

California State Auditor

B U R E A U O F S T A T E A U D I T S

State Bar of California:

**Financial Outlook for the Admissions
Fund Is Not As Bleak As Portrayed**



May 1998
98106

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CALIFORNIA STATE AUDITOR

KURT R. SJOBERG
STATE AUDITOR

MARIANNE P. EVASHENK
CHIEF DEPUTY STATE AUDITOR

May 20, 1998

98106

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 Bureau of State Audits presents its audit report concerning the Admissions Fund of the State Bar of California (State Bar). This report concludes that the State Bar's Office of Admissions (admissions) has inaccurately portrayed a bleak financial outlook for the Admissions Fund by basing its projections of revenues and expenses on questionable assumptions. As a result, rather than incurring a deficit of \$2.1 million by the end of calendar year 2000, we estimate the fund balance for admissions will range from a deficit no greater than \$629,000 to a positive balance of \$319,000.

Respectfully submitted,

KURTR. SJOBERG
State Auditor

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Summary



Audit Highlights . . .

Our review of the State Bar's projections for its Admissions Fund reveals that it inaccurately portrays a bleak financial outlook because it:

- Understated revenue by basing projections on questionable assumptions.***
- Overstated its expense projection by including duplicative costs.***
- Used inconsistent assumptions to develop some of its estimates.***

Moreover, the State Bar could incur fewer expenses than projected due to recent events related to its overall membership fees.

Results in Brief

The State Bar of California (State Bar) is a public corporation established by the California State Constitution. The Business and Professions Code provides the State Bar with guidance and direction in fulfilling its mission to preserve and improve the justice system to assure a free and just society under law. Its committee of bar examiners assists in this mission by overseeing one of the major responsibilities, the licensing of attorneys. The State Bar's Office of Admissions (admissions) provides direct support to this committee in the fulfillment of its duties.

During the next three years, admissions will not generate revenue sufficient to cover its yearly costs of operation and will have to use its existing fund balance of \$2.2 million to cover its costs. Admissions projects that by the end of 2000 it will consume the existing fund balance and incur a deficit of \$2.1 million. While we agree it is possible admissions could consume its fund balance during the next three years, we believe that the decline will not occur as quickly as it has projected. In 1998, we estimate the fund balance will drop to \$1.5 million, not the \$1 million predicted by admissions. Furthermore, in 1999, we expect admissions will still have money left in its fund, rather than incur a deficit as it predicted. Not until 2000 do we anticipate the fund to potentially incur a deficit; even then, we expect that the deficit will be no greater than \$629,000, considerably less than the \$2.1 million deficit projected by admissions. On the other hand, the fund could retain a positive balance of as much as \$319,000 in 2000.

Admissions has inaccurately portrayed a bleak financial outlook for the Admissions Fund by basing its revenue and expense estimates for 1998 on questionable assumptions and then carrying these assumptions forward to its estimates for 1999 and 2000. Specifically, it based its revenue projection of \$7.9 million for 1998 primarily on data from 1995 rather than using a combination of revenue figures, law school enrollment data, and the number of exam applicants from prior years. As a result, admissions projected its revenue to drop by \$680,000, from \$8.6 million in 1997 to \$7.9 million in 1998. However,

our review of historical trends indicated that such a dramatic decrease appears unlikely. Instead, we project that revenues in 1998 will be approximately \$8.2 million.

Meanwhile, admissions' expense projection of \$9.1 million contained questionable and duplicative costs. Specifically, we question \$125,000 in expenses because they represent unusually high increases from actual expenses in prior years. In addition, admissions did not coordinate budgeting decisions for parking and building maintenance expenses among its staff and with other State Bar staff, resulting in a duplication of \$61,000 in expenses. By understating its revenue projection by \$359,000 and overstating its expense projection by \$186,000 for 1998, admissions understated its fund balance by \$545,000. By carrying these assumptions forward, admissions also understated its fund balance in 1999 and in 2000.

In October 1997, the governor vetoed the State Bar's annual membership fee bill. As a result, actual expenses could be \$329,000 less than the amount projected by admissions. Because of the uncertainty regarding the effect of organizational funding decisions as well as the impact of legislation currently being considered, we cannot project the impact of these events for 1999 and 2000.

Recommendations

To develop a more reliable picture of its future financial condition, admissions should do the following:

- Use current statistical data and historical data to project exam revenues.
- Use reasonable and justifiable assumptions in developing estimates of future activity and apply these assumptions consistently.
- Coordinate responsibilities among its directors to ensure that all costs are covered but not duplicated.
- Prepare and maintain documentation to support its basis for projecting revenues and expenses that are significantly different from those of prior years.

In addition, admissions and the Office of Financial Planning should clarify with each other the methods used to budget certain admissions fund expenses, such as parking and building costs, to ensure that these expenses are not duplicated in the overall projection for the Admissions Fund.

Agency Comments

The State Bar agrees with our recommendations and stated that it will be revising some of its budgeting procedures to ensure that revenue and expense projections for the Admissions Fund are reasonable and justifiable. The State Bar also stated that the membership fee structure that has not yet been determined will have a direct impact on the budget of the Admissions Fund in 1998 and future years.

Introduction

The California State Constitution established the State Bar of California (State Bar) as a public corporation and requires every person admitted and licensed to practice law in California to be a member of the State Bar except when holding office as judge of a court of record. Chapter 4 of the Business and Professions Code, commonly referred to as the State Bar Act, provides guidance and direction to the State Bar in fulfilling its mission and carrying out its responsibilities. According to its strategic action plan, the State Bar's mission is to preserve and improve the justice system and assure a free and just society under the law. The State Bar's responsibilities include reviewing and approving applicants for membership.

The State Bar is guided by a board of governors (board) that consists of a president and 22 members: 16 attorneys and 6 members of the public who have neither been members of the State Bar nor admitted to practice before any court in the United States. The board has established several committees that provide policy and guidance regarding various functions. One such committee is the Committee of Bar Examiners (committee), which consists of 19 members: 10 attorneys appointed by the board and 9 members of the public appointed by the governor or Legislature. The committee oversees the development, administration, and grading of the California Bar Examination and determines the moral character of applicants for admission to practice law.

The State Bar's Office of Admissions (admissions) is headed by a senior executive and has approximately 70 staff who provide support to the committee in the fulfillment of its duties. Four directors oversee examinations, moral character determinations, operations and management, and administration and educational standards. In 1997, admissions generated approximately \$8.6 million in revenue out of a total State Bar revenue of \$91.3 million. The majority of this revenue came from examination fees and moral character determination fees. All applicants seeking admission to practice law must register with the committee prior to filing any applications. At any time after registering with the committee, an applicant can file an application for determination of moral character. In addition to passing the bar exam, all applicants must establish that they are of "good moral character." Upon receiving this application, the committee determines if the

individual has certain qualities, including honesty, fairness, candor, respect for, and obedience to the laws of the state and the nation, as well as respect of others and for the judicial process. Moral character determinations are valid for 24 months from the date of the positive determination. However, if an applicant has not satisfied the other requirements for admission to practice law, the applicant may request an extension of an additional 24 months.

During 1997, admissions incurred approximately \$8.3 million in expenses while the entire State Bar incurred approximately \$87.9 million. Admissions incurs expenses for staff and resources required to run the program, including processing applications, administering the exam, and determining moral character. The State Bar's Admissions Fund accounts for the fees and the expenses related to admissions activities.

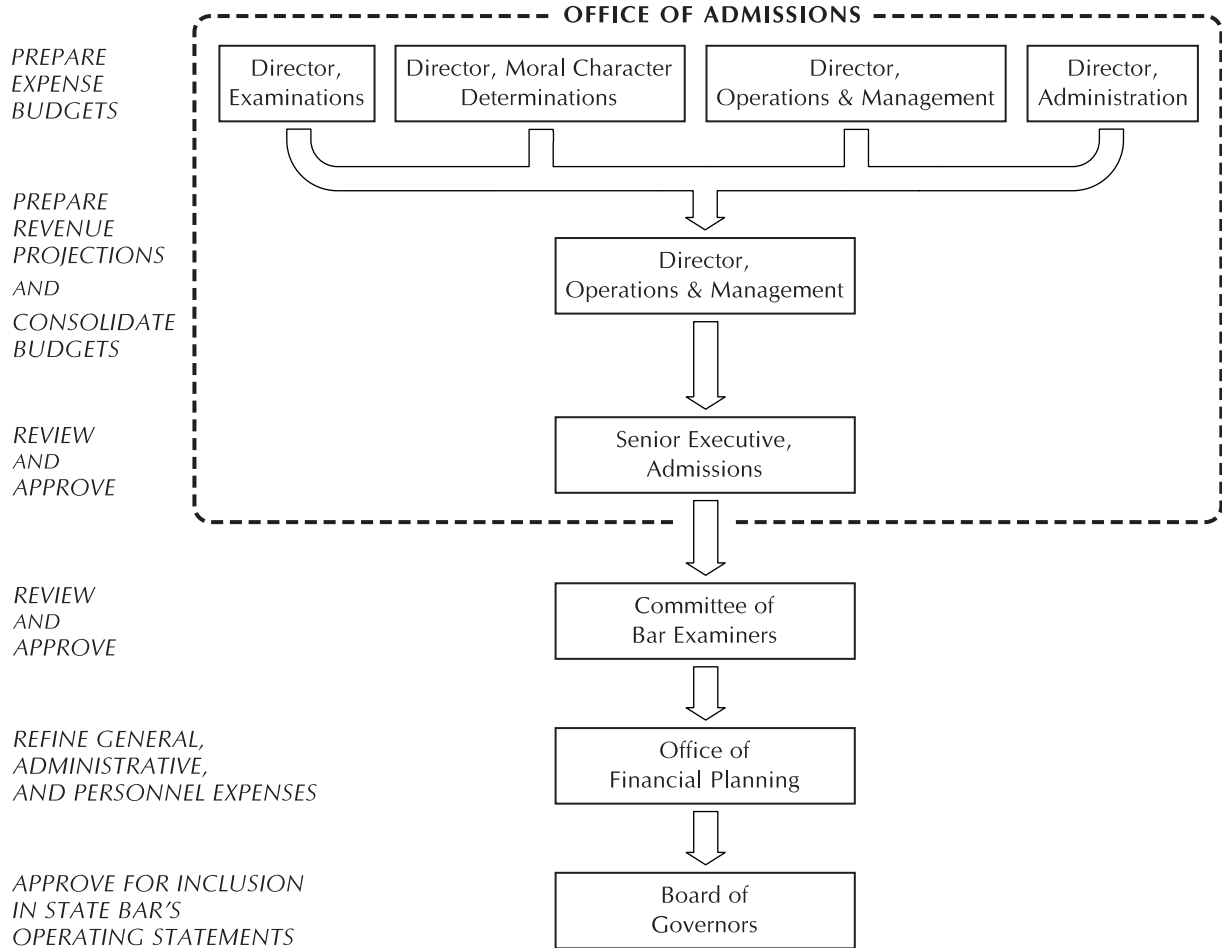
The Four Directors Prepare Budget Projections for the Admissions Fund

Figure 1 illustrates the steps the State Bar follows to prepare its annual budget for the Admissions Fund. Admissions tracks its revenues and expenses through individual cost centers. Each of the four directors is responsible for preparing expense budgets for the cost centers in his or her domain. In general, the directors review budgeted expenses from the previous year and revise them to arrive at their budget for the upcoming year. For example, the director of administration estimates the meeting room expenses in a particular year based on her knowledge of the number of meetings held during the past year and adjusts this amount for any anticipated changes. Likewise, the director of moral character determinations will adjust the expense budget for staff travel based on the number of individuals she estimates to be traveling during the upcoming year, the number of meetings requiring travel, and workload.

Once the four directors have prepared their budget projections, the director of operations and management consolidates the information and develops an overall expense budget for the entire Admissions Fund. The director of operations and management also prepares the revenue projections for the entire Admissions Fund. The director then forwards the projections to the senior executive. The senior executive reviews the budget and forwards it to the committee for approval. After committee review, the committee forwards the budget to the Office of Financial Planning. The senior financial analyst in the Office of Financial Planning prepares

Figure 1

The Admissions Fund Budget Process Involves Many Steps



a budget for the State Bar's general and administrative expenses and then allocates a portion of those expenses to all funds within the State Bar, including the Admissions Fund. Similarly, he refines salary estimates and prepares the fringe benefit allocation projection for all State Bar funds. After he completes these steps, he forwards the budget to the board for final approval. As shown in Appendix A, at the end of 1997, the Admissions Fund had a balance of approximately \$2.2 million. However, because it believes expenses will far exceed revenues, the State Bar projects that the fund will be depleted in the next two years. Furthermore, the State Bar projects that by the end of 2000, the fund will incur a deficit of nearly \$2.1 million.

Scope and Methodology

At the request of the Joint Legislative Audit Committee, we audited the State Bar's revenue and expense projections for its Admissions Fund for calendar years 1998 through 2000. To determine if the projections were reasonable, we reviewed actual revenues and expenses of the Admissions Fund for calendar years 1993 through 1997.

To determine whether historical revenues and expenses for admissions are a reliable standard for comparison with future projections, we compared information from the year-end operating statements for calendar years 1993 through 1996 to the corresponding audited financial statements. At the time of our review, the independent auditors for the State Bar had not yet issued audited financial statements for calendar year 1997. Therefore, for that year we relied on the State Bar's accounting records. Using the year-end operating statements, we prepared a five-year trend analysis of revenues and expenses and investigated any significant discrepancies.

We also prepared an analysis of the number of applicants taking the exam during this period and determined whether the numbers were consistent with revenues and expenses. Further, we determined whether the State Bar's fee structure for exams is fair and appropriate by reviewing the revenues generated from fees and assessing whether they are adequate to cover the costs of administering the bar exams.

To assess whether the projections for the Admissions Fund were reasonable and valid, we documented the methodology admissions used to project revenues and expenses. We also reviewed the assumptions admissions used in its projections. To evaluate the reliability of the methodology, we compared budgeted revenues and expenses for calendar years 1993 through 1997 with actual figures from these same years. Using the results of this comparison, we evaluated the State Bar's projections for calendar years 1998 through 2000.

We also prepared our own trend analysis to project future revenues and expenses based on historical data. We then compared this analysis with that of admissions to determine whether its projection of a deficit in the Admissions Fund by calendar year 2000 is reasonable.

The State Bar Inaccurately Portrays a Bleak Financial Outlook for Its Admissions Fund

Summary

The Office of Admissions (admissions) for the California State Bar (State Bar) based its budget projections for revenues and expenses for 1998, 1999, and 2000 on faulty assumptions and did not coordinate decisions among the various contributors to the budgeting process. As a result, admissions understated the amount of revenue the program will generate and overstated the costs it expects to incur for the same three years. According to its projections, admissions will use up its existing fund balance of \$2.2 million by the end of 1999 and incur a deficit of \$2.1 million by the end of 2000. We agree the fund balance will decrease during the next three years, but our calculations indicate that admissions will incur a deficit of no more than \$629,000 by the end of 2000.

Projected Deficits Distort the Admissions Fund Financial Condition

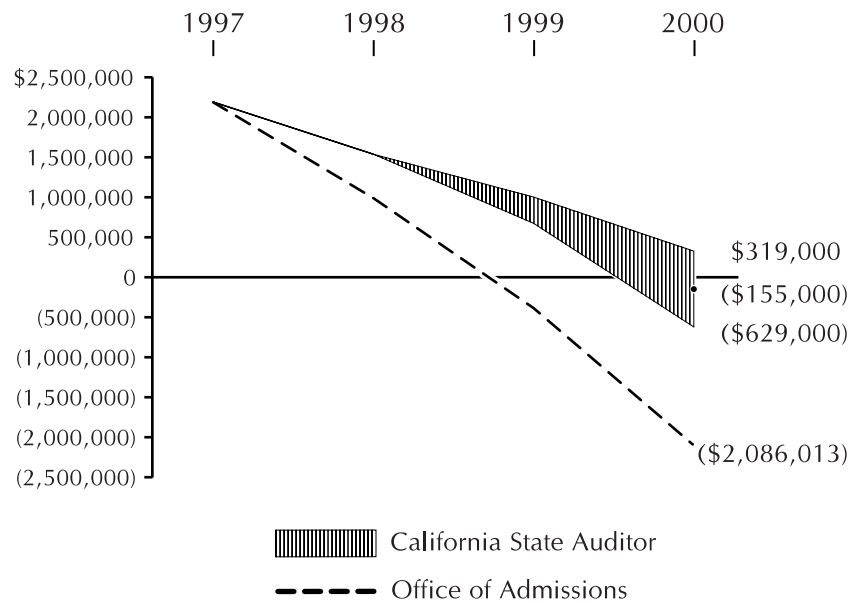
The bleak future financial condition of the Admissions Fund is distorted because admissions understated its revenue estimates and overstated its expense estimates for 1998 through 2000. If admissions had projected revenues based on historical trends and had developed a reliable projection of expenses, it would have presented a more realistic picture of its financial outlook. Instead, admissions projected expenses to exceed revenues by \$1.2 million during 1998, thus reducing the fund balance from \$2.2 million at the end of 1997 to only \$1 million at the end of 1998. Moreover, it carried these estimates forward and projected expenses to exceed revenues by \$1.4 million in 1999 and \$1.7 million in 2000, thus creating fund deficits of approximately \$400,000 in 1999 and \$2.1 million in 2000.

Unlike admissions' projection of a deficit in 1999, we believe that admissions will continue to maintain a positive balance in its fund.

Based on our analyses, we estimate that admissions will generate revenue totaling \$8.2 million and incur \$8.9 million of expenses in 1998. As a result, expenses are likely to exceed revenues by only \$654,000, not the \$1.2 million that admissions projected. Therefore, as shown in Figure 2, we estimate that the fund balance will drop to \$1.5 million, but not nearly to the \$1 million predicted by admissions. Furthermore, in 1999, we believe that the Admissions Fund will continue to maintain a fund balance, rather than incur a deficit. Based on

various analyses we developed to estimate revenues, our forecast for 2000 shows that the fund balance will range from a positive balance of \$319,000 to a deficit of \$629,000 with a deficit of \$155,000 as the midpoint. As shown in Figure 2, the low end of the range is a deficit that is considerably less than the \$2.1 million deficit projected by admissions.

Figure 2
Admissions Projections Have Distorted Its Fund Balance



***Projections of Future
Revenues Appear Too Low***

The revenue projection of \$7.9 million made by admissions for the 1998 budget is too low. In addition, because admissions based its revenue projections for 1999 and 2000 on 1998 projections, these are similarly understated. To project its revenues for 1998, admissions primarily used data from 1995 rather than using a combination of revenue figures, law school enrollment data, and the number of exam applicants from prior years. As a result, admissions projected revenue would drop more than \$680,000 from \$8.6 million in 1997 to \$7.9 million in 1998 (Table 1).

Our review of historical trends indicated that such a dramatic decrease appears unlikely. Specifically, of the various categories of applicants who take the bar exam, some show declines while others are steadily increasing. Based on

historical trends and the actual number of applicants who took the February 1998 exam, we estimate that revenues for 1998 will reach approximately \$8.2 million. In addition, although enrollment in law schools accredited by the American Bar Association (ABA) declined in 1997, this should not have a significant effect on revenue projections before the year 2000.

Table 1

Projections of 1998 Revenue by the Office of Admissions and California State Auditor

	Office of Admissions	State Auditor ^a
February 1998 exam revenues	\$1,688,844	\$1,846,317 ^b
July 1998 exam revenues	2,854,661	3,056,285
Moral character revenues ^c	1,931,920	1,931,920
Other revenues ^c	1,411,503	1,411,503
Total	\$7,886,928	\$8,246,025

^aAppendix B describes our methodology for projecting revenues.

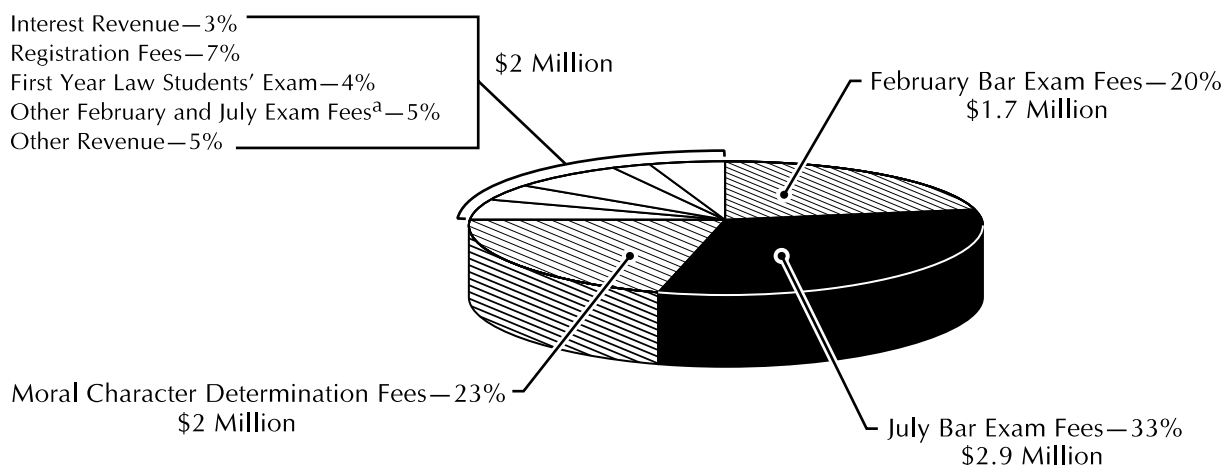
^bRepresents actual February 1998 revenues based on the State Bar's operating statement as of March 31, 1998.

^cAmounts are based on projected revenues by the Office of Admissions for 1998.

Most of the revenue generated by admissions comes from fees for the bar exam, which is administered twice a year, in February and July, and the application fees related to determining if an applicant is of good moral character. As shown in Figure 3, these categories constitute approximately \$6.6 million (76 percent) of the \$8.6 million admissions generated in calendar year 1997. General applicants, who are typically recent law school graduates, pay \$325 to take the bar exam, while attorney applicants, who are members of other state bars, pay \$475. Applicants must also establish that they are of good moral character as determined by the Committee of Bar Examiners (committee). The moral character application fees have two components: the application for determination of moral character, for which the State Bar charges \$265, and the application for an extension, for which the fee is \$125. Those applicants who have passed a moral character determination but take longer to pass the bar exam may have to file an extension of the determination.

Figure 3

**76 Percent of Total Admissions Fund Revenue for 1997
Was Generated From Bar Exam and Moral Character Determination Fees**



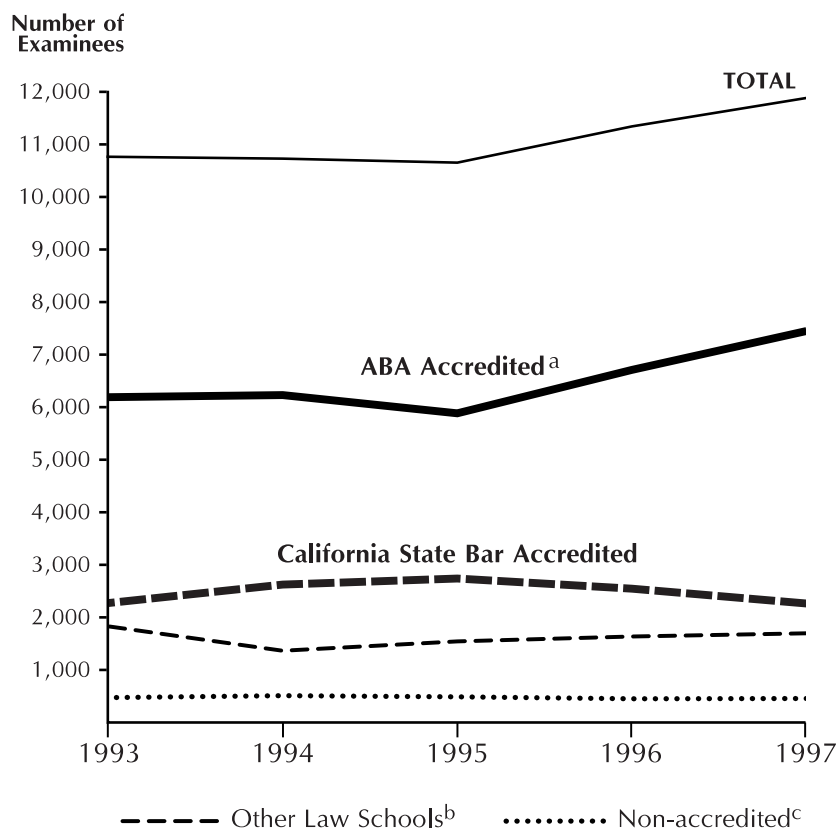
^aRepresents additional fees related to the bar exam, such as late fees and typing fees.

***A Dramatic Drop in Revenue
for 1998 Is Unlikely***

Although admissions projects that its revenues will drop more than \$680,000 from the \$8.6 million it earned in 1997 to \$7.9 million in 1998, historical trends reflect that such a dramatic decrease is unlikely. Our review of the various categories of applicants who take the bar exam indicates that while some categories show a decline in recent years, other categories are steadily increasing. Specifically, the number of students attending law schools accredited by the State Bar has decreased 17 percent from 2,739 in 1995 to 2,264 in 1997. However, three other categories comprising 78 percent of examinees reflect increases. As illustrated in Figure 4, the number of examinees from ABA accredited law schools increased 26.6 percent from 5,883 in 1995 to 7,449 in 1997. Furthermore, the total number of examinees has increased 11 percent from 10,653 in 1995 to 11,866 in 1997. In addition, the number of attorneys practicing in other states who took the California bar exam has increased 22 percent between 1995 and 1997. Moreover, 1,055 attorneys took the February 1998 exam, an increase of 45 from the 1,010 who took the exam in February 1997.

Figure 4

Overall Number of Bar Examinees Continues to Rise



^a American Bar Association (ABA) accredited law schools nationwide.

^b Other law schools include those in Canada and other states that are not accredited by the ABA, correspondence law schools, and applicants studying in law offices or judges' chambers. This category also includes applicants that are not affiliated with a particular law school.

^c Law schools located in California that are not accredited by either the ABA or the California State Bar.

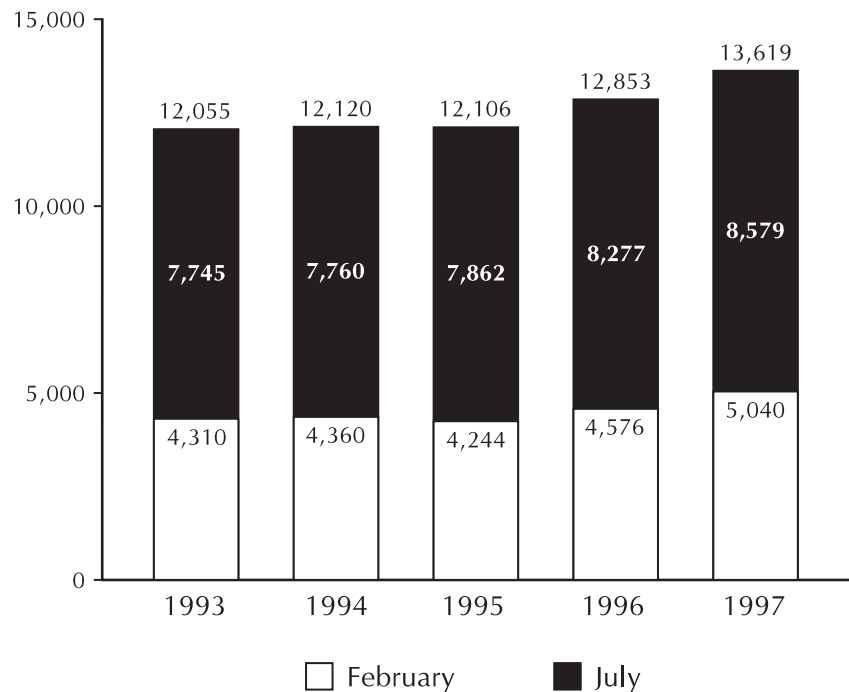
Despite increases in both revenues and the number of individuals applying to take the bar exam in recent years, admissions projected a decrease in revenues for 1998 through 2000, basing estimates on the number of individuals applying to take the exam in calendar year 1995, the lowest number during any of the past four years. As a result, it underestimated the amount of revenue it will generate from these exams. For instance, using 1995 data, admissions expected to receive 3,449 general and 850 attorney applications for the February 1998 exam. Considering the fee schedule, these figures would generate approximately \$1.5 million. However, admissions actually received 3,753 general and 1,055 attorney

The actual number of February 1998 exam applicants was considerably higher than the February 1995 base-period used by admissions.

applications for the February exam equating to approximately \$1.7 million in fees, an underestimate of 11 percent. Although the number of applicants dipped slightly from 5,040 in 1997 to 4,808 in 1998, the actual February number falls into a pattern with the 1996 and 1997 figures, rather than those of 1995.

Because admissions used the same assumptions to project the number of applications expected for the July 1998 bar exam, we believe its revenue estimate for the July exam is also understated. As shown in Figure 5, the number of applications for the July bar exam has steadily increased over the past five years. Furthermore, because the July bar exam typically represents 64 percent of the applicants taking the two exams, underestimating July's revenue would have a more significant impact on the budget for 1998.

Figure 5
Number of Applications Received for the July Exam Has Steadily Increased



The State Bar believes the high numbers of applications received in 1996 and 1997 were anomalies and the number of exam applicants in 1998 will be similar to 1995. The senior executive of admissions informed us that the higher number of applications received during 1996 and 1997 were from

out-of-state applicants. He further stated that he did not know why this increase occurred; he therefore believes that there was no basis for assuming that the higher number would continue. The senior executive also believes that it is not reasonable to develop a projection based on the higher number of applicants without explaining the reason for the high level. Finally, he concluded that it is more fiscally sound to underestimate revenue than to overestimate it and stated that the committee agreed with his analysis.

However, the projection of 4,299 applications for the February 1998 exam proved to be too low. In fact, the actual number of applications received not only exceeded the February 1995 number but also exceeded the number of applications received for the February 1996 exam, which is one of the two years admissions believes was abnormally high.

Recent Declines in Law School Enrollment Should Not Affect Revenue in the Next Three Years

The enrollment level in law schools is a primary indicator for examination participation. We therefore reviewed enrollment data for schools accredited by the ABA, both nationally and in California, as well as law schools accredited by the State Bar. As Table 2 shows, from 1993 through 1996, enrollment in ABA-accredited schools nationwide remained fairly constant; however, in 1997 the number of students dropped slightly. Assuming that students typically take from three to four years to complete law school, the nationwide decline in the 1997 enrollment at ABA-accredited schools should not affect revenue until 2000 or 2001.

Table 2

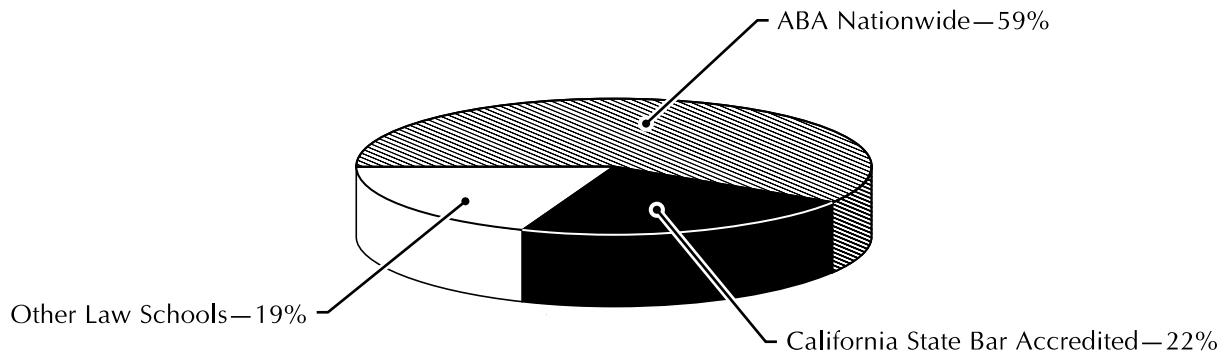
Total Enrollment in ABA-Accredited Schools Has Remained Fairly Stable

Total Law School Enrollment	1991	1992	1993	1994	1995	1996	1997
Schools nationwide accredited by ABA	129,580	128,212	127,802	128,989	129,318	128,623	125,886
California schools accredited by ABA	13,964	13,775	13,748	13,958	13,793	14,241	13,894
Schools accredited by State Bar	5,568	5,507	5,801	5,646	5,213	4,132	3,769

Unlike ABA-accredited schools, the enrollment figures for law schools accredited by the State Bar have decreased every year since 1993. However, as shown in Table 2, the sharpest decline occurred in 1996, which should not affect revenues until 1999 or 2000. Furthermore, because the number of students enrolled in these law schools is small, the decline in enrollment should not have a significant impact on revenue. As illustrated in Figure 6, using the average number of applicants taking the bar exam from 1993 through 1997, we determined that students from law schools accredited by the State Bar constituted 22 percent of all examinees, while students from ABA-accredited law schools represent 59 percent of examinees.

Figure 6

The Majority of Examinees Come From ABA-Accredited Law Schools



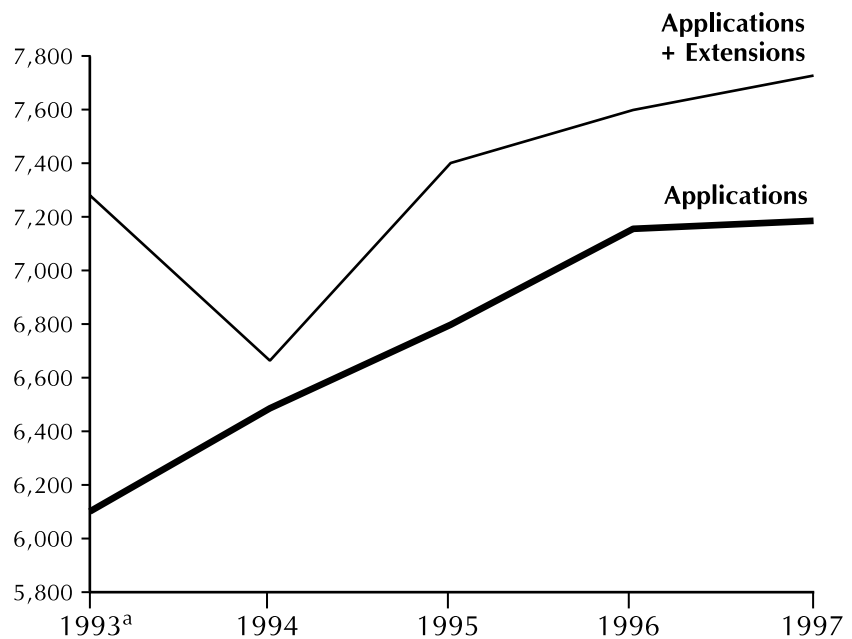
Note: Represents average percentages for the five-year period from 1993 to 1997.

While applications from students who attended schools accredited by the State Bar decreased in 1996 and 1997, overall admissions revenue increased from \$7.9 million in 1995 to \$8.3 million in 1996 and \$8.6 million in 1997. The revenues increased in 1996 and 1997 because the number of students from ABA-accredited schools applying to take the California bar exam increased steadily from 1995 through 1997. Some of this increase can be attributed to higher first-year enrollment in California ABA law schools from 4,691 in 1992 to 4,945 in 1994, which is likely to be reflected in the number of exam applicants in 1996 and 1997.

Admissions Projects the Number of Applications for Moral Character Determination to Remain Constant

Another area where we noted a trend of small increases was in the number of people who applied for moral character determinations. As shown in Figure 7, the number of applications increased from 7,407 in 1995 to 7,605 in 1996 and 7,733 in 1997. These changes are reasonable since during those same years, the number of people applying to take the bar exam also increased. With more people taking the exam in 1996 and 1997 and the passage rates remaining relatively constant at 45 percent for the February exam and 60 percent for the July exam, the number of applications for moral character determination should also rise in those years.

Figure 7
Applications for Moral Character Determination Continue to Rise



^a Changes in the extension requirements for moral character determination resulted in fewer extension applications after 1993.

To estimate the number of applications it would receive for moral character determinations, admissions considered the 1996 and 1997 increases in the number of exam applicants. As a result, rather than showing a significant decrease in the


number of applications it would receive, admissions projected only a slight decrease of 3 percent from 7,733 in 1997 to 7,500 in 1998.

***Revenue Projections for
1999 and 2000 Merely Reflect
Reductions in Interest Revenue***

The State Bar's revenue projections of \$7.8 million for 1999 and \$7.7 million for 2000 are understated not only because of expected low volume but also because of reductions in expected interest revenue. To prepare projections for these years, admissions merely used the 1998 projections for all revenue categories with one exception, interest revenue. Admissions projected revenue for 1999 to decrease \$86,205 from 1998, based on less interest revenue from the decreased fund balance. Similarly, because it projected a fund deficit for 2000, admissions did not include any interest revenue for that year. We believe that projected revenue figures for these years are also understated.



***The Expense Projection Contains
Questionable and Duplicative Expenses***

Although admissions prepared an expense projection that generally appears to be representative of its expected costs, we found that the projection contains certain questionable and duplicative expenses. Specifically, we question why admissions projected certain expenses to be significantly higher than actual expenses during most or all of the past five years. In addition, because admissions and the Office of Financial Planning did not coordinate certain decisions, they duplicated certain expenses associated with employee parking and building maintenance in the projection. Based on the information that admissions had when it prepared its projection, we determined that it should have projected expenses of \$8.9 million in 1998 rather than \$9.1 million. Furthermore, because it based its expense projections for 1999 and 2000 on its projection for 1998, we determined that these projections are also too high by \$190,983 in 1999 and \$196,158 in 2000.


Based on information it had when it prepared the projection, we believe admissions overstated expenses for 1998 by nearly \$200,000.

Admissions Projected Some Expenses Significantly Higher Than in Previous Years

In its projection for 1998, admissions estimated unusually high amounts for some expenses. Most notably, our review identified 17 expense categories for which admissions projected significant percentage increases in expenses for 1998 as compared to the past five years. Because past years' actual expenses were considerably lower, we question whether admissions had a reasonable basis for projecting these amounts.


Admissions projected significant increases for 17 expense categories without a reasonable basis for such projections.


For example, admissions projected three question-editing sessions in 1998 pertaining to the bar exam similar to its projections for the past three years. However, admissions only conducted two sessions during each of these years, resulting in it overprojecting these expenses by an average of \$24,000 per year. We therefore question the additional expense of \$23,494 projected for a third session. Similarly, admissions projected \$19,532 for travel costs for its exam readers even though the actual costs had not exceeded \$10,618 in any of the three previous years. The director of examinations could not explain why he had projected the \$19,532, but acknowledged that this amount was too high and that he would revise his estimate.

In another example, admissions projected \$15,000 for private sector services in 1998, yet expenses did not exceed \$1,366 during any of the five previous years. The director of operations and management projected this expense because he anticipated that admissions would make building modifications once it moved to a new building. He stated that the projection was based on past experience when admissions moved to a new location in Los Angeles. We questioned this amount because of the significant increase and because new office modifications are generally a one-time expense, yet admissions projected \$15,000 in this expense category for 1999 and 2000 as well.

Finally, admissions budgeted \$7,200 for telephone expenses in 1998 despite the fact that actual expenses were only \$1,859 in 1997 and did not exceed \$4,100 in any of the past five years. The director of operations and management stated that the estimate was based on the prior years' actual costs. However, we do not see any correlation between the projection for 1998 and actual telephone costs in the past five years.

Although individually, the dollar amounts for the 17 items may appear small, they comprise approximately \$125,000 of the increase in the projection of expenses for 1998. Furthermore, we identified 47 other expense categories in the projection that

appeared substantially higher than prior years. Although we did not inquire about these categories, they represent an increase of \$61,066 in the projection.

Lack of Coordination Resulted in Inflated Projection of Parking and Maintenance and Repair Expenses

Admissions and the Office of Financial Planning did not coordinate efforts when developing the projection for certain expenses. For example, we identified three separate amounts for employee parking in the expense projection for 1998. The State Bar leases parking spaces from private garages and from the California Department of Transportation and provides them free to its employees at its existing San Francisco locations. As part of its annual budget, the State Bar distributes these lease costs among its various funds and cost centers. Therefore, parking costs for admissions staff are included within the fringe benefit allocation for admissions. The Office of Financial Planning projected \$3,855 for parking expenses in 1998 in this category.

◆
Admissions and another State Bar office should have jointly agreed on a method for projecting parking expenses to avoid duplication.

Meanwhile, the director of operations and management also earmarked \$46,200 in the special projects cost center for parking. According to the director, this amount is an estimate of the annual parking costs that will be incurred by all admissions staff in San Francisco after the office moved to a new location. He assumed that admissions would move in January 1998. The director informed us that he was unaware parking costs were already included in the fringe benefit allocation. At the same time, the director of examinations budgeted \$5,760 in parking expenses for eight employees in his section who had already moved to the new location. Apparently this director was also not aware of the \$3,855 included in the fringe benefit allocation. In addition, it appears that neither director was aware that the other had budgeted for parking.

Because admissions based its projection on the assumption that it would be moving to the new location at the beginning of the year, it should have identified the total amount to budget for parking and instructed its directors on how to properly reflect this estimate. Instead, the directors did not coordinate their efforts and ended up budgeting the same parking expenses in two different cost centers. In addition, admissions and the Office of Financial Planning should have jointly agreed on a method for projecting parking expenses that avoids duplicating costs. As shown in Table 3, by budgeting three separate

amounts, admissions and the Office of Financial Planning collectively inflated the estimate of parking costs by \$9,615 in 1998.

Table 3

***Admissions Projected
Duplicate Parking Expenses***

Cost Center	Amount Included in State Bar Budget	Appropriate Budget Amount	Duplicate Budget Amount
Special projects	\$46,200	\$46,200	\$ 0
Examinations	5,760	0	5,760
Fringe allocation	3,855	0	3,855
Total Parking/Transportation	\$55,815	\$46,200	\$9,615

Admissions and the Office of Financial Planning also did not coordinate efforts when budgeting for rental expense and maintenance and repair costs. The State Bar purchased a new building in San Francisco in March 1996 and planned to move employees from its two existing San Francisco offices and its San Mateo office in January 1998. Admissions budgeted \$130,000 in rental expense for 1998. The director of operations and management said this amount represents his estimate of the rent that the State Bar planned to charge admissions for occupying the new building for the entire year. At the same time, the senior financial analyst of the Office of Financial Planning, on behalf of the State Bar, budgeted maintenance and repair costs associated with one of its existing buildings, \$51,383 of which represented the share for admissions. However, the budgeted amount was based on the assumption that admissions would remain in the existing building for the entire year, which contradicts admissions' assumption that it would move to the new building at the beginning of the year. By not coordinating their efforts, admissions and the Office of Financial Planning collectively overbudgeted maintenance costs by \$51,383.


◆
The State Bar budgeted over \$50,000 for maintenance and repair expenses on a building that it planned to vacate.
 ◆

Admissions Established a Reserve to Cover Certain General and Administrative Expenses

A large portion of the increase in projected expenses for 1998 pertains to a reserve that admissions established for the first time to pay for certain general and administrative services provided by the State Bar. Specifically, admissions budgeted \$190,000 for the cost of services in 1998 by the State Bar Court, the Office of General Counsel, and the Office of the Chief Trial Counsel. According to its senior executive, admissions routinely uses these resources of the State Bar as part of its operations. For example, it uses the State Bar Court to adjudicate appeals of moral character determination denials. In the past, admissions was not required to pay for these services. However, the senior executive, in anticipation that the State Bar intended to charge the Admissions Fund through the allocation of general and administrative expenses, projected this expense for 1998. The senior executive informed us that he projected this cost by estimating the amount of staff resources admissions uses from these three entities and totaling the salaries associated with those resources. For instance, he estimated that during an average year, admissions uses the equivalent of one full-time experienced attorney from the Office of General Counsel with a salary of \$90,000. Although this methodology appears reasonable, the senior executive informed us that at the time he projected the expense, he did not prepare written documentation to support these calculations; thus, we were unable to verify them.

Admissions Overstated Its Projection of Expenses

Because admissions based its estimates of 1998 expenses on questionable assumptions and incorporated those assumptions into its expense projections for 1999 and 2000, we believe that its projections for all three years are too high. As shown in Table 4, we found that the expense projection for 1998 is overstated by \$185,958 because of erroneous and questionable costs. In addition, the expense projections for 1999 and 2000 are also overstated. Specifically, admissions increased many of its expense categories in the 1999 and 2000 projections by 2.5 percent or 3 percent to adjust for inflation. Because it used this inflation factor to carry the erroneous and questionable costs for 1998 to its projections for 1999 and 2000, these projections are overstated by \$190,983 for 1999 and \$196,158


Erroneous and questionable costs in the 1998 projection were also included in expense projections for 1999 and 2000.

for 2000. While these overstatements may not appear significant, they contribute to the overall distortion of admissions' financial condition.

Table 4

The Projected Expenses for the Admissions Fund Are Overstated

State Bar Projected Expenses for 1998	\$9,086,333
Less questionable and duplicate expenses:	
Questionable costs ^a	\$(124,960)
Duplicative costs:	
Building repair and maintenance	(51,383)
Parking	(9,615)
Overstated Expenses	\$(185,958)
Total Auditor Projected Expenses for 1998	\$8,900,375

^a Appendix C summarizes these questionable costs.

Inconsistent Assumptions Diminish the Reliability of the Overall Projection of Revenues and Expenses

Admissions used the lower number of applicants in 1995 to project revenues, yet it used the higher numbers in 1996 and 1997 to project certain expenses.

Admissions used inconsistent assumptions when it developed its estimates for certain revenue and expense categories. Certain assumptions it used for projecting expenses were clearly inconsistent with those it used for projecting revenues. For example, the director of examinations projected \$489,921 for the grading of a portion of the February 1998 and July 1998 bar exams based on the assumption that the same number of people would take the exam in 1998 as in 1997. The same director also estimated the costs of readers to grade the bar exams in 1998 at \$452,382, which was similar to actual costs incurred in 1996. Furthermore, the director of operations and management estimated costs for examination proctors in 1998 to be comparable to those in 1997. However, when projecting exam revenues, this director estimated the number of applicants in 1998 to be equivalent to those in 1995, a considerably lower number. By not using consistent assumptions for estimating both revenues and expenses, admissions has diminished the reliability of its overall projection of fund balance.

***Actual Expenses May Differ
Based on Events Occurring After
the State Bar and Admissions
Prepared the Projection***

Admissions based its 1998 projection of expenses on the assumption that it would continue to exist in the normal environment of the State Bar. In October 1997, the governor vetoed Senate Bill 1145, the bill that would have established annual membership fees in 1998 and 1999 for members of the State Bar. Previously, the State Bar could collect from \$379 to \$478 annually from each active member; however, as a result of the governor's veto, the State Bar is only collecting a base fee of \$77 per member. No additional fees are required, although members can voluntarily pay additional amounts. Because few members are paying voluntary fees, membership fee revenue in the State Bar's general fund for the first quarter of 1998 was only \$1.1 million as compared to \$12.3 million during the first quarter of 1997. Due to the significant reduction in fee revenue, the State Bar is now requiring other funds, such as the Admissions Fund, to cover some of the costs previously paid from the general fund.

◆
*Due to a decrease in
general fund revenue, the
State Bar is requiring the
Admissions Fund to bear
the cost of outside
counsel.*

The senior executive of admissions informed us that because of the veto, actual costs charged to the Admissions Fund will likely be different from the amounts presented in the projection. One significant difference pertains to outside legal costs that the State Bar is now requiring admissions to pay. In September 1997, a lawsuit was filed against the State Bar charging a lack of reasonable accommodations for disabled exam applicants. As a result, the State Bar contracted with a legal firm that specializes in representing this type of case. When contracting for specialized legal counsel to defend outside lawsuits, the State Bar's normal policy is to pay the legal fees from its general fund. The State Bar informed us that it paid \$61,993 from the general fund from November 1997 to January 1998 for legal fees related to this lawsuit.

Because of the veto and the lack of revenue in the general fund, the State Bar's general counsel informed the committee that the State Bar would no longer pay outside counsel expenses from its general fund at some point in 1998. Because the case pertained to admissions, the committee agreed in December 1997 to pay the legal costs from the Admissions Fund. Admissions informed us that it paid \$45,973 for these costs during February and March 1998. The State Bar's outside counsel informed us that typical costs for comparable cases in a

similar pretrial stage range between \$300,000 and \$350,000. However, these costs are not reflected in the expense projection admissions prepared in October 1997.

In addition, the senior executive informed us that salary expenses will differ from those in the projection. The board delayed salary increases for State Bar employees, pending resolution of the membership fee structure. Because the projection included these salary increases, the senior executive expects actual expenses to be lower in 1998. Similarly, the State Bar placed a freeze on hiring employees to fill vacant positions. However, projected salaries and wages are based on authorized positions; therefore, actual expenses will be less than budgeted. The senior executive also informed us that admissions may delay the purchase of \$272,000 in new computer equipment it included in its projection.

Table 5 summarizes the impact of these recent funding decisions on the Admissions Fund for 1998. Because of the uncertainty regarding the outcome of the governor's veto and the impact on the organizational funding decisions as well as the impact of legislation currently being considered, we do not know how these events will affect the projections for 1999 and 2000.

Table 5

Recent Events Will Impact the Actual Expenses of the Admissions Fund


Total Auditor Projected Expenses for 1998	\$8,900,375
Adjustments to expenses resulting from the veto of the membership fee bill:	
Salaries	\$(381,975)
Computer equipment	(272,000)
Potential litigation expenses ^a	325,000
Total Adjustments	\$(328,975)
Total Auditor Projected Expenses for 1998 After Adjustments	\$8,571,400

^a We used the midpoint of the estimate referred to above.

***The State Bar's New Policy
for Charging Rent Creates Another
Revenue Source for Its Building Fund***

As part of its statutory base membership fee, the State Bar collects \$10 from each member for restricted uses such as financing, constructing, purchasing, or leasing facilities to house State Bar staff. The State Bar has pledged a portion of the \$10 to pay off the loan that it incurred to purchase the new building in San Francisco. As a result of this pledge, the State Bar cannot reduce the \$10 amount charged to its members until the debt is paid.

While we were not asked to review the activity of the State Bar's building fund, we determined that admissions budgeted \$130,000 in 1998 for rent that the State Bar planned to charge admissions after it moves into the new building. According to the senior executive of administration and finance, the State Bar does plan to charge rent to admissions and other self-funded operations at the State Bar as part of its policy to allocate general costs to the entities that benefit from them. As of April 1998, the State Bar has not yet determined the amounts it will charge. However, when it does collect rent, the State Bar will now have a source of revenue to pay off the loan, in addition to the \$10 it collects from current members of the State Bar. The State Bar therefore may be able to reduce the mandatory \$10 fee that it collects from its members sooner than originally expected.


The State Bar may be able to retire the new building loan sooner than expected.

Conclusion

Admissions understated its projection of revenues in 1998 because it primarily used data from 1995 rather than using statistical data on law school enrollments and historical data of exam applicants. In addition, admissions overstated its projection of expenses in this same year because it included questionable and duplicative costs in the projection. As a result, its projection of a bleak financial condition in 1998 is distorted. Moreover, because it based its revenue and expense projections for 1999 and 2000 on this erroneous projection for 1998, we believe that estimates of revenues, expenses, and fund balance for these years are also distorted. As a result, admissions is inaccurately portraying a bleak financial outlook. We estimate the Admissions Fund will incur a deficit of no more than \$629,000 in 2000, which is significantly less than the deficit of \$2.1 million projected by admissions.

Actual expenses for 1998 could be \$329,000 less than the amount projected by admissions because of funding decisions resulting from the governor's veto of the State Bar's membership fee bill. Because of the uncertainty regarding the effect of organizational funding decisions as well as the impact of legislation currently being considered, we cannot project the impact of these events for 1999 and 2000.

Recommendations

To develop reliable projections of revenues and expenses, and thus its future financial condition, admissions should do the following:

- Use statistical data on law school enrollments and historical data of exam applicants to project exam revenues.
- Use assumptions that are reasonable and justifiable in developing estimates of future activity. In addition, ensure that it consistently applies these assumptions on both the revenue and expense sections of the projection.
- Coordinate responsibilities among its directors to ensure they are accounting for all cost categories and are not budgeting for expenses already accounted for by others.
- Prepare and maintain documentation to support its basis for projecting revenues and expenses that are significantly different from those of prior years.

In addition, admissions and the Office of Financial Planning should clarify with each other the methods used to budget certain Admissions Fund expenses, such as parking and building costs, to ensure that these expenses are not duplicated in the overall projection for the Admissions Fund.

Finally, the State Bar should consider the impact of an additional revenue source for the State Bar's building fund and assess the possibility of reducing the mandatory \$10 fee sooner than expected.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

A handwritten signature in black ink, reading "Kurt R. Sjoberg". The signature is written in a cursive style with a prominent initial "K".

KURT R. SJOBERG
State Auditor

Date: May 20, 1998

Staff: Elaine M. Howle, CPA, Audit Principal
Linus A. Li, CPA, CMA
Tyler Covey
Dawn Tomita

Appendix A

Financial Condition of the Admissions Fund, Including the State Bar's Projections for 1998 Through 2000

	Year	Revenues	Expenses	Beginning Fund Balance	Difference Between Revenues and Expenditures	Year-End Adjustment ^a	Ending Fund Balance
	1993	\$7,559,879	\$7,358,626	\$ 761,698	\$ 201,253	\$(37,828)	\$ 925,123
	1994	7,785,089	7,618,055	925,123	167,034	(47,423)	1,044,734
Actual	1995	7,871,121	7,337,808	1,044,734	533,313	(48,329)	1,529,718
	1996	8,339,381	7,886,216	1,529,718	453,165	(4,592)	1,978,291
	1997	8,568,816	8,319,436	1,978,291	249,380	(39,539)	2,188,132
State Bar's Projections	1998	7,886,928	9,086,333	2,188,132	(1,199,405)	0	988,727
	1999	7,800,723	9,171,821	988,727	(1,371,098)	0	(382,371)
	2000	7,691,964	9,395,606	(382,371)	(1,703,642)	0	(2,086,013)

^a Adjustment represents transfer of fixed assets to the State Bar's Fixed Assets Fund.

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Appendix B

California State Auditor's Methodology for Projecting Revenue

To develop our estimate of 1998 revenue, we focused on three revenue sources constituting 76 percent of all revenue collected in 1997: fees collected from the February and July bar exams, and moral character determinations. Because the Office of Admissions (admissions) has already administered the February 1998 exam, we used actual revenues generated by that exam in our projection, information that was not available at the time admissions prepared its original projection. To project the amount of revenue that the July 1998 exam would generate, we developed three analyses to estimate the number of applicants admissions could expect. These three analyses resulted in estimates of 8,094, 8,457, and 8,356 applicants.

We also consulted with a statistics expert who prepared a regression analysis of exam applicants from 1993 to 1997. This analysis identified a high correlation between the number of applicants for the February and July exams, meaning that the fluctuations in the number of applicants for the two exams are similar. Using this analysis, our expert estimated 8,309 applicants for the July 1998 exam. We selected this number to use in our revenue projection because of the high correlation and the proximity to our three estimates.

We also reviewed the projection admissions made for the amount of revenue it will generate in 1998 for moral character determinations and concluded that based on prior-year history, these projections appear reasonable. We therefore used that same amount in our estimate. Finally, because the remaining revenue sources, such as registration fees and fees paid by students taking the first-year law student exam, are relatively small compared to the three major sources of revenue discussed above, we also used the projections admissions made for these other revenue categories in our estimate.

To project revenues for 1999 and 2000, we developed four analyses to estimate the number of applicants for the February and July exams. We based these analyses on the changes in the number of applicants from past years' exams. For the same reasons as described above, we used the projections made by admissions for the other revenue sources. Using each of these

analyses, along with our projections of expenses discussed on page 18, we calculated a range of the potential fund balance for 1999 and 2000.

Appendix C

Summary of Questionable Projected Expenses

Cost Center	Name	Questionable Amount
Admissions—Special Projects	Outside services other	\$ 13,886
Committee of Bar Examiners	Catering	5,947
	Travel volunteers	10,936
Educational Standards	Catering	6,000
Examination Development	Readers travel	9,015
	Question development	23,494
	Readers book fee	6,707
Measurement Center	Outside services other	4,000
	Transportation staff	1,025
Operations—Los Angeles	Exam room rental—February general bar examination	15,159
	Telephone—February general bar examination	5,341
	Reporting transcribing	4,299
	Electrical—general bar examination	4,220
	Meeting room rental	4,000
	Furniture rental	4,000
	Proctors—February general bar examination	1,214
Operations—San Francisco	Equipment rental	5,717
Total Questionable Expenses		\$124,960

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Agency's response to the report provided as text only:

THE STATE BAR OF CALIFORNIA
555 Franklin Street
San Francisco, CA 94102
(415) 561-8200

May 12, 1998

Kurt R. Sjoberg
California State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, California 95814

Dear Mr. Sjoberg:

Thank you for the opportunity to respond to your review of the 1998 revenue and expense projections for the Admissions Fund of The State Bar of California.

We particularly appreciate your recognition that the uncertainties facing the State Bar of California because of the veto of the State Bar's 1998 license fee bill were not known at the time the 1998 budget for the Admissions Fund was drafted and that the yet to be determined structure and fee level for the State Bar will have a direct, but as of yet unknown, impact on the budget of the Admissions Fund in 1998 as well as in future years. For example, outside litigation costs were not provided for in the 1998 budget because the pre-veto general practice was to pay for such counsel from the State Bar General Fund. We also appreciate your recognition that it is reasonable for admissions to pay for State Bar staff resources it utilizes (such as General Counsel, State Bar Court and the Office of Trial Counsel), and we expect that our future budgeting for such items will be significantly impacted by the post-veto environment.

We are also gratified that the State Auditor's audit team's projections, using actual figures for the February 1998 administration of the California Bar Examination that were not available to the Committee in 1997 when it prepared its projections in, agree with the Committee and the Admissions Office that expenses during 1998, 1999 and 2000 are likely to be greater than revenue and that the January 1, 1998 carry forward of \$2,200,000 may very well be exhausted during the year 2000. Both the Committee and the Admissions Office intend to implement your recommendations and propose appropriate expense and revenue corrections to insure the continued solvency of the bar admissions process in California.

Our specific comments to the audit recommendations follow:

- Use current statistical data and historical data to project exam revenues.

We agree. The Committee has been doing this as well as using its experience and expertise in predicting anticipated applications to take Committee administered examinations. It will take into account statistically accepted models for projecting the number of applications likely to be annually received for purposes of preparing future budgets.

- Use reasonable and justifiable assumptions in developing estimates of future activity and apply these assumptions consistently.

We agree. The budgeting assumptions will be reviewed to ensure that they are reasonable and justifiable. Future budgets will assume a consistent number of applicants for both revenue and expenditure purposes, and the Committee will be asked to explore creating a contingency line item based on trends and historical expenses to ensure against a variance in application driven revenue and expenses.

- Coordinate responsibilities among its directors to ensure that all costs are covered but not duplicated.

We agree. Budgeting procedures will be reviewed to ensure that each department covers all costs attributable to it and that there are no duplicated items.

- Prepare and maintain documentation to support its basis for projecting revenues and expenses that are significantly different from those of prior years.

We agree. Projections of revenue and expense that differ significantly from prior years will be required to be justified in writing and will be subjected to enhanced scrutiny.

- In addition, admissions and the Office of Financial Planning should clarify with each other the methods used to budget certain admissions fund expenses, such as parking and building costs to ensure that these expenses are not duplicated in the overall projection for the Admissions Fund.

Kurt R. Sjoberg
May 12, 1998
Page 3

We agree. Budget instructions distributed to departments by the Office of Financial Planning will be reviewed and modified where necessary to ensure it is clear which expenses are to be budgeted directly, and which will be part of the State Bar's overhead. We anticipate that some of the issues relative to this recommendation will be resolved when the State Bar is permanently housed in one facility.

The State Bar of California, its Committee of Bar Examiners and its Office of Admissions share the obligation to ensure that only those who are able and of good character are recommended to the California Supreme Court for admission to practice law in this state. They are committed to maintaining what is generally acknowledged to be the finest and most psychometrically sound bar examination in the United States. They conduct thorough but not unnecessarily intrusive moral character determinations at the most economical cost to those who apply to be licensed as lawyers in California, whose application fees provide the overwhelming majority of the fiscal resources available to the Committee and the Admissions Office to carry out their duties and responsibilities. And in this regard, it is important to note that the fees for taking Committee examinations and for determinations of moral character have been unchanged since 1992. We are particularly pleased to receive your comments and recommendations with respect to the revenue and expense projections of the Admissions Fund from 1998 through 2000, that we note were prepared at no cost to the applicants for admission to practice law in California who will benefit from them. We are confident that implementation of your suggestions combined with the good judgment and prudence of the Committee will result in the continued fiscal health of the Admissions Fund.

Finally, we would like to thank you and your staff who prepared the review. The audit team was both courteous and thoughtful.

Sincerely,

Marc D. Adelman
President

cc: Adisa Abudu-Davis, Chair
Committee of Bar Examiners
Steve Nissen, Executive Director
State Bar of California
Jerome Braun, Senior Executive
T. William Melis, Senior Executive

cc: Members of the Legislature
Office of the Lieutenant Governor
Attorney General
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps