California State Auditor

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State Board of Equalization

Its Tobacco Tax Enforcement Efforts Are Effective and Properly Funded, but Other Funding Options and Cost Savings Are Possible

Report 2015-119

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California State Auditor

Elaine M. Howle State Auditor
Doug Cordiner Chief Deputy

March 1, 2016 2015-119

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 requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning the costs of the Cigarette and Tobacco Products Tax Program (tax program) and the Cigarette and Tobacco Products Licensing Program (licensing program) administered by the State Board of Equalization (board). Excise taxes on cigarettes and tobacco products fund early childhood development, smoking prevention, and environmental programs, among others. The board's tax and licensing programs collect and enforce these excise taxes.

This report concludes that although the board's enforcement efforts are effective and properly funded, other funding options and cost saving measures exist for the licensing program. In 2004 the board implemented the licensing program and began licensing all entities involved in the sale of cigarette and tobacco products in California, with a goal to inspect annually 10,000 of these licensees. In 2005 the board's tax program put into use an encrypted cigarette tax stamp. According to the board's most recent estimate, in fiscal year 2012–13 the board's three-part approach to enforcing compliance with California's cigarette and tobacco products excise tax laws—licensing, inspections, and an encrypted cigarette tax stamp—prevented the loss of $91 million in tobacco tax revenue.

In addition to using an encrypted tax stamp, the requirement that retailers, distributors, wholesalers, manufacturers, and importers of cigarettes and tobacco products be licensed is a fundamental component of the board's enforcement effort. However, since fiscal year 2006–07, license fees have not covered all of the licensing program's costs. For example, in fiscal year 2014–15 licensing fees contributed only $1.8 million of the $9.8 million needed to administer the program. To make up the program's $8.0 million shortfall, the board uses money from the four funds that receive cigarette and tobacco products taxes. Although it is legally permissible to use excise taxes to fund the licensing program, the board has accumulated an excess amount of unspent license fees that it could use to offset the shortfall. Furthermore, there are several options to address the licensing program's funding shortfall, eliminate the excessive unspent license fees, and maximize the funding for the programs of three of the four tobacco tax funds that support the licensing program. These options include a combination of retailer, wholesaler, and distributor license fee changes and increases, as well as a cigarette tax increase.

Finally, the board's method for identifying costs associated with each program is reasonable; however, it incorrectly derived some of its time charges which are the basis of some of its cost allocations. As a result, there was a misallocation of costs among the board's programs, which we were not able to quantify. Also, because of a decline in the number of licensees, we estimate the board could save $360,000 annually by conducting the same frequency of inspections as it did when it set up the licensing program. We believe conducting fewer inspections would not compromise excise taxes enforcement outcomes.

Respectfully submitted,

Elaine M. Howle

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Summary

Results in Brief

Cigarettes and tobacco products are subject to various federal, state, and local taxes and fees, including excise taxes—taxes on the sale or consumption of these products—which provide funds for early childhood development, environmental, and other programs. The California State Board of Equalization (board) administers the collection and enforcement of these excise taxes through its Cigarette and Tobacco Products Tax and Licensing Programs (tax and licensing programs). The board's most recent estimate is that in fiscal year 2012–13 the State lost $214 million in excise tax revenue for cigarettes and tobacco products due to the evasion of these taxes by consumers, retailers, wholesalers, and distributors. According to the board's economists, however, the board's efforts to stop such tax evasion prevented the State from losing an additional $91 million in tobacco tax revenue that year.

Since 2004 and 2005 the board has used a three-part approach involving licensing, an encrypted cigarette tax stamp, and inspections to enforce compliance with excise tax laws in California. Of the four states that we surveyed, two have a similar three-part enforcement approach to California. However, unlike the four states we surveyed and most others, California uses an encrypted tax stamp for cigarettes—while most of the other states use a lower-technology unencrypted cigarette tax stamp with traditional security features instead. The board adopted an encrypted tax stamp in 2005, as required by law. According to the board, to date the tax stamp's encrypted digital signature has never been successfully counterfeited. Following these improvements, inspectors found that instances of stamp counterfeiting leading to tax evasion declined by 94 percent and have remained very low.

In addition to using an encrypted tax stamp, the requirement that retailers, distributors, wholesalers, manufacturers, and importers of cigarettes and tobacco products be licensed is a fundamental component of the board's enforcement efforts. However, the fees charged for the licenses do not cover all of the licensing program's costs. For example, in fiscal year 2014–15 the licensing program received about $1.8 million mostly from license fees, but the program cost more than $9.8 million to administer. As a result, the licensing program had a funding shortfall of roughly $8.0 million that fiscal year, and has experienced annual funding shortfalls since fiscal year 2006–07. To make up the program's funding shortfall, the Legislature approved a budget change proposal in fiscal year 2006–07 to appropriate funds from the four funds that receive taxes from cigarette and tobacco products. The board splits the shortfall among these four tax funds

Audit Highlights . . .

Our audit concerning the costs to administer the Cigarette and Tobacco Products Tax Program (tax program) and Cigarette and Tobacco Products Licensing Program (licensing program) by the State Board of Equalization (board) revealed the following:

- *The methods used by the board to enforce compliance with excise tax laws for cigarettes and tobacco products prevented the loss of $91 million in tobacco tax revenue.*
- *The fees charged for licenses do not cover all of the licensing program's costs, resulting in an $8 million shortfall a year.*
- *The licensing program's compliance fund has accumulated an excess balance that the board could use to offset the licensing program's costs.*
- *Options exist to make the licensing program self-supporting that include a combination of retailer, wholesaler, and distributor license fee changes and increases, as well as a cigarette tax increase.*
- *The board's method for identifying costs associated with each program appears to be reasonable, but its allocation of some of these costs is flawed.*
- *A reduction in the number of inspections for the licensing program could result in an annual savings of more than $360,000 for the board with no sacrifice in effectiveness.*

in proportion to how much cigarette tax revenue they receive. The practical effect of using these four funds to offset the $8 million shortfall is that the administrators of those funds are not able to provide the level of services or activities that they otherwise would have, absent the need to make up the licensing program's funding gap.

Even though the licensing program has a continuing funding shortfall, as of June 2015 it had accumulated more than $9 million in revenue from license fees, which are maintained in the Cigarette and Tobacco Products Compliance Fund (compliance fund), that it could use to offset the costs of the licensing program and reduce its shortfall. According to the board, the balance in the compliance fund steadily grew from $1 million in fiscal year 2006–07 to almost $9 million in fiscal year 2014–15 due to various factors, including underestimating revenues and an almost $3 million fund balance increase due to an accounting adjustment by the Department of Finance. According to best practice guidance for government finance, a reasonable fund balance would equate to two months' worth of operating expenditures, or $1.6 million using the licensing program's fiscal year 2014–15 expenditures, leaving the remainder, $7 million, as excess license fee revenue.

Although it is legally permissible to use tobacco taxes to fund the licensing program, options exist to make the program self-supporting. These options include a combination of retailer, wholesaler, and distributor license fee changes and increases, as well as a cigarette tax increase. For example, the cigarette and tobacco products retailers' one-time licensing fee of $100 could be changed to an annual fee of $170 for five years and then increase to $215 annually thereafter. During the first five years of this fee increase, the $7 million in excess license fees collected over the past several years could be used to delay the eventual fee increase to $215, which is the annual amount necessary to make the licensing program self sufficient. Another way to finance the licensing program could be accomplished through a combination of raising the license fees paid by cigarette and tobacco products retailers, wholesalers, and distributors; using the excess license fees that the board has collected; and increasing the cigarette tax. The final option would be to increase the cigarette tax, which would allow for a smaller increase in the annual retailer license fee—an increase to $180 rather than the $215 per year proposed in the first option—and could be a reasonable option to make the licensing program self-supporting because California currently has one of the lowest cigarette tax rates in the nation, at 87 cents per pack of 20 cigarettes.

The board's method for identifying costs associated with each program appears to be reasonable, but its allocation of some of these costs is flawed. Although our testing determined that the types of operating costs the board charged to the tax program and licensing program were appropriate, we noted problems with the basis it uses to allocate some of its costs. Specifically, the board uses the percentage of time that staff in two of its divisions work directly on a particular program to allocate personnel and some of its operating costs. However, the board's Special Taxes Policy and Compliance Division (special taxes division) did not use supervisor and support staff's actual time charges to make cost allocations, and some staff in the Investigations and Special Operations Division (investigations division) were using a predetermined, outdated, and discontinued time allocation method from 2005. As a result, allocated payroll costs and any other operating cost allocations based on those time charges were not accurate.

Finally, the cost of the third part of the board's excise tax enforcement approach, inspections, could be reduced. Specifically, because of the decline in the number of licensees, we believe the board could reduce the number of annual inspections it currently conducts of retailers, wholesalers, and distributors of cigarette and tobacco products in the state without diminishing its ability to enforce the excise tax. The number of cigarette and tobacco product licenses held by retailers, wholesalers, and distributors has declined by 8 percent, from 39,150 to 35,894, since the board's licensing program began conducting annual inspections of licensed entities in fiscal year 2005–06. We estimate the board may be able to conduct over 800 fewer inspections each year while maintaining the same frequency of inspections that it initially conducted in fiscal year 2005–06. Such a reduction in the number of inspections could result in annual savings of more than $360,000.

Recommendations

To make the board's licensing program self-supporting, the Legislature should consider passing legislation to implement a funding model that would include a license fee increase or a combination of license fee increases, continued use of money from the Cigarette Tax Fund, and a cigarette tax increase similar to one of the proposed options outlined in this report.

Unless the Legislature directs the board to eliminate the compliance fund's excess fund balance within a time frame of more than a year, the board should eliminate the excess fund balance by June 30, 2017 by using it to offset the licensing program's annual funding shortfall.

Also, in the future, the board should limit the fund's balance to no more than two months' worth of licensing program's operating expenditures.

The special taxes division should amend its budgeting process to ensure that it reflects actual work that supervisors and support staff perform instead of adjusting these staff members' predetermined allocations of time to ensure that the division does not exceed each program's budget.

The investigations division should ensure that investigators charge their time according to division policy and determine a method to more accurately allocate investigators' time instead of using a predetermined method established in 2005 and since discontinued.

To reduce the licensing program's enforcement costs without compromising the level of compliance with the cigarette and tobacco products tax law that the inspection program has produced, the board should reduce the number of inspections and reinspections of retailers, distributors, and wholesalers it conducts each year.

Agency Comments

The board agreed with all but one of our recommendations. Specifically, the board does not believe that it is economically feasible to implement one of our recommendations and contends that its current approach to allocating staff time is the most equitable.

Introduction

Background

Cigarettes and tobacco products are subject to various federal, state, and local taxes and fees. In addition to charging a sales tax, California imposes on cigarettes and tobacco products certain excise taxes, which are taxes on the use or consumption of particular goods. As of January 1, 2016, California imposes an 87-cent excise tax on each pack of 20 cigarettes and an excise tax of 28.13 percent of the wholesale cost of tobacco products, which include chewing tobacco, smoking tobacco, and other products containing at least 50 percent tobacco.[1] Distributors of cigarettes and tobacco products pay these taxes and usually pass these costs on to their consumers. As Figure 1 on page 7 shows, most of the revenue from these excise taxes, which totaled $835 million in fiscal year 2014–15, is allocated to the State's General Fund and programs established by two voter-approved propositions: Proposition 99, passed in 1988 to provide funding for certain environmental programs as well as for tobacco-related health programs; and Proposition 10, passed in 1998 to fund early childhood development and smoking prevention programs.

The sales of cigarettes for which distributors have paid the excise tax have steadily declined over time, as Figure 2 on page 8 shows. This decline is primarily due to fewer people smoking. According to a report by the California State Board of Equalization (board), higher prices are one of the factors causing the downward trend in the number of cigarette packs sold. The report concludes that higher tax rates are usually passed on to consumers as higher prices. As Figure 2 shows, tax revenue spiked after Proposition 99 and Proposition 10 increased the excise tax by 25 cents and 50 cents per pack, respectively. However, revenue has steadily declined since fiscal year 2000–01, following when the excise tax was last increased, and this decrease in revenue parallels the ongoing decline in cigarette packs sold. Evasion of the excise tax is another possible reason for declines in revenue. The cigarette packs sold depicted in Figure 2 do not include untaxed cigarette packs or those for which distributors evaded the excise tax.

The board administers the excise taxes on cigarettes and tobacco products, performs such administrative functions as processing tax returns for distributors of cigarettes and tobacco products, and supplies cigarette distributors with tax stamps that they must affix to every package of cigarettes. State law requires that each pack of cigarettes have an encrypted tax stamp affixed to it; the stamp indicates that the distributor has paid the cigarette tax. The board's

[1] This tax rate was effective on July 1, 2015, and is for fiscal year 2015–16.

collection of cigarette and tobacco product excise taxes and other administrative efforts constitute the board's Cigarette and Tobacco Products Tax Program (tax program). In addition to administering the tax program, the board also enforces tax payment through its retail inspections, criminal investigations, civil audits—specialized audits that provide supporting documentation for the prosecution of criminal cases of tax evasion—and other enforcement activities. Generally, the board's Investigations and Special Operations Division (investigations division) performs these enforcement activities. The Department of Justice helps the board prosecute tax evasion cases, and the Office of the Attorney General assists the board in enforcing tax payment on cigarette and tobacco products sold via other means, such as on the Internet, by telephone, and through mail orders.

Evasion of Tax Payments on Cigarettes and Tobacco Products

The board estimates that in fiscal year 2012–13, the State did not collect $214 million in tax revenue because sellers and consumers failed to pay required excise taxes on cigarettes and tobacco products. Retailers that purchased and sold cigarettes that lacked encrypted stamps or that purchased and sold other untaxed tobacco products are responsible for $198 million of the estimated $214 million in unpaid taxes. According to the board, consumers evaded an estimated $16 million in excise taxes by buying cigarettes and tobacco products in another state and transporting them back into California as well as by purchasing cigarette and tobacco products from another state or country on the Internet or by mail. According to the U.S. Government Accountability Office, illicit trade in cigarettes and tobacco occurs because it offers high rewards and low risks compared to crimes with high penalties, such as smuggling drugs. The investigations division reports that retailers who evade the excise tax can gain in two ways: They can increase their profit margins by selling untaxed cigarettes and tobacco products at the regular, taxed price, or they can pass the savings from their untaxed products along to their consumers in order to undercut the retailers' competition and increase their market share. In either case, the State does not receive excise tax revenue from those products. The text box lists several types of evasion of the taxes on cigarettes and tobacco products that take place in California.

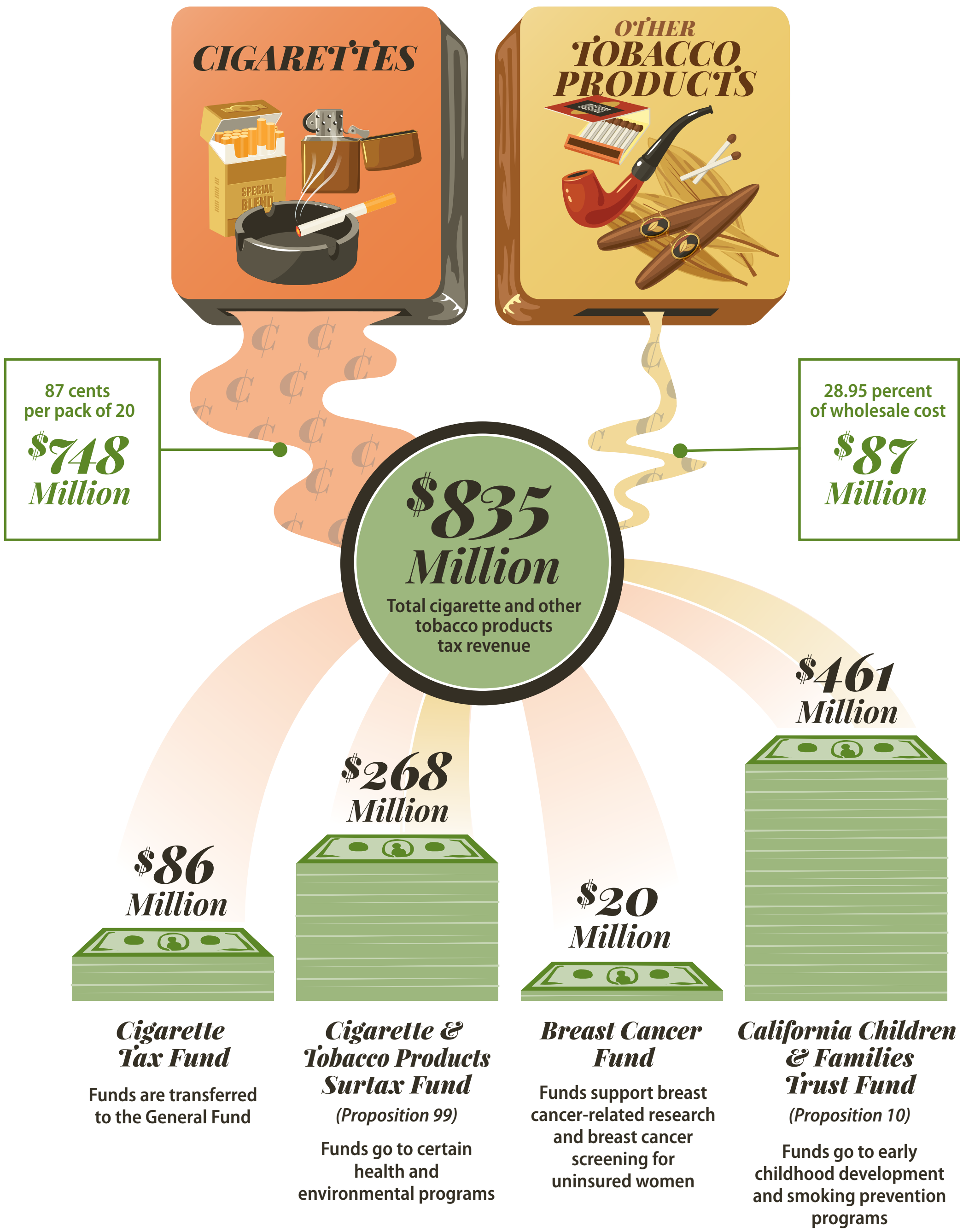
Types of Activities Used to Evade Cigarette and Tobacco Products Taxes in California

Excise tax evasion through the illegal sale of untaxed cigarettes and other tobacco products takes many forms in California, including the following:

- Distributing untaxed tobacco products and cigarettes, including cigarettes bearing counterfeit, reused, or out-of-state tax stamps or cigarettes without a stamp.
- Purchasing untaxed products over the Internet or by mail order from out-of-state suppliers.
- Purchasing untaxed cigarettes and tobacco products from Indian tribal retail establishments by individuals who are not tribal members.
- Hijacking trucks transporting tobacco products and stealing unstamped and stamped domestic cigarettes.
- Establishing companies under false pretenses to acquire and distribute untaxed cigarettes and tobacco products. These companies typically vanish upon detection or selection for audit.

Source: Fiscal year 2013–14 *Investigations Division Annual Report*, State Board of Equalization.

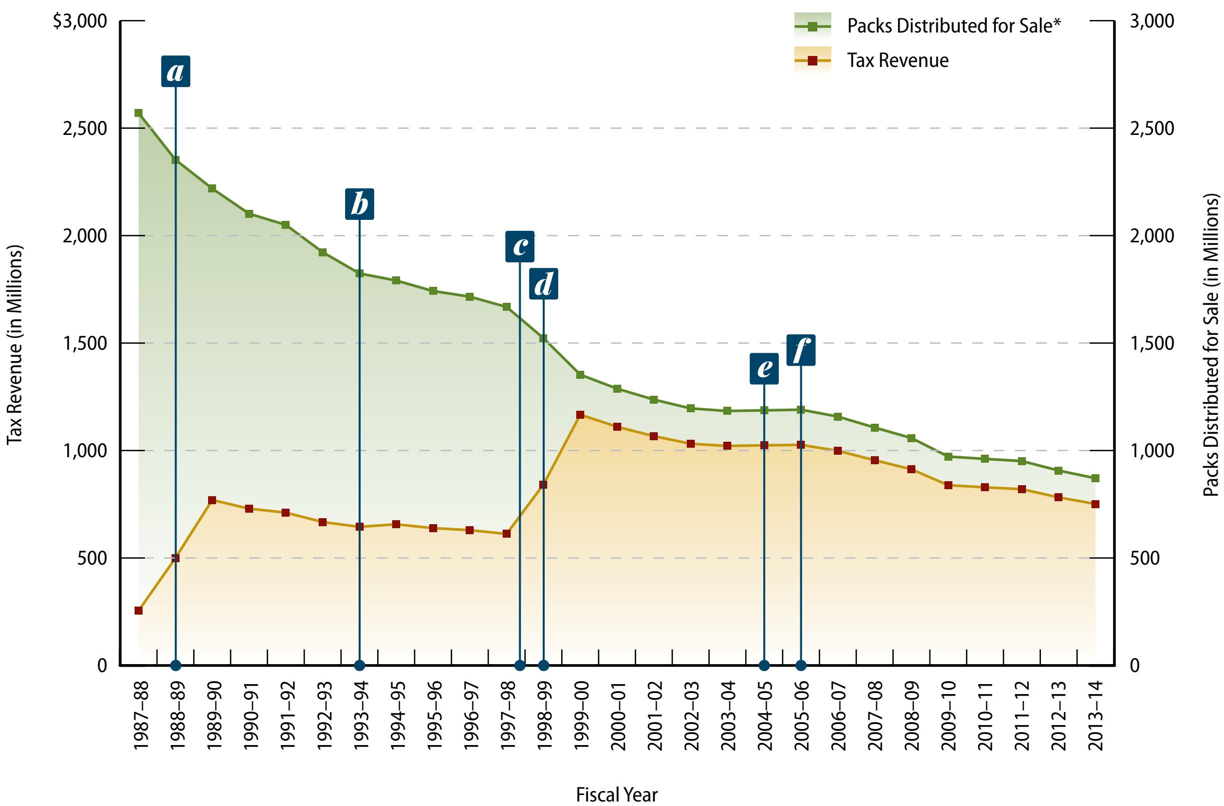
Figure 1
California's Revenue From Taxes on Cigarettes and Other Tobacco Products During Fiscal Year 2014–15



Sources: Publication 93; *Cigarette and Tobacco Products Taxes*, June 2015, by the State Board of Equalization (board); the Department of Finance's *Manual of State Funds*; Revenue and Taxation Code and Health and Safety Code; and documentation provided by the board's accounting branch.

Note: Of the $835 million of taxes collected on cigarettes and other tobacco products in fiscal year 2014–15, the board used $30 million to pay for the administration, collection, and enforcement of these taxes. Each fund paid a share of this cost mostly in proportion to its share of the total taxes collected. Refer to Table A2 in the Appendix for additional information. The other tobacco product tax rate of 28.95 percent was in effect for fiscal year 2014–15.

Figure 2
While Cigarette Tax Revenue Has Increased, the Number of Cigarette Packs Distributed for Sale Has Declined



Sources: The State Board of Equalization (board) Annual Report, fiscal year 2013–14; California Debt and Investment Advisory Commission's report titled *Issue Brief Tobacco Securitization Bond Issuance in California*; and state law.

Note: Cigarette taxes were first imposed on July 1, 1959, at 3 cents per pack, and by October 1, 1967, the cigarette tax had increased to 10 cents per pack until January 1, 1989.

a) On January 1, 1989, the cigarette tax increased by 25 cents per pack (Proposition 99).

b) On January 1, 1994, the cigarette tax increased by 2 cents per pack.

c) In 1998 California entered into the Master Settlement Agreement with tobacco manufacturers to settle lawsuits for damages related to the health effects of smoking.

d) On January 1, 1999, the cigarette tax increased by 50 cents per pack (Proposition 10).

e) On January 1, 2004, the Cigarette and Tobacco Licensing Act went into effect.

f) On January 1, 2005, the requirement to use an encrypted tax stamp for cigarettes became effective.

* Does not include the distribution of tax-exempt cigarettes, which were 2 percent of all packs distributed in fiscal year 2013–14.

California's Participation With Tobacco Companies in the Master Settlement Agreement for Damages Related to Smoking

In 1998 California and 45 other states entered into an agreement with the four largest tobacco manufacturers to settle a number of lawsuits against the manufacturers for damages related to the negative health effects of smoking. This agreement, known as the Master Settlement Agreement (MSA), imposes multiple obligations on participating tobacco manufacturers, including a requirement to make annual payments to each settling state in perpetuity. Annual MSA payments to California over the last five years have averaged a little more than $800 million per year, and the State has received a total of nearly $13.4 billion from 1999 through April 2015. One-half of this amount goes to local governments, while the other half goes to the State. In the past, to balance the budget, the State borrowed against its share of this payment stream by selling bonds. The State has pledged 100 percent of its share of settlement revenue to repay bondholders. As of 2014 the State still owed $18.4 billion on these bonds.

Although many tobacco manufacturers have agreed to participate in the MSA, some have not. Because they are not subject to the payments and other requirements, manufacturers that are not party to the MSA (nonparticipating manufacturers) could obtain a competitive advantage over the participating manufacturers. Therefore, the MSA provides that, in order to receive full payment, settling states must enact laws requiring the nonparticipating manufacturers to make payments to the states based on those manufacturers' cigarette sales. Moreover, the settling states are obligated to diligently enforce these payment requirements by tracking all cigarettes sold within the states. If a state does not diligently enforce payments by nonparticipating manufacturers, participating manufacturers can seek to lower their payments through arbitration.

Cigarette and Tobacco Products Tax Enforcement

To ensure compliance with the MSA and decrease tax evasion, between January 2004 and June 2006 the board implemented two statutes—the Cigarette and Tobacco Products Licensing Act of 2003 (licensing act), which became effective on January 1, 2004, and another bill related to the cigarette tax stamp, which became effective on January 1, 2005. The licensing act expanded to retailers, manufacturers, and importers an existing statutory requirement for each wholesaler and distributor to obtain a license to sell cigarettes and tobacco products. The licensing act also created additional enforcement powers for the board, established additional penalties—including fines, imprisonment, and seizure of untaxed products—for distributors that engage in tax evasion activities, and appropriated $11 million from the Cigarette and Tobacco Products Compliance Fund to the board for the purpose of implementing the act. The board created the Cigarette and Tobacco Products Licensing Program (licensing program), which implements, enforces, and administers the licensing act through such activities as processing license applications and each year performing approximately 10,000 inspections of licensees, which are primarily retailers.

The second piece of tax enforcement-related legislation required the board to replace the existing cigarette tax stamp by January 1, 2005. The new stamp had to be readable by a scanning device and bear encrypted information, such as the name and address of the distributor affixing the stamp. According to the investigations division chief, switching from a traditional paper stamp to a high-technology stamp with a hidden encrypted serial number has made authenticating cigarette tax stamps easier and more effective. According to the acting chief of the Special Taxes Policy and Compliance Division (special taxes division), the board does not use a tax stamp for tobacco products, such as chewing tobacco, because the law instead requires distributors to pay taxes on tobacco products by filing a tax return along with a remittance. During their inspections, investigations division inspectors verify tax payments for tobacco products when the inspectors reconcile purchase invoices to the retailers' inventories.

The board's economist estimates that evasion of taxes on cigarette and tobacco products would be much higher each year without these enforcement improvements. For fiscal year 2012–13, the most recent estimate available, the economist believes that evasion of the excise taxes would have been $91.3 million more than the $214 million in evaded taxes that the economist quoted for that year. The economist also estimates that evasion of an additional $44.4 million in state and local sales and in use taxes would have occurred were it not for the compliance improvements.

The retail license requirement, the encrypted cigarette tax stamp, and the inspections of retailers work together to ensure compliance with the excise tax requirements. Each of these three elements of cigarette and tobacco product tax enforcement is distinct yet interdependent. The requirement that retailers obtain licenses allows the board to identify retailers who sell cigarettes and tobacco products that investigations division inspectors must inspect for tax compliance. In addition, penalties for selling cigarettes without a retail license provide both an incentive for retailers to comply with the licensing requirement and a means for the board to enforce the requirement. According to the investigations division chief, the encrypted information within the tax stamp enables inspectors using scanners in retail stores to validate legitimate stamps immediately and to identify counterfeit ones even when those stamps appear visually identical to the real California tax stamp. Finally, inspections of retailers help prevent retailers from simply selling cigarettes illegally with no stamps or with counterfeit stamps. Similarly, such inspections also discourage retailers from selling tobacco products without paying the excise and other taxes.

Sources of Funding for the Board's Tax and Licensing Programs

License fees and penalties as well as cigarette and tobacco products taxes are the primary sources of funding for the licensing program. As the text box shows, the act that helps fund the licensing program imposes various fees on the companies involved in the sale of cigarettes and tobacco products in California.

> **License and Administrative Fees on Cigarettes and Other Tobacco Products That the Board Collects and Uses to Help Pay for Its Licensing Program**
>
> Retailer—$100 one-time license fee to sell cigarettes and other tobacco products.
>
> Distributor and wholesaler—$1,000 annual license fee to distribute or sell cigarettes and other tobacco products.
>
> Manufacturer and importer of chewing tobacco or snuff—one-time license fee of $10,000.
>
> Manufacturer and importer of tobacco products, including cigarettes but excluding chewing tobacco or snuff—one-time license fee of $2,000.
>
> Cigarette manufacturer or importer—one-time administrative fee based on its respective market share of cigarettes manufactured or imported and sold in California during the next calendar year.
>
> Source: California Business and Professions Code.

These fees brought in about $1.8 million in fiscal year 2014–15. However, the licensing program's costs for the same period were more than $9.8 million, leaving a shortfall of roughly $8.0 million between the licensing program's revenue and its costs. The board's licensing program costs first exceeded available funding in fiscal year 2006–07, and shortages have occurred in every subsequent year. To cover this ongoing funding shortfall, the board imposes a charge against each fund that receives cigarette and tobacco tax revenue. Specifically, each fund covers a portion of the shortfall that is roughly equivalent to the proportion of all revenue from cigarette and tobacco products taxes that the fund receives.

Unlike the licensing program, which covers some of its costs with license fees and penalties, the tax program is funded entirely by cigarette and tobacco products taxes. Its costs in fiscal year 2014–15 were $22.4 million. Similar to the licensing program, the tax program has its costs spread across each of the four funds receiving cigarette and tobacco products taxes, with each fund paying a share of costs that is roughly in proportion to its share of total excise tax revenue. More than one-third of the tax program's costs are for the encrypted cigarette tax stamp, which is one facet of the board's tobacco tax enforcement efforts. The Appendix shows additional detail on both programs' expenditures and funding sources over the past five fiscal years.

Overview of the Board's Methods for Allocating Costs

The board does not have dedicated staff for either the tax or the licensing program. Instead, the special taxes division manages program area work, such as processing license registrations, processing tax returns and billings, handling appeals and refunds, and providing tax advice. Both the staff of the special taxes division, which conducts tax audits, and the staff of the investigations division, which performs enforcement and compliance activities, work on the tax and licensing programs. Additionally, staff of these two divisions conduct activities related to the 27 other tax and fee programs that the board administers.

The board allocates in several ways the direct and indirect program costs for all programs, including the tax and licensing programs. For direct personnel service costs, the board allocates these costs based on the percentage of hours that staff in each division work directly on a particular program; the board uses the average pay for each different personnel classification. The board also allocates direct operating expense and costs using the percentage of hours that staff from each division directly charge to each program. Additionally, the board allocates costs of several indirect support units—including those related to technology, legal, and cashier services—based on actual use. For example, the cashier unit costs are allocated to programs based on the number of transactions the unit processes for each program. Further, after calculating each program's share of direct and indirect unit costs, the board allocates what it refers to as distributed administration, which includes costs for accounting, human resources, and any other units that support the board as a whole. Each program is allocated a portion of distributed administration based on a program's overall share of direct and indirect costs. Finally, the board distributes its share of the costs of the centralized administrative services provided to all state agencies and departments, known as pro rata costs, to its programs in proportion to the programs' funding levels.

Scope and Methodology

The Joint Legislative Audit Committee (audit committee) directed the California State Auditor's Office to perform an audit of the costs to administer the board's tax and licensing programs. Table 1 includes the audit objectives that the audit committee approved and the methods we used to address them.

Table 1
Audit Objectives and the Methods Used to Address Them

AUDIT OBJECTIVE	METHOD
1. Review and evaluate the laws, rules, and regulations significant to the audit objectives.	We reviewed relevant laws, regulations, and other background materials applicable to California's cigarette and tobacco products taxes.
2. Review the policies of the State Board of Equalization (board) as well as its procedures and practices for identifying tax program versus licensing program costs to ensure the following: a. Compliance with all relevant laws, rules, and regulations. b. The reasonableness of costs and staffing allocated to each program.	We reviewed relevant administrative policies, procedures, and practices, and interviewed budget and accounting staff. We evaluated the board's cost allocation plan by selecting expenditures and time charges, and determining whether they adhered to the plan and to other board policies and practices for allocating costs.

AUDIT OBJECTIVE	METHOD
3. For the past five fiscal years, determine the sources and amounts of funding used by the licensing program and whether this funding is consistent with applicable laws.	We obtained documentation from the board to determine the sources and amounts of funding used by the licensing program. We also reviewed applicable laws and determined that the funding was consistent with applicable laws.
4. Review and evaluate the board's approach for determining how to effectively and efficiently manage the tax and licensing programs while maximizing the revenue generated by tobacco excise taxes and the Master Settlement Agreement. To the extent possible, recommend other methods to further reduce administrative costs.	We interviewed board staff that manage the licensing and tax programs. We evaluated outcomes of the licensing program, such as seizures of cigarettes and other tobacco products during inspections, and we evaluated the frequency of inspections of cigarette and tobacco products retailers.
5. Determine whether the current level of funding is reasonable to maintain the tax and licensing programs' effectiveness and whether funding and resources are being used for other purposes. To the extent possible, determine what a selection of other states is doing to enforce those states' cigarette and tobacco programs.	We evaluated the effectiveness of the tax and licensing programs in the course of addressing objectives 1 through 4. Further, when we determined the sources and amounts of funding used by the licensing program, we also determined that those funds were not being used for other purposes. We interviewed chief investigators and tax administrators involved in cigarette and tobacco products tax enforcement in four other states to determine the enforcement methods that they use and compared these methods to those of California. We selected four states that share one or more of the following characteristics with California: a large population, an international border, or a location in the West.
6. Review and assess any other issues that are significant to the audit.	We did not find any other issues relevant and significant to this audit.

Sources: The California State Auditor's analysis of Joint Legislative Audit Committee audit request 2015-119 and information and documentation identified in the table column titled *Method*.

Assessment of Data Reliability

In performing this audit, we relied on data from the information systems listed in Table 2 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 2 describes the analyses we conducted using data from these information systems, our methodology for testing them, and the result of our assessment which is, the data is not sufficiently reliable for our audit purposes. Although this determination may affect the precision of the numbers we present, there is sufficient evidence in total to support our audit findings, conclusions, and recommendations.

Table 2
Methods Used to Assess Data Reliability

INFORMATION SYSTEM	PURPOSE	METHOD AND RESULT	CONCLUSION
State Board of Equalization (board) Revenue and cost allocations databases and spreadsheets for fiscal years 2010–11 through 2014–15	• Determine the reasonableness of the costs the board allocated to the Cigarette and Tobacco Products Tax and Licensing programs (tax and licensing programs) for fiscal year 2014–15. • Determine the source and amounts of funding the board used to pay the tax and licensing programs' costs and determine whether the board used this funding for purposes other than the tax and licensing programs.	We obtained data related to the board's tax and licensing programs' expenditures and funding sources from a series of Microsoft Access databases (Access) and Excel spreadsheets (Excel). The board uses computer code written in Access and Excel to allocate its tax and licensing programs' costs and revenues. Due to the complexity of the calculations related to these allocations, we determined that it was cost prohibitive to perform a review of these allocations. However, to gain some assurance of the accuracy of the tax and licensing program expenditures, we tested a selection of fiscal year 2014–15 expenditures and hours worked. We also analyzed the board's cost allocation plan. We found that the operating expenditures were reasonably allocated. As discussed in the Audit Results on page 24, we determined that some of the hours worked—which the board uses as a basis for allocating costs—were not accurate. Further, to assess the completeness of fiscal year 2014–15 financial records, we reviewed the tax and licensing programs' combined total expenditures and revenues from each cigarette and tobacco tax fund. The funds we reviewed included the Cigarette Tax Fund, the Breast Cancer Fund, the Cigarette and Tobacco Products Surtax Fund, and the California Children and Families Trust Fund. For each of these funds, we compared fiscal year 2014–15 financial statement records with documentation from the State Controller's Office (controller). We found that the amounts reported by the board reconciled to the controller's records.	Not sufficiently reliable for these audit purposes. Although this determination may affect the precision of the numbers we present, there is sufficient evidence in total to support our audit findings, conclusions, and recommendations.

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

Audit Results

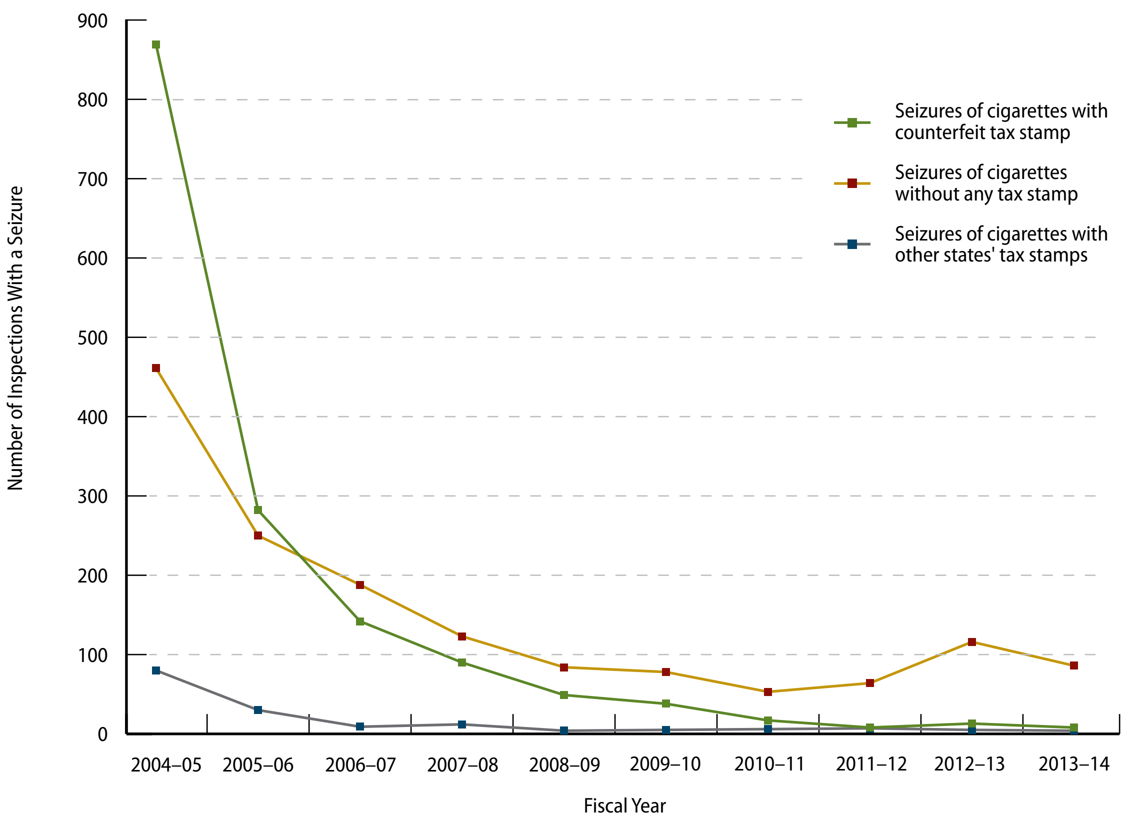
The State Board of Equalization Has Substantially Reduced Cigarette and Tobacco Products Tax Evasion With Methods Similar to Those of Other States

The methods used by the State Board of Equalization (board) to enforce compliance with excise tax laws for cigarettes and tobacco products have reduced significantly levels of tax evasion in the retail marketplace that were previously high. The board uses a three-part approach to enforcement: the board licenses all entities that sell cigarettes and tobacco products, it uses a digital signature in an encrypted tax stamp for packs of cigarettes, and it inspects retailers, distributors, and wholesalers that sell cigarettes and tobacco products. The board began using the encrypted tax stamp in 2005, and for fiscal year 2004–05 it reported that 869 inspections resulted in a seizure of cigarettes with counterfeit stamps. However, without altering the number of inspections, the number of instances in which inspectors found cigarettes with counterfeit stamps declined to 49 by fiscal year 2008–09, a 94 percent decrease—and it has remained low. Because the Cigarette and Tobacco Products Tax Program (tax program) and the Cigarette and Tobacco Products Licensing Program (licensing program) each help to enforce retailer compliance with tax laws, both programs are responsible for these improvements in retailer compliance. Finally, the board generally uses the same basic enforcement methods as two of the four other states we surveyed, although California is unique in its use of an encrypted tax stamp on cigarette packages.

Licensing, the Encrypted Tax Stamp, and Inspections Constitute an Enforcement Approach That Has Substantially Reduced Tax Evasion

In 2004 the board began licensing all entities involved in the sale of cigarette and tobacco products, including retailers, distributors, and wholesalers, and inspecting roughly 10,000 of these entities' licensed locations each year as a part of implementing the Cigarette and Tobacco Products Licensing Act of 2003 (licensing act). Another law that took effect in 2005 required the board to add an encryption security feature to the cigarette tax stamp. In addition to serving as an enforcement mechanism, the tax stamp provides a means for the collection of tax payments for cigarettes in California; distributors pay the tax and affix a stamp to every pack of cigarettes they sell to wholesalers and retailers. Before 2004 the board was finding instances of retailers selling cigarette packages that lacked tax stamps, had tax stamps from other states, or had counterfeit stamps. However, after the board initiated annual inspections of roughly one-quarter of all licensed locations, of which 97 percent are retail locations, and required distributors to affix the encrypted tax stamp to cigarette packs, the board observed a significant and sustained decline in all forms of tax evasion. In fact, by fiscal year 2008–09 the number of inspections in which the board seized cigarettes that had counterfeit tax stamps had declined by 94 percent, as Figure 3 indicates.

Figure 3
Inspections That Result in a Seizure of Cigarettes That Lack a California Tax Stamp Have Declined Significantly



Sources: Investigations reports and other documents prepared by the State Board of Equalization.

The tax program and the licensing program are each responsible for at least one piece of the board's approach to enforcing retailers' compliance with the excise tax law. The tax program provides an encrypted tax stamp for all packs of cigarettes, and the licensing program administers the retailer licensing requirement and the inspections of retailers. On its own, the encrypted tax stamp would not effectively deter tax evasion by retailers because without inspections to enforce the sale of legal, tax-paid products, retailers could simply sell untaxed products with little fear of being caught. However, the combined enforcement powers provided by the licensing process, the encrypted stamp, and the inspections have yielded compliance improvements. A licensing requirement helps the board identify all retailers in the state legally allowed to sell cigarettes and tobacco products; security features in tax stamps protect the integrity of the cigarette tax stamp from counterfeiting; and inspections provide the means for checking whether retailers are attempting to sell cigarettes with counterfeit stamps, no stamps, or stamps from other states.

The Board Uses Enforcement Methods That Are Generally Similar to Those of Other States

The board uses generally the same enforcement methods as those of other states we surveyed; one difference being that the board adopted an encrypted tax stamp in 2005 to comply with a state law intended to address an increase in the counterfeiting of cigarette tax stamps in California. As Table 3 shows, California and two of the four other states we surveyed use the following three enforcement methods: a licensing requirement for retailers, a cigarette tax stamp, and inspections of retailers.

Table 3
Enforcement of Sellers' Compliance with Taxes on Cigarette and Other Tobacco Products in California and Other States

ENFORCEMENT METHOD	CALIFORNIA	TEXAS	NEW YORK	ARIZONA	OREGON
License requirement for retailers	Yes	Yes	Yes	No	No
Cigarette tax stamp using encrypted, unique serialized numbers or traditional security features	Encrypted, unique serialized numbers	Traditional security features	Traditional security features	Traditional security features	Traditional security features
Approximate frequency of inspections*	3.6 years	3 years	*Not enough information to allow for a determination.*	1.3–1.7 years†	3.8 years

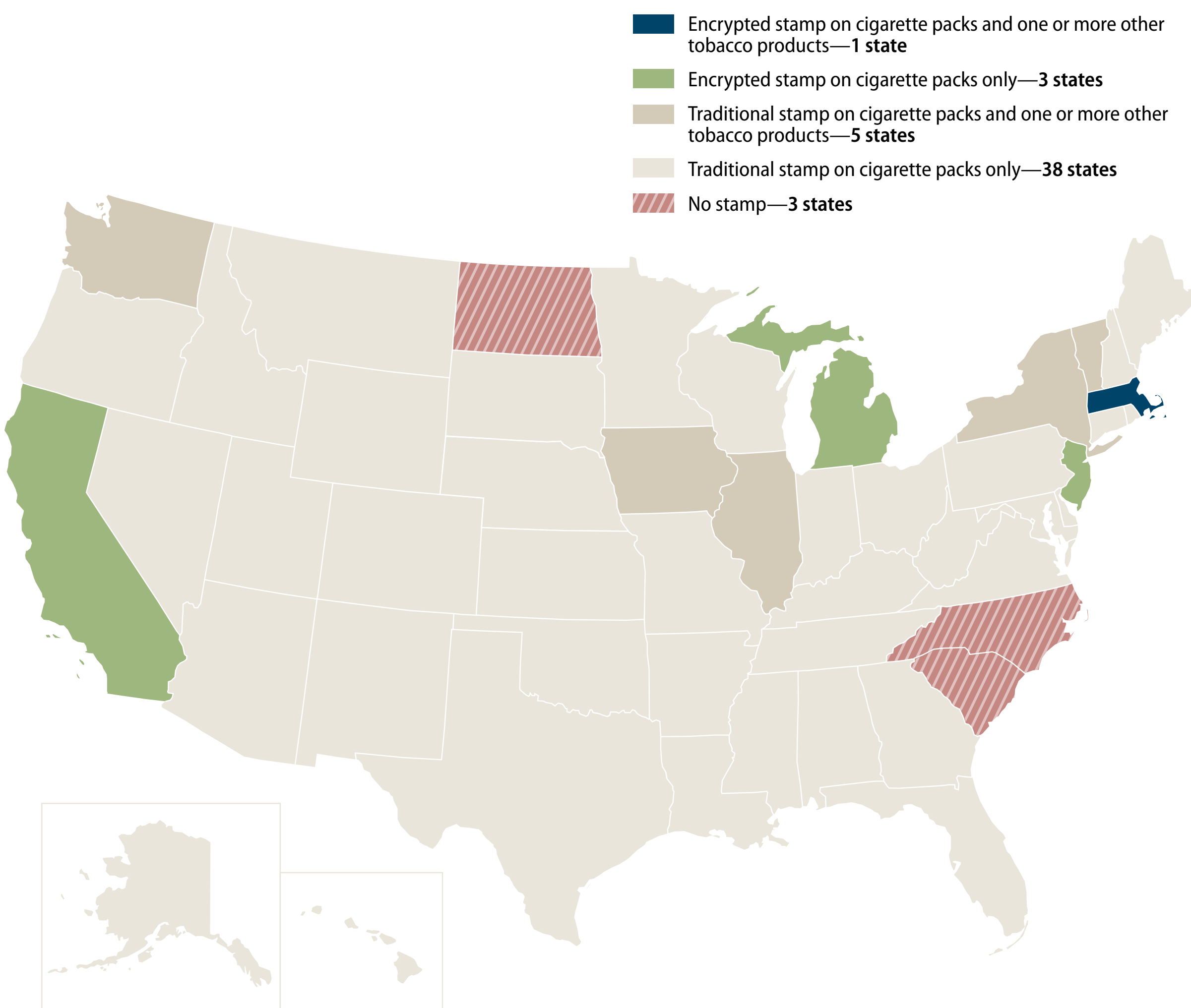
Sources: Interviews by the California State Auditor's Office with other states and its analysis of various sources.

* Average number of years between inspections. The average is derived using the total number of annual inspections and total number of entities inspected in the state. New York conducts inspections, but we were not given enough information to compute its frequency.

† This range of years reflects uncertainty in the total number of retailers. Because Arizona does not license retailers, only estimates of the total number of retailers are available.

Arizona and Oregon differ from California in that they do not license the retailers involved in the sale of cigarettes and tobacco products. As also shown in Table 3 on the previous page, none of the other states that we reviewed use an encrypted tax stamp; instead, these states have opted for unencrypted tax stamps employing traditional features. In fact, few other states in the country use encryption technology, as Figure 4 indicates.

Figure 4
The Different Types of Stamps Used by States to Tax Cigarettes and Other Tobacco Products



Source: Centers for Disease Control and Prevention report titled *Morbidity and Mortality Weekly Report*, Volume 60, Number 20, May 29, 2015.

A state law required the board to replace, by January 2005, California's existing cigarette tax stamp with a stamp containing encrypted information. The author of this legislation intended for the stamp to address a dramatic increase in counterfeiting that the board had reported. In contrast, according to Arizona's chief of investigations, Arizona has continued to use a traditional stamp partly because inspectors and investigators have not uncovered much counterfeiting. Similarly, the chief of investigations for Texas told us that he believes the incidence of counterfeit cigarette tax stamps in Texas is low. The two other states that we surveyed—New York and Oregon—cited the high costs of encryption and new equipment as reasons for continuing to use a traditional stamp on cigarette packs.

According to the board's chief of investigations, the encrypted stamp improves upon the previous tax stamp because it allows inspectors to more efficiently and reliably validate the authenticity of California's cigarette tax stamps and to identify counterfeit stamps during inspections. In addition, the chief of investigations stated that no one has successfully duplicated the encryption of the current tax stamp. The small number of counterfeit tax stamps that inspectors continue to find in retail stores are typically similar in appearance to authentic stamps, but inspectors can use their handheld scanners to determine immediately that the imitation stamps are counterfeit.

Although the Board May Fund the Licensing Program With Cigarette and Tobacco Products Taxes, It Has Accumulated an Excess Amount of Unspent License Fees

Although it is legally permissible to use cigarette and tobacco product taxes to fund the licensing program, the program's Cigarette and Tobacco Products Compliance Fund (compliance fund), into which the board deposits the program's license fees, fines, and penalties, has amassed a larger-than-necessary fund balance. This is particularly problematic because, under the current license fee structure, the licensing program does not generate enough revenue to cover all of its costs primarily because retailers, which make up 97 percent of the licensees, only pay a one-time license fee of $100. Nevertheless, there are options available to the Legislature to address this ongoing shortfall and make the licensing program self-supporting. These options would also enable the taxes that are now being used to fund the licensing program to fund the programs they were primarily intended to sponsor.

The licensing program does not generate enough revenue to cover all of its costs primarily because retailers only pay a one-time license fee of $100.

The Board Uses Money from Propositions 99 and 10 to Support the Licensing Program

The licensing program uses several million dollars a year of cigarette and tobacco products taxes to help fund its licensing program. Since fiscal year 2006–07 the licensing program has not generated sufficient revenue to cover its costs, so revenue from cigarette and tobacco products taxes pays for most of the licensing program's costs for inspections, licensing, and the program's other functions. As Table A1 beginning on page 31 of the Appendix shows, the licensing program's costs in fiscal year 2014–15 were more than $9.8 million. However, the program brought in only about $1.8 million from license fees and fines in that fiscal year, so the licensing program's revenue fell short of covering its costs by roughly $8.0 million.

Two of the four cigarette and tobacco product tax funds—those created by Propositions 10 and 99—covered 86 percent of the licensing program's shortfall in fiscal year 2014–15, amounting to $6.8 million.

In 2006 the board received approval for a budget change proposal to make up for the licensing program's funding shortfall by offsetting a portion of the revenue of the following four funds that receive revenue from taxes on cigarette and tobacco products: the Breast Cancer Fund, the Cigarette and Tobacco Products Surtax Fund, the California Children and Families Trust Fund, and the Cigarette Tax Fund. The board splits the shortfall among the four tax funds in proportion to how much cigarette tax revenue each receives. Two of the four cigarette and tobacco products tax funds—the two created by Propositions 99 and 10—covered 86 percent of the licensing program's shortfall in fiscal year 2014–15, amounting to $6.8 million. Propositions 99 and 10 require revenue to be deposited into specific funds and used for particular purposes, except for refunds and reimbursement of the board's expenses incurred in the administration and collection of these taxes. Although the licensing program itself does not directly collect taxes, its activities—including licensing, inspecting, auditing, and seizing of untaxed cigarettes and tobacco products—are integral functions of the administration and collection of these taxes. As a result, it is permissible to use money from these four funds to administer the licensing program. However, if other sources of revenue were used to fund the licensing program, the Legislature could increase the amount of funding that would go to programs funded by Propositions 99 and 10.

The Licensing Program's Compliance Fund's Excess Balance Could Be Used to Offset the Licensing Program's Future Costs

The compliance fund has accumulated an excess fund balance that the board could use to offset the licensing program's costs. According to the licensing act, all money collected—including license fees and license violation penalties and fines—must be deposited in the compliance fund, and it must be available only for the purpose of administering the licensing program. As of June 2015, the compliance fund had built a sizable fund balance, amounting to $8.9 million. According to the budget section manager, several factors contributed to the increase in the compliance fund's balance, including underestimating revenue; budgeting expenditures at levels significantly lower than estimated revenue; experiencing a large, unexpected drop in the fund's share of statewide apportioned costs; and, in fiscal year 2011–12, a special fund reconciliation by the Department of Finance that increased the fund balance by $2.8 million. Consequently, the balance steadily grew from $1.1 million in fiscal year 2006–07 to $8.9 million in fiscal year 2014–15. The budget manager noted that beginning in fiscal year 2014–15, the board planned to appropriate expenditures above estimated revenue until the fund balance is decreased to an appropriate level. In order to determine what might be a reasonable compliance fund balance, we consulted the guidelines published by the Government Finance Officers Association (GFOA). The GFOA's mission is to enhance and promote the professional management of government entities by identifying, developing, and advancing fiscal strategies, policies, and best practices for the public benefit. According to GFOA's guidelines, a reasonable fund balance for a general fund would be an amount equivalent to two months of operating expenditures, which in this case would be $1.6 million if the licensing program's expenditures for fiscal year 2014–15 were used. The remaining amount, $7.3 million, would be considered an excess fund balance.

Options Exist to Eliminate the Licensing Program's Funding Shortfall and Make the Program Self-Supporting

The Legislature has several options to address the licensing program's ongoing shortfall, eliminate the excessive fund balance of the compliance fund, and maximize the funding for the programs, such as breast cancer research and early childhood development, that tobacco taxes support. The options we outline later include the board's using one-fifth of the excess fund balance discussed in the last section over a five-year period to partially offset the license fee increase proposed in each alternative. Also, each option would support the licensing program with some money from one of the four tobacco tax funds, the Cigarette Tax Fund. All remaining money in the Cigarette Tax Fund would be transferred to the State's General Fund. Support from the Cigarette Tax Fund would be fixed at the amount that the fund contributed to the licensing program in fiscal year 2014–15 for the first two options. None of the options would change or increase the manufacturers' and importers' one-time license and administrative fees. These options assume program costs are stable and that the actual number of retailers, distributors, wholesalers, manufacturers, and importers remains the same, as the text box shows. However, if program costs increase or the number of businesses needing a cigarette and tobacco products license decreases, the Legislature may need to revisit the funding options.

Number of Entities With Licenses to Sell Cigarette and Other Tobacco Products as of July 2015

Retailers—35,020

Distributors—523

Wholesalers—351

Manufacturers and Importers—121

Source: State Board of Equalization report titled *Summary of Total Active Accounts by Location*, July 1, 2015.

Currently, state law requires cigarette and tobacco products retailers to pay a one-time licensing fee of $100, distributors and wholesalers to pay an annual licensing fee of $1,000, and manufacturers and importers to pay both a one-time licensing fee of either $2,000 or $10,000, depending on the products that they sell, and an administrative fee based on their California market share of cigarettes and tobacco products. In 2004, the first year of the licensing program, the distributors' and wholesalers' annual fee, the retailers' one-time license fees, and a one-time administrative fee for manufacturers and importers generated sufficient revenue to cover the cost of the program when all retailers—about 45,000—paid this fee. However, since this initial period, only new retailers applying for a license to sell cigarettes and tobacco products—about 5,600 per year—pay the $100 fee. In fiscal year 2014–15 the total for this one-time fee amounted to about $560,000. Even after combining this revenue with the $1.2 million from fines and fees from the other licensees, the total is significantly less than what is needed to fund the licensing program's operations.

Funding Options Would Have Increased the Tobacco Tax Revenue Available for Non-Enforcement Programs in Fiscal Year 2014–15 (in Millions)

Revenue from cigarette taxes	$748.0
Revenue from other tobacco products	87.0
Total revenue	**$835.0**
Cigarette and Tobacco Products Tax Program costs	$(22.4)
Cigarette and Tobacco Products Licensing Program costs	(7.9)
Total tax and licensing program costs paid with cigarette and tobacco tax revenue	**$(30.3)**
Total revenue available for non-enforcement programs before licensing program funding options	**$804.7**
Total revenue recovered by this report's proposed funding options*	$7.0
Total revenue available after funding options	**$811.7**

Source: California State Auditor's analysis of the State Board of Equalization's accounting records.

* Under each funding option, $913,000 from the Cigarette Tax Fund, which is the amount the fund provided the licensing program in fiscal year 2014–15, would still go to fund the licensing program. We suggest continuing to use these cigarette taxes to fund the licensing program because the money would otherwise go to the State's General Fund as opposed to a specific program. Therefore, the funding options would recover only $7.0 million of the $7.9 million of cigarette and tobacco taxes used to fund the licensing program in fiscal year 2014–15.

Under the first option, the retailer's license fee would change from a one-time fee of $100 to an annual fee of $170 for five years, and then the fee would increase to $215 annually after the licensing program has used its excess fund balance. There would be no change to the distributors' and wholesalers' annual license fees. These fee changes and increases, combined with money from the compliance fund's excess fund balance and from the offset to the Cigarette Tax Fund that otherwise would be transferred to the General Fund, would eliminate the need to pay for the licensing program's costs by offsetting revenue from cigarette and tobacco products taxes that would otherwise go to the funds created by propositions 10 and 99 and the Breast Cancer Fund.

The second option would include a retailer license fee increase as well as an increase in the distributor and wholesaler license fee from $1,000 annually to $1,200 annually. As with option one, the retailer's license fee under this option would be changed from a one-time fee to an annual fee. With an increase in the distributor and wholesaler license fee, the retailer fee increase would be less than the option one increase: an annual fee of $165 for five years, then increasing to $210 after the excess compliance fund balance is reduced. As shown in the text box, if one of the funding options in Table 4 had been in place in fiscal year 2014–15, the amount of cigarette and tobacco products taxes available for the programs they sponsor would have increased from $804.7 million to $811.7 million, a $7.0 million increase.

Table 4

Funding Options That Could Make the Cigarette and Tobacco Products Licensing Program Self-Supporting (Dollars in Thousands)

	LICENSING PROGRAM IN FISCAL YEAR 2014–15	OPTIONS FOR FUNDING THE LICENSING PROGRAM: 1 • USE EXCESS FUND BALANCE FOR 5 YEARS • CHANGE RETAILER LICENSE - ANNUAL - INCREASE FEE • CONTINUE GENERAL FUND (GF) CONTRIBUTION	2 • USE EXCESS FUND BALANCE FOR 5 YEARS • CHANGE RETAILER LICENSE - ANNUAL - INCREASE FEE • DISTRIBUTOR & WHOLESALER LICENSE FEE INCREASE • CONTINUE GF CONTRIBUTION	3 • USE EXCESS FUND BALANCE FOR 5 YEARS • CHANGE RETAILER LICENSE - ANNUAL - INCREASE FEE • DISTRIBUTOR & WHOLESALER LICENSE FEE INCREASE • CONTINUE GF CONTRIBUTION • DOUBLE CIGARETTE TAX RATE
COSTS				
Program administration and overhead	$8,994	$8,994	$8,994	$8,994
Distributed statewide costs	854	391	391	391
Total Costs	**$9,848**	**$9,385**	**$9,385**	**$9,385**
FUNDING SOURCES				
Cigarette and Tobacco Products Compliance Fund (compliance fund) excess fund balance*	$104	$1,460	$1,460	$1,460
Fines and audit payments†	156	156	156	156
Retailers' License Fee:				
$100 one time†	558			
$170 annually for five years, then $215 annually		5,953‡		
$165 annually for five years, then $210 annually			5,778‡	
$140 annually for five years, then $180 annually				4,903‡
Distributors' & Wholesalers' License Fee:				
$1,000 annually†	1,000	1,000		
$1,200 annually			1,200	
$1,100 annually for five years, then $1,200				1,100
Manufacturers' and Importers' License and Administrative Fees:				
$2,000 to $10,000 one-time license fee and one-time administrative fee based on market share†	94	94	94	94
Cigarette Tax Fund / General Fund:				
Contribution at current tax rate§	913	913	913	
Contribution at double the tax rate‖				1,826
All other cigarette and tobacco tax funds#:				
Breast Cancer Fund	182			
California Children & Families Trust Fund	4,561			
Cigarette & Tobacco Products Surtax Fund	2,280			
Total Funding	**$9,848**	**$9,576**	**$9,601**	**$9,539**
Amount by which revenue from funding sources exceed program costs	**–**	**$191**	**$216**	**$154**

Sources: California State Auditor's analysis and accounting records of the State Board of Equalization (board).

* As of June 30, 2015, the compliance fund has an excess fund balance of $7.3 million. If the board used these excess funds equally over a five-year period to help fund the licensing program, it would amount to $1.46 million per year. As a result, some license fee increases would not fully occur for five years.

† The board derived these amounts manually. The amounts listed are the board's estimates for fiscal year 2014–15.

‡ We derived this figure by multiplying the suggested fee by the number of licensees on July 1, 2015.

§ The General Fund will continue to contribute the same amount of money to the licensing program as it did in fiscal year 2014–15 through the offset to the Cigarette Tax Fund.

‖ This change doubles the current cigarette tax rate of $0.87 to $1.74 and applies the additional revenue to the four existing cigarette and tobacco tax funds at the same rate currently in place.

\# The funding options include one or more other revenue sources—compliance fund's excess fund balance, license fee increases, and cigarette tax increases—to offset these funding sources, which totaled $7 million in fiscal year 2014–15.

The third option would add an increase in the cigarette tax as well as increases to retailer, distributor, and wholesaler license fees. Specifically, the cigarette tax rate would be increased 100 percent, from $0.87 to $1.74 on a pack of 20 cigarettes. However, because of the cigarette tax increase, this option would require a smaller retailer license fee increase of $140 annually for the first five years until the excess balance in the compliance fund is exhausted, then $180 annually thereafter. The distributor and wholesaler annual license fee would increase to $1,100 for five years and then go to $1,200 per year thereafter. Under this option, the State, licensees, and consumers would share the licensing program's costs. Funds from these additional taxes would go to the four existing cigarette and tobacco products tax funds in the same proportion that the four are currently receiving in law and used for the same purposes. For example, Proposition 99's tax would increase from 25 cents per pack of 20 cigarettes to 50 cents per pack, but its share of the total tax would stay at the same proportion, which is 29 percent of the new tax rate of $1.74 per pack of cigarettes. Also, the contribution to the licensing program from the General Fund via the offset to the Cigarette Tax Fund would double from the contribution amount of $913,000 in fiscal year 2014–15 to $1.8 million, and it would remain at this amount each year. As Figure 5 shows, California has one of the lowest cigarette tax rates in the nation, and its rate is also significantly below the tax rates of neighboring states of Arizona, Nevada, and Oregon. Further, doubling the cigarette tax would put California only slightly above the national average for taxes on a pack of cigarettes.

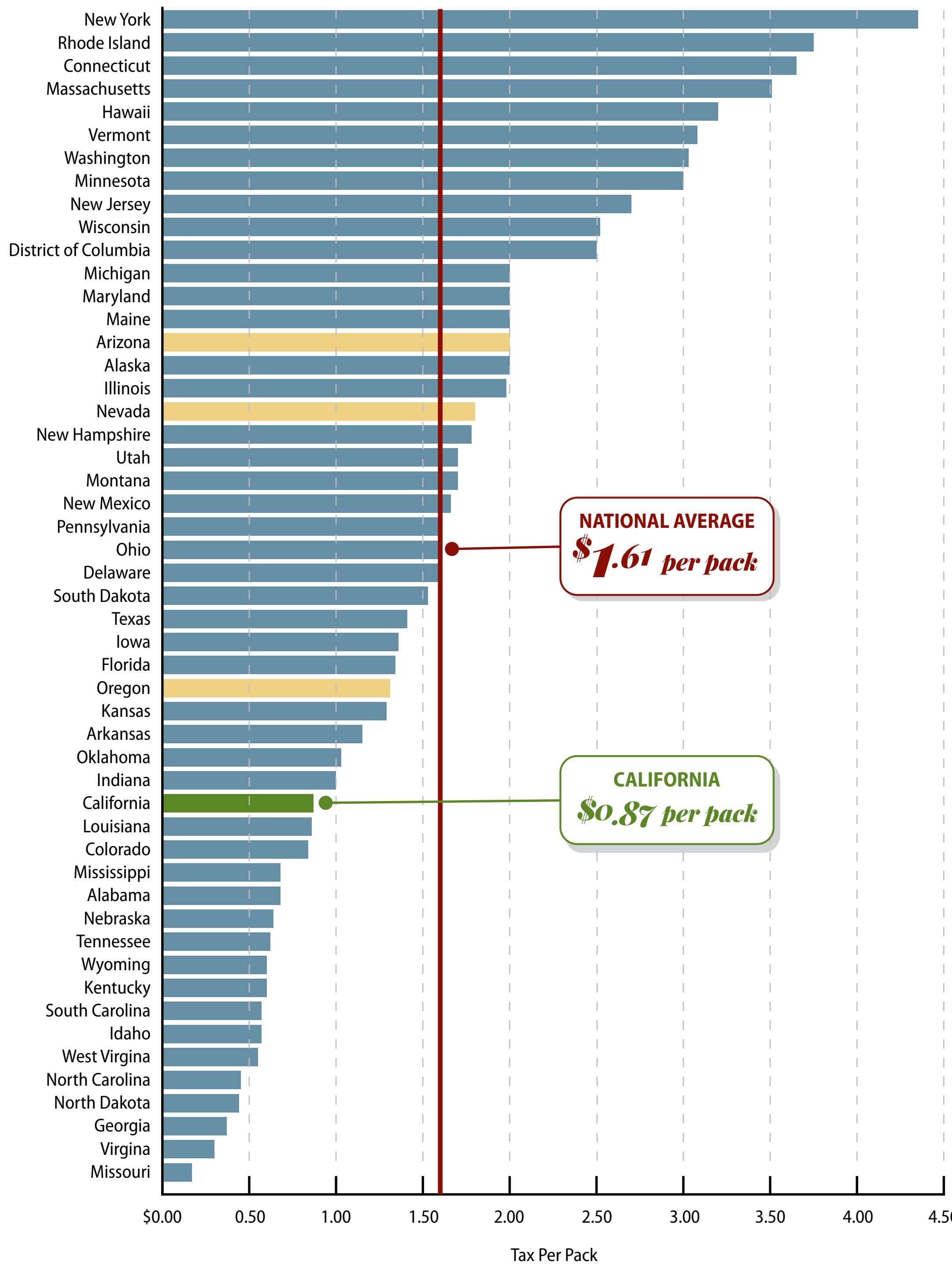
Although the Board's Cost Allocation Methodology Is Reasonable, It Derived Some of Its Time Charges Incorrectly

If followed and if using accurate data, the board's methods for identifying program costs and allocating them to each program, including the tax and licensing programs, would result in a fair and reasonable distribution of most costs. However, some of the entries in this cost allocation plan are based on incorrect time charges. Specifically, the special taxes division used a method that does not reflect actual staff time charges for its supervisor and support staff, and some investigations division staff used an outdated worksheet to derive their time charges. These methods resulted in inaccurate time charges, which have weakened the effectiveness of cost allocations that are based on these direct time charges.

The board's methods for identifying program costs and allocating them to each program resulted in inaccurate time charges, which have weakened the effectiveness of cost allocations that are based on these direct time charges.

Figure 5

As of October 2015 California's Cigarette Tax Was Almost Fifty Percent Less Than the National Average



Source: Campaign for Tobacco-Free Kids, publication titled *State Cigarette Excise Tax Rates and Rankings*, January 5, 2016.

Note: States that border California are highlighted using yellow bars.

We selected and tested 10 operating expenses, five each from the tax and licensing programs, to determine whether the expenses were allocated reasonably. The policy and compliance division has an informal process in place to charge expenses to the applicable program, and we found that this process was reasonable. However, the board does not have an automated process that tracks, records, and allocates payroll costs on an individual level. Instead, the board allocates payroll costs as well as some operating expenses to programs based on time-reporting information using employee time as recorded in its Business Taxes Time Reporting system (time-reporting system). To test the time reported for the tax and licensing programs, we selected 20 payroll transactions, 10 from each program, and found that they all agreed with what was recorded in the time-reporting system. In addition, we interviewed each employee about his or her work activities and found that the employees' descriptions of the work they performed aligned with the charges on their time sheets.

Some staff charge their time according to a predetermined allocation, while others charge their time directly to the programs on which they are working.

However, from the interviews we also learned that some staff charge their time according to a predetermined allocation, while others charge their time directly to the programs on which they are working. Of the 20 time sheets we tested, 10 were based on a predetermined allocation. These time sheets were for supervisors and support staff in the special taxes division. The board made adjustments to this allocation during the fiscal year to avoid exceeding budgets rather than to use the actual work that staff performed to make this allocation. Specifically, the special taxes division establishes an initial budget of the costs to charge to the largest of its 23 special tax programs, including the tax and licensing programs, then makes adjustments to the allocation to ensure staff's time charges enable each program to stay within its initial budget. However, if the board's special taxes division followed traditional cost accounting principles, it would adjust its initial allocation to match the actual amount of time its staff worked on each of the 23 programs. Overall, about 80 staff of the special taxes division's 454 staff are supervisors and support staff who use the predetermined allocation to charge their time to the programs that the division administers. In fiscal year 2014–15 the board's adjustments to the 80 staff members' predetermined allocation for the tax program ranged from a reduction of 10 percent to an increase of 2 percent, depending on the unit within the division. As previously noted, these adjustments were not done to make the predetermined allocation match staffs' actual time charges. Instead, according to the board, they were done to ensure each program was spending no more than the amount of money it was originally budgeted. We were unable to determine whether these adjustments caused the tax and licensing programs to be overcharged or undercharged their fair share of supervisor and support staff costs because total actual time charges were not available to compare against the adjustments.

The remaining 10 time sheets we tested belonged to staff who charge their time to the programs directly. However, one of these time sheets used a mechanism that automatically split an investigator's time between the tax and licensing program when the employee worked on a cigarette and tobacco products tax case. Specifically, although the investigation division's procedures instruct investigators to charge their time directly to the program being investigated, this investigator was using a discontinued time sheet template from 2005 that automatically distributes 42 percent of the investigator's time to the licensing program and 58 percent to the tax program when the investigator works on a cigarette and tobacco products tax case. According to its assistant chief, the investigation division does not have a record of why or when it ceased using the 2005 time sheet template, but it was sometime before 2012, when he started working in the division. Also, the assistant chief was unaware that some investigators were continuing to use the discontinued template as a basis for charging their time. The assistant chief estimates that 20 of the division's 40 investigators were using the discontinued 2005 time sheet template but that in fiscal year 2014–15 only three investigators—the person we selected in our testing and two others—charged time to cigarette and tobacco products tax investigations using the discontinued template. Going forward, the assistant chief indicated that he will work with the board's budget unit to determine how staff that work on investigations that relate to cigarette and tobacco products taxes should allocate their time to the tax and licensing programs. However, until this determination is made, these staff will continue to use the outdated 2005 time sheet template.

The assistant chief was unaware that some investigators were using a discontinued 2005 time sheet template that automatically distributes 42 percent of the investigator's time to the licensing program and 58 percent to the tax program when the investigator works on a cigarette and tobacco products tax case.

Fewer Inspections by the Board Could Reduce Costs Without Compromising Cigarette and Tobacco Products Tax Enforcement Outcomes

The board could reduce its costs more than $360,000 by adjusting the annual number of inspections so that the frequency of inspections is the same as it was when the licensing program started. The frequency with which the board inspects each licensed location has increased over time because although the number of licensees has significantly declined, the board continued to perform about the same number of inspections. The licensing act authorizes the board to conduct inspections as part of its enforcement efforts, and the board's initial plan for implementing the act called for periodic on-site inspections of all cigarette and tobacco retailers, distributors, and wholesalers in the State. The board proposed that it would inspect 10 percent of the 85,000 retailers that it estimated would be required to be licensed. Specifically, the board proposed conducting 10,625 inspections of retailers—8,500 initial inspections and 2,125 reinspections of retailers who had violations in the initial inspection—in fiscal year 2004–05 and established a goal of 10,000 inspections for every year thereafter. However, the board's data show that the actual number of retailers applying for licenses in fiscal year 2004–05 was only about 45,000, and the number of licensed retailers further dropped the following fiscal year to 38,000 because a large number of retailers had mistakenly applied for a license in the act's first year.

According to the branch administrator of the special taxes division, the board acknowledges that its initial estimate of the number of retailers in the State was not specific enough to accurately determine the cigarette and tobacco product retailer population. The licensing act also authorizes the board to inspect licensed cigarette and tobacco product distributors and wholesalers, which amounted to slightly more than 1,000 in June 2006. With a little more than 39,000 licensed retailers, distributors, and wholesalers as of June 2006 and a goal of 10,000 inspections per year, the frequency of inspection would be about 26 percent of the licenses per year. On average, the board has met its goal of conducting 10,000 inspections per year. However, the total number of locations licensed by retailers, distributors, and wholesalers has declined to 35,894 in June 2015, an 8 percent decrease since June 2006. According to the board, some of the decline is due to retail chain stores that have decided to stop selling cigarettes and tobacco products at many or all of their stores, citing health concerns as the impetus for their decision. Regardless of the reason, the decline in retailers as well as distributors and wholesalers has resulted in an increased frequency of inspections.

We estimate that conducting over 800 fewer inspections each year would result in cost savings of more than $360,000 per year.

Because the number of licensees selling cigarettes and tobacco products has declined, the average percentage of licensees' locations that the board inspects each year has increased from about 26 percent of the total locations in fiscal year 2005–06 to 28 percent in fiscal year 2014–15. Although the difference between these percentages seems minor, in fiscal year 2014–15 the board would have inspected over 800 fewer licensee locations than it did 10 years ago had the board kept the frequency of inspections at the rate of about 26 percent of licensee locations. We estimate that conducting over 800 fewer inspections each year would result in cost savings of more than $360,000 per year. According to the chief of the investigations division, the reason he has not proposed changing the number of inspections conducted each year is because the current number has worked well and has contributed to the significant positive outcomes of the three-part cigarette and tobacco products tax enforcement program, including reductions in cigarette and tobacco products tax evasion that the board's economist estimated at $91 million in fiscal year 2012–13. Inspections in the early years do appear to have contributed to a marked decline in the evasion of cigarette excise taxes. As was previously shown in Figure 3 on page 16, the annual number of inspections that resulted in a seizure of untaxed cigarettes has dropped dramatically since fiscal year 2004–05.

However, we do not believe the increase in the frequency of inspections that has occurred is necessary to maintain these positive results. Specifically, Figure 3 shows the large declines in seizures of untaxed cigarettes occurred at the beginning of the inspection program, but that since fiscal year 2008–09 seizures have remained low. Therefore, we believe the board could return to its initial frequency of inspections and continue to maintain the high level of compliance with the cigarette tax law that the three-part enforcement program has already achieved.

Recommendations

To make the board's licensing program self-supporting, the Legislature should consider passing legislation to implement a funding model that will include a license fee increase or a combination of license fee increases, continued use of money from the Cigarette Tax Fund, and a cigarette tax increase similar to one of the proposed options outlined in this report.

Unless the Legislature directs the board to eliminate the compliance fund's excess fund balance within a time frame of more than a year, the board should eliminate the excess fund balance by June 30, 2017 by using it to offset the licensing program's annual funding shortfall. The board should also limit the fund's future balance to no more than two months' worth of licensing program expenditures.

The special taxes division should amend its budgeting process to reflect actual work that supervisors and support staff perform instead of adjusting staff members' predetermined allocations of time to ensure that the division does not exceed each program's budget.

The investigations division should ensure that investigators charge their time according to division policy and should determine a method to more accurately allocate investigators' time instead of using the predetermined method established in 2005 and since discontinued.

To reduce the licensing program's enforcement cost without compromising the level of increased compliance with the cigarette and tobacco products tax law that the inspection program has produced, the board should reduce the number of annual inspections and reinspections of retailers, distributors, and wholesalers that it conducts each year to reflect changes in the number of licensees that sell cigarette and tobacco products in California. This adjustment should align with the same frequency of inspections that the board followed when it implemented the inspection program, which is 26 percent—or approximately one inspection every four years—of these licensed locations.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California 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

ELAINE M. HOWLE, CPA
State Auditor

Date:	March 1, 2016
Staff:	John Baier, CPA, Audit Principal Jerry A. Lewis, CICA Whitney M. Smith Inna A. Prigodin, CFE
Legal Counsel:	J. Christopher Dawson, Sr. Staff Counsel

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

Appendix

Expenditures and Funding For the Cigarette and Tobacco Products Tax and Licensing Programs During the Past Five Years

This appendix provides information on the expenditures and funding sources for the Cigarette and Tobacco Products Tax Program (tax program) and the Cigarette and Tobacco Products Licensing Program (licensing program). The State Board of Equalization (board) administers both programs. For fiscal year 2014–15 the tax program's expenditures totaled $22.5 million. Of that amount, $10.5 million was for specific program administrative costs, such as processing tax returns. The remaining $12.0 million was for the board's overhead costs, costs distributed statewide, and the cost of encrypted cigarette tax stamps. In fiscal year 2014–15 the licensing program's expenditures totaled $9.8 million. Of this total, $7.8 million was for specific program administrative costs, such as those for license inspections. The remaining $2 million included costs for the board's overhead and for its share of costs apportioned statewide. The board did not start charging some of the tobacco tax fund's apportioned costs to the licensing program until fiscal year 2013–14. These and other program costs for the past five years appear in Table A1 on the following page.

Table A2 on page 33 shows the funding sources for tax and licensing programs for fiscal year 2014–15. The board funded the tax program's costs from the four funds that receive cigarette and tobacco products tax revenue generally in proportion to each fund's share of cigarette and tobacco tax products revenue that it received. The board funded the licensing program in the same manner and also used licensing fees and license violation fines and penalties collected. For example, the licensing program collects a one-time fee from retailers that sell cigarette and tobacco products and from entities that manufacture and import cigarette and tobacco products, while it also collects an annual fee from wholesalers and distributors of those same products. As shown in Table A2, the Cigarette and Tobacco Products Compliance Fund provided only $1.9 million—which is comprised of $1.8 million in licensing fees and fines and $100,000 from the fund balance—of the more than $9.8 million that licensing program spent in fiscal year 2014–15. The shortfall of $7.9 million shown in Table A2 was funded with revenue from taxes on cigarette and tobacco products.

Table A1
Expenditures by Task for the Cigarette and Tobacco Products Tax and Licensing Programs During Fiscal Years 2010–11 Through 2014–15 (in Thousands)

	FISCAL YEAR				
	2010–11	2011–12	2012–13	2013–14	2014–15
CIGARETTE AND TOBACCO PRODUCTS TAX PROGRAM (tax program)					
Processing tax registrations	$892	$578	$569	$453	$687
Processing tax returns	1,257	1,078	1,092	1,157	1,302
Auditing tax returns	3,848	4,423	6,166	6,559	5,728
Collecting taxes	2,574	2,975	3,099	2,900	2,749
Subtotals	**$8,571**	**$9,054**	**$10,926**	**$11,069**	**$10,466**
Overhead for the State Board of Equalization (board)	$1,586	$2,313	$1,827	$2,178	$2,297
Costs distributed statewide*	1,959	2,209	2,676	1,901	1,608
Subtotals	**$3,545**	**$ 4,522**	**$4,503**	**$4,079**	**$3,905**
Cost of cigarette tax stamps	$7,624	$8,500	$8,257	$7,877	$8,081
Totals	**$19,740**	**$22,076**	**$23,686**	**$23,025**	**$22,452**
CIGARETTE AND TOBACCO PRODUCTS LICENSING PROGRAM (licensing program)					
Processing license registrations	$1,399	$1,596	$1,497	$1,536	$1,953
Licensing inspections and investigations	5,599	4,961	5,725	5,647	5,560
Collecting license violation penalties	453	268	130	264	240
Subtotals	**$7,451**	**$6,825**	**$7,352**	**$7,447**	**$7,753**
Overhead for the board	$1,011	$940	$1,105	$1,279	$1,241
Costs distributed statewide*	–	–	33	879	854
Subtotals	**$1,011**	**$940**	**$1,138**	**$2,158**	**$2,095**
Totals	**$8,462**	**$7,765**	**$8,490**	**$9,605**	**$9,848**
PROGRAMS COMBINED					
Totals	**$28,202**	**$29,841**	**$32,176**	**$32,630**	**$32,300**

Source: The board's budget unit.

* In fiscal year 2013–14 the board began charging the licensing program a proportional share of the cigarette and tobacco products tax funds' allotment of statewide distributed costs. The cigarette and tobacco products tax funds include the Cigarette Tax Fund, the Breast Cancer Fund, the Cigarette and Tobacco Products Surtax Fund, and the California Children and Families Trust Fund. Before then the board charged to the tax program the entire statewide distributed costs for the cigarette and tobacco products taxes funds even though the licensing program was receiving cigarette and tobacco products taxes.

Table A2
Funding Sources for the Cigarette and Tobacco Products Tax and Licensing Programs During Fiscal Years 2010–11 Through 2014–15 (in Thousands)

	FISCAL YEAR				
	2010–11	2011–12	2012–13	2013–14	2014–15
CIGARETTE AND TOBACCO PRODUCTS TAX PROGRAM (tax program)					
Taxes from cigarette and other tobacco products:					
Cigarette Tax Fund*	$3,566	$2,698	$4,056	$3,415	$3,362
Breast Cancer Fund	475	562	574	572	556
Cigarette and Tobacco Products Surtax Fund	5,886	6,991	7,113	7,074	6,881
California Children and Families Trust Fund	9,813	11,825	11,943	11,964	11,653
Total funding for the tax program	**$19,740**	**$22,076**	**$23,686**	**$23,025**	**$22,452**
CIGARETTE AND TOBACCO PRODUCTS LICENSING PROGRAM (licensing program)					
License fees, fines, and penalties:					
Cigarette and Tobacco Products Compliance Fund†	$777	$846	$1,189	$1,559	$1,912
Taxes from cigarette and other tobacco products:					
Cigarette Tax Fund*	$884	$933	$1,313	$925	$913
Breast Cancer Fund	176	155	155	185	182
Cigarette and Tobacco Products Surtax Fund	2,208	1,944	1,945	2,312	2,280
California Children and Families Trust Fund	4,417	3,887	3,888	4,624	4,561
Total funds from cigarette and tobacco taxes	**$7,685**	**$6,919**	**$7,301**	**$8,046**	**$7,936**
Total funding for the licensing program	**$8,462**	**$7,765**	**$8,490**	**$9,605**	**$9,848**
PROGRAMS COMBINED					
Funding from cigarette and tobacco products taxes	$27,425	$28,995	$30,987	$31,071	$30,388
Funding from license fees, fines, and penalties	777	846	1,189	1,559	1,912
Total funding	**$28,202**	**$29,841**	**$32,176**	**$32,630**	**$32,300**

Source: The State Board of Equalization's budget unit.

* The State Controller's Office transfers funds from the Cigarette Tax Fund to the General Fund.

† This fund is for license fees and license violation penalties. The amounts shown here are the amounts appropriated for the licensing program. The actual amounts of license fees and penalties collected each year over the five-year period ranged from $1.7 million to $1.8 million. Any remaining revenue collected above the appropriated amount contributed to the fund's ending balance.

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STATE OF CALIFORNIA

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February 12, 2016

Ms. Elaine Howle, CPA*
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento, CA 95814

Dear Ms. Howle:

The State Board of Equalization (BOE) would like to thank the California State Auditor's Office (CSA) for its recommendations contained in the *California State Board of Equalization, Cigarette and Tobacco Licensing Fee Program Audit 2015-119*, draft report provided on February 8, 2016. The BOE concurs with the observations described in the State Auditor's report. The following is the BOE's response to CSA's findings and recommendations.

Recommendations as stated in California State Auditor (CSA) Report:

1. *Unless the Legislature directs the board to eliminate the compliance fund's excess fund balance within a time frame of more than a year, the board should eliminate the excess fund balance by June 30, 2017. Also, in the future, the board should limit the fund's balance to no more than two months' worth of licensing program expenditures.*

   BOE's Reply:

   The BOE agrees that the excess balance in the Cigarette and Tobacco Products Compliance Fund should be drawn down to the recommended level. As noted in the report, BOE's appropriation is currently at a higher level than the average annual revenue. This would draw down the balance over time, albeit, at a relatively slow pace. A more aggressive approach, as recommended in the report, would be acceptable. The BOE will follow the direction of the Department of Finance and the Legislature as to the best approach to eliminating the excess fund balance. Any funding change, including making the program self-funded, should have a mechanism for adjusting the program's budget due to increasing or decreasing program costs. 1

2. *The special taxes division should amend its budget to reflect actual work that supervisors and support staff perform instead of adjusting staff members' predetermined allocations of time to ensure that the division does not exceed each program's budget.*

   BOE's Reply:

   In 2010, the Special Taxes and Fees Department underwent a large-scale reorganization. For many years prior to 2010, the department had been divided by like programs into three divisions: the Excise Taxes Division, the Environmental Fees Division, and the Fuels Division. Each of these divisions was responsible for approximately 7 - 9 tax programs, with Cigarette and Tobacco Taxes and Licensing falling under the Excise Taxes Division. At that time, it was quite workable for supervisors and support staff to report actual hours worked to the individual programs as there were far fewer programs and time codes to keep track of each day/month.

   As of July, 2010, the Special Taxes and Fees Department was established; staff were aligned by work function and reassigned to one of five branch offices: Collection and Registration Branch, Return

* California State Auditor's comments appear on page 39.

Processing Branch, Program Policy and Administration Branch, Audit Examination Branch and the Appeals and Data Analysis Branch. Each of these branches now handles specific functions and duties, providing their particular tasks and services for all of the 29 tax and fee programs administered. As a result, the scope of knowledge and number of programs expected to be handled by each employee greatly increased.

This reorganization was brought about for consistency, to streamline processes and to provide better customer service. For example, we consolidated our phone reception by utilizing one main phone number, centralized our mail processing areas, filing and scanning areas, combining the staff and functions into one administrative support area, instead of maintaining three separate smaller groups performing each function under three divisions.

The commingling of work functions does not readily lend itself to reporting each individual's work product by individual tax program codes, making it especially difficult for the supervisory and support staff. The vast majority of our employees are reporting actual time worked to the actual tax and fee
2 program worked. For the smaller population of supervisors and support staff, it would not be economically feasible for them to spend the time to track or separate their work for the purpose of time allocation. For example, a supervisor will review time sheets for all of their employees every month. Their employees may work on all 29 programs to varying degrees throughout the month. Another employee might spend 8 hours a day sorting and prepping material for digital scanning. In either
3 situation there is no economically feasible way for these staff to record and report their actual time spent by individual program code and attempting to do so when the materials or subject matter is commingled increases the difficulty.

The prorated time codes are based on the number of staff and work activities associated with the programs, which reasonably translates to an allocable amount of time needed to perform the supervisory and support functions without parsing the activities performed down to a minute level. We have developed a formula to allocate our supervisory and support time to the various tax and fee programs. The formula is based on the number of Personnel Years (PYs) in each branch allocated to each tax and fee program. The formula is reviewed and adjusted as needed throughout the fiscal year.
3 We looked at several ways to allocate the time and have found that this approach is the most equitable to all our tax and fee programs.

The Centralized Revenue Opportunity System (CROS), a five-year Business/IT project to replace BOE's aging legacy computer systems, will provide additional tools to track work activities and time. We will be examining this issue as part of the CROS post-implementation phase to determine how work activity can be tracked without reducing employee productivity.

3. *The investigations division should ensure that investigators charge their time according to division policy and determine a method to more accurately allocate investigators' time instead of using a predetermined method established in 2005 and since discontinued.*

BOE's Reply:

The Investigation Division (ID) will discontinue the use of the timesheet template from 2005. The 2010 timesheet template will be re-distributed with instructions for supervisors to discuss in their next staff meeting as well as confirming the appropriate template is being used when the supervisors approve the monthly and weekly timesheets for their criminal investigators. An analysis of criminal investigator functions will be completed to determine if a time study will be helpful in addressing the allocation of time between the three integrated cigarette and tobacco codes for the criminal cigarette and tobacco investigations.

In addition, the ID will be working with the BOE Budget Unit to ensure that the allocation of time to the three integrated cigarette and tobacco codes are better defined.

Ms. Elaine Howle, CPA February 12, 2016

4. *To reduce enforcement cost without compromising the level of increased compliance with the cigarette and tobacco tax law that the inspection program has produced, the board should reduce the number of annual inspections and inspections of retailers, distributors, and wholesalers that it conducts each year to reflect changes in the number of licensed retailers, distributors, and wholesalers that sell cigarettes and tobacco products in California. This adjustment should align with the same frequency of inspections that the board followed when it implemented the inspection program, which is 26 percent of these licenses' locations each year, or approximately one inspection every four years for each licensed location.*

BOE's Reply:

To implement the reduction in enforcement resources and, subsequently, the number of inspections, for the cigarette and tobacco licensing program, the necessary steps will require time, resources and board approval. Additional hours will be allocated to the cigarette and tobacco program to develop and execute an implementation plan for the CSA recommendations, track ID actions, and complete any required follow-up reports to the CSA.

Upon receiving Board approval, the current ten AB 71 inspection teams could be reduced to nine teams to satisfy the described reduction of enforcement activity. With a reduction of one inspection team, the assigned geographical area and associated distributor, wholesaler and retailer permits will require a re-allocation from the current designated zones to a reduced number of zones. Zones determine the permits and geographical territory assigned to each AB 71 inspection team. The impact of this re-zoning will generate a need to update all pertinent databases, zone maps and reports. A primary goal to rezoning will be to ensure adequate team staffing to meet operational needs and ensure staff safety.

With changes to the zones and increased geographical areas for each of the remaining inspection teams, travel expenses and inspection time may increase, resulting in fewer inspections than the envisioned 27% to ensure inspections, re-inspections and suspended account inspections are completed uniformly throughout the state. The logistics may impact the division's efficiencies relating to expanded travel times.

BOE's Human Resources Division, the Board, and SEIU will need to be notified of the intended reduction in staff. It will be assumed that a meet and confer with SEIU will be needed to explain the details of the recommendation and the impact to staff from this program. With a reduction of an inspection team, specialized facility space may become vacant. This may result in ongoing cost until the conclusion of the current lease terms. With the administrative costs associated with the reduction of a team, the full stated savings in the report may not be realized for at least two fiscal years.

The BOE is committed to exploring alternative cost savings and other funding options in order to improve overall effectiveness and efficiency of tobacco enforcement. We appreciate the State Auditor's review and analysis of the tobacco programs and look forward to the State Auditor's feedback on the above corrective actions.

If you have any questions concerning the enclosed BOE response please contact me at (916) 327-4975 or David J. Gau, Chief Deputy Director, at (916) 323-9070.

Regards,

Cynthia Bridges

Cynthia Bridges
Executive Director

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Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE STATE BOARD OF EQUALIZATION

To provide clarity and perspective, we are commenting on the response to our audit by the State Board of Equalization (board). The numbers below correspond to the numbers we have placed in the margin of board's response.

To clarify, absent any direction from the Legislature or the California Department of Finance, the intent of our second recommendation on page 29 is for the board is to eliminate the excess Cigarette and Tobacco Products Compliance Fund (compliance fund) balance by June 30, 2017 by using it to offset the licensing program's annual funding shortfall. Also, in the future, the board should limit the compliance fund's balance to no more than two months' worth of licensing program expenditures. 1

What the board refers to as a smaller population of supervisors and support staff in the Special Taxes and Fees Division (special taxes division) amounts to 80 staff as indicated on page 26, which we believe is a significant number of employees. 2

We stand by our recommendation for the board to implement a process in which the special taxes division's time charges reflect, as close as possible, the actual amount of time its supervisors and support staff work on each program. This process would provide the most realistic costs for each program irrespective of what was budgeted for each program. However, as we indicate on page 26, the board increases or decreases the time charges of the special taxes division's supervisors and support staff to ensure each program does not exceed its budget. Without implementing our recommendation the tax and licensing programs' actual costs are irrelevant and merely reflect whatever the board budgets for supervisor and support staff rather than reflecting the actual work they perform. Moreover, although the board believes such a process is economically unfeasible, many state departments use this type of system to ensure that costs are properly allocated. 3