AGENDA ITEM

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DATE: February 29, 2016

TO: Board of Trustees

FROM: Leah Wilson, Chief Operating Officer

SUBJECT: Removal of Spending Authority Limit and Full Adoption of 2016-2018 Budget and Cost Allocation Plan

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EXECUTIVE SUMMARY

At its February 1, 2016, meeting, the Board of Trustees adopted a 2016-2018 budget reflecting a modified methodology for allocating certain operating costs to State Bar programs. This agenda item provides the Board with an opportunity to specifically review and adopt that modified methodology, known as the revised Cost Allocation Plan (CAP). In addition, the Board is asked to make decisions regarding the treatment of capital improvement and debt service costs, and to consider potential adjustments to the revised CAP based on concerns raised by State Bar Sections. In the event that the Board determines that modification is appropriate, the adopted 2016-2018 budget will need to be revised accordingly.

In 1999, the State Bar engaged Deloitte & Touche LLP to recommend a methodology for allocating administration and support costs (indirect costs) to State Bar programs; changes in the organization resulted in the firm again being engaged in 2002 to modify the 1999 approach. The Bar has continued to use the 2002 methodology, absent any significant changes or review, since that time. Given the significant period of time since the last review, and the number of organizational changes that have occurred during that period, the State Bar engaged an independent consultant, Mr. William Statler, to conduct a new assessment of the cost allocation methodology in 2015; that review was completed on January 25, 2016, and is provided as Attachment A. Appendix A of that Attachment also contains the 2002 methodology.

The 2015 review included several key findings – most notably, that the existing CAP was technically sound. However, several CAP modifications were recommended, including broadening the base of costs to be allocated as indirect costs pursuant to the plan, and reducing the frequency with which the CAP required reassessment of all program costs. In addition to these changes, which have been made by staff and are discussed below, Mr. Statler recommended a revised, more “user-friendly” format for the document. That recommendation has not been fully implemented, but will be as related to 2017-2019 budget development.

Along with being asked to make several policy decisions regarding, and to approve, the CAP, the Board is being asked to remove the 2016 spending authority limit imposed at the February 1, 2016, Board meeting.

BACKGROUND

A cost allocation methodology identifies indirect operating costs to be distributed to direct cost programs or functional areas, and uses standardized categorical factors to determine relative program allocation burdens in lieu of tracking individualized transactions.

The Bar's current cost allocation methodology was last revised in 2002. That methodology was based on an approach developed by the federal government to enable state and local governments to recover the cost of administering federal grants without placing undue burden on grant recipients.

In 2015, Mr. William Statler was engaged to conduct a comprehensive review of the State Bar's methodology. Mr. Statler was specifically asked to:

- Assess the reasonableness of the existing cost allocation methodology;
- Analyze cost and allocation base data sources; and
- Recommend changes as appropriate.

That review resulted in several key findings and recommendations which have been incorporated into the revised CAP and process. These include:

- The existing cost allocation methodology is technically sound;
- All indirect costs are not currently allocated, but should be;
- Cost allocation should occur at the fund, not cost center, level;
- Cost allocation should be an annual, as opposed to a monthly, process;
- Decisions regarding whether and how to include capital projects and debt service in the cost base to be allocated should be made on a case-by-case basis; and
- The CAP should be approved annually by the Board of Trustees.

Mr. Statler also made additional recommendations which have not been fully implemented. These include the creation of a stand-alone policy document as the format for CAP presentation, and Board adoption of a formal cost recovery policy. Staff anticipates developing a more narrative based, "user-friendly" format for the CAP as related to 2017-2019 budget development, and presenting a cost recovery policy to the Board for consideration later this year.

A summary of Mr. Statler's major recommendations and corresponding implementation status is provided as Attachment B.

DISCUSSION

Consultant Findings and Recommendations

All Indirect Costs Should be Allocated
The current CAP does not allocate all indirect costs, with only 50 percent of Executive Director and Appointment costs allocated; 25 percent of Board of Trustees, Deputy Director (Chief Operating Officer) and Elections costs allocated; and 7 percent of Communication costs allocated.

While Mr. Statler noted that this partial allocation was consistent with the recommendations of Deloitte & Touche, he also indicated that there is little justification for allocating only a portion of these costs, and that, absent a reason for doing otherwise, all indirect costs should be allocated in the CAP.

The revised CAP reflects this recommendation. An additional recommendation, to treat Communications as direct (and thus unallocated) costs, predicated on the position that Communications is a direct service of the Bar, rather than an indirect support function, is also reflected in the revised CAP.

Cost Allocation Should Occur at the Fund or Program Level
The current model allocates indirect costs to 118 cost centers. Mr. Statler found the current practice to have no readily identifiable benefits, but that it instead makes the process overly convoluted and difficult to understand.

Mr. Statler recommended modification of the CAP so that indirect costs are allocated to major programs areas based on Departments/Funds. This recommendation is reflected in the revised CAP.

Cost Allocation Should Occur Annually
Mr. Statler noted that the current process involves monthly preparation and posting of allocated costs, as opposed to the annual approach employed by most public agencies. Mr. Statler recommended a transition to an annual process, with the ability to “true-up” in subsequent years in the event of significant variances between budgeted and actual costs.

Staff intends to implement this recommendation prospectively, with a CAP to be considered by the Board annually as part of the budget development process.

Capital Project and Debt Service Costs
Mr. Statler noted that, while cost allocation plans typically initially exclude from the direct cost base capital project and debt service expenditures, decisions regarding funding capital projects and indirect cost debt service obligations should be made on a case-by-case basis at the time when capital projects and debt service obligations are approved.

Currently, capital improvement costs are not included in the CAP. The adopted 2016-2018 budget reflects $4.6 million in such costs, for scheduled improvements to the Howard Street location.

In contrast to capital improvement costs, debt service expenditures are currently included in the CAP. Annual debt service for the Los Angeles building mortgage, totaling $2.3 million, is allocated via a separate indirect cost pool only to programs that are located in the Los Angeles office.

While Mr. Statler did not recommend any changes to the current approach to capital improvement or debt service allocation, he suggested that, in the case of capital projects, the decision as to whether or not, and upon what basis to, allocate capital improvement costs should be clearly articulated when the Board approves the project budget (or makes subsequent amendments to it). Similarly, in the case of debt service for facilities, decisions regarding allocation should be made as new debt is assumed. In addition, the Board might consider an alternate methodology in which costs are allocated Bar-wide, as opposed to on a location-specific, basis.

The Board is asked to determine whether the $4.6 million in Howard Street capital improvements costs, currently unallocated, should be included in the cost basis for the CAP. These costs have not been allocated previously because of concerns regarding the impact on recipient Departments/Funds. While sensitive to these concerns, staff believes it appropriate to cost allocate a portion of these costs, as follows:

- Identify the portion of the $4.6 million associated with improvements of tenant- versus Bar-occupied space on a square foot basis
    - 41.9 percent of the Howard Street building is currently allocated for tenant occupancy
- Cost allocate only the amount associated with Bar-occupied space on a square foot basis, leaving tenant improvement costs unallocated
    - 58.1 percent of $4.6 million, or $2.67 million, would be cost allocated

The Board is also asked to consider whether future anticipated debt service costs (as related to the $10 million loan for Howard Street tenant improvements approved by the Board at its last meeting) should be included in the CAP. Because this debt will be incurred solely for the purpose of funding tenant improvement work, staff does not recommend that it be cost allocated.

The revised CAP is provided as Attachment C-1; Attachments C-2, C-3 and C-4 provide historical context information. The CAP reflects a total cost allocation of $31,345,900.

The impact of including budgeted Howard Street capital improvement costs in costs to be allocated is reflected in Attachment D.

Impact of Cost Allocation on State Bar Sections

The State Bar provides direct personnel and operating support to its Sections through the Office of Education. These direct supports are only possible because of the indirect infrastructure of the broader State Bar. Business and Professions Code (B&P) section 6031.5 (Attachment E) requires that the State Bar be fully reimbursed for any administrative or support services provided to the Sections. The statute also provides that the financial audit required by section 6145 must "*confirm that the amount assessed by the State Bar for providing the services reimburses the costs of providing them, and shall verify that mandatory dues are not used to fund the sections*".

Annual Section membership dues have ranged from $85-$95. From this revenue source, totaling approximately $8.6 million annually, the Sections fund both direct costs (personnel and operating costs associated with day-to-day Sections support) and indirect costs (levied via implementation of the CAP). The per capita ratio of membership dues to State Bar costs is known as the Cost Per Member (CPM).

Over the years, the CPM has increased overall. In 2007, that figure equated to $37.31, with modest annual increases being realized until 2014, when the CAP was modified to reflect San Francisco building costs. Prior to that year, the Sections had not been charged appropriately for facility-related costs. Correction of the formula resulted in a 13 percent one-year increase in the CPM, bringing the total CPM to $56.36. Section leadership, already concerned about escalating costs, became alarmed, fearing that the impact of these charges would be a significant reduction in their collective abilities to implement programming.

Given these concerns, Mr. Statler was asked to specifically engage the Sections as part of his CAP review. A Sections taskforce – The Council of State Bar Sections Taskforce on Overhead Cost Allocations – met with Mr. Statler during his review process to that end. In addition, Mr. Statler presented his preliminary findings to the Council of State Bar Sections on January 14, 2016.

In response to continued questions regarding the appropriateness of the CAP, State Bar staff met with the Taskforce on the Organizational Structure of the Bar on February 18, 2016. Detailed information regarding the cost basis for each component of the CAP was provided at that time; that material is provided as Attachment F.

Subsequent to that meeting, staff identified two possible modifications to the CAP as related to the Sections for Board consideration. Implementation of these modifications would provide some relief to the Sections, while continuing to ensure compliance with the statutory requirement that the Sections be self-supporting. These modifications are described below.

Removing Facilities Costs from CAP and Instead Charging Sections Rent
The facilities-related portion of the 2016 budget Sections indirect cost allocation is $408,000. Removing this cost, and instead charging the Sections market rate per square foot rent for space occupied at the Howard Street location would result in a

$153,000 reduction in costs to the Sections. This variance is primarily due to the fact that, under a rent/square foot approach, General Services Department personnel costs are not addressed.

Although staff believes this alternative approach to addressing Sections facilities costs is consistent with the directive of B&P Code section 6031.5, staff does not recommend that the Board adopt this modification to the CAP. There is not a clear justification for making this adjustment with respect to only the Sections' portion of the CAP, as opposed to modification of the methodology for allocating facilities costs overall. Implementing this adjustment more broadly would present significant negative consequences for the General Fund; as a result it is not recommended.

Removing Office of General Counsel (OGC) Costs from CAP
The Sections currently fund 50 percent of a full-time equivalent (FTE) OGC attorney via direct charge. The current CAP also includes indirect costs associated with OGC. Removing OGC costs from the CAP given the direct charge contribution of 50 percent of 1 FTE attorney would result in a $202,000 reduction in costs to the Sections.

Staff recommends that the OGC adjustment be made. Under the current methodology, it could reasonably be argued that the Sections are being double-charged for OGC services.

Taken together, these modifications to the CAP would reduce the Sections' 2016 CPM from $63.70 to $58.20. These savings, totaling $355,000, reflect costs that would have to be borne by other programs; a summary of the potential fiscal impact on these programs is provided as Attachment G.

RECOMMENDATION

Staff recommends that the Board adopt the revised Cost Allocation Plan as provided in Attachment C-1.

Staff further recommends that a prorated share of Howard Street capital improvement costs be cost allocated through the CAP.

Staff recommends that the CAP be modified to remove OGC costs from the Sections' cost allocation.

Staff recommends that the Board remove the 2016 spending authority limits currently in place.

FISCAL/PERSONNEL IMPACT

As discussed above.

RULE AMENDMENTS

Not Applicable

BOARD BOOK IMPACT

None

BOARD RESOLUTION

RESOLVED, that the Board adopts the revised Cost Allocation Plan (CAP) as provided in Attachment C-1; and it is

FURTHER RESOLVED, that a prorated share of Howard Street capital improvement costs be cost allocated through the CAP; and it is

FURTHER RESOLVED, that the CAP be modified to remove OGC costs from the Sections' cost allocation; and it is

FURTHER RESOLVED, that the Board remove the 2016 spending authority limits currently in place.