear to comply with this policy. However, we identified a number of concerns about the State Bar's budgeting process. Specifically, the State Bar has not adequately documented its budget assumptions and methodologies. Further, it has not provided information on its budget assumptions and details regarding its funds to the Legislature. Finally, the State Bar recently entered into a loan agreement without informing the Legislature even though the agreement might have restricted the Legislature's ability to lower the State Bar's fees. After we informed the State Bar of our concerns, it modified this loan agreement to avoid such an outcome.

The Reserves for the State Bar's Largest Funds Generally Comply With Its New Reserve Limits

As we noted in June 2015, the State Bar has historically reported excess funding from which it could draw to cover its costs. To address its excess balances, the State Bar implemented a new reserve policy in February 2016. In accordance with this policy, the State Bar calculates reserves as the excess of its current assets over its current liabilities. The resulting amount, referred to as *working capital*, is a measure of the ability to pay operating expenses in the short-term. The new policy requires the State Bar to maintain reserves equal to 17 percent (or two months) of each fund's annual operating expenses. This new policy also requires the State Bar to use reserves in excess of 30 percent of each fund's operating expenses on a number of initiatives, which include offsetting member fees and supporting the Client Security Fund program where possible.

The State Bar's general fund had \$11.9 million in reserves, which met the 17 percent target.

According to our analysis, which Table 6 shows, as of December 31, 2015, the State Bar's general fund had \$11.9 million in reserves, which met the 17 percent target. The Admissions Fund also met the target, with a \$4.0 million or 20 percent reserve. In accordance with the new reserve policy, the State Bar is developing plans to spend certain funds' excess reserves. For example, in March 2016, the State Bar informed its board that the California Board of Legal Specialization, which oversees the legal specialization programs, was in the process of developing a plan to reduce its reserve level, which was 301 percent over the 30 percent limit at December 31, 2015. The State Bar's board also recently approved the transfer of \$2 million from the Lawyers Assistance Fund and Legislative Activities Program Fund to its Client Security Fund to increase payments that alleviate losses resulting from the dishonest conduct of attorneys, as discussed earlier in the report. The State Bar's plan to transfer these reserves and to spend an additional \$147,000 from the Lawyer Assistance Fund on program evaluation and redesign would reduce from 86 percent to 33 percent of operating expenses the reserves listed in the column labeled *Other Funds* in Table 6.

Table 6**Percentages of Reserves in the State Bar of California's Funds as of December 31, 2015**

	GENERAL FUND [†]	ADMISSIONS FUND	CLIENT SECURITY FUND*	SECTIONS FUND	LEGAL SPECIALIZATION FUND	OTHER FUNDS
Current assets	\$101,815,137	\$9,175,136	\$4,110,966	\$10,259,742	\$5,991,564	\$4,585,807
Current liabilities	89,885,322	5,159,600	1,895,629	1,648,031	573,759	1,087,861
Working capital	11,929,815	4,015,536	2,215,337	8,611,711	5,417,805	3,497,946
Operating expense	69,954,439	20,072,708	7,744,501	8,281,686	1,637,547	4,056,388
Two months of operating expenses (17 percent)	11,892,255	3,412,360	1,316,565	1,407,887	278,383	689,586
Amount over or under two-month reserve	\$37,560	\$603,176	\$898,772	\$7,203,824	\$5,139,422	\$2,808,360
Reserves percentage	17%	20%	29%	104%	331%	86%

Source: California State Auditor's analysis of the State Bar of California's financial statements for 2015.

Note: Grant-related funds are excluded from this table. These funds' reserves fluctuate routinely based on the cyclical nature of their inflows and outflows.

* The Client Security Fund's reserve does not reflect its need for additional resources. See the section beginning on page 23 for further information regarding the Client Security Fund's financial situation.

† General fund current assets exclude \$3.6 million related to the Technology Improvement Fund. See page 30 for further information regarding the Technology Improvement fund.

The State Bar has not taken steps, however, to address the high reserve level in its Sections Fund. Its Sections Fund had \$7.2 million more than it needed to meet the two-month reserve target as of December 31, 2015, but the State Bar exempted the Sections Fund from having to spend its reserves once they exceed the 30 percent threshold. According to the operations officer, the State Bar Sections operate independently because attorneys voluntarily choose to be members of Sections and to pay the related annual fees. She said that because of this independence, the Sections may use reserves at their discretion as long as the Sections comply with legal requirements for the Sections Program to be self-supporting. Nevertheless, given the high level of reserves, the State Bar should consider working with the Sections to reduce these balances.

The State Bar Did Not Adequately Document or Disclose Its Budget Process

The State Bar did not adequately document or communicate the assumptions and methodology it used when preparing its budget forecasts from 2013 through 2015. According to best practices established by the Government Finance Officers Association (GFOA) for financial forecasting in the budget preparation process, entities should clearly identify and make available to stakeholders their budget forecasts, along with those

forecasts' underlying assumptions and methodology.⁶ Although the State Bar included some of the necessary information in the budget documents it submitted to its board during the years in question, it did not provide the Legislature with any information regarding its budget assumptions and methodology. We find this particularly problematic because the Legislature uses the State Bar's budget to determine appropriate member fee levels. The analyst involved in the budget process at the time could not explain why the State Bar did not include such information in the budgets it submitted to the Legislature. Consequently, the Legislature did not have important information necessary to question or evaluate the State Bar's budget.

When we asked the State Bar to provide complete documentation showing how it calculated its budget projections from 2013 to 2015, it was unable to do so.

Further, when we asked the State Bar to provide complete documentation showing how it calculated its budget projections from 2013 to 2015, it was unable to do so. The State Bar's budget process during this period involved each department director's developing revenue and expenditure estimates for the upcoming year based on the previous year's activity, with adjustments for anticipated changes. The directors submitted the budgets to a budget and performance analyst (analyst) in the Office of Finance, who compiled and consolidated them. According to the analyst, the former director of budgets, performance analysis, and internal audits (former budget director) developed revenue forecasts for future years based on revenue in the previous year and information provided by the directors. The analyst also stated that the State Bar's budget database automatically calculated expense forecasts. However, other than spreadsheets of budget data and a few emails indicating that the senior director of admissions provided the analyst with estimates of revenue and expenses, the State Bar could not provide documentation regarding the assumptions or methodologies the former budget director used to develop the forecasts.

According to the finance director, the State Bar stopped using the budget database and transitioned to a more spreadsheet-based process for the 2016 budget. She further explained that the old budget system did not allow users to see clearly the assumptions and methodologies underlying personnel cost estimates. However, at the time that the State Bar prepared its 2016 budget, it had not yet developed procedures to guide its staff and managers on preparing its budget using the new method. Without procedures and adequate documentation, State Bar staff are more likely to

⁶ The GFOA represents public finance officials throughout the United States and Canada. Its mission is to enhance the professional management of governmental financial resources by identifying, developing, and advancing financial strategies, policies, and practices.

make errors when preparing the budget, and the State Bar is less able to provide critical information regarding its budget forecasts and assumptions to the Legislature or its other stakeholders.

The State Bar has also chosen not to follow advice that it adopt a more comprehensive and transparent budget process. Specifically, a consultant the State Bar hired to analyze its use of fund accounting recommended that the State Bar strongly consider preparing its budget document in accordance with California Society of Municipal Finance Officers (CSMFO) and GFOA excellence criteria. However, according to the State Bar's operations officer, the State Bar's existing budget and financial reporting practices already satisfy legal requirements and are in compliance with generally accepted accounting principles in terms of content, presentation, and design. In her view, the budget and financial statement models recommended by the CSMFO and GFOA are very comprehensive, and they would require extensive staff resources and additional qualified accountants to deliver. However, we believe the State Bar could benefit from following at least some portion of these best practices, such as presenting its underlying assumptions for revenue estimates and significant revenue trends.

Additionally, the State Bar made significant changes to the way it presented information about its funds in budget documents that it presented to the Legislature in February 2016. These changes significantly reduced the amount of information about its funds that the State Bar presented within the budget documents. Before 2016 the State Bar's budget documents included fund condition statements, which identified each fund's beginning balance, its revenue by type, and its expenses. In its 2016 budget documents, however, the State Bar instead presented a schedule showing fund reserves and containing information similar to that shown previously in Table 6 on page 37.⁷ Although we agree that this schedule displays a useful measure of the State Bar's reserves, its decision to eliminate fund condition statements removed detailed information about each fund's major revenues and thus significantly decreased the transparency of the State Bar's budgeting process.

State law requires the State Bar to present a budget in the same format as the budgets prepared by State departments for the governor's budget. Further, state law requires the State Bar to provide supplementary schedules detailing its funds' operating expenses and equipment, all revenue sources, any reimbursements or interfund transfers, and fund balances. However, the State Bar eliminated much of this information from its budget when it switched to providing a schedule of reserves. According to the

The State Bar's decision to eliminate fund condition statements removed detailed information about each fund's major revenues and thus significantly decreased the transparency of its budgeting process.

⁷ In its 2016 budget documents, the State Bar refers to its fund reserves as projected working capital.

finance director, the State Bar changed the presentation of its budget to the Legislature in order to increase transparency and to show the State Bar's financial position at a consolidated level. Nonetheless, we believe that the required schedules also provide important information, such as detailed revenue sources. According to the operations officer, the State Bar's new budget presentation complies with the requirements in state law because it provides revenue information at the fund level. However, she agreed that the presentation is not as thorough as it was in previous budgets, and said that the State Bar plans to provide a greater level of detail regarding revenue in future budgets.

Further, the State Bar did not provide the Legislature with information in its 2016 budget documents that would have allowed the Legislature to compare the budget under its new, consolidated fund structure to its previous year's budget. As previously discussed, the State Bar consolidated eight of its funds into its general fund in 2015. Although the State Bar's decision to consolidate funds for financial reporting is reasonable, it effectively eliminated comparability between its budgets for 2015 and 2016 because it did not provide the Legislature with information regarding its fund consolidation, such as a schedule showing the funds that it included in the consolidated general fund. Because the State Bar omitted information regarding its budget assumptions, fund conditions, and new fund structure, it prevented the Legislature from making fully informed decisions to authorize or modify fee levels.

Because the State Bar omitted information regarding its budget assumptions, fund conditions, and new fund structure, it prevented the Legislature from making fully informed decisions to authorize or modify fee levels.

After We Stated Our Concern the State Bar Modified Provisions in Its Building Loans that Might Have Otherwise Limited the Legislature's Ability to Lower Member Fees

After we raised concerns about the structure of its loan agreements, the State Bar modified provisions in those agreements that might have limited the Legislature's ability to lower membership fees for several years. In July 2015, the board asked the State Bar to conduct an analysis of the costs and benefits of improving its San Francisco building so that it could lease space on three vacant floors to tenants as well as to evaluate the feasibility of securing a loan to pay for the improvements. To evaluate the feasibility of a loan, State Bar staff held discussions with a number of financial institutions but received a proposal only from Bank of America. The State Bar has an existing loan agreement maturing in 2027 with Bank of America that it entered in 2012. The loan provided \$25.5 million for the purchase of the State Bar's Los Angeles building. In February 2016, the board approved the State Bar's request to secure a \$10 million bank loan to finance the San Francisco building's improvements. The State Bar executed the agreement in March 2016, with a repayment period ending March 2026.

The initial terms of the State Bar's new loan were substantially the same as the terms and conditions of its Los Angeles building loan, except that it secured the new loan in part by a pledge of revenue in lieu of the debt service reserve requirement included in the Los Angeles loan agreement. In addition, the bank agreed to substitute a pledge of revenue for the first loan's reserve requirement. Therefore, the \$4.6 million reserve that the State Bar previously established for the purpose of securing the Los Angeles building debt was slated to be returned to the State Bar's general fund. The operations officer said that the loan terms provided financial benefits by freeing up reserve funds to address a number of the State Bar's priorities, such as implementing recommendations related to workforce planning. However, the loans' terms contractually required the State Bar to allocate its unrestricted future revenue first to the payment of both loans' principal and interest.

By negotiating these loan terms, the State Bar obligated its future revenue in a way that might have limited the Legislature's ability to lower fees. According to state law, whenever the board pledges revenue from membership fees, the "Legislature shall not reduce the maximum membership fee below the maximum in effect at the time such obligation is created or incurred, and the provisions of this section shall constitute a covenant to the holder or holders of any such obligation." State law does not require the State Bar to notify the Legislature of this business decision or to seek its approval. After we asked the State Bar whether it had considered the potential effect of its action on the Legislature's ability to lower fees, the State Bar amended both of its loan agreements to replace the revenue pledges with debt service reserves, thus again restricting the use of \$4.6 million and restricting an additional \$2.5 million until the loans are paid.

The State Bar Created an Unnecessary Nonprofit Organization, Then Used State Bar Funds to Cover the Nonprofit's Financial Losses

With little or no board oversight, the State Bar created and used a nonprofit organization from 2013 through 2015. State law allows the State Bar to create nonprofit organizations for the purpose of generating additional revenue for its operations. According to the deputy general counsel, the State Bar has used nonprofit organizations in the past because they offer the incentive of tax deductibility for donations, an advantage the State Bar itself cannot offer. The State Bar's former executive director incorporated the State Bar Access and Education Foundation (foundation) in May 2013 purportedly to collect money from donors and to administer activities benefiting the State Bar's Legal Services Trust Fund and Sections Program. However, about two-thirds of the expenses the State Bar recorded in the foundation's fund from 2013 through 2015

The State Bar has used nonprofit organizations in the past because they offer the incentive of tax deductibility for donations, an advantage the State Bar itself cannot offer.

were for purposes unrelated to these two programs. Further, the foundation's expenses under the State Bar's management significantly exceeded its revenue. In fact, in December 2015, the State Bar used almost \$15,000 from nonmember fee revenue in its general fund to eliminate the foundation's fund deficit. Without increased oversight, there is a risk that the State Bar could create similar nonprofits in the future and use their funds for questionable purposes.

The State Bar's former executive director incorporated the foundation in May 2013 with bylaws that gave him and two other managers of the State Bar complete control and oversight. Specifically, the State Bar's former executive director, former deputy executive director, and its former director of administration for member services were all directors of the foundation and had control over the receipt and use of all the revenue the foundation received, subject only to charitable trust restrictions.⁸ Further, the bylaws allowed these directors to authorize reasonable compensation for themselves for their services as directors. Although we found no instances in which the State Bar actually used the foundation to compensate its management, we find it deeply concerning that the State Bar was able to establish a nonprofit organization with provisions for such additional compensation.

According to our review of board documents between 2013 and 2015, the board was aware of the foundation but exerted little to no oversight of it. Specifically, the board included a description of the foundation's fund in its policy manual but did not include in the manual any policies related to nonprofit organizations, including for their creation or oversight. Further, the State Bar's deputy general counsel said that the board did not have any specific policy directing its oversight of any nonprofit that the State Bar establishes. The State Bar did not include the foundation's fund in the budgets it submitted to its board, and it provided no detailed information regarding the foundation in the budgets it submitted to the Legislature.

We believe that the lack of oversight policies for nonprofit foundations contributed to the ability of the State Bar's executive staff to create the foundation and to charge inappropriate expenses to it.

We believe that this lack of policies for the oversight for nonprofit foundations contributed to the ability of the State Bar's executive staff to create the foundation and to charge inappropriate expenses to it. Specifically, the State Bar charged to the foundation more than \$22,000 in expenses that were unrelated to the Legal Services Trust Fund or Sections Program, the foundation's ostensible beneficiaries. Of this amount, almost \$4,800 was for a dinner event and hotel accommodations at the Citizen Hotel in Sacramento, as Table 7 shows. According to an email from the former chief financial

⁸ A revision to the foundation's bylaws in October 2015 replaced the director of administration for member services with the State Bar's assistant secretary as a director of the foundation.

officer to the finance director in January 2014, the former chief financial officer instructed that the cost of the dinner related to a State Fair project should be charged to the foundation. However, State Bar staff incurred the dinner and other Citizen Hotel expenses in February 2013, two months before the State Bar created the foundation and four months before the State Fair event. For the State Fair, the foundation further incurred around \$17,300 in expenses related to an exhibit called *A Conversation with Abraham Lincoln*. The exhibit was a civic education and public outreach event developed by the State's Third District Court of Appeal to commemorate the 150th anniversary of the Emancipation Proclamation. These events and expenses were inconsistent with the foundation's stated purpose of supporting both the Legal Services Trust Fund, which funds free legal services for low-income Californians, and the Sections Program, which provides continuing legal education and other services for attorneys.

In September 2013, the former executive director and former deputy executive director created a resource sharing agreement between the State Bar and the foundation that said the State Bar might, at its sole discretion, cover foundation costs. Despite incurring about \$22,000 in expenses between February and November 2013, the foundation only received \$3,500 in corporate sponsor revenue and did not receive that until November and December 2013. As a result, in its 2013 financial statements, the State Bar reported a deficit of about \$18,500 for the foundation's fund.

Table 7
The State Bar of California's Access and Education Foundation's Expenses From 2013 Through 2015

INVOICE DATE	DESCRIPTION	COST
February 27, 2013	Four rooms and banquet charges from the Citizen Hotel in Sacramento	\$4,797
June 21, 2013	Emancipation Proclamation coloring book	1,142
July 13, 2013	Painted artwork for booth at State Fair called <i>Conversation with Abraham Lincoln</i>	1,200
July 16, 2013	Exhibit services for Freedom's Promise exhibit at the State Fair	11,048
July 31, 2013	Scholarship awards for State Fair essay contest	3,875
June 4, 2015	Travel reimbursement for Tax Law Section	128
June 25, 2015	Environmental Law Fellowship summer program stipend	4,000
July 16, 2015	Environmental Law Fellowship summer program stipend	4,000
August 27, 2015	Environmental Law Fellowship summer program stipend	2,000
Various	Bank charges	1,149
Total		\$33,338

Source: State Bar of California's bank documents, invoices, and accounting records.

In December 2015, State Bar management violated policy when it transferred without board approval \$14,800 from its general fund to the foundation's fund to cover the foundation's outstanding deficit.

In 2015 the State Bar's Sections Program used the foundation for the purposes for which it was established. Specifically, the Sections Program used the foundation to pay about \$10,000 for the 2015 Environmental Law Fellowship summer program. Nevertheless, because the State Bar already had a program in place to pay for such events and a process for receiving donations, we question the need for a separate nonprofit organization for this purpose.

Further, State Bar management violated the State Bar's policy on transfers when it transferred in December 2015 without board approval about \$14,800 of non-member fee revenue from its general fund to the foundation's fund to cover the foundation's outstanding deficit. In our 2015 report, we recommended that the State Bar implement policies and procedures to limit its ability to transfer money between funds. In July 2015, the State Bar implemented a transfer policy that requires transfers between funds to be included in a budget or budget amendment that the board approves. The policy also requires the State Bar to support transfers by identifying a clear connection between the purpose of the transferring fund and the need for the transfer by the fund receiving the transfer. However, according to the finance director, State Bar senior management decided not to obtain board approval when transferring the \$14,800 to the foundation because they believed the amount of money involved was insignificant and because the board had not been involved in the creation of the foundation. Instead, the former acting executive director approved the transfer, which the finance director recorded.

In addition, the State Bar did not involve the board in the dissolution of the foundation. In December 2015, the State Bar closed the foundation's bank account, and in March 2016 it filed documents with the Secretary of State's Office that formally dissolved the foundation. According to the finance director, State Bar senior management believed that because the board was not involved in the foundation's creation, it was not required to approve its dissolution.

Before 2012 the State Bar had a similar nonprofit organization—the Education Foundation—that it used to fund some of its Sections' educational programs. In its 2011 financial report, the State Bar reported a loss of about \$746,800 for the Education Foundation's fund. The State Bar also reported that it closed the Education Foundation as of December 31, 2011, and it used Sections resources to cover its loss. According to the State Bar's deputy general counsel, the State Bar dissolved the Education Foundation because it believed additional administration was needed to ensure the Education Foundation operated substantially to serve the public interest and not just the legal community, individual lawyers, or its

private sponsors. He further said the State Bar was concerned that the Education Foundation needed greater organizational formality, such as separate accounting records and bank accounts.

Despite these concerns over the use and administration of its previous nonprofit organization, executives at the State Bar created this most recent foundation in May 2013, less than a year and a half later, while providing no additional oversight to ensure the State Bar used it appropriately. Without appropriate oversight from its board and the Legislature, there is a risk that the State Bar could use its authority to create similar nonprofit organizations and use their funds for questionable purposes in the future.

The State Bar's Management Violated Its Board Policies for Interfund Loans and Expenses

In addition to the inappropriate transfer described previously, the State Bar violated a board decision to pay interest on interfund loans. In April 2013, the board approved three loans totaling \$4.3 million to its Los Angeles building fund from these sources: \$3.5 million from the Legal Education and Development Fund, \$782,000 from the Elimination of Bias and Bar Relations Fund, and \$52,000 from the Legislative Activities Fund.⁹ The board approved these three loans for a term of up to 10 years with an annual interest rate of 4.26 percent, the same rate the State Bar paid for its Los Angeles building bank loan.

According to an email from the former acting general counsel, the State Bar expedited the repayment of the three loans, paying the full amount in less than two years to avoid paying interest over the remaining term. We found that the State Bar repaid the principal of these three loans in full by December 2014. However, the State Bar failed to pay the \$258,000 due in interest at the time of its repayment. According to the finance director, the former acting chief financial officer believed that it did not make sense for the lending funds to earn 4.26 percent interest when these funds would have earned less than 1 percent interest on deposits in the investment pool. However, we find it problematic that the former acting chief financial officer did not follow the board-adopted loan agreement.

Additionally, we found that the State Bar violated its expense policies in 2013. According to the finance director, the former chief financial officer instructed her to issue a \$15,000 check for a board president's stipend in July 2013. The State Bar could not provide documentation

The State Bar repaid the principal of three loans in full by December 2014. However, it failed to pay the \$258,000 due in interest at the time of the repayment.

⁹ The State Bar refers to the three funds collectively as the Administration of Justice Fund.

of a check request or two levels of approval for this transaction, as required by its policies. Further, we found that the State Bar issued the stipend check several months before the president was sworn in. During the course of our audit, the State Bar removed from its policies the provision for a president's stipend. However, by failing to follow its policies, the State Bar bypassed controls meant to ensure its expenses were reasonable and necessary.

The State Bar's Salaries for Its Executives Are Significantly Higher Than Salaries for Comparable Positions in State Government

The State Bar's salaries are its largest and fastest-growing expense. This situation has occurred in part because the State Bar's pay scales for executive staff salaries are significantly higher than those of executive staff in state government agencies. In fact, as Table 8 shows, the maximum salaries for the State Bar's 13 top executives exceed the annual salary paid to the governor. For example, the senior director of admissions' maximum annual salary is \$208,255, more than the governor's annual salary of \$182,784. This senior director's responsibilities include overseeing, planning, organizing, and directing the examination and admission of attorneys to the State Bar. In contrast, the maximum salary for state agencies' civil service executives with comparable responsibilities—known as *career executive assignment positions* (CEA positions)—is \$135,948, while civil service CEA attorneys, earn no more than \$172,908.¹⁰ Even though the State Bar recently eliminated several executive positions as noted in the Introduction, it estimated that its remaining 48 executive staff positions would cost \$7.9 million during 2016. After adjusting for regional salary differences in Los Angeles and San Francisco, this amount is equivalent to roughly \$7.3 million in salary costs for comparable positions in Sacramento, which has the highest concentration of state employees. If the State Bar capped all executive staff salaries in positions below that of the operations officer at the highest level for comparable CEA positions, it could save as much as \$428,000 annually, after taking regional differences into account.

If the State Bar capped all executive staff salaries in positions below that of the operations officer at the highest level for comparable state government positions, it could save as much as \$428,000 annually.

Additionally, the State Bar provides most of its executive staff with benefits that are more generous than the State gives to those in CEA positions. For example, State Bar executive staff receive health, dental, and vision benefits that cost the State Bar nearly \$38,000 per person annually. This amount is almost double the amount that the State pays for its CEA positions' benefits—about \$19,500 annually. If the State Bar capped its employer contributions at the level that the State uses, it could save as much as \$433,000 annually.

¹⁰ CEA are high administrative and policy influencing positions within state civil service, and often have direct contact with department directors. They may often compose the executive management team and have primary responsibility for managing agencies' major functions.

Table 8**Comparison of the Salaries for the State Bar of California's Executive Staff to Those of Other Selected State Employees**

TITLE	AGENCY	SALARY
Executive Director/CEO	State Bar of California (State Bar)	\$267,500
Agency Secretary	California Department of Corrections and Rehabilitation	243,360
Chief Operating Officer	State Bar	239,500
Director	California Department of Public Health	239,064
Chief Trial Counsel	State Bar	229,079
Director	California Department of Social Services	219,264
Chief Legal Officer	State Bar	216,869
Deputy General Counsel	State Bar	208,255
Senior Director, Admissions	State Bar	208,255
Senior Director, State Bar Court	State Bar	202,257
Senior Director, Information Technology	State Bar	195,445
Executive Director	State Board of Equalization	188,448
Deputy Chief Trial Counsel	State Bar	188,223
Chief Assistant General Counsel	State Bar	188,223
Senior Director, Education	State Bar	187,927
Senior Director, Administration of Justice	State Bar	187,927
Director, General Services	State Bar	187,676
Governor	State of California	182,784
Director	California Department of Water Resources	177,683
Director	California Department of Transportation	177,683
Top Allowable Career Executive Assignment (CEA) salary for positions requiring licensure as an attorney, engineer, or physician.	CEA	172,908
Assistant Chief Trial Counsel	State Bar	171,983
Assistant Chief Trial Counsel	State Bar	171,983
Chief Assistant Court Counsel	State Bar	171,983
Director, Client Security Fund	State Bar	171,983
Director, Professional Competence	State Bar	171,983
Director	California Department of General Services	171,545
Director	California Department of Human Resources	171,168
Chief Counsel	California High Speed Rail Authority	168,216
Assistant Chief Trial Counsel	State Bar	166,650
Director	Department of Consumer Affairs	161,650
Director	California Department of Resources Recycling and Recovery	161,650
Director	Employment Development Department	161,640
Assistant Chief Trial Counsel	State Bar	161,600
Director, Finance/Controller	State Bar	159,363
Director	Department of Motor Vehicles	156,936
Court Administrator	State Bar	154,125
Director, HR and Labor Relations	State Bar	154,125
Court Administrator	State Bar	154,125

continued on next page...

TITLE	AGENCY	SALARY
Director, Information Systems and Business Solutions	State Bar	154,125
Director of Applications	State Bar	154,125
Director, Central Administration, Chief Trial Counsel	State Bar	152,712
Chief Assistant Court Counsel	State Bar	151,500
Director, Operations and Management	State Bar	151,281
Director, Examinations	State Bar	151,281
Director, Legal Specialization	State Bar	151,281
Director, Technology Systems	State Bar	149,841
Director, Educational Standards	State Bar	149,841
Director of Administration	State Bar	145,440
Director, Moral Character Determinations	State Bar	141,400
Director, Procurement and Risk Management	State Bar	140,788
Deputy Director, Operations and Management	State Bar	140,172
Managing Director, Bar Relation	State Bar	140,172
Managing Director, Diversity Outreach	State Bar	140,172
Managing Director, Legal Services Trust Fund	State Bar	140,172
Director, Communications	State Bar	138,127
Top Allowable CEA Level C	CEA	135,948
Director, Section Education and Meeting Services	State Bar	131,578
Managing Director, Planning Admin	State Bar	129,126
Top Allowable CEA Level B	CEA	128,436
Director, Lawyers Assistance Program	State Bar	126,250
Director, Fee Arbitration	State Bar	123,699
Managing Director, Member Records, and Compliance	State Bar	123,048
Finance Manager	State Bar	118,789
Deputy Director, General Services	State Bar	111,862
Top Allowable CEA Level A	CEA	111,324

Sources: The State Bar's website and California Human Resources website.

Note: Green highlights indicate salaries of executive branch staff within state agencies.

Like the State Bar's other executive staff, the executive director receives significantly more in terms of salary and benefits than she would at a state agency. The executive director negotiates his or her contract directly with the board. The State Bar pays its current executive director an annual salary of \$267,500. The executive director is most similar to the director of an agency with fewer than 800 employees. However, the top directors for the Department of Social Services and the Board of Equalization—who each oversee 4,000 employees—are eligible to receive maximum salaries of \$219,264 and \$188,448, respectively. The State Bar's executive director also receives \$36,000 annually in lieu of receiving health, dental, and disability benefits. The payment in lieu of insurance is comparable to the amount the State Bar spends on insurance for a number of its

other executives, as previously noted; however, this payment far exceeds the \$1,860 per year that the State pays to employees who opt out of insurance. In 2015 and 2016 the State Bar also paid its executive director a total of \$32,500 for a housing allowance and moving expenses, but this expense payment is not an ongoing benefit. Although state agencies can pay for relocation expenses, state policy imposes stringent requirements that are absent from the State Bar's policies.

The State Bar has not conducted an in-depth update of its job classification and compensation structure throughout the organization in more than 10 years, but it is currently in the process of performing a study that would enable such an update. Senate Bill 387 of 2015 requires the State Bar to conduct a public sector compensation and benefits study (compensation study) for staff involved in its disciplinary activities. However, the State Bar expanded this compensation study to include all of its positions, not just those related to attorney discipline. Its current structure includes approximately 150 job classifications that encompass approximately 600 positions. In February 2016, the State Bar hired CPS HR Consulting (CPS) to complete the compensation study of all of its departments. The agreement requires CPS to develop a new classification structure, assign all employees to classifications, conduct a survey of public sector salaries, and develop a new salary step plan. To assess the need for a new classification structure, the State Bar also sent position description questionnaires to staff in the Office of the Chief Trial Counsel (Trial Counsel). CPS must issue a final report on its analysis of the staff involved in the State Bar's discipline activities of the Trial Counsel by May 15, 2016, and for the remaining State Bar departments by October 3, 2016.

Although we believe a compensation study will prove helpful to the State Bar, we were concerned that it was not considering the State's executive branch agencies when determining appropriate salary ranges. The State Bar had selected 15 agencies it deemed comparable to itself. They included five counties, five cities, three superior courts, the Los Angeles Unified School District, and the Judicial Council, as listed in the text box. After we brought this to the attention of the operations officer, the State Bar added a State executive branch salaries and benefits comparison to its compensation study covering staff involved in its disciplinary activities. The operations officer said the State Bar would also include comparisons to the State's executive branch in its agency-wide compensation study.

Agencies to which the State Bar was Comparing Itself when Determining Executive Compensation

Counties: Alameda, San Francisco*, Los Angeles, Orange, Santa Clara

Cities: Anaheim, Long Beach, Los Angeles, Oakland, San Jose

Superior Courts: Alameda County, Los Angeles County, San Francisco County

Judicial Council of California

Los Angeles Unified School District

*San Francisco is both a city and a county.

Source: The State Bar of California's selection of comparable agencies.

Recommendations

To reduce the length of time that victims of dishonest lawyers must wait for reimbursement from the Client Security Fund, the State Bar should continue to explore fund transfers, member fee increases, and operating efficiencies that would increase resources available for payouts.

To ensure that it maximizes its cost-recovery efforts related to the Client Security Fund, the State Bar should do the following:

- Adopt a policy to file for money judgments against disciplined attorneys for all eligible amounts as soon as possible after courts settle the discipline cases.
- Evaluate annually the effectiveness of the various collection methods it uses to recover funds from disciplined attorneys.

To reduce the risk of errors in financial reporting, the State Bar should update its procedures to include guidance on the following:

- Detailed steps that staff should take to prepare financial statements and to ensure that the statements are accurate and complete.
- Management's review and approval of financial statements.

To increase the transparency and comparability of its financial information, the State Bar should do the following:

- Limit significant changes in its indirect cost reporting.
- Clearly disclose any changes in its accounting practices.
- Disclose the reasons for any significant changes to program costs.

To ensure that it accounts appropriately for information technology project costs and their related funding sources, the State Bar should do the following:

- Develop a reasonable method for allocating information technology project costs.
- Apply this new cost-allocation method to the costs of its Technology Improvement Fund.

To ensure it informs stakeholders of conditions that may affect its policy and programmatic decisions, the State Bar should document the assumptions and methodology underlying its budget estimates. It should concisely present such assumptions and methodology in the final budget document it provides to its board and the Legislature.

To make certain that its budget documents conform to the requirements in state law and that they are comparable to prior budgets, the State Bar should do the following:

- Establish a process for ensuring that budget documents conform to the requirements in state law.
- Update its budget policies to require supplementary schedules and narratives for any budget in the year in which the State Bar implements changes to the presentation of its budget.

To ensure that the State Bar's board can make informed decisions about its consultant's recommendations regarding budgeting and financial reporting, the State Bar should analyze the costs and benefits of implementing its consultant's recommendations about budgets and present this analysis to its board for consideration.

To make certain that the Legislature is not limited in its ability to set member fees, the Legislature should require the State Bar to notify or seek its approval when the State Bar plans to pledge its member fee revenue for a period that exceeds 12 months or overlaps fiscal years.

To ensure that it retains appropriate supervision and control over the State Bar's financial affairs, the board should establish a policy that includes the following:

- A description of the parameters for the creation of nonprofit organizations limiting such organizations to the purposes consistent with the law and the State Bar's mission.
- A description of the board's oversight role in relation to the State Bar's nonprofit organizations.
- Requirements to make sure that the board reviews and approves all documents the State Bar uses in the creation and use of a nonprofit organization, including original and amended bylaws as well as agreements between the State Bar and the organization.
- Requirements ensuring that the board reviews, approves, and monitors regularly the budgets and other financial reports of any nonprofit organizations.
- Requirements that the State Bar develop policies and procedures to prevent the mingling of its funds and any nonprofit organization's funds.

To improve its oversight of the State Bar's financial affairs, the Legislature should require the State Bar to disclose the creation of and use of nonprofit organizations, including the nonprofits' annual budgets and reports on their financial condition explaining the sources and uses of the nonprofits' funding.

To ensure that the compensation it provides its executives is reasonable, the State Bar should do the following:

- Include in the comprehensive salary and benefits study that it plans to complete by October 2016 data for the salaries and benefits for comparable positions in the state government's executive branch.
- Revise its policy for housing allowances and relocation expenses to align with the requirements in the state law that are applicable to managerial employees.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the Government Code and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the Scope and Methodology section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

Date: May 12, 2016

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For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.



THE STATE BAR OF CALIFORNIA

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April 26, 2016
Via Encrypted Secured Email

Elaine M. Howle, State Auditor
 Bureau of State Audits
 621 Capitol Mall, Suite 1200
 Sacramento, CA 95814

Re: State Bar of California Response to State Audit Report 2015-047

Dear Ms. Howle:

Please find below the response of the State Bar of California to the Audit 2015-047. Before turning to our specific observations, we wish to thank your audit team for its courtesy and professionalism. We found them co-operative, thorough and easy to work with throughout a lengthy process. We know that they spent a considerable effort to gather information that would be comprehensive and allow careful issue exploration. We believe that their final report offers a meaningful and balanced analysis of the myriad of issues facing the State Bar from which we can benefit, going forward.

That said, we were disappointed that the final report did not make a clearer demarcation between past management issues faced by the State Bar and the efforts of new leadership to transform legacy practices and approaches over the last seven months. It is important to understand the challenges faced by a completely new management team: a new Executive Director, Chief Operating Officer, and General Counsel. We believe that external readers need to understand this change in leadership and the efforts it is making to address a host of longstanding organizational, operational, and fiscal challenges. This reform-minded State Bar leadership team welcomed the audit and, we believe, exhibited significant openness to the audit process. Accordingly, we proactively identified potential areas for audit exploration. Our cooperation in consistently providing timely and comprehensive responses to the large number of inquiries and requests for documentation presented throughout the audit period is further evidence of this change in approach, and is deserving of mention.

(1)

Unfortunately, the report, while relatively modest in content, is dominated by headlines that set a highly critical tone which we believe is inconsistent with both the audit findings themselves, and the State Bar's overall co-operation and demonstrated commitment to transparency and accuracy.

(2)

Perhaps the best example of our concern is the report's title: "*Its Lack of Transparency Has Undermined Its Communications with Decision Makers and Stakeholders.*" Use of the phrase "lack of transparency" suggests an intentional and deceptive approach.

(3)

* California State Auditor's comments begin on page 61.

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Yet no evidence is presented to support either proposition. A more accurate description might have been “New Leadership Has Worked Conscientiously to Address Past Lack of Transparency Which Has Undermined...”

We hope you will accept these suggestions as an effort to better describe what we believe your team actually experienced. While we remain conscious of the State Bar’s past failings, we also believe that if a more collaborative relationship with all stakeholders, based on trust, is to be developed in the future, it will be important to highlight the efforts of new leadership.

RESPONSE TO SPECIFIC AUDIT FINDINGS

The State Bar has not ensured that its financial reports clearly communicate its financial situation.

As evidence of this assertion, the report points to the following:

- Client Security Fund (CSF) payouts have been slowed due to a backlog of outstanding payments and this fact has not been communicated to stakeholders.

(4)

While the State Bar agrees that additional efforts can be made to educate the public and other stakeholders about the condition of the CSF, the Bar rejects the assertion that the condition of the fund has not been communicated. The status of the CSF has been reported to the Board of Trustees via public board reports on multiple occasions, and has been communicated to legislative staff spanning back to the prior executive leadership of the Bar, and continuing to discussions regarding the current fee bill.

- Lack of reporting transparency as related to CSF outstanding payments, the Information Technology Improvement Fund, and changes in presentation of indirect costs.

(5)

While the State Bar agrees that more explanation of changes can and should be provided in the State Bar’s financial statements, it is important to note that the audit did not find a single instance of impropriety with respect to any of these areas. With respect to unpaid CSF claims, these do not in fact represent a financial liability to the Bar. Inclusion in the organization’s financial statements as such overstated the Bar’s liabilities, thus artificially reducing the Bar’s available fund balances. So, while the Bar could have explained this change in financial statements more effectively, there is no doubt that removal of these unpaid claims as a negative liability reflects a more accurate depiction of the Bar’s fiscal position. We believe this point is important to a clear understanding of the report.

The State Bar has not clearly informed stakeholders that it lacks the funding necessary to pay victims of attorney misconduct.

(4)

As noted above, the Bar does not believe that this assertion by the State Auditor is accurate.

The State Bar has not accurately reported its use of certain restricted funds because it lacks a reasonable process for allocating costs of information technology projects.

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We believe that this assertion is overly broad and that it is incorrect to assert that there is not a reasonable methodology in place for allocating information technology project costs, or that the Bar has inaccurately reported the use of restricted funds. The Bar accepts the audit finding as related to the inaccurate characterization of the IT Fund as unrestricted when in fact it is comprised of some restricted funding sources. However, there was no finding of improper use; all expenditures from the IT Fund were appropriately spent for IT related purposes, and there is a process in place to allocate costs appropriately to various technology projects. (6)

The State Bar has frequently changed how it presents certain costs in its financial statements, causing the statements to lose comparability.

While the State Bar agrees that additional explanation of changes can and should be provided in its financial statements, the Bar notes that the audit did not find any of the changes identified to be improper or inappropriate and in fact took no exception to the changes themselves. The Bar's new leadership is committed to adopting 'best practices' wherever possible; this is part of our continuing commitment to improve the organization which may very well result in additional methodological changes. We agree, however, with your recommendation to provide more information about such changes, and will commit to explaining any future changes thoroughly.

The State Bar Misclassified the Legal Services Trust Fund as unrestricted and did not accurately report its administrative expenses.

While the Bar acknowledges this one-time error that occurred under the prior leadership, it also notes that there was no finding of any inappropriate use of funds. This should be made clear, lest such an administrative error suggest the presence of more serious problems to the non-technical reader.

The State Bar's compliance with a new accounting standard has caused significant changes to its financial statements.

While the Bar acknowledges the accuracy of this statement, it is important to note that the implementation of GASB 68 caused significant changes to the financial statements of the vast majority of governmental organizations. The Bar is not unique, and has in fact accurately and timely implemented this new accounting standard. We would urge that this be made clear in the heading.

Although the State Bar's Reserves are generally reasonable it has not adequately communicated the assumptions underlying its budget. (7)

While this header leads to the conclusion that the issue of the Bar's reserves is tied to budget assumptions, a careful reading of this section of the audit reflects the fact that these two statements are unrelated. In fact, the audit notes that, with the exception of the Sections fund, the Bar has developed and implemented a reasonable reserve policy pursuant to recommendations of the State Auditor's 2015 report which suggested the need for same. This

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is an accomplishment for which the State Bar's new leadership should be recognized, rather than being hidden in a header from which it might be inferred that there is something inadequate in its budget design.

The State Bar did not adequately document or disclose its budget process.

Significant improvements have been made in this area beginning with the 2016 budget, and the State Bar looks forward to implementing additional enhancements in budget documentation and disclosure in the future.

⑧ ***The State Bar's recent actions to improve its San Francisco building may limit the legislature's ability to lower membership fees.***

While the State Bar acknowledges that the statute relied on to substitute a revenue pledge for a debt service reserve for both the Los Angeles and San Francisco buildings contained a provision that limited the ability of the legislature to reduce membership fees absent amendment, and that this provision was inadvertently overlooked by executive management, the Bar also asserts that the substitution reflected sound fiscal management of the organization. However, the Bar has demonstrated its commitment to acknowledging concerns and moved expeditiously to revert to a debt service reserve fund structure. As of the date of audit publication, it has executed modifications for both loan agreements and established a combined debt service reserve fund in excess of \$7 million.

The State Bar created an unnecessary nonprofit organization then used State Bar funds to cover the nonprofit's financial losses.

The Bar agrees that the creation and operation of this nonprofit organization, which took place under the leadership of the former Executive Director, occurred in a highly unusual manner.

The State Bar's management violated its board policies for interfund loans and expenses.

The Bar agrees that, under the leadership of the former Executive Director, this policy was violated.

The State Bar's Salaries for its executives are significantly higher than salaries for comparable positions in state government.

While this proposition may be true, the State Bar believes that other State Bar associations are appropriate comparison entities for executive positions; we are advised that salaries for the new executive team were based on such comparisons. Moreover, a 2016 State Bar Executive Director salary survey sponsored by the District of Columbia Bar reflects the fact that the State Bar of California's Executive Director salary is well within the range of other comparable positions nationwide.

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RESPONSE TO AUDIT RECOMMENDATIONS

1. To ensure it maximizes its cost recovery efforts related to the Client Security Fund, the State Bar should do the following:

- a. Adopt a policy to file for money judgments against disciplined attorneys for all eligible amounts as soon as possible after courts settle the discipline cases.

Under the direction of the Bar's new General Counsel, dedicated staff are addressing a backlog of judgment filings covering a several year period during which the Bar had put such work on a hiatus; while the State Auditor's recommendation may in fact be appropriate, a cost benefit analysis of the current effort should be conducted prior to adoption of a policy regarding universal judgment filing.

- b. Annually evaluate the effectiveness of the various collection methods it uses to attempt to recover funds from disciplined attorneys.

The State Bar agrees with this recommendation.

2. To reduce the risk of errors in financial reporting, the State Bar should update its procedures to include guidance on the following:

- a. Detailed steps staff should take to prepare financial statements and to ensure the statements are accurate and complete.

The State Bar agrees with this recommendation, and it has already been implemented.

To ensure the accuracy, consistency and completeness of the Bar's financial reporting, in March 2016, staff created a financial statement template in Excel. This report template allows staff to automatically roll up general ledger balances exported from the Oracle financial system to appropriate expenditure and revenue categories for each program fund. General ledger account consolidation converted from a manual to an automated process in 2016. This new process not only increases the accuracy and completeness of the Bar's financial statements, but also maintains the consistency for comparability. In addition, a financial statement preparation check list which includes all necessary steps to compile quarterly and annual financial statements has been developed.

- b. Management's review and approval of financial statements.

The State Bar agrees with this recommendation.

Bar financial statements were historically reviewed by the Chief Financial Officer and the Executive Director, prior to submission to the Board of Trustees. Currently, the Chief Operating Officer and Executive Director review the statements, which have been prepared by the Director of Finance, a CPA. Staff will continue this practice and will

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properly document the approval process for future audit purposes.

3. To increase transparency and comparability of its financial information, the State Bar should do the following:

- a. Limit significant changes in its indirect cost reporting.

The State Bar agrees with this recommendation in principle.

In 2015, the State Bar conducted a thorough study and review of the indirect cost allocation methodology. While this review confirmed the appropriateness of the Bar's existing allocation methodology, several modifications were recommended. In January 2016, the Board of Trustees adopted a modified cost allocation plan pursuant to these recommendations. While it is the Bar's intention to maintain this revised methodology going forward, additional modifications may be needed as related to one-time capital expenses, for example, or ongoing business improvement efforts. Thus, while in principle the Bar might agree to limit changes in indirect cost reporting, where that principle contradicts with the need to modify the methodology to make it more accurate, the latter concern will prevail.

- b. Clearly disclose any changes in its accounting practices.

The State Bar agrees with this recommendation.

- c. Disclose the reasons for any significant changes to program costs.

The State Bar agrees with this recommendation.

4. To ensure it accounts appropriately for information technology project costs and their related funding sources, the State Bar should do the following:

- a. Develop a reasonable method for allocating information technology project costs
 - b. Apply this new cost allocation method to the costs of its Technology Improvement Fund

(6) The State Bar agrees with this recommendation but believes that a reasonable allocation methodology is in place; this methodology will be codified as a procedure pursuant to State Audit findings.

5. To ensure its budget documents conform to the requirements in State law and are comparable to prior budgets, the State Bar should do the following:

- a. Establish a process for ensuring budget documents conform to the requirements in State law.

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- b. Update its budget policies to require supplementary schedules and narratives for any in the year in which it implements changes to the presentation of its budget.

The State Bar agrees with this recommendation.

6. To ensure it informs stakeholders of conditions that may impact its policy and programmatic decisions, the State Bar should document the assumptions and methodology underlying its budget estimates. It should concisely present such assumptions and methodology in the final budget document it provides to its board and the legislature.

The State Bar agrees with this recommendation.

7. To ensure that the State Bar's Board of Trustees can make informed decisions regarding the recommendations its consultant made regarding budgeting and financial reporting, the State Bar should prepare a cost/benefit analysis of implementing its consultant's recommendations regarding budgets and present this analysis to the board for consideration.

The State Bar agrees with this recommendation.

It should be noted that the Bar's existing budget and financial reporting practices satisfy relevant legislative provisions and are in compliance with generally accepted accounting principles, in terms of its content, presentation and design. The consultant referenced by the auditor recommended that, in addition, the Bar implement budget and financial statement models recommended by the CSMFO and GFOA; implementation of these models would require extensive staff resources and additional qualified accountants to deliver. (9)

8. To ensure that the board retains appropriate supervision and control over the State Bar's financial affairs, it should establish a policy that includes the following:
 - a. A description of the parameters for the creation of nonprofit organizations limiting such organizations to the purposes consistent with the law and the State Bar's mission.
 - b. A description of its oversight role in relation to its nonprofit organization.
 - c. Requirements that ensure the board reviews and approves all documents the State Bar uses in the creation and use of a nonprofit organization including, but not limited to, original and amended bylaws, as well as agreements between the State Bar and the organization.
 - d. Requirements that ensure the board reviews, approves, and monitors on an ongoing basis the budgets and other financial reports of any nonprofit organizations.

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- e. Requirements that it develop policies and procedures to prevent the mingling of the State Bar's funds and any nonprofit organization's funds.

The State Bar agrees with this recommendation.

9. To ensure that the compensation it provides is reasonable, the State Bar should do the following:

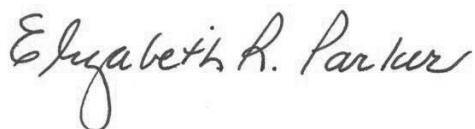
- a. Include state government executive branch salaries and benefits for comparable positions in the comprehensive salary and benefits study it plans to complete by October 2016.

The State Bar agrees with this recommendation and its contract with CPS HR Consulting, Inc., the classification and compensation vendor, has already been modified to reflect the inclusion of executive branch salaries.

- b. Revise its policy for housing allowances and relocation expenses to align with the requirements in state law that are applicable to excluded employees.

The State Bar agrees with this recommendation.

Respectfully,



Elizabeth Parker
Executive Director

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE STATE BAR OF CALIFORNIA

To provide clarity and perspective, we are commenting on the response to our audit report from the State Bar of California (State Bar). The numbers below correspond with the numbers we have placed in the margin of the State Bar's response.

We believe our report provides appropriate context regarding the management issues faced by the State Bar. Our report focuses on the period between January 2013 and December 2015. On page 8, we acknowledge that the State Bar experienced significant executive management turnover beginning in November 2014 and note that the current executive team started in September and October 2015. Finally, in multiple places in the report, we acknowledge the State Bar's recent efforts to change management practices to address certain problem areas.

(1)

We disagree with the State Bar's contention that the headings in the report are inconsistent with the audit finding themselves. The headings in our report are intended to summarize report content and they do so accurately. They are not intended to contain every detail of the report.

(2)

We disagree with the State Bar's contention that a lack of transparency necessarily suggests an intentional and deceptive approach. We believe the lack of transparency we note made it difficult for stakeholders to understand the State Bar's financial condition, irrespective of intent. We identified multiple instances in our report in which the State Bar reported information either inaccurately or in a manner that decreased comparability or understandability.

(3)

The State Bar mischaracterizes our conclusion regarding communications about the Client Security Fund. On page 28, we conclude that the State Bar could have done more to communicate the fund's difficulties and offer solutions sooner. We noted on this same page that the State Bar's lobbyist stated that the State Bar has discussed the shortage of money in the Client Security Fund with the Legislature for a number of years and has explored solutions with legislators, including a fee increase. However, recent budgets the State Bar has provided to its board and to the Legislature have not discussed the fund's problems or proposed any solutions.

(4)

- ⑤ While the State Bar’s decision not to report unpaid Client Security Fund claims as liabilities on the face of its financial statements is defensible, as we note in the report at page 28, we believe that it should have disclosed in the notes to the financial statements that it had a commitment related to a large, continuing estimated payout. Specifically, the State Bar did not include information in its financial statements of its inability to pay estimated claims between 2012 and 2014. After we raised this issue with the State Bar, it added a disclosure to the notes of its 2015 financial statements that included an estimated payout of \$18.9 million as of December 31, 2015.
- ⑥ We disagree with the State Bar’s assertion that it has a reasonable methodology for allocating information technology project costs. For example, we reported on page 31 that the State Bar transferred \$1 million from the Admissions Fund to the Technology Improvement Fund in 2012 but that it had only incurred about \$173,000 in admissions project costs by the end of 2015. A reasonable cost allocation process would not have yielded such a result.
- ⑦ We disagree with the State Bar’s contention that the “header” at page 35 is misleading. Further, we discuss the State Bar’s reserves and its budget assumptions under separate subheadings at pages 36 and 37.
- ⑧ Despite the fact that we maintained communication with the State Bar during the agency response period and provided it with revisions based on the actions it took after we had completed our fieldwork, the State Bar chose not to include the revised heading located on page 40 in its response.
- ⑨ We disagree with the State Bar’s assertion that its existing budget practices satisfy relevant legislative provisions. As we discuss on page 39, the State Bar’s decision to eliminate its fund condition statements from its 2016 budget documents removed detailed information about each fund’s revenues and significantly decreased the transparency of the State Bar’s budgeting process. State law requires the State Bar to provide supplementary schedules detailing, among many other things, all revenue sources, any reimbursements or interfund transfers, and fund balances. However, the State Bar eliminated much of this information from its budget when it switched from providing fund condition statements to providing a schedule of reserves.