STATE of CALIFORNIA
COMMISSION ON STATE MANDATES

November 9, 2026

Ms. Annette Chinn
Cost Recovery Systems, Inc.
705-2 East Bidwell Street, #294
Folsom, CA 95630

Ms. Anne Kato
State Controller's Office
Local Government Programs
and Services Division
3301 C Street, Suite 740
Sacramento, CA 95816

And Parties, Interested Parties, and Interested Persons (See Mailing List)

Re: Draft Proposed Decision, Schedule for Comments, and Notice of Hearing
Identity Theft, 25-0308-I-02
Statutes 2000, Chapter 956 (AB 1897); Penal Code Section 530.6(a)
Fiscal Years: 2002-2003, 2003-2004, 2004-2005, 2005-2006, 2006-2007, 2007-2008, 2008-2009, 2009-2010, 2010-2011, 2011-2012, 2012-2013
City of Hesperia, Claimant

Dear Ms. Chinn, and Ms. Kato:

The Draft Proposed Decision for the above-captioned matter is enclosed for your review and comment.

Written Comments: Written comments may be filed on the Draft Proposed Decision **by November 30, 2026**. Please note that all representations of fact submitted to the Commission must be signed under penalty of perjury by persons who are authorized and competent to do so and must be based upon the declarant's personal knowledge, information, or belief. (Cal. Code Regs., tit. 2, § 1187.5.) Hearsay evidence may be used for the purpose of supplementing or explaining other evidence but shall not be sufficient in itself to support a finding unless it would be admissible over an objection in civil actions. (Cal. Code Regs., tit. 2, § 1187.5.) The Commission's ultimate findings of fact must be supported by substantial evidence in the record.[1]

You are advised that comments filed with the Commission are required to be electronically filed (e-filed) in an unlocked legible and searchable PDF file, using the Commission's Dropbox. (Cal. Code Regs., tit. 2, § 1181.3(f).) Refer to https://www.csm.ca.gov/dropbox.shtml on the Commission's website for electronic filing instructions. If e-filing would cause the filer undue hardship or significant prejudice, filing may occur by first class mail, overnight delivery or personal service only upon approval of a request to the executive director. (Cal. Code Regs., tit. 2, § 1181.3(j).)

If you would like to request an extension of time to file comments, please refer to section 1187.9(a) of the Commission's regulations.

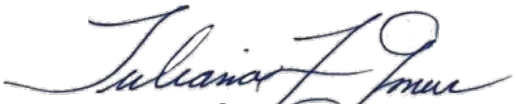
[1] Government Code section 17559(b), which provides that a claimant or the state may commence a proceeding in accordance with the provisions of section 1094.5 of the Code of Civil Procedure to set aside a decision of the Commission on the ground that the Commission's decision is not supported by substantial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

Hearing: This matter is set for hearing on **Friday, February 12, 2027**, at 10:00 a.m. The Proposed Decision will be issued on or about January 29, 2027.

If you plan to address the Commission on this item, please notify the Commission Office not later than noon on **February 9, 2027.** Please also include the names of the people who will be speaking for inclusion on the witness list and the names and emails addresses of the people who will be speaking both in person and remotely to receive a hearing panelist link in Zoom. When calling or emailing, please identify the item you want to testify on and the entity you represent. The Commission Chairperson reserves the right to impose time limits on presentations as may be necessary to complete the agenda.

If you would like to request postponement of the hearing, please refer to section 1187.9(b) of the Commission's regulations.

Very truly yours,



Juliana F. Gmur
Executive Director

Hearing Date: February 12, 2027

ITEM ___

INCORRECT REDUCTION CLAIM

DRAFT PROPOSED DECISION

Penal Code Section 530.6(a)

Statutes of 2000, Chapter 956

Identity Theft

Fiscal Years 2002-2003 – 2012-2013

25-0308-I-02

City of Hesperia, Claimant

EXECUTIVE SUMMARY

Overview

This Incorrect Reduction Claim (IRC) addresses a reduction of indirect costs made by the State Controller (Controller) to costs claimed by the City of Hesperia (claimant) during fiscal years 2002-2003 to 2012-2013 to implement the *Identity Theft* program. The claimant contracts with the County of San Bernardino for all of its law enforcement services, which are provided through the San Bernardino County Sheriff's Department.[1] The claimant challenges the Controller's reduction of claimed indirect costs and its separate calculation of an administrative cost allowance for direct contract service costs.

Staff recommends that the Commission on State Mandates (Commission) deny this IRC.

Commission Responsibilities

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

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

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[1] Exhibit A, Incorrect Reduction Claim, page 8 (Written Narrative); see also Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 79 (Law Enforcement Service Contract).

The Commission must review questions of law, including interpretation of parameters and guidelines, de novo, without consideration of legal conclusions made by the Controller in the context of an audit. The Commission is vested with exclusive authority to adjudicate disputes over the existence of state-mandated programs within the meaning of article XIII B, section 6 of the California Constitution.[2] The Commission must also interpret the Government Code and implementing regulations in accordance with the broader constitution and statutory scheme. In making its decisions, the Commission must strictly construe article XIII B, section 6 and not apply it as an "equitable remedy to cure the perceived unfairness resulting from political decisions on funding priorities."[3]

With regard to the Controller's audit decisions, the Commission must determine whether they were arbitrary, capricious, or entirely lacking in evidentiary support. This standard is similar to the standard used by the courts when reviewing an alleged abuse of discretion of a state agency.[4]

The Commission must also review the Controller's audit in light of the fact that the initial burden of providing evidence for a claim of reimbursement lies with the claimant.[5] In addition, sections 1185.1(f)(3) and 1185.2(d) and (e) of the Commission's regulations require that any assertions of fact by the parties to an IRC must be supported by documentary evidence. The Commission's ultimate findings of fact must be supported by substantial evidence in the record.[6]

Claims

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

Issue	Description	Staff Recommendation
Did the claimant timely file this IRC?	Government Code section 17558.7(a) states "If the Controller reduces a claim approved by the	*Yes, the IRC was timely filed.*

[2] *Kinlaw v. State of California* (1991) 54 Cal.3d 326, 331-334; Government Code sections 17551, 17552.

[3] *County of Sonoma v. Commission on State Mandates* (2000) 84 Cal.App.4th 1264, 1281, citing *City of San Jose v. State of California* (1996) 45 Cal.App.4th 1802, 1817.

[4] *Johnston v. Sonoma County Agricultural Preservation and Open Space District* (2002) 100 Cal.App.4th 973, 983-984; *American Bd. of Cosmetic Surgery, Inc. v. Medical Bd. of California* (2008) 162 Cal.App.4th 534, 547.

[5] *Gilbert v. City of Sunnyvale* (2005) 130 Cal.App.4th 1264, 1274-1275.

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

Issue	Description	Staff Recommendation
	commission, the claimant may file with the commission an incorrect reduction claim pursuant to regulations adopted by the commission." Section 1185.1(c) of the Commission's regulations requires an IRC to be filed no later than three years after the date the claimant receives a final state audit report, letter, or other written notice of adjustment to a reimbursement claim.	The City of Hesperia was issued the final audit report on June 21, 2023.[7] The IRC was filed by the City of Hesperia on February 18, 2026.[8] As this was within three years of the final audit report's date of issuance, the IRC was timely filed.
Is the Controller's reduction of indirect costs from $93,642 to $0 correct?	The Parameters and Guidelines require reimbursement only for actual costs incurred by a claimant to implement the mandated activities.[9] The Parameters and Guidelines allow reimbursement for direct costs, such as contract costs, and indirect costs. Indirect costs are incurred	*Yes, the reduction of indirect costs is correct as a matter of law.* The claimant does not employ its own peace officers or incur its own peace officer labor costs, yet it based its ICRPs on the salary and wage costs of peace officers employed by San Bernardino County as though they were the

[7] Exhibit A, Incorrect Reduction Claim, page 639 (Final Audit Report).

[8] Exhibit A, Incorrect Reduction Claim, page 1.

[9] Exhibit A, Incorrect Reduction Claim, page 608 (Parameters and Guidelines, Section IV.). This is consistent with the purpose of article XIII B, section 6, which is to require reimbursement only when a mandated new program or higher level of service forces a local government claimant to incur "increased actual expenditures of limited tax proceeds that are counted against the local government's spending limit." (*County of Sonoma v. Commission on State Mandates* (2000) 84 Cal.App.4th 1264, 1283.) See also, *Department of Finance v. Commission on State Mandates* (2016) 1 Cal.5th 749, 763, citing to *County of San Diego v. Commission on State Mandates* (1997) 15 Cal.4th 68, 81 ("The purpose of section 6 is to prevent "the state from shifting financial responsibility for carrying out governmental functions to local agencies, which are 'ill equipped' to assume increased financial responsibilities because of the taxing and spending limitations that articles XIII A and XIII B impose.").

Issue	Description	Staff Recommendation
	for a common or joint purpose, benefit more than one program, and are not directly assignable to a particular program. They may include overhead of the unit performing the mandate and central government service costs distributed to other departments under a cost allocation plan.[10] Section V.B. of the Parameters and Guidelines provides that a claimant incurring indirect costs due to this mandated program may use 10% of labor (excluding fringe benefits) or prepare an Indirect Cost Rate Proposal (ICRP) if the claimed rate exceeds 10% pursuant to the procedure in OMB Circular A-87 (2 CFR Part 225). An ICRP's distribution base may be total direct costs (subject to exclusions), direct salaries and wages, or another base which results in an equitable distribution.[11] Parameters and Guidelines are regulatory	claimant's own direct labor costs, calculating rates ranging from 71.7% to 100.4%.[14] The claimant's actual direct costs were those incurred under its contract for law enforcement services. The ICRPs therefore did not use the claimant's actual direct costs or another permissible distribution base and did not comply with the Parameters and Guidelines. Independently, the claimant has not demonstrated that it incurred actual increased costs that qualify as reimbursable indirect costs under the *Identity Theft* Program. The claimant's contract service costs are direct costs for the reimbursable activities. San Bernardino County's overhead and support costs do not become the claimant's indirect costs by virtue of the claimant's contract for law enforcement services. Further, the claimant has not claimed or

[10] Exhibit A, Incorrect Reduction Claim, page 610 (Parameters and Guidelines, Section V.B.).

[11] Exhibit A, Incorrect Reduction Claim, page 610 (Parameters and Guidelines, Section V.B.).

[14] Exhibit A, Incorrect Reduction Claim, pages 663, 670, 677, 684, 691, 698, 705, 712, 719, 727, 735 (Reimbursement Claims, ICRPs).

Issue	Description	Staff Recommendation
	and binding on the parties.[12] For the review period, the claimant claimed $196,301, consisting of $102,659 in salary costs and $93,642 in related indirect costs. The Controller found both cost categories unallowable as claimed. This included $102,659 in unallowable salary costs, which the Controller determined should have been classified as contract costs, and $93,642 in unallowable indirect costs, which the Controller reduced to $0. The Controller recognized $115,473 in allowable contract service costs, including an additional allowance for administrative costs, resulting in a net adjustment of $80,828 in unallowable costs.[13]	demonstrated that it incurred any overhead or other support costs of its own on which to base a claim for indirect costs under the Parameters and Guidelines. On both grounds, the Controller's reduction of indirect costs is correct as a matter of law.
Is the Controller's administrative cost allowance related to its reduction of indirect costs, or otherwise arbitrary, capricious, or entirely	Section V.A.3. of the Parameters and Guidelines identifies contracted services as a direct-cost category.[15] For contracted services, the claimant must identify the	*No, the Controller's additional allowance for administrative costs included in the claimant's direct contract service costs is separate from its reduction of indirect costs*

[12] *California School Boards Association v. State of California* (2009) 171 Cal.App.4th 1183, 1201; *Clovis Unified School District v. Chiang* (2010) 188 Cal.App.4th 794, 798; Government Code sections 17561(d)(1), 17564(b), and 17571.

[13] Exhibit A, Incorrect Reduction Claim, page 648 (Final Audit Report).

[15] Exhibit A, Incorrect Reduction Claim, page 609 (Parameters and Guidelines).

Issue	Description	Staff Recommendation
lacking in evidentiary support?	contractor and services performed.[16] The claim must be supported by the contract and invoices, together with the applicable hours and costs.[17] The Controller identified in the claimant's contract with San Bernardino County certain administrative line items applicable to the *Identity Theft* program that were not incorporated into employee hourly rates. The Controller provided an additional allowance to account for those charges when calculating allowable direct contract service costs. To do so, it calculated annual administrative percentages ranging from 4.87% to 7.75% by dividing the designated line-item amounts by total contract costs and applied those percentages to increase employee hourly rates.[18]	*and is not arbitrary, capricious, or entirely lacking in evidentiary support.* The Controller's allowance of additional administrative costs increased allowable direct costs. This increase was distinct from and independent of the Controller's reduction of claimed indirect costs. The Controller made that reduction because the claimant's ICRPs were improperly prepared using salary and benefits costs that the claimant did not incur.[19] In contrast, the Controller recalculated allowable direct contract costs to reflect administrative contract line items not otherwise captured by employee hourly rates. These were separate determinations addressing different reimbursement questions and distinct cost categories. The record demonstrates a rational connection between the factors considered and the Controller's determination.

[16] Exhibit A, Incorrect Reduction Claim, page 609 (Parameters and Guidelines).

[17] Exhibit A, Incorrect Reduction Claim, page 609 (Parameters and Guidelines).

[18] Exhibit A, Incorrect Reduction Claim, pages 651-652 (Final Audit Report).

[19] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 15 (Background) and page 16 (Issue).

Issue	Description	Staff Recommendation
		The Controller's allowance of these additional administrative costs therefore was not arbitrary, capricious, or entirely lacking in evidentiary support.

Staff Analysis

A. The Claimant Timely Filed this IRC Within Three Years from the Date the Claimant First Received from the Controller a Final State Audit Report, Letter, or Other Written Notice of Adjustment to a Reimbursement Claim, which Complies with Government Code Section 17558.5(c).

Section 1185.1 of the Commission's regulations requires an IRC to be filed no later than three years after the Controller's final audit report, or other notice of adjustment that complies with Government Code section 17558.5(c). The Final Audit Report, issued June 21, 2023, specifies the claim components and amounts adjusted, and the reasons for the adjustments, and thereby complies with the notice requirements in section 17558.5(c).[20] Because the claimant filed the IRC on February 18, 2026,[21] less than three years from the issuance date of the Final Audit Report, staff finds that the IRC was timely filed.

B. The Controller's Reduction of Indirect Costs from $93,642 to $0 Is Correct as a Matter of Law.

Under the Parameters and Guidelines, which are regulatory and binding on the parties, only costs actually incurred by the claimant to implement the mandated activities may be claimed for reimbursement.[22] Contract service costs are direct costs under the

[20] Exhibit A, Incorrect Reduction Claim, page 639 (Final Audit Report).

[21] Exhibit A, Incorrect Reduction Claim, page 1.

[22] Exhibit A, Incorrect Reduction Claim, page 608 (Parameters and Guidelines). This is consistent with the purpose of article XIII B, section 6, which is to require reimbursement only when a mandated new program or higher level of service forces a local government claimant to incur "increased actual expenditures of limited tax proceeds that are counted against the local government's spending limit." (*County of Sonoma v. Commission on State Mandates* (2000) 84 Cal.App.4th 1264, 1283.) See also, *Department of Finance v. Commission on State Mandates* (2016) 1 Cal.5th 749, 763, citing to *County of San Diego v. Commission on State Mandates* (1997) 15 Cal.4th 68, 81 ("The purpose of section 6 is to prevent "the state from shifting financial responsibility for carrying out governmental functions to local agencies, which are 'ill equipped' to assume increased financial responsibilities because of the taxing and spending limitations that articles XIII A and XIII B impose.").

Parameters and Guidelines.[23] Whereas, indirect costs, like overhead and central government services costs, are costs incurred for a common purpose, benefiting more than one program, and are not directly assignable to a particular department or program. Indirect costs are eligible for reimbursement in accordance with the Office of Management and Budget (OMB) Circular A-87 (previously codified in Code of Federal Regulations, title 2, part 225). Claimants seeking reimbursement for indirect costs have the option of using 10 percent of labor, excluding fringe benefits, or preparing an Indirect Cost Rate Proposal (ICRP) if the indirect cost rate claimed exceeds 10 percent. Claimants calculating an ICRP may use as a distribution base one of the following: (1) total direct costs (excluding capital expenditures and distorting items); (2) direct salaries and wages; or (3) another base that results in an equitable distribution.[24]

In this case, the claimant's ICRP calculations were improper because the claimant used as a distribution base salary and wage costs the claimant did not actually incur. The claimant does not employ peace officers or operate its own police department; instead, it obtains law enforcement services through a contract with San Bernardino County. Yet the claimant based its ICRPs on the salaries and wages of San Bernardino County peace officers, treating the County's salary and wage costs as its own direct labor costs. Those salary and wage costs were incurred by San Bernardino County, not the claimant, and cannot serve as the claimant's direct salaries and wages under the Parameters and Guidelines.

Moreover, as a threshold matter, the claimant has not demonstrated that it incurred reimbursable indirect costs. The claimant maintains that administrative and support costs incurred through its law enforcement contract qualify as reimbursable indirect costs because the associated functions support the mandated activities.[25] The claimant incurred direct costs to obtain law enforcement services, while San Bernardino County incurred the underlying support and overhead expenses of providing those services. Neither the Parameters and Guidelines nor the applicable federal cost principles provide a basis for treating another agency's underlying overhead and support expenses as the claimant's indirect costs by virtue of a contract for services. Further, while the claimant's contracting arrangement does not preclude it from incurring reimbursable indirect costs, the claimant has not claimed or demonstrated any qualifying overhead or other support costs of its own.

Accordingly, staff finds the Controller's reduction of the claimant's indirect costs is correct as a matter of law on both grounds.

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[23] Exhibit A, Incorrect Reduction Claim, page 609 (Parameters and Guidelines).

[24] Exhibit A, Incorrect Reduction Claim, page 610 (Parameters and Guidelines).

[25] Exhibit A, Incorrect Reduction Claim, pages 1, 11, 22 (Written Narrative).

C. The Controller's Administrative Cost Allowance Was Separate from the Reduction of Claimed Indirect Costs and is Not Arbitrary, Capricious, or Entirely Lacking in Evidentiary Support.

The claimant argues that the Controller's allowance for administrative costs is improper and an insufficient "alternative methodology" to recover the indirect costs the Controller disallowed.[26] The Commission's jurisdiction over an IRC extends only to whether the Controller incorrectly *reduced* payments to a local agency. Here, the Controller's administrative cost allowance increased allowable direct contract service costs rather than reducing reimbursement.[27] In making that allowance, the Controller reviewed Los Angeles County's law enforcement service contracts and observed that it incorporated administrative-type charges into employee contract rates. In contrast, San Bernardino County separately itemized comparable charges outside those rates. To account for that difference, the Controller divided identified administrative charges in the claimant's contract by total contract costs to calculate annual percentages, which it applied to employee classification hourly rates.

The claimant therefore conflates the resulting allowance of direct administrative expenses with the reduction of the claimed indirect costs. The administrative cost allowance addressed administrative charges not otherwise captured by employee hourly rates in calculating allowable direct contract service costs. Separately, the Controller reduced the claimed indirect costs because the claimant's ICRPs were improperly prepared using salary and benefit costs that the claimant did not incur.[28] Each determination is analytically independent and neither conclusion depends on or follows from the other. With regard to the allowance, the Controller's identification of the relevant contract charges and calculation of the annual percentages demonstrate a rational connection between the evidence considered and the resulting adjustment. Accordingly, staff finds the allowance is not arbitrary, capricious, or entirely lacking in evidentiary support.

Conclusion

Based on the forgoing analysis, staff finds that:

- The IRC is timely filed.
- The Controller's reduction of indirect costs of $93,642 to $0 is correct as a matter of law.

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[26] Exhibit A, Incorrect Reduction Claim, pages 9, 14 (Written Narrative); see also page 57 (Declaration of Annette S. Chinn, paragraph 4).

[27] Exhibit A, Incorrect Reduction Claim, pages 609-610 (Parameters and Guidelines), emphasis added; see also pages 651-654 (Final Audit Report).

[28] Exhibit A, Incorrect Reduction Claim, pages 651-652 (Final Audit Report); Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 15 (Background) and page 16 (Issue).

- The Controller's administrative cost allowance was separate from the reduction of claimed indirect costs and is not arbitrary, capricious or entirely lacking in evidentiary support.

Staff Recommendation

Staff recommends that the Commission adopt the Proposed Decision to deny the IRC. Staff further recommends that the Commission authorize staff to make any technical, non-substantive changes to the Proposed Decision following the hearing.

BEFORE THE

COMMISSION ON STATE MANDATES

STATE OF CALIFORNIA

IN RE INCORRECT REDUCTION CLAIM Penal Code Section 530.6(a) Statutes of 2000, Chapter 956 Fiscal Years 2002-2003 – 2012-2013 Filed on February 18, 2026 City of Hesperia, Claimant	Case No.: 25-0308-I-02 *Identity Theft* DECISION PURSUANT TO GOVERNMENT CODE SECTION 17500 ET SEQ.; CALIFORNIA CODE OF REGULATIONS, TITLE 2, DIVISION 2, CHAPTER 2.5, ARTICLE 7. (*Adopted February 12, 2027*)

DECISION

The Commission on State Mandates (Commission) heard and decided this Incorrect Reduction Claim (IRC) during a regularly scheduled hearing on February 12, 2027. [Witness list will be included in the adopted Decision.]

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

The Commission [adopted/modified] the Proposed Decision to deny the IRC by a vote of [vote will be included in the adopted Decision], as follows:

Member	**Vote**
Lee Adams, County Supervisor	
Deborah Gallegos, Representative of the State Controller	
Karen Greene Ross, Public Member	
William Pahland, Representative of the State Treasurer, Vice Chairperson	
Michele Perrault, Representative of the Director of the Department of Finance, Chairperson	
Alexander Powell, Representative of the Director of the Governor's Office of Land Use and Climate Innovation	

Summary of the Findings

This IRC addresses reductions made by the State Controller (Controller) to costs claimed by the City of Hesperia (claimant) for fiscal years 2002-2003 through 2012-2013 (audit period) to implement the *Identity Theft* program. The program requires county and city law enforcement agencies to take a police report and begin an investigation when a complainant residing within their jurisdiction reports suspected

identity theft.[29] The claimant contracts with the County of San Bernardino for all of its police services, which are provided through the San Bernardino County Sheriff's Department.[30]

During the audit period, the claimant claimed $196,301 in costs, consisting of $102,659 in salary costs and $93,642 in related indirect costs.[31] The Controller determined that $115,473 in direct contract service costs were allowable, including an additional administrative allowance, while reducing the $93,642 in claimed indirect costs to $0.[32]

The claimant calculated the indirect costs by preparing Indirect Cost Rate Proposals (ICRPs) for each fiscal year of the audit period, with rates ranging from 71.7% to 100.4%.[33] The claimant calculated these ICRP rates using "total direct salaries" based on San Bernardino County's peace officers, and "total allowable indirect costs" based on San Bernardino County's salaries, wages, and overhead.[34] The Controller reduced these costs to $0 on the grounds that, since the claimant employed no staff who performed the reimbursable activities, and since the claimant contracted with San Bernardino County for all its police services, the claimant did not incur any direct or related indirect *salary* costs, but rather incurred direct *contract service* costs.[35] In addition, the Controller identified certain administrative costs in the contract between the claimant and San Bernardino County and made an additional allowance for them in calculating contract hourly rates.[36] The Controller calculated an administrative cost percentage for each fiscal year, ranging from 4.87% to 7.75%, and used it to *increase* the hourly rates for *direct* contract service costs.[37]

The claimant challenges the Controller's reduction of its indirect cost claim and seeks reimbursement of the disallowed amount, arguing the Controller's administrative allowance was an improper and inadequate substitute.[38]

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[29] Exhibit A, Incorrect Reduction Claim, page 607 (Parameters and Guidelines, Section I.).

[30] Exhibit A, Incorrect Reduction Claim, page 8 (Written Narrative).

[31] Exhibit A, Incorrect Reduction Claim, page 648 (Final Audit Report).

[32] Exhibit A, Incorrect Reduction Claim, page 648, 654 (Final Audit Report).

[33] Exhibit A, Incorrect Reduction Claim, pages 663, 670, 677, 684, 691, 698, 705, 712, 719, 727, 735 (ICRPs with each reimbursement claim).

[34] Exhibit A, Incorrect Reduction Claim, pages 663, 670, 677, 684, 691, 698, 705, 712, 719, 727, 735 (ICRPs with each reimbursement claim).

[35] Exhibit A, Incorrect Reduction Claim, page 648 (Final Audit Report).

[36] Exhibit A, Incorrect Reduction Claim, pages 648, 651 (Final Audit Report).

[37] Exhibit A, Incorrect Reduction Claim, pages 651-652 (Final Audit Report).

[38] Exhibit A, Incorrect Reduction Claim, pages 9, 16, 22 (Written Narrative).

The Commission finds that the claimant timely filed this IRC on February 18, 2026, within three years of the Controller's June 21, 2023, Final Audit Report.[39]

The Commission also finds that the Controller's reduction of indirect costs to $0 is correct as a matter of law. Under the Parameters and Guidelines, which are regulatory and binding on the parties, only costs actually incurred by the claimant to implement the mandated activities may be claimed for reimbursement.[40] Contract service costs are direct costs under the Parameters and Guidelines.[41] Whereas, indirect costs, like overhead and central government services costs, are costs incurred for a common purpose, benefiting more than one program, and are not directly assignable to a particular department or program. Indirect costs are eligible for reimbursement in accordance with the Office of Management and Budget (OMB) Circular A-87 (2 CFR 225). Claimants seeking reimbursement for indirect costs have the option of using 10 percent of labor, excluding fringe benefits, or preparing an Indirect Cost Rate Proposal (ICRP) if the indirect cost rate claimed exceeds 10 percent. Claimants calculating an ICRP may use as a distribution base one of the following: (1) total direct costs (excluding capital expenditures and distorting items); (2) direct salaries and wages; or (3) another base that results in an equitable distribution.[42]

In this case, the claimant's ICRP calculations were improper because the claimant used as a distribution base salary and wage costs the claimant did not actually incur. The claimant does not employ peace officers or operate its own police department; instead, it obtains law enforcement services through a contract with San Bernardino County. Yet the claimant based its ICRPs on the salaries and wages of San Bernardino County peace officers, treating the County's salary and wage costs as its own direct labor costs. Those salary and wage costs were incurred by San Bernardino County, not the

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[39] California Code of Regulations, title 2, section 1185.1(c); Exhibit A, Incorrect Reduction Claim, page 1 (Incorrect Reduction Claim Form) and page 639 (Final Audit Report).

[40] Exhibit A, Incorrect Reduction Claim, page 608 (Parameters and Guidelines). This is consistent with the purpose of article XIII B, section 6, which is to require reimbursement only when a mandated new program or higher level of service forces a local government claimant to incur "increased actual expenditures of limited tax proceeds that are counted against the local government's spending limit." (*County of Sonoma v. Commission on State Mandates* (2000) 84 Cal.App.4th 1264, 1283.) See also, *Department of Finance v. Commission on State Mandates* (2016) 1 Cal.5th 749, 763, citing to *County of San Diego v. Commission on State Mandates* (1997) 15 Cal.4th 68, 81 ("The purpose of section 6 is to prevent "the state from shifting financial responsibility for carrying out governmental functions to local agencies, which are 'ill equipped' to assume increased financial responsibilities because of the taxing and spending limitations that articles XIII A and XIII B impose.").

[41] Exhibit A, Incorrect Reduction Claim, page 609 (Parameters and Guidelines).

[42] Exhibit A, Incorrect Reduction Claim, page 610 (Parameters and Guidelines).

claimant, and cannot serve as the claimant's direct salaries and wages under the Parameters and Guidelines.

Moreover, as a threshold matter, the claimant has not demonstrated that it incurred reimbursable indirect costs. The claimant maintains that administrative and support costs incurred through its law enforcement contract qualify as reimbursable indirect costs because the associated functions support the mandated activities.[43] The claimant incurred direct costs to obtain law enforcement services, while San Bernardino County incurred the underlying support and overhead expenses of providing those services. Neither the Parameters and Guidelines nor the applicable federal cost principles provide a basis for treating another agency's underlying overhead and support expenses as the claimant's indirect costs by virtue of a contract for services. Further, while the claimant's contracting arrangement does not preclude it from incurring reimbursable indirect costs, the claimant has not claimed or demonstrated any qualifying overhead or other support costs of its own.

Accordingly, the Controller's reduction of the claimant's indirect costs is correct as a matter of law on both grounds.

The Commission also finds that the Controller's administrative cost allowance was separate from the reduction of claimed indirect costs and is not arbitrary, capricious or entirely lacking in evidentiary support. The claimant argues that the Controller's allowance for administrative costs is improper and an insufficient "alternative methodology" to recover the indirect costs the Controller disallowed.[44] The Commission's jurisdiction over an IRC extends only to whether the Controller incorrectly *reduced* payments to a local agency.[45] Here, the Controller's administrative cost allowance increased allowable direct contract service costs rather than reducing reimbursement.[46] In making that allowance, the Controller reviewed Los Angeles County's law enforcement service contracts and observed that it incorporated administrative-type charges into employee contract rates. In contrast, San Bernardino County separately itemized comparable charges outside those rates. To account for that difference, the Controller divided identified administrative charges in the claimant's contract by total contract costs to calculate annual percentages, which it applied to employee classification hourly rates.

The claimant therefore conflates the resulting allowance of direct administrative expenses with the reduction of the claimed indirect costs. The administrative cost allowance addressed administrative charges not otherwise captured by employee hourly rates in calculating allowable direct contract service costs. Separately, the

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[43] Exhibit A, Incorrect Reduction Claim, pages 8, 11, 22 (Written Narrative).

[44] Exhibit A, Incorrect Reduction Claim, pages 9, 14 (Written Narrative); see also page 57, paragraph 4 (Declaration of Annette S. Chinn).

[45] Government Code sections 17551(d), 17558.7(a).

[46] Exhibit A, Incorrect Reduction Claim, pages 609-610 (Parameters and Guidelines), emphasis added; see also pages 651-654 (Final Audit Report).

Controller reduced the claimed indirect costs because the claimant's ICRPs were improperly prepared using salary and benefit costs that the claimant did not incur.[47] Each determination is analytically independent and neither conclusion depends on nor follows from the other. With regard to the allowance, the Controller's identification of the relevant contract charges and calculation of the annual percentages demonstrate a rational connection between the evidence considered and the resulting adjustment. Accordingly, the allowance is not arbitrary, capricious, or entirely lacking in evidentiary support.

The Commission therefore denies this IRC.

COMMISSION FINDINGS

I. Chronology

07/28/2011	The Commission adopted the Parameters and Guidelines for the *Identity Theft* program.[48]
09/30/2011	The Controller issued claiming instructions, which stated that fiscal years 2002-2003 through 2009-2010 must be filed with the Controller by January 30, 2012 and claims for fiscal year 2010-2011 must be filed with the Controller by February 15, 2012.[49]
01/24/2012	The claimant certified by signing under penalty of perjury its fiscal year 2002-2003, 2003-2004, 2004-2005, 2005-2006, 2006-2007, 2007-2008, 2008-2009, 2009-2010, and 2010-2011 reimbursement claims.[50] These claims were received by the Controller's Office on January 27, 2012.[51]
09/28/2012	The Commission adopted the Statewide Cost Estimate for the program.[52]

[47] Exhibit A, Incorrect Reduction Claim, pages 651-652 (Final Audit Report); Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 15 (Background) and page 16 (Issue).

[48] Exhibit A, Incorrect Reduction Claim, page 607 (Parameters and Guidelines).

[49] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 24.

[50] Exhibit A, Incorrect Reduction Claim, pages 659, 666, 673, 680, 687, 694, 701, 708, 715 (Reimbursement Claims).

[51] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 15 (Background).

[52] Commission on State Mandates, Statewide Cost Estimate on *Identity Theft*, 03-TC-08, adopted September 28, 2012, https://csm.ca.gov/documents/SCEadopt092812.pdf (accessed June 15, 2026), page 1.

01/15/2013	The claimant certified by signing under penalty of perjury its fiscal year 2011-2012 reimbursement claim.[53] This claim was deemed filed by the Controller on or soon after this date.[54]
07/01/2013	The Legislature suspended the *Identity Theft* program and no appropriations were made for the fiscal year 2002-2003 through 2011-2012 reimbursement claims.[55]
02/07/2014	The claimant certified by signing under penalty of perjury its fiscal year 2012-2013 reimbursement claim.[56] This claim was deemed filed by the Controller on or soon after this date.[57]
07/01/2014	The Legislature suspended the *Identity Theft* program and no appropriations were made for the 2012-2013 reimbursement claims.[58]
06/21/2023	The Controller issued the Final Audit Report, with no payments for the program having been made as of this date.[59]
02/18/2026	The claimant filed the IRC.[60]
07/13/2026	The Controller filed comments on the IRC.[61]
11/05/2026	Commission staff issued the Draft Proposed Decision.[62]

[53] Exhibit A, Incorrect Reduction Claim, page 723 (Reimbursement Claims).

[54] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 7 ("The SCO performed a review of the City's claims… for the period of July 1, 2002, through June 30, 2013.").

[55] Exhibit A, Incorrect Reduction Claim, page 657 (Final Audit Report); Statutes 2013, chapter 20, Item 8885-295-0001, schedule 3(y).

[56] Exhibit A, Incorrect Reduction Claim, page 731 (Reimbursement Claims).

[57] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 7 ("The SCO performed a review of the City's claims… for the period of July 1, 2002, through June 30, 2013.").

[58] Exhibit A, Incorrect Reduction Claim, page 657 (Final Audit Report); Statutes 2014, chapter 25, Item 8885-95-0001, schedule 3(x). This program is still suspended. See, Stats. 2026, ch. 19, Item 8885-295-0001, schedule 5(u).

[59] Exhibit A, Incorrect Reduction Claim, page 639 (Final Audit Report, which states: "The State made no payments to the city. The State will pay $115,473, contingent upon available appropriations.").

[60] Exhibit A, Incorrect Reduction Claim, page 1 (Incorrect Reduction Claim).

[61] Exhibit B, Controller's Comments on the Incorrect Reduction Claim.

[62] Exhibit C, Draft Proposed Decision.

II. Background

This IRC addresses the Controller's reduction of indirect costs claimed under the *Identity Theft* program. A background of the program and the issues presented in this IRC are below.

A. The Test Claim Statute

The test claim statute requires county and city law enforcement agencies to take a police report and begin an investigation when a complainant residing within their jurisdiction reports suspected identity theft.[63]

The Parameters and Guidelines allow reimbursement for the following activities:

1. Either a) or b) below:
   a) Take a police report supporting a violation of Penal Code section 530.5 which includes information regarding the personal identifying information involved and any uses of that personal identifying information that were non-consensual and for an unlawful purpose, including, if available, information surrounding the suspected identity theft, places where the crime(s) occurred, and how and where the suspect obtained and used the personal identifying information. This activity includes drafting, reviewing, and editing the identity theft police report; or
   b) Reviewing the identity theft report completed on-line by the identity theft victim.
2. Begin an investigation of the facts, including the gathering of facts sufficient to determine where the crime(s) occurred and what pieces of personal identifying information were used for an unlawful purpose. The purpose of the investigation is to assist the victims in clearing their names. Reimbursement is not required to complete the investigation for purposes of criminal prosecution.

   Providing a copy of the report to the complainant is not reimbursable under this program.

   Referring the matter to the law enforcement agency where the suspected crime was committed for further investigation of the facts is also not reimbursable under this program[.][64]

The Parameters and Guidelines state that claimants are eligible for reimbursement for the direct costs of salaries and benefits and contracted services as follows:

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[63] Exhibit A, Incorrect Reduction Claim, page 607 (Parameters and Guidelines, Section I.).

[64] Exhibit A, Incorrect Reduction Claim, pages 608-609 (Parameters and Guidelines, Section IV.).

A. Direct Cost Reporting

Direct costs are those costs incurred specifically for reimbursable activities. The following direct costs are eligible for reimbursement.

1. Salaries and Benefits

Report each employee implementing the reimbursable activities by name, job classification, and productive hourly rate (total wages and related benefits divided by productive hours). Describe the specific reimbursable activities performed and the hours devoted to each reimbursable activity performed.

[¶] … [¶]

3. Contracted Services

Report the name of the contractor and services performed to implement the reimbursable activities and attach a copy of the contract to the claim. If the contractor bills for time and materials, report the number of hours spent on the activities and all costs charged. If the contract is a fixed price, report the dates when services were performed and itemize all costs for those services during the period covered by the reimbursement claim. If the contract services were also used for purposes other than the reimbursable activities, only the pro-rata portion of the services used to implement the reimbursable activities can be claimed. Submit contract consultant and invoices with the claim and a description of the contract scope of services.[65]

The Parameters and Guidelines also allow claimants to claim indirect costs for overhead, as specified in the federal Office of Management and Budget (OMB) Circular A-87, by using either ten percent of labor, excluding fringe benefits, or preparing an indirect cost rate proposal if the indirect cost rate exceeds ten percent, as follows:

B. Indirect Cost Rates

Indirect costs are costs that are incurred for a common or joint purpose, benefiting more than one program, and are not directly assignable to a particular department or program without efforts disproportionate to the result achieved. Indirect costs may include: (1) the overhead costs of the unit performing the mandate; and (2) the costs of the central government services distributed to the other departments based on a systematic and rational basis through a cost allocation plan.

Compensation for indirect costs is eligible for reimbursement utilizing the procedure provided in 2 CFR Part 225 (Office of Management and Budget (OMB) Circular A-87). Claimants have the option of using 10% of labor,

[65] Exhibit A, Incorrect Reduction Claim, pages 609-610 (Parameters and Guidelines, Section V.A.).

excluding fringe benefits, or preparing an Indirect Cost Rate Proposal (ICRP) if the indirect cost rate claimed exceeds 10%.

If the claimant chooses to prepare an ICRP, both the direct costs (as defined and described in 2 CFR Part 225, Appendix A and B (OMB Circular A-87 Attachments A and B)) and the indirect costs shall exclude capital expenditures and unallowable costs (as defined and described in 2 CFR Part 225, Appendix A and B (OMB Circular A-87 Attachments A and B)). However, unallowable costs must be included in the direct costs if they represent activities to which indirect costs are properly allocable.

The distributions base may be: (1) total direct costs (excluding capital expenditures and other distorting items, such as pass-through funds, major subcontracts, etc.); (2) direct salaries and wages; or (3) another base which results in an equitable distribution.

In calculating an ICRP, the claimant shall have the choice of one of the following methodologies:

> 1. The allocation of allowable indirect costs (as defined and described in 2 CRF [sic] Part 225, Appendix A and B (OMB Circular A-87 Attachments A and B)) shall be accomplished by: (1) classifying a department's total costs for the base period as either direct or indirect; and (2) dividing the total allowable indirect costs (net of applicable credits) by an equitable distribution base. The result of this process is an indirect cost rate which is used to distribute indirect costs to mandates. The rate should be expressed as a percentage which the total amount of allowable indirect costs bears to the base selected; or
>
> 2. The allocation of allowable indirect costs (as defined and described in 2 CFR Part 225, Appendix A and B (OMB Circular A-87 Attachments A and B)) shall be accomplished by: (1) separating a department into groups, such as divisions or sections, and then classifying the division's or section's total costs for the base period as either direct or indirect; and (2) dividing the total allowable indirect costs (net of applicable credits) by an equitable distribution base. The result of this process is an indirect cost rate that is used to distribute indirect costs to mandates. The rate should be expressed as a percentage which the total amount of allowable indirect costs bears to the base selected.[66]

B. The Controller's Audit

For the period of July 1, 2002, through June 30, 2013, the claimant claimed $196,301 ($102,659 in salary costs and $93,642 in related indirect costs) for the *Identity Theft*

[66] Exhibit A, Incorrect Reduction Claim, pages 610-611 (Parameters and Guidelines, Section V.B.).

program.[67] The Controller found both cost categories unallowable as claimed. This included $102,659 in unallowable salary costs, which the claimant should have classified as contract costs, and $93,642 in unallowable indirect costs. However, the Controller recognized $115,473 in allowable contract service costs, including an additional allowance for administrative costs, resulting in a net adjustment of $80,828 in unallowable costs.[68]

The claimant calculated $93,642 in indirect costs by preparing an Indirect Cost Rate Proposal (ICRP) for each year of the audit period, with rates ranging from 71.7% to 100.4% percent.[69] The Controller reduced these indirect costs to $0 on the ground that the claimant did not employ any city staff responsible for providing the mandated activities, and, therefore, did not incur any corresponding direct salary costs or related indirect costs under the reimbursable mandate. Instead, the Controller concluded the claimant incurred direct contract service costs because the claimant contracted with San Bernardino County for all its police services, including performance of the reimbursable activities.[70]

The audit report states, in part:

> The City of Hesperia claimed $196,301 ($102,659 in salary costs and $93,642 in related indirect costs) for the Identity Theft Program. We found that $115,473 is allowable and $80,828 is unallowable. The costs are unallowable because the city claimed unallowable indirect costs.
>
> The city used the correct methodology to calculate salary costs. It multiplied the number of identity theft police reports by the time required to perform the reimbursable activities, and it multiplied the product by hourly rates obtained from the city's contracts with the San Bernardino County Sheriff's Department (SBCSD). The SBCSD's contracts included costs for salaries and benefits, as well as additional administrative costs.
>
> However, the city should have classified its salary costs as contract services costs because no city staff members performed the reimbursable activities. The city contracted with San Bernardino County to have the SBCSD perform all of its law enforcement services during the review period. Therefore, the city did not incur any salary costs—or indirect costs related to salary costs—but rather incurred contract services costs. We reallocated the costs to the appropriate cost category of Contract Services.
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> [¶] … [¶]

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[67] Exhibit A, Incorrect Reduction Claim, page 648 (Final Audit Report).

[68] Exhibit A, Incorrect Reduction Claim, page 648, 654 (Final Audit Report).

[69] Exhibit A, Incorrect Reduction Claim, pages 663, 670, 677, 684, 691, 698, 705, 712, 719, 727, 735 (Reimbursement Claims, ICRPs).

[70] Exhibit A, Incorrect Reduction Claim, page 648 (Final Audit Report).

Contract Services Costs

> The city contracted with San Bernardino County to have the SBCSD provide all of its law enforcement services during the review period. These services included the reimbursable activities claimed for the mandated program. The city contracted for various SBCSD staff positions each fiscal year, and paid the SBCSD annual contract rates for the positions. These positions included, but were not limited to, Deputy Sheriffs, Office Specialists, Sergeants, and Detectives. No city staff members performed any of the reimbursable activities under this program; therefore, the city did not incur salary and related indirect costs as claimed, but rather incurred contract services costs. We reallocated the costs to the appropriate cost category of Contract Services.[71]

The Controller further explained why the claimant's indirect costs based on the salaries and wages of San Bernardino County peace officers were unallowable, and why the claimant's contract service costs were not indirect costs under the Parameters and Guidelines:

> For the review period, the city included copies of its Indirect Cost Rate Proposals with its mandated cost claims. The city claimed related indirect costs totaling $93,642 for the review period based on $102,659 in claimed salaries and wages related to implementing the Identity Theft Program. We found that the entire amount is unallowable, because no city staff members performed any of the reimbursable activities under this program during the review period. Instead, the city contracted with the SBCSD for all of its law enforcement services during the review period. Therefore, the city did not incur any direct salary costs or related indirect costs.
>
> Furthermore, none of the costs that the city incurred for law enforcement services provided by the SBCSD were indirect costs. The parameters and guidelines (Section V.B., "Indirect Cost Rates") provide that indirect costs are "incurred for a common or joint purpose, benefiting more than one program, and . . . not directly assignable to a particular department or program." In this instance, there is only one program (law enforcement services provided by a contractor) and there are no departments.

The Controller, separately, provided an additional allowance for direct contract service costs based on charges in the claimant's contracts with San Bernardino County.[72] The Controller found these contracts included items that were "clearly administrative in nature," and determined it was appropriate to allow reimbursement for certain administrative costs.[73] The Controller calculated an annual administrative cost

[71] Exhibit A, Incorrect Reduction Claim, page 648 (Final Audit Report).

[72] Exhibit A, Incorrect Reduction Claim, page 651 (Final Audit Report).

[73] Exhibit A, Incorrect Reduction Claim, page 651 (Final Audit Report).

percentage from contract line items and used it to increase the allowable contract hourly rates.[74] The Controller explained:

> The city's contracts with the SBCSD include various employee classifications and items—such as vehicles, dispatch services, and equipment—that are part of the direct costs incurred to provide law enforcement for the city. However, the contracts also include items that are clearly administrative in nature.
>
> The SCO's Mandated Cost Manual states that costs for contract services are allowable and can be claimed using hourly billing rates. However, the SCO's Mandated Cost Manual does not provide specific guidance on how to calculate them. In general, an hourly rate for a specific employee classification is determined by dividing the contract cost for an individual employee who performs reimbursable activities by 1,800 annual productive hours. Unfortunately, this method of calculating hourly billing rates does not account for other contract costs, such as administrative costs, that could be reimbursable.
>
> For additional guidance, we reviewed law enforcement service contracts for cities contracting with Los Angeles County. We noted that the County's total costs for various employee classifications included a "liability percentage" in addition to salaries and benefits. A specific liability percentage amount was added to each contract hourly rate. It is our understanding that the liability percentage covers costs for administrative items, such as insurance and central services costs. Although we audited a number of the contracting cities, we did not audit these billing rates.
>
> San Bernardino County does not structure its contracts the same way as Los Angeles County. Instead, San Bernardino County includes administrative costs and indirect costs as separately billed line items in its contracts for law enforcement services. In order to be equitable with other California cities that contract for law enforcement services, we concluded that it was appropriate to allow the city to claim its administrative costs as an addition to the contract hourly rates for employee classifications included in its contracts with the SBCSD.
>
> We calculated an administrative cost percentage for each fiscal year of the review period based on the city's contracts with the SBCSD. To calculate the percentage, we divided the cost of the following line items by the total contract cost:
>
> - Administrative support
> - Office automation
> - Services and supplies

[74] Exhibit A, Incorrect Reduction Claim, pages 651-654 (Final Audit Report).

- Vehicle insurance
- Personnel liability and bonding
- Telephone Reporting Unit – FY 2002-03 and FY 2003-04
- County-wide Cost Allocation Plan (COWCAP) - Administrative and indirect costs
- COWCAP subsidy – One-time for FY 2012-13
- Startup costs – FY 2004-05 through FY 2008-09, and FY 2012-13

The Controller used the resulting adjusted contract hourly rates to then calculate the allowable contract service costs by multiplying the hourly rates by allowable reports and allowable time increments.[75] Thus, the allowance for administrative costs is reflected in the adjusted hourly contract rates used to calculate the $115,473 in allowable contract costs.

III. Positions of the Parties

A. The City of Hesperia

The claimant disputes the $93,642 reduction of indirect costs to $0 and the methodology used to compute allowable administrative costs.[76]

The claimant first explains in its narrative that, like many California cities, it has no in-house police department. Instead, the claimant contracts to obtain law enforcement services from the San Bernardino County Sheriff's Department:

> The City of Hesperia (City) has contracted with San Bernardino County Sheriff's Department (SBCSD) since its incorporation in 1988. The City contracts with and pays the County (using general funds) to provide a complete Police Department equivalent to what is provided by a full-service City: legally and functionally. […]
>
> Hesperia has no in-house Police Department other than the one provided through its contract with SBCSD. The contract provides for the delivery of law enforcement services, including personnel and operational support necessary for service delivery comparable to a city operating its own police department.[77]

The claimant states it had prepared reimbursement claims dating back to 2002, in which it consistently included indirect costs. The claimant states it calculated those indirect costs by developing ICRPs using as an allocation base "contract-based costs" in accordance with the Parameters and Guidelines, claiming instructions, and federal cost

[75] Exhibit A, Incorrect Reduction Claim, page 654 (Final Audit Report).

[76] Exhibit A, Incorrect Reduction Claim, page 2 ("Amount of Reduction" claimed adds up to $93,642). See also pages 8-21 (Written Narrative) and pages 646, 648, 654-655 (Final Audit Report).

[77] Exhibit A, Incorrect Reduction Claim, page 8 (Written Narrative).

principles."[78] The claimant states it is not seeking reimbursement for San Bernardino County's internal indirect or overhead costs or the claimant's citywide overhead cost, but rather the administrative and support service costs incurred through its contract with San Bernardino County:

> Instead, the City's ICRP was designed to capture and allocate support and administrative functions associated with law enforcement service delivery that are embedded within and incurred through the contract (e.g., dispatch, supervision, clerical support, and vehicle usage). These functions are necessary to perform the mandated activities and are allocable under applicable cost principles. These costs were not claimed as standalone contract charges, but were identified and allocated through the ICRP as part of a structured cost allocation methodology consistent with Ps&Gs.[79]

The claimant states the Controller was wrong to reduce its indirect costs "solely because they were incurred within a contract," and argues the Controller's reduction is unsupported by governing authorities and past treatment.[80] The claimant summarized the issue as follows:

> Whether the State Controller's Office (SCO) improperly reduced the City of Hesperia's reimbursable costs by rejecting a compliant ICRP methodology and recharacterizing contract service costs as "fully burdened" to eliminate otherwise allowable indirect cost recovery, while imposing an alternative methodology (Allowable Administrative Percentage) not contained in the Parameters and Guidelines (Ps&Gs) or applicable federal cost principles.[81]

The claimant states the Controller denied its claimed indirect costs because "the city contracted with the San Bernardino Sheriff's Department to provide law enforcement services and because 'city staff' did not perform the mandated activities."[82] The claimant states:

> Because of this, SCO determined that the city was not able to use the existing ICRP methodology to compute overhead costs, nor rely on Federal OMB/CFR and Guidelines to determine which costs were eligible for inclusion in the rate.
>
> As a result, the SCO stated they had to create a new overhead cost methodology they named the "Administrative Percentage" rate, but the new unwritten rate did not comply with existing methodologies, and

[78] Exhibit A, Incorrect Reduction Claim, page 8 (Written Narrative).

[79] Exhibit A, Incorrect Reduction Claim, page 8 (Written Narrative).

[80] Exhibit A, Incorrect Reduction Claim, page 8 (Written Narrative).

[81] Exhibit A, Incorrect Reduction Claim, page 9 (Written Narrative).

[82] Exhibit A, Incorrect Reduction Claim, page 9 (Written Narrative).

because the methodology and standards were unwritten, it lacks defined criteria, leaving its application to the SCO's discretion in determining how to compute this rate and what costs were deemed "clearly administrative."

The SCO determined that the new rate allowed the recovery of certain administrative and indirect costs typically incurred outside the contract (e.g., central service costs, insurance, and general government functions), but disallows recovery of comparable administrative functions **performed within the contract**—such as dispatch/communications, supervisory oversight, vehicle usage charges, and clerical support.[83]

The claimant summarizes its argument as follows:

> The SCO's reduction is based on a series of unsupported assumptions and unauthorized interpretations that are inconsistent with the Parameters and Guidelines (Ps&Gs), Claiming Instructions, and applicable federal cost principles. Specifically, the SCO improperly concluded that indirect costs cannot exist in a contract service model, misapplied the definition of indirect costs by equating organizational structure with cost allowability, and imposed a new "Allowable Administrative Percentage" methodology that is not contained in any governing authority. In doing so, the SCO departed from claiming instructions and accepted practice without notice, applied its new methodology retroactively, and treated identical functions inconsistently based solely on the manner in which services are delivered. Because these actions lack legal support and conflict with established reimbursement principles, the reduction must be reversed.[84]

The claimant then presents 10 issues in support of its claim:

1. The Controller's distinction between "external" and "contract-embedded" administrative costs is arbitrary and unsupported by the Parameters and Guidelines, claiming instructions, or applicable cost principles.[85]
2. The Controller's methodology constitutes an underground regulation.[86]
3. Claimant's indirect cost rate proposals comply with the Claiming Instructions.[87]
4. Claimant's indirect cost rate proposals fully comply with applicable state and federal cost principles.[88]

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[83] Exhibit A, Incorrect Reduction Claim, page 9 (Written Narrative), emphasis in original.

[84] Exhibit A, Incorrect Reduction Claim, page 9 (Written Narrative), emphasis in original.

[85] Exhibit A, Incorrect Reduction Claim, page 11 (Written Narrative).

[86] Exhibit A, Incorrect Reduction Claim, page 14 (Written Narrative).

[87] Exhibit A, Incorrect Reduction Claim, page 14 (Written Narrative).

[88] Exhibit A, Incorrect Reduction Claim, page 15 (Written Narrative).

5. The Controller imposed an unauthorized methodology in calculating administrative costs.[89]
6. Claimant used an "allocation base" that was reasonable and permissible.
7. The Controller's interpretation conflicts with the Parameters and Guidelines and Claiming Instructions.[90]
8. The Controller has accepted similar methodologies in prior audits.[91]
9. The Controller's position is inconsistent with prior Commission guidance. [92]
10. The reduction of indirect costs prevents full cost recovery.[93]

Although the claimant presents its arguments across these ten sections, many of the arguments overlap or recur throughout. A summary of those arguments relevant to this IRC follows:

1. No authority excludes administrative functions solely because they are provided through a contract.

The claimant repeatedly emphasizes that no governing authority prohibits its methodology for calculating costs.[94] The claimant argues that the governing authorities do not distinguish between costs incurred through in-house personnel and costs incurred through contract.[95] The claimant argues the Controller improperly excluded administrative and support functions, including dispatch, supervision, and clerical support solely because those functions were provided through its contract.[96] This, according to the claimant, improperly narrows the cost base and thereby distorts the allocation of indirect costs by omitting legitimate support functions.[97]

The claimant further argues that the Parameters and Guidelines, the Controller's Claiming Instructions, the State Mandated Cost Manual, and applicable cost principles do not:

- Exclude contract costs from being used in an ICRP's total direct cost base;
- Preclude indirect cost recovery associated with contracted services;

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[89] Exhibit A, Incorrect Reduction Claim, page 16 (Written Narrative).

[90] Exhibit A, Incorrect Reduction Claim, page 17 (Written Narrative).

[91] Exhibit A, Incorrect Reduction Claim, page 18 (Written Narrative).

[92] Exhibit A, Incorrect Reduction Claim, pages 18-19 (Written Narrative).

[93] Exhibit A, Incorrect Reduction Claim, page 19 (Written Narrative).

[94] Exhibit A, Incorrect Reduction Claim, pages 11-13, 15, 18 (Written Narrative).

[95] Exhibit A, Incorrect Reduction Claim, pages 11-13 (Written Narrative).

[96] Exhibit A, Incorrect Reduction Claim, page 13 (Written Narrative).

[97] Exhibit A, Incorrect Reduction Claim, page 12 (Written Narrative).

- Prohibit the use of contract labor in a distribution base; or
- Prohibit the application of an indirect cost rate to contract-based direct costs.[98]

The claimant further argues that the Controller's reference to "audit principles" as a basis for rejecting its ICRP is unsupported by citation or governing authority.[99] The claimant states general audit concepts, such as those preventing double recovery, do not categorically bar otherwise permissible cost-allocation methods.[100] It argues that absent evidence of duplication, its ICRP is consistent with governing cost principles.[101]

2. Contract labor and support functions are properly included in an indirect cost allocation.

The claimant argues the Controller wrongly excludes communications and dispatch, supervisory staff, clerical services, and similar functions from indirect cost recovery.[102] It characterizes those functions as support and administrative functions that support multiple activities, cannot be traced to a single incident or report, and are necessary to frontline service delivery, and therefore constitute allocable indirect costs.[103] The claimant further contends that the Controller incorrectly concludes that no indirect costs exist because there is "only one program" and "no departments," asserting that indirect costs depend on whether costs are incurred for a common or joint purpose and are not readily assignable to a single activity.[104] The claimant explained:

> Even within a single functional program such as law enforcement services, numerous support functions (including dispatch, supervision, administrative coordination, and contract administration) support multiple activities simultaneously and cannot be directly traced to individual reimbursable tasks.[105]

The claimant also states that the Parameters and Guidelines authorize recovery of indirect costs through an ICRP and permit total direct costs to be used as the distribution base.[106] The claimant contends that, where mandated services are provided by contract, the associated contract costs are part of that direct contract

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[98] Exhibit A, Incorrect Reduction Claim, pages 13, 15-16 (Written Narrative).

[99] Exhibit A, Incorrect Reduction Claim, page 16 (Written Narrative).

[100] Exhibit A, Incorrect Reduction Claim, page 16 (Written Narrative).

[101] Exhibit A, Incorrect Reduction Claim, page 16 (Written Narrative).

[102] Exhibit A, Incorrect Reduction Claim, pages 11-12 (Written Narrative).

[103] Exhibit A, Incorrect Reduction Claim, page 12 (Written Narrative).

[104] Exhibit A, Incorrect Reduction Claim, page 13 (Written Narrative).

[105] Exhibit A, Incorrect Reduction Claim, page 13 (Written Narrative).

[106] Exhibit A, Incorrect Reduction Claim, page 12 (Written Narrative).

base.[107] And, in a contract for service model, the claimant maintains contract labor costs are its direct labor costs and also the appropriate distribution base for indirect costs.[108] The claimant reasons that, because the contracted department performs the mandate, the contractor's personnel costs represent the functional workload of the mandate and therefore serve as a rational proxy for indirect cost distribution.[109] The claimant further asserts that the contracted law enforcement provider constitutes the unit performing the mandate and that limiting that unit to city-employed staff is inconsistent with the Parameters and Guidelines.[110]

3. The Controller wrongly reduced indirect costs by equating organizational structure with cost allowability.

The claimant argues that the Controller improperly distinguishes costs based on whether services are performed by city employees or by a contractor.[111] According to the claimant, cost allowability and allocability depend on the nature and function of the cost and its relationship to the benefiting activity, rather than the identity of the employer or the mechanism of service delivery.[112] The claimant further asserts that the Controller's approach improperly renders otherwise reimbursable program-support costs non-reimbursable merely because they are included in a contract.[113]

4. The Controller's reduction of indirect costs is inconsistent with its allowance of administrative costs.

The claimant argues the Controller reduced the city's indirect costs, replacing the claimant's ICRP with the Controller's own methodology for calculating administrative costs.[114] The claimant asserts logical inconsistency in this treatment:

> The SCO's position is internally inconsistent. On one hand, it asserts that contract costs are "fully burdened" and therefore preclude recovery of indirect costs. On the other hand, it independently extracts and allows selected administrative components from those same contracts using an "administrative percentage" methodology. This demonstrates that contract costs are not, in fact, treated as fully burdened, and that the SCO is selectively redefining which support costs are recoverable…[115]

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[107] Exhibit A, Incorrect Reduction Claim, page 15 (Written Narrative).

[108] Exhibit A, Incorrect Reduction Claim, page 16 (Written Narrative).

[109] Exhibit A, Incorrect Reduction Claim, page 17 (Written Narrative).

[110] Exhibit A, Incorrect Reduction Claim, page 18 (Written Narrative).

[111] Exhibit A, Incorrect Reduction Claim, pages 11, 17 (Written Narrative).

[112] Exhibit A, Incorrect Reduction Claim, pages 11, 13 (Written Narrative).

[113] Exhibit A, Incorrect Reduction Claim, pages 11, 17 (Written Narrative).

[114] Exhibit A, Incorrect Reduction Claim, page 16 (Written Narrative).

[115] Exhibit A, Incorrect Reduction Claim, page 17 (Written Narrative).

B. State Controller's Office

The Controller urges the Commission to deny this IRC. The Controller states that:

> However, the city claimed its contract services costs incorrectly as salaries and benefits, which we re-classified.
>
> The city also claimed indirect costs by preparing Indirect Cost Rate Proposals (ICRPs) based on salary and benefit costs which, per its own admission in this IRC, it did not incur. As we noted in the final report, substituting contract services costs as salary and benefit costs for the purpose of preparing ICRPs is in direct violation of the Parameters and Guidelines as well as cost principles contained in 2 CFR, Part 225. Given these indisputable facts, we determined that all indirect costs claimed are unallowable. The city states that "The SCO excluded these costs based solely because they were incurred within a contract…" That is incorrect. The costs were unallowable because they are based on improperly prepared ICRPs.[116]

The Controller further explained that the claimant misunderstands the Controller's rationale for the reduction and why it found the claimant's ICRPs improperly prepared:

> …[T]he city states that the SCO determined that its indirect costs were unallowable "because the city contracted with the San Bernardino Sheriff's Department to provide law enforcement services." That statement is incorrect. The city's statement that the costs were determined to be unallowable "because "city staff" did not perform the mandated activities" is also incorrect. It is incorrect because the city prepared its claims and its ICRPs on the basis that it incurred salary and benefit costs for its own staff to perform the reimbursable activities. The city has already acknowledged that no city staff performed the reimbursable activities. In addition, the city did not support claimed salary and benefit costs during our review nor within this IRC filing with any applicable payroll documentation. Instead, the costs were unallowable because the city improperly used salary and benefit costs in its ICRPs as a base to determine indirect costs.[117]

The Controller then explained its administrative cost finding:

> We could have stopped there and issued our final report. The city's IRC states that "the SCO *had to create* [emphasis added] a new overhead cost methodology they named as "Administrative Percentage" rate…" However, the SCO was under no obligation whatsoever to allow additional costs that the city incurred under its contract with the SBCSD for law

[116] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 15 (Background).

[117] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 16 (Issue Statement).

enforcement services beyond the contract charges for the county personnel that conducted the reimbursable activities.

Having performed many previous audits and reviews of Identity Theft Program claims, we noticed that it is not uncommon for contracts between cities and counties for law enforcement services to include various types of costs that we describe as "administrative costs." We use the term "administrative costs" because these do not relate to the contract costs for personnel that perform law enforcement services. Examples of the types of costs that we see in contracts include the following:

- San Bernardino County – law enforcement contracts include line-item amounts for such items as administrative support, office automation, services and supplies, vehicle insurance, personnel liability and bonding, county administrative costs (COWCAP), and startup costs.
- Los Angeles County – law enforcement contracts include an additional cost within its contract rates for all county personnel labeled as "Liability Percentage." This amount covers the cost of liability insurance for officers performing law enforcement services within contract cities.
- Orange County – law enforcement contracts include a line item described as "Other Charges and Credits." This line item includes various types of miscellaneous administrative costs.
- San Diego County – law enforcement contracts include an additional line-item charge for "ancillary support, supply, vehicles, space, management support, and liability."

We also observed that not all counties include these types of charges within their contracts for law enforcement services. For those that do, it is not uncommon for us to see calculations within mandated cost claims filed by cities contracting for law enforcement services to include an allocation of these "administrative costs" within the calculation of contract hourly rates.

This is a similar methodology to what Los Angeles County does within its contracts. Absent issues that we identified pertaining to mathematical calculations within these administrative cost allocation methods, the SCO has not had any issues with this type of methodology, even though it is not included as a methodology within the SCO's annual *Mandated Cost Manual for Local Agencies.* As we noted in our final report, "The SCO's *Mandated Cost Manual* states that contract services costs are allowable and can be claimed using hourly billing rates." However, there is no specific guidance on how to calculate contract hourly billing rates. As noted in the previous examples of administrative costs appearing within law enforcement contracts, there are too many variables within contracts

for the SCO to establish a "one-size-fits-all" approach to calculating contract hourly rates.[118]

The Controller then addresses the issues raised by the claimant.

As to the claimant's argument that no governing authority prohibits its cost recovery methodology, the Controller states:

> The city's IRC goes on to state that "nothing in the claiming instructions, Ps&Gs, or Manual excludes contract services from the category of direct costs or from the distribution base used to allocate indirect costs." However, more importantly, we would point out that none of those documents *include* contract services as a distribution base used to allocate indirect costs. From our perspective, it is not logical to state that something *is* included because it is *not* excluded.
>
> 2 CFR, Part 225 contains the controlling language for calculating indirect costs. We believe that if the writers that drafted this document meant to include a methodology for claiming indirect costs within a contract for professional services, they would have done so. They did not.[119]

As to the claimant's arguments that contract labor and support functions are properly included in an indirect cost allocation, the Controller states why the claimant did not incur these indirect costs:

> The city's extensive arguments concerning its ability to prepare ICRPs and claim indirect costs based on contract services costs it incurred demonstrate a fundamental misunderstanding of indirect costs and what they represent. If the city had been operating its own Police Department during the years of the review period, it would have incurred direct costs for providing such law enforcement services as traffic patrols, criminal investigations, incarceration, and public security, just to name a few. The direct cost of providing such direct law enforcement services is typically the cost of the salaries and wages of the personnel assigned to these duties. In addition to the direct costs incurred to provide law enforcement services to the citizens of the City of Hesperia, the city would also have incurred related indirect costs.
>
> The Ps and Gs note that "indirect costs are costs that are incurred for a common or joint purpose, benefitting more than one program and are not directly assignable top a particular department or program without efforts disproportionate to the result achieved." What this means is that if the city had operated its own Police Department, it would have incurred costs for such items as (but not limited to):

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[118] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, pages 16-17 (Issue Statement).

[119] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 21 (Issue 4), emphasis in original.

- Owning, operating, and maintaining a police station(s),
- Police Officer uniforms,
- Law enforcement tactical gear,
- Owning, operating, and maintaining a fleet of law enforcement vehicles,
- Officer training,
- Utility services (e.g., electricity, water, trash, & sewer),
- Operating and staffing a Human Resources Department,
- Operating a payroll function,
- Calculating, collecting, and submitting withholdings to the appropriate state and federal offices,
- Negotiating and administering employee benefit plans,
- Maintaining and preparing appropriate accounting records and reports,
- Negotiating and administering contracts with unions for police officers and clerical staff,
- Insurance (liability, fire, & automotive), and
- General legal costs as appropriate[.]

While this is not an exhaustive list, it represents legitimate costs associated with operating a law enforcement operation. However, any effort to allocate and assign such costs to a particular program or division within the Police Department would be very difficult, or as the Ps and Gs explain, "without efforts disproportionate to the results achieved." In some cases, the costs originate within other city departments that would typically charge the city's Police Department for its services pursuant to a properly prepared Citywide Cost Allocation Plan using the methodology described in 2 CFR, Part 225, Appendix C (State/Local-Wide Central Services Cost Allocation Plans). To capture such costs when billing for its services and/or preparing reimbursement claims, adding an indirect cost component to the salaries and wages of its employees is the designated method to recover such costs. The methodology to calculate this indirect cost component is outlined in 2 CFR, Part 225 (Cost Principles for State, Local, and Indian Tribal Governments (OMB Circular A-87)), including Appendices A (General Principles for Determining Allowable Costs), B (Select Items of Cost), and E (State and Local Indirect Cost Rate Proposals) […].

However, the City of Hesperia did not operate its own Police Department at any time during the review period and did not incur the indirect costs contained in the previous bullet point list. Instead, San Bernardino County

> incurred such costs. Accordingly, costs appearing in the city's contract with the county are contract services costs, not salaries, benefits, and related indirect costs. Since the city did not incur related indirect costs, section V.B. (Indirect Cost Rates) of the Ps and Gs does not apply to the city's claims.[120]

The Controller further argues the claimant's ICRP distribution base did not comply with the Parameters and Guidelines and that the claimant cannot cure its claims using the IRC process. The Controller states:

> In the language cited previously from Section V.B. of the Ps and Gs, there are three options for using a distribution base. The city chose option #2 – direct salaries and wages. However, the city did not incur any direct salaries and wages costs. It incurred contract services costs and erroneously re-classified such costs as salaries and benefits for the purpose of preparing its ICRPs. In addition, each of the city's ICRPs were prepared for the City of Hesperia Sheriff, which does not exist as an entity or as a person.
>
> Regardless of any arguments raised by the city in its IRC filing concerning its belief about the allowability of indirect costs for contract services, it did not comply with the Ps and Gs to claim indirect costs in any of its claims during the audit period. The city cannot now use the IRC process to cure its incorrectly prepared claims.

As to the claimant's contention that disallowing indirect costs while allowing administrative costs is inconsistent, the Controller argues that it did not "impose" the Allowable Administrative Percentage, but instead devised the calculation to provide the claimant with additional reimbursement for contract costs the Controller found were "administrative in nature and have little or no relation with law enforcement activities."[121] The Controller further maintains that the claimant is incorrect in insisting these costs must be calculated solely under the OMB A-87 indirect cost methodology because, in the Controller's view, that methodology was not designed for use with contract service costs.[122] In addition, the Controller states the reduction of indirect costs and allowance of its administrative percentage calculation are separate issues.[123] In this respect, the Controller argues the administrative percentage calculation did not reduce the claimant's claimed costs; rather, it was a separate calculation used to provide additional

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[120] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, pages 17-19 (Issue 1).

[121] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 19 (Issue 2).

[122] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 19 (Issue 2).

[123] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 19 (Issue 2).

allowable reimbursement.[124] The reduction at issue, according to the Controller, concerned different costs—indirect costs calculated from salary and benefit expenses that the claimant did not incur.[125]

As to the claimant's argument that the Controller misapplied the definition of indirect costs by equating organizational structure with cost allowability, the Controller objects to this characterization, stating instead that its finding is based on the improper use of salaries and benefits as a base to calculate indirect costs.[126] The Controller states:

> As also explained earlier, we have seen various allocation methods used by contract cities within filed mandated cost claims that have been deemed allowable. To reiterate, what is not allowable is preparing ICRPs using the OMB A-87 methodology by converting contract services costs to salaries and benefit costs in order to create an allocation base.[127]

As to the claimant's argument that contract labor costs may be treated as salary and benefit costs in calculating the allocation base, the Controller objects on the basis that the claimant did not itself incur the underlying salary and benefits costs.[128] The Controller rejects the claimant's position that the "labor costs" included in its payments to San Bernardino County are equivalent to salary and benefit costs paid to employees.[129] The claimant's treatment, according the Controller, is inconsistent with generally accepted accounting principles.[130] The Controller notes that 2 CFR part 225 does not define "labor costs," but instead separately address personnel services costs and professional services costs.[131] According to the Controller, the claimant incurred professional services costs under its contract, not salary, wage, or employee benefits

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[124] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 19 (Issue 2).

[125] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 19 (Issue 2).

[126] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 17 (Summary of the Argument).

[127] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 21 (Issue 5).

[128] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 22 (Issue 2).

[129] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 22 (Issue 2).

[130] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 22 (Issue 2).

[131] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 22 (Issue 2).

costs.[132] In support of this position, the Controller states the claimant's contract confirms County personnel are not city employees, and also notes that the claimant provided no payroll documentation showing that it incurred employee compensation costs during the audit period.[133]

IV. Discussion

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

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

The Commission must review questions of law, including interpretation of the parameters and guidelines, de novo, without consideration of legal conclusions made by the Controller in the context of an audit. The Commission is vested with exclusive authority to adjudicate disputes over the existence of state-mandated programs within the meaning of article XIII B, section 6 of the California Constitution.[134] The Commission must also interpret the Government Code and implementing regulations in accordance with the broader constitutional and statutory scheme. In making its decisions, the Commission must strictly construe article XIII B, section 6 and not apply it as an "equitable remedy to cure the perceived unfairness resulting from political decisions on funding priorities."[135]

With regard to the Controller's audit decisions, the Commission must determine whether they were arbitrary, capricious, or entirely lacking in evidentiary support. This standard is similar to the standard used by the courts when reviewing an alleged abuse of discretion of a state agency.[136] Under this standard, the courts have found that:

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[132] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, pages 20, 22 (Issue 2).

[133] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 22 (Issue 2).

[134] *Kinlaw v. State of California* (1991) 54 Cal.3d 326, 331-334; Government Code sections 17551, 17552.

[135] *County of Sonoma v. Commission on State Mandates* (2000) 84 Cal.App.4th 1264, 1281, citing *City of San Jose v. State of California* (1996) 45 Cal.App.4th 1802, 1817.

[136] *Johnson v. Sonoma County Agricultural Preservation and Open Space Dist.* (2002) 100 Cal.App.4th 973, 983-984. See also *American Bd. of Cosmetic Surgery, Inc. v. Medical Bd. of California* (2008) 162 Cal.App.4th 534, 547.

> When reviewing the exercise of discretion, "[t]he scope of review is limited, out of deference to the agency's authority and presumed expertise: 'The court may not reweigh the evidence or substitute its judgement for that of the agency. [Citation.]'" … "In general … the inquiry is limited to whether the decision was arbitrary, capricious, or entirely lacking in evidentiary support.…" [Citations.] When making that inquiry, the " ' "court must ensure that an agency has adequately considered all relevant factors, and has demonstrated a rational connection between those factors, the choice made, and the purposes of the enabling statute." [Citation.]' "[137]

The Commission must review the Controller's audit in light of the fact that the initial burden of providing evidence for a claim of reimbursement lies with the claimant.[138] In addition, sections 1185.1(f)(3) and 1185.2(d) and (e) of the Commission's regulations require that any assertions of fact by the parties to an IRC must be supported by documentary evidence. The Commission's ultimate findings of fact must be supported by substantial evidence in the record.[139]

A. The Claimant Timely Filed this IRC Within Three Years from the Date the Claimant First Received from the Controller a Final State Audit Report, Letter, or Other Written Notice of Adjustment to a Reimbursement Claim, which Complies with Government Code Section 17558.5(c).

Government Code section 17558.7(a) states: "If the Controller reduces a claim approved by the commission, the claimant may file with the commission an incorrect reduction claim pursuant to regulations adopted by the commission."

Section 1185.1(c) of the Commission's regulations requires an IRC to be filed no later than three years after the date the claimant receives a final state audit report, letter, or other written notice of adjustment to a reimbursement claim, which complies with Government Code section 17558.5(c). Under Government Code section 17558.5(c), the Controller is required to notify the claimant in writing within 30 days after issuance of a remittance advice of any adjustment to a reimbursement claim resulting from an audit or review. The notice must specify which claim components were adjusted and in what amount, as well as interest charges, and the reason for the adjustment.[140]

Here, the final audit report was issued to the claimant on June 21, 2023.[141] The audit report specifies the claim components and amounts adjusted, as well as the reasons for

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[137] *American Bd. of Cosmetic Surgery, Inc. v. Medical Bd. of California* (2008) 162 Cal.App.4th 534, 547-548.

[138] *Gilbert v. City of Sunnyvale* (2005) 130 Cal.App.4th 1264, 1274-1275.

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

[140] Government Code section 17558.5(c).

[141] Exhibit A, Incorrect Reduction Claim, page 639 (Final Audit Report).

the adjustments, and therefore complies with the section 17558.5(c) notice requirements.[142]

The IRC was filed on February 18, 2026.[143] As this was within three years of issuing the final audit report, the IRC was timely filed.

B. The Controller's Reduction of Indirect Costs from $93,642 to $0 Is Correct as a Matter of Law.

1. The Controller's Reduction of Indirect Costs to Zero Is Correct Because the Claimant's Indirect Cost Rate Proposals Were Not Prepared in Accordance with the Parameters and Guidelines.

The Controller reduced the $93,643 in claimed indirect costs to $0 on the ground that, as a contract city, the claimant has no direct salaries or benefits on which to base indirect costs.[144] As explained in the Background, the claimant claimed indirect costs by preparing ICRPs for each year of the audit period, with rates ranging from 71.7% to 100.4%.[145] In other words, the claimant is suggesting it incurred indirect costs of as much as $100.4 for every $100 in direct salaries and wages the County incurred to provide the claimant with law enforcement services.[146] The claimant admits, however, it has incurred no direct salary and benefit expenses for law enforcement services, since it has no in-house police services.[147] Instead, the claimant contracts with the San Bernardino County for its police services, provided through the San Bernardino Sheriff's Department, including services under this mandated program.[148]

The claimant nevertheless contends that, under a contract-for-service model, contract labor costs constitute both its direct labor costs and an appropriate distribution base for indirect costs.[149] Because the contracted department performs the mandated activities, the claimant argues that the contractor's personnel costs reflect the workload attributable to the mandate and therefore serves as a rational proxy for calculating the indirect costs the claimant seeks to claim.[150] In support of this position, the claimant argues that the Controller's reduction is incorrect since the Parameters and Guidelines

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[142] Exhibit A, Incorrect Reduction Claim, page 639-657 (Final Audit Report).

[143] Exhibit A, Incorrect Reduction Claim, page 1.

[144] Exhibit A, Incorrect Reduction Claim, page 654 (Final Audit Report).

[145] Exhibit A, Incorrect Reduction Claim, pages 663, 670, 677, 684, 691, 698, 705, 712, 719, 727, 735 (Reimbursement Claims, ICRPs).

[146] Exhibit A, Incorrect Reduction Claim, page 691 (Reimbursement Claim, FY 2006-07).

[147] Exhibit A, Incorrect Reduction Claim, pages 8, 20 (Written Narrative), page 54 (Declaration of Casey Brooksher); see also page 654 (Final Audit Report).

[148] Exhibit A, Incorrect Reduction Claim, page 8 (Written Narrative).

[149] Exhibit A, Incorrect Reduction Claim, pages 15-16 (Written Narrative).

[150] Exhibit A, Incorrect Reduction Claim, page 17 (Written Narrative).

allow claimants to claim indirect costs based on an ICRP: "[N]either the Parameters and Guidelines nor applicable federal cost principles prohibit the use of contract-based direct costs as the distribution base for an ICRP or otherwise impose any limitation on indirect cost recovery based on the method of service delivery."[151]

As explained below, the Commission finds that the Controller's reduction is correct as a matter of law.

Section IV. of the Parameters and Guidelines specifies that only actual costs are eligible for mandated cost reimbursement in a given fiscal year.[152] Actual costs are those costs actually incurred by a claimant to implement the mandated activities.[153] Actual costs must be traceable to and supported by source documents that show the validity of such costs, when they were incurred, and their relationship to the reimbursable activities.[154]

Under Section V. of the Parameters and Guidelines, cost elements for reimbursable activities include direct costs reporting and indirect cost rates.[155] Direct costs are those costs incurred specifically for reimbursable activities.[156] Salaries and benefits and contract service costs are direct costs eligible for reimbursement.[157] Indirect costs, like overhead and central government services costs, are costs incurred for a common purpose, benefiting more than one program, and are not directly assignable to a

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[151] Exhibit A, Incorrect Reduction Claim, page 22 (Written Narrative).

[152] Exhibit A, Incorrect Reduction Claim, page 608 (Parameters and Guidelines, Section IV.).

[153] Exhibit A, Incorrect Reduction Claim, page 608 (Parameters and Guidelines, Section IV.). This is consistent with the purpose of article XIII B, section 6, which is to require reimbursement only when a mandated new program or higher level of service forces a local government claimant to incur "increased actual expenditures of limited tax proceeds that are counted against the local government's spending limit." (*County of Sonoma v. Commission on State Mandates* (2000) 84 Cal.App.4th 1264, 1283.) See also, *Department of Finance v. Commission on State Mandates* (2016) 1 Cal.5th 749, 763, citing to *County of San Diego v. Commission on State Mandates* (1997) 15 Cal.4th 68, 81 ("The purpose of section 6 is to prevent "the state from shifting financial responsibility for carrying out governmental functions to local agencies, which are 'ill equipped' to assume increased financial responsibilities because of the taxing and spending limitations that articles XIII A and XIII B impose.").

[154] Exhibit A, Incorrect Reduction Claim, page 608 (Parameters and Guidelines, Section IV.).

[155] Exhibit A, Incorrect Reduction Claim, page 609 (Parameters and Guidelines, Section V.).

[156] Exhibit A, Incorrect Reduction Claim, page 609 (Parameters and Guidelines, Section V.A.).

[157] Exhibit A, Incorrect Reduction Claim, page 609 (Parameters and Guidelines, Section V.A.).

particular department or program.[158] Section V.B. of the Parameters and Guidelines allows reimbursement for indirect costs based on the OMB Circular A-87 (previously codified in Code of Federal Regulations, title 2, part 225).[159]

The Parameters and Guidelines include the following provisions relevant to indirect cost reimbursement:

- Indirect costs are costs that are incurred for a common or joint purpose, benefiting more than one program, and are not directly assignable to a particular department or program without efforts disproportionate to the result achieved. Indirect costs may include: (1) the overhead costs of the unit performing the mandate; and (2) the costs of the central government services distributed to the other departments based on a systematic and rational basis through a cost allocation plan.[160]
- Compensation for indirect costs is eligible for reimbursement utilizing the procedure provided in 2 CFR Part 225 (OMB Circular A-87). Claimants have the option of using 10% of labor, excluding fringe benefits, or preparing an Indirect Cost Rate Proposal (ICRP) if the indirect cost rate claimed exceeds 10%.
- In calculating an ICRP, the allocation of allowable indirect costs (as defined and described in 2 CRF [sic] Part 225, Appendix A and B (OMB Circular A-87 Attachments A and B)) shall be accomplished by: (1) classifying a department's total costs for the base period as either direct or indirect; and (2) dividing the total allowable indirect costs (net of applicable credits) by an equitable distribution base. The result of this process is an indirect cost rate which is used to distribute indirect costs to mandates. The rate should be expressed as a percentage which the total amount of allowable indirect costs bears to the base selected.
- The distributions base may be:

  (1) total direct costs (excluding capital expenditures and other distorting items, such as pass-through funds, major subcontracts, etc.);

  (2) direct salaries and wages; or

  (3) another base which results in an equitable distribution.[161]

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[158] Exhibit A, Incorrect Reduction Claim, pages 610 (Parameters and Guidelines).

[159] Exhibit A, Incorrect Reduction Claim, pages 607-612 (Parameters and Guidelines). OMB Circular A-87, formerly codified at Code of Federal Regulations, title 2, part 225, was superseded by the Uniform Guidance at 2 CFR part 200.

[160] Exhibit A, Incorrect Reduction Claim, page 610 (Parameters and Guidelines, Section V.B.).

[161] Exhibit A, Incorrect Reduction Claim, pages 610-611 (Parameters and Guidelines, Section V.B.).

These provisions are consistent with the OMB Circular A-87.[162]

Government Code section 17564(b) states that reimbursement claims filed with the Controller shall be filed in the manner prescribed in the Parameters and Guidelines.[163] The Parameters and Guidelines are regulatory in nature and are binding on the parties.[164] Thus, the claimant is required to comply with the rules stated in the Parameters and Guidelines in order to obtain reimbursement.

In this case, the claimant calculated ICRPs for each fiscal year of the review period using salary and wage costs incurred by San Bernardino County.[165] The Parameters and Guidelines provide that an ICRP may use as a distribution base total direct costs, direct salaries and wages, or another base that results in an equitable distribution.[166] The parties disagree as to how the claimant's distribution base should be characterized. The claimant states it used total direct costs, while the Controller states that the claimant used direct salaries and wages.[167] That disagreement does not affect the analysis of those two asserted bases: The claimant's calculation was derived from direct salaries and wages that were incurred by San Bernardino County, not by the claimant.[168] In particular, the claimant used "total direct salaries" derived from San Bernardino County's direct salary and wage costs less County overhead costs.[169] These amounts were used as the distribution base for each ICRP. The claimant then divided San Bernardino County overhead costs it treated as allowable indirect costs by

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[162] Exhibit A, Incorrect Reduction Claim, pages 620-623 (70 Fed. Reg. 51910-51913), with the explanation of indirect cost rate proposals under the OMB Circular A-87 in Appendix E, pages 634-636 (70 Fed. Reg. 51924-51926). The corresponding federal provision concerning state and local government indirect cost rate proposals appear at Code of Federal Regulations, title 2, section 200.416 and appendix VII to part 200.

[163] Government Code section 17564(b).

[164] *California School Boards Association v. State of California* (2009) 171 Cal.App.4th 1183, 1201; *Clovis Unified School District v. Chiang* (2010) 188 Cal.App.4th 794, 798; Government Code sections 17561(d)(1), 17564(b), and 17571.

[165] Exhibit A, Incorrect Reduction Claim, pages 663, 670, 677, 684, 691, 698, 705, 712, 719, 727, 735 (Reimbursement Claims, ICRPs).

[166] Exhibit A, Incorrect Reduction Claim, pages 610-611 (Parameters and Guidelines, Section V.B.).

[167] Exhibit A, Incorrect Reduction Claim, pages 15-16 (Written Narrative), and Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 19 (Issue 1).

[168] Exhibit A, Incorrect Reduction Claim, pages 12, 14-16, 22 (Written Narrative), and pages 658-737 (Reimbursement Claims).

[169] Exhibit A, Incorrect Reduction Claim, pages 663, 670, 677, 684, 691, 698, 705, 712, 719, 727, 735 (Reimbursement Claims, ICRPs).

that base, producing rates of 71.7% to 100.4%.[170] Thus, in each ICRP, the claimant calculated the indirect cost rate by dividing San Bernardino County overhead costs by San Bernardino County salary and wage costs used as the distribution base.

Under Section IV. of the Parameters and Guidelines, only costs actually incurred are eligible for reimbursement for mandated activities.[171] Here, the claimant contracts with San Bernardino County for law enforcement services, and its direct costs for those services are its contract costs. The claimant does not employ any peace officers and thus it incurs no peace officer direct salary and wage costs. Moreover, the claimant did not incur the salary and wage costs of the San Bernardino County peace officers who performed the mandated services, because the claimant does not employ them—San Bernardino County does. The direct salary and wage costs of that employment are borne by San Bernardino County. Accordingly, San Bernardino's salary and wage costs do not constitute the claimant's direct salaries and wages. The ICRPs therefore cannot be sustained on that basis.

Nor does the claimant's characterization of the distribution base as total direct costs cure the defect. The same problem remains—the direct-cost component of the claimant's ICRP calculation was derived from San Bernardino County salary and wage costs that the claimant did not incur, rather than its actual direct contract service costs.[172] The claimant's characterization of those costs as total direct costs does not transform San Bernardino's salary and wage costs into the claimant's direct costs. Moreover, the Parameters and Guidelines exclude from total direct costs "capital expenditures and other distorting items, such as pass-through funds, major subcontracts."[173] Here, using San Bernardino County's salary and wage costs as the claimant's own direct costs inaccurately reflects claimant's actual total direct costs and instead distorts the distribution base used in the ICRPs. Representing County salary and wage costs as the claimant's own direct costs is therefore inconsistent with a total-direct-cost distribution base under the Parameters and Guidelines.

The claimant argues that San Bernardino County's personnel costs reflect the workload associated with the mandates activities and therefore provide an appropriate basis for allocating indirect costs by proxy.[174] But that argument addresses the relationship between the County's personnel costs and the mandated activities, not whether those

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[170] Exhibit A, Incorrect Reduction Claim, pages 663, 670, 677, 684, 691, 698, 705, 712, 719, 727, 735 (Reimbursement Claims, ICRPs).

[171] Exhibit A, Incorrect Reduction Claim, page 608 (Parameters and Guidelines, Section IV.).

[172] Exhibit A, Incorrect Reduction Claim, pages 660, 663; 667, 670; 674, 677; 681, 684; 668, 691; 695, 698; 702, 705; 709, 712; 716, 719; 724, 727; 732, 735 (Reimbursement Claims).

[173] Exhibit A, Incorrect Reduction Claim, page 610 (Parameters and Guidelines, Section V.B.).

[174] Exhibit A, Incorrect Reduction Claim, page 17 (Written Narrative).

costs are the claimant's direct costs. San Bernardino County incurred the salaries and wages; the claimant's costs for the reimbursable activities were contract service costs under its agreement with the County. Although those costs may reflect the labor associated with the mandated activities, they remain costs incurred by San Bernardino County and do not thereby become the claimant's direct salaries and wages or total direct costs. The asserted relationship to workload therefore does not provide a basis for treating the County's personnel costs as the claimant's direct salaries and wages or total direct costs in preparing its ICRPs.

The ICRPs prepared by the claimant also include San Bernardino County overhead as allowable indirect costs of the claimant.[175] Section V.B. of the Parameters and Guidelines allows indirect costs to include overhead of the unit performing the mandate. That provision does not, however, authorize the claimant to treat San Bernardino County's overhead as its own allowable indirect costs merely because the County performed the mandated activities. Indeed, Section IV. of the Parameters and Guidelines requires that reimbursable costs actually be incurred by the claimant. Here, San Bernardino County incurred overhead costs in providing the contracted law enforcement services. The claimant incurred the costs of the contract; it does not separately incur the County's overhead. The claimant therefore cannot treat San Bernardino County's overhead as its own allowable indirect costs. That defect is independent of the distribution base used in the ICRPs: a permissible distribution base provides a means of allocating allowable indirect costs, but it cannot transform overhead incurred by the County into an indirect cost of the claimant.

More broadly, article XIII B, section 6 does not generally permit reimbursement in excess of the claimant's actual increased costs.[176] The claimant incurred the cost of its contract with San Bernardino County; the County incurred the personnel and overhead costs used to comply with the mandated activities. Although the claimant's contract charges may reflect those underlying County expenses, that does not establish that the claimant incurred them as additional indirect costs. Treating San Bernardino County's overhead as an additional indirect cost of the claimant would therefore permit reimbursement beyond the claimant's actual increased costs, contrary to article XIII B, section 6. The claimant's methodology also risks duplicative reimbursement if the same underlying County overhead were recovered through both the claimant's direct contract service costs and its claimed indirect costs, or if the same allocable portion of County overhead were claimed by both the claimant and San Bernardino County for their respective mandated activities. Reimbursing the same overhead twice would exceed the actual increased costs properly reimbursable under article XIII B, section 6.

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[175] Exhibit A, Incorrect Reduction Claim, pages 660, 663; 667, 670; 674, 677; 681, 684; 668, 691; 695, 698; 702, 705; 709, 712; 716, 719; 724, 727; 732, 735 (Reimbursement Claims).

[176] California Constitution, article XIII B, section 6; Government Code sections 17514 and 17561(a); *County of Sonoma v. Commission on State Mandates* (2000) 84 *County of Los Angeles v. Commission on State Mandates* (2003) 110 Cal.App.4th 1176, 1187.

Accordingly, the claimant's claimed indirect costs are not supported because they were based on ICRPs that were not prepared in accordance with the Parameters and Guidelines. Those ICRPs relied on San Bernardino County's salary and wage costs rather than the claimant's actual direct costs or another permissible distribution base, and treated County overhead costs as the claimant's allowable indirect costs. The claimant's characterization of the County's costs as its own direct costs, or as a proxy for allocating indirect costs, does not cure those defects. The Controller's reduction of indirect costs from $93,642 to $0 was therefore correct as a matter of law.

2. The Controller's Reduction of the Claimed Indirect Costs to Zero Is Correct as a Matter of Law Because San Bernardino County's Expenses Are Not the Claimant's Indirect Costs and the Claimant Has Not Demonstrated that It Incurred Other Qualifying Indirect Costs.

An ICRP is a method for allocating allowable indirect costs, such as overhead costs; it presupposes that such costs were actually incurred by the claimant.[177] As explained below, San Bernardino County's overhead expenses in providing contract services to the claimant for the *Identify Theft* program are not the claimant's indirect costs and the claimant has not demonstrated that it incurred any qualifying indirect costs for this program. Thus, on this basis, the Controller's reduction of indirect costs is correct as a matter of law.

As discussed above, the Parameters and Guidelines provide that only actual costs may be claimed and define actual costs as those actually incurred by the claimant to implement the mandated activities.[178] They further define indirect costs as costs incurred for a common or joint purpose, benefiting more than one program, that are not directly assignable to a particular department or program without disproportionate effort.[179] Such costs may include the overhead costs *"of the unit performing the mandate"* and central government service costs distributed through a cost allocation plan.[180] Read together, these provisions require that an indirect cost claim rest on actual increased costs incurred by the claimant; identifying a type of cost that may qualify as indirect does not itself establish that the claimant incurred those costs. Rather, the claimant must establish that it incurred costs satisfying the definition of indirect costs.

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[177] Exhibit A, Incorrect Reduction Claim, page 610 (Parameters and Guidelines, Section V.B.1.).

[178] Exhibit A, Incorrect Reduction Claim, page 608 (Parameters and Guidelines, Section IV.).

[179] Exhibit A, Incorrect Reduction Claim, page 610 (Parameters and Guidelines, Section V.B.).

[180] Exhibit A, Incorrect Reduction Claim, page 610 (Parameters and Guidelines, Section V.B.).

Here, the claimant obtains its law enforcement services through its contract with San Bernardino County.[181] The claimant's direct expenditure for those activities was therefore a direct contract cost. The personnel, administrative, and support costs incurred in operating the San Bernardino County Sheriff's Department, by contrast, are costs incurred by the County in performing the contracted services. Neither the Parameters and Guidelines nor the applicable federal cost principles provide a basis for treating another agency's underlying overhead and support expenses as the claimant's indirect costs by virtue of a contract for services. Those costs may be reflected in the contract charges, but that does not establish that the claimant separately incurred them as indirect costs.

Indeed, the claimant states that it is not seeking the County's internal indirect or overhead costs and did not seek citywide overhead service costs. Instead, it characterizes dispatch, supervision, clerical support, vehicle usage, and similar functions as costs "embedded within and incurred through" the law enforcement contract.[182] Those functions reflect costs incurred by San Bernardino County in providing law enforcement services, but the claimant's expenditure for those services remains a direct contract cost. Even if those County costs are incorporated into the contract rates, their inclusion would establish only that those expenses contribute to the price the claimant is charged for law enforcement services. It would not establish that the claimant incurred the underlying County expenses as its own overhead or that those expenses qualify as indirect costs under the Parameters and Guidelines.

The costs associated with the support and administrative functions identified by the claimant arise from San Bernardino County's law enforcement operations. That overhead supports the Sheriff's Department's law enforcement services across multiple County programs, including *Identity Theft,* and is not attributable to any one activity. But these would be San Bernardino County's indirect costs, not the claimant's, because the County incurred the underlying expenses. The claimant offers no comparable application to demonstrate how it has incurred costs that qualify as indirect costs under the Parameters and Guidelines: neither how it incurs comparable overhead, nor how the contract service costs it incurred satisfy the definition of indirect costs under the Parameters and Guidelines.

The claimant contends that the contracted law enforcement provider functions as the unit performing the mandate and that costs associated with that unit are therefore recoverable by the claimant as indirect costs under the Parameters and Guidelines. However, the unit performing the mandate is the San Bernardino County Sheriff's Department. The claimant's decision to obtain those services by contract does not place the claimant in the position of San Bernardino County for purposes of determining who incurred the associated overhead and support costs. The County incurred those costs in providing the contracted law enforcement services; the claimant's costs for obtaining those services are its contract service costs. The claimant's argument thus treats its expenditure for contracted services as establishing that it also incurred the

[181] Exhibit A, Incorrect Reduction Claim, page 8 (Written Narrative).

[182] Exhibit A, Incorrect Reduction Claim, page 8 (Written Narrative).

County's underlying overhead and support costs as its own indirect costs. But the Parameters and Guidelines' reference to overhead of the "unit performing the mandate" identifies a type of costs that may qualify as indirect; it does not eliminate the requirement that reimbursement be based on actual costs incurred by the claimant.

The contractual arrangement reinforces this distinction. Under the law enforcement services contract, San Bernardino County undertakes to provide the personnel, equipment, administration, and other services necessary to perform the contracted law enforcement functions, while the claimant agrees to pay the charges specified in the agreement.[183] The contract further provides that, except as otherwise specified, the claimant assumes no liability for costs or expenditures incurred by San Bernardino County in performing the agreement.[184] Thus, although the claimant pays for the services of the unit performing the mandate, that arrangement does not establish that the claimant provided the unit's underlying overhead and support and incurred those expenses as its own indirect costs.

The Parameters and Guidelines' separate reference to central government services does not alter this conclusion. Such services may constitute indirect costs when they are distributed to other departments through a cost allocation plan, but the claimant has not demonstrated or provided any evidence that it incurred any central government service costs in connection with the reimbursable activities. Costs incurred by the County in supporting the contracted law enforcement services do not become indirect costs of the claimant merely because those services were provided under contract.

The federal guidance incorporated by the Parameters and Guidelines supports the same distinction. Appendix A of 2 CFR part 225 provides that indirect costs are costs of that type that originate in the "grantee department," as well as costs incurred by other departments in supplying goods, services, and facilities.[185] It defines a "grantee department or agency" as the component of a governmental unit responsible for performance or administration of all or some part the award.[186] This framework distinguishes indirect costs by where they originate and who incurs them, not solely by whether those costs support the activities being performed.

Here, the salaries, wages, supplies, and support services at issue did not originate with the claimant. Rather, those costs originated with San Bernardino County, which employs and compensates the peace officers performing the mandated activities and incurs the related supply, administrative, and support costs associated with providing those services. Moreover, the claimant has not claimed or demonstrated that any of its own departments incurred costs supplying goods, services, facilities, or other overhead

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[183] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 83 (Law Enforcement Service Contract, sections III-IV).

[184] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 83 (Law Enforcement Service Contract, sections IV).

[185] Exhibit A, Incorrect Reduction Claim, page 623 (70 Fed. Reg. 51913).

[186] Exhibit A, Incorrect Reduction Claim, page 622 (70 Fed. Reg. 51912).

costs to comply with the reimbursable activities. Accordingly, the claimed costs do not satisfy either recognized basis for attributing indirect costs to the claimant under the applicable federal cost principles.

Accordingly, the claimant has not made the threshold showing that it incurred actual increased costs qualifying as reimbursable indirect costs under the Parameters and Guidelines. The Controller's reduction of the claimed indirect costs to zero is therefore correct as a matter of law on this independent ground.

C. The Controller's Allowance of Administrative Costs as Part of the Claimant's Direct Contract Service Costs Is An Additional Allowance Separate from the Reduction of Indirect Costs and Is Not Arbitrary, Capricious, or Entirely Lacking in Evidentiary Support.

The claimant argues that the Controller improperly rejected its ICRP methodology in favor of an "Allowable Administrative Percentage" methodology, which the claimant further contends constitutes an underground regulation.[187] The record, however, shows two distinct audit determinations: the Controller reduced the claimed indirect costs to zero, and separately increased the hourly rates used to calculate allowable direct contract service costs through an administrative cost percentage.[188] That upward adjustment is not itself an incorrect reduction within the Commission's IRC jurisdiction, and the record also shows a reasoned basis for the Controller's administrative cost determination.

Government Code section 17561 authorizes the Controller to audit a local agency's records to verify the actual amount of mandated costs.[189] The Commission, in turn, has jurisdiction over claims that the Controller incorrectly reduced payments to a local agency.[190] In exercising that jurisdiction, the Commission reviews the Controller's discretionary audit determinations to determine whether they are arbitrary, capricious, or entirely lacking in evidentiary support.[191]

Section V.A.3. of the Parameters and Guidelines identifies contracted services as a direct-cost category. For contracted services, the claimant must identify the contractor

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[187] Exhibit A, Incorrect Reduction Claim, pages 9, 16-17 (Written Narrative).

[188] Exhibit A, Incorrect Reduction Claim, pages 651-655 (Final Audit Report).

[189] Government Code section 17561(d)(1)-(2). See also Government Code section 12410, which states: "The Controller shall superintend the fiscal concerns of the state. The Controller shall audit all claims against the state, and may audit the disbursement of any state money, for correctness, legality, and for sufficient provisions of law for payment." The courts have held that the Controller's duty to audit includes the duty to ensure that expenditures are authorized by law. (*Tirapelle v. Davis* (1993) 20 Cal.App.4th 1317, 1335.)

[190] Government Code section 17551(d).

[191] *Johnston v. Sonoma County Agricultural Preservation and Open Space District* (2002) 100 Cal.App.4th 973, 983-984; *American Bd. of Cosmetic Surgery, Inc. v. Medical Bd. of California* (2008) 162 Cal.App.4th 534, 547.

and services performed. Depending on the form of the contract, the claimant must also report the hours and costs charged for time-and-materials contracts, or itemize the costs for fixed-price contracts, with the contract and invoices submitted in support of the claim.[192]

The Final Audit Report explains that the Controller recalculated contract hourly billing rates using the claimant's annual contracts with the San Bernardino County.[193] In doing so, the Controller noted that the contracts included employee classifications and other direct law-enforcement components, as well as items it considered "clearly administrative in nature."[194] The Controller explained that while its Mandated Cost Manual permits reimbursement of contract service costs using hourly billing rates, the manual provides no specific guidance for calculating those rates.[195]

To determine how to account for those administrative contract costs, the Controller reviewed comparable city-county law enforcement contracts. It observed that Los Angeles County incorporated an administrative-type component into its employee contract rates, while San Bernardino County separately stated similar costs as contract line items. To account for these differences in contract structures, the Controller concluded that it was appropriate to allow the claimant to claim its administrative costs "as an addition to" the contract hourly rates for employee classifications in its contracts.[196] This allowance, the Controller explained, would promote equitable treatment among cities that contract for law-enforcement services.[197] To calculate that allowance, the Controller totaled the contract line items it identified as administrative, divided the sum by the total contract cost, and applied the resulting percentage to the employee classification hourly rates.[198]

The resulting administrative cost percentage *increased* the claimant's allowable direct contract service costs. The Controller's calculations increased the contract hourly rates used to calculate allowable direct contract costs by percentages ranging from 4.87% to 7.75% over the review period.[199] For example, in fiscal year 2012-2013, the revised contract hourly rate for a deputy sheriff increased 7.27%, raising the corresponding hourly rate from $82.41 to $88.40.[200] The revised hourly rates were then used, together

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[192] Exhibit A, Incorrect Reduction Claim, page 609 (Parameters and Guidelines).

[193] Exhibit A, Incorrect Reduction Claim, page 650 (Final Audit Report).

[194] Exhibit A, Incorrect Reduction Claim, page 651 (Final Audit Report).

[195] Exhibit A, Incorrect Reduction Claim, page 651 (Final Audit Report).

[196] Exhibit A, Incorrect Reduction Claim, page 651 (Final Audit Report).

[197] Exhibit A, Incorrect Reduction Claim, page 651 (Final Audit Report); see also pages 665, 672, 679, 686, 700, 707, 714, 721, 729, 737 (Schedule A), showing line items by fiscal year.

[198] Exhibit A, Incorrect Reduction Claim, page 652 (Final Audit Report).

[199] Exhibit A, Incorrect Reduction Claim, page 652 (Final Audit Report).

[200] Exhibit A, Incorrect Reduction Claim, page 653 (Final Audit Report).

with the allowable report counts and the claimed time increments, to calculate allowable contract service costs not previously captured in the claimant's hourly rates.[201] This calculation and the resulting allowance reflect a reasoned exercise of audit judgement: The Controller considered comparable contracting practices, determined that an additional allowance would promote equitable treatment, and calculated the allowance from identified line items and applied the resulting percentage to increase allowable direct contract service hourly rates.

That increase in allowable direct contract service costs, however, was distinct from the Controller's disallowance of claimed indirect costs. The Controller reduced the claimed indirect costs because the claimant's ICRPs were improperly prepared using salary and benefit costs that the claimant did not incur.[202] In contrast, the administrative cost allowance arose in the context of direct contract service charges. The Controller recognized that San Bernardino County itemizes certain contract line items that are not captured its employee classification hourly rates, while some other counties included comparable charges in their contract rates.[203] The Controller therefore allowed recovery of certain administrative costs by calculating an administrative cost percentage, which increased the employee classification hourly rates used to calculate allowable direct contract service costs. The disallowance of indirect costs turned on whether San Bernardino County's underlying expenses qualified as indirect costs incurred by the claimant; the administrative allowance instead accounted for separately itemized contract charges in calculating allowable direct contract costs. That allowance sought equitable treatment across differently structured county contracts, not reimbursement of the disallowed indirect cost claim. Thus, the Controller's administrative cost allowance was neither a consequence of, nor a replacement for, the claimant's reduced indirect costs: These were separate determinations addressing different reimbursement questions and distinct cost categories.

Furthermore, the record also supports the Controller's exercise of audit discretion. The Commission's review of the Controller's discretionary audit determinations is limited out of deference to the Controller's audit expertise. The Commission may not reweigh the evidence or substitute its judgment for that of the Controller. Rather, the Commission reviews the Controller's discretionary audit determinations under the standard of whether they are arbitrary, capricious, or entirely lacking in evidentiary support. In applying this standard, the Commission considers whether the Controller adequately considered the relevant factors and demonstrated a rational connection between those factors and the choices made.[204] Here, the Controller identified contract costs not accounted for in the employee classification hourly rate calculation, reviewed the

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[201] Exhibit A, Incorrect Reduction Claim, pages 652-654 (Final Audit Report).

[202] Exhibit B, Controller's Comments on the Incorrect Reduction Claim, page 15 (Background) and page 16 (Issue).

[203] Exhibit A, Incorrect Reduction Claim, page 651 (Final Audit Report).

[204] *American Bd. of Cosmetic Surgery, Inc. v. Medical Bd. of California* (2008) 162 Cal.App.4th 534, 547-548.

treatment of additional costs in law enforcement contracts with Los Angeles County, determined that an additional allowance would promote equitable treatment among contracting cities, and calculated the allowance using identified line items in the claimant's own contracts. The record thus demonstrates a rational connection between the factors considered and the Controller's determination. The Controller's allowance of these additional administrative costs therefore was not arbitrary, capricious, or entirely lacking in evidentiary support.

Accordingly, the Controller's allowance of administrative costs as part of the claimant's direct contract service costs is an additional allowance separate from the Controller's reduction of indirect costs and is not arbitrary, capricious, or entirely lacking in evidentiary support.

V. Conclusion

Based on the forgoing analysis, the Commission denies this IRC.

DECLARATION OF SERVICE BY EMAIL

I, the undersigned, declare as follows:

I am a resident of the County of Sacramento and I am over the age of 18 years, and not a party to the within action. My place of employment is 980 Ninth Street, Suite 300, Sacramento, California 95814.

On November 9, 2026, I served the:

- **Current Mailing List dated November 5, 2026**
- **Draft Proposed Decision, Schedule for Comments, and Notice of Hearing issued November 9, 2026**

  Identity Theft, 25-0308-I-02
  Statutes 2000, Chapter 956 (AB 1897); Penal Code Section 530.6(a)
  Fiscal Years: 2002-2003, 2003-2004, 2004-2005, 2005-2006, 2006-2007, 2007-2008, 2008-2009, 2009-2010, 2010-2011, 2011-2012, 2012-2013
  City of Hesperia, Claimant

by making it available on the Commission's website and providing notice of how to locate it to the email addresses provided on the attached mailing list.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct, and that this declaration was executed on November 9, 2026 at Sacramento, California.

Jill Magee

Jill Magee
Commission on State Mandates
980 Ninth Street, Suite 300
Sacramento, CA 95814
(916) 323-3562

COMMISSION ON STATE MANDATES

Mailing List

Last Updated: 11/5/26

Claim Number: 25-0308-I-02

Matter: Identity Theft

Claimant: City of Hesperia

TO ALL PARTIES, INTERESTED PARTIES, AND INTERESTED PERSONS:

Each commission mailing list is continuously updated as requests are received to include or remove any party or person on the mailing list. A current mailing list is provided with commission correspondence, and a copy of the current mailing list is available upon request at any time. Except as provided otherwise by commission rule, when a party or interested party files any written material with the commission concerning a claim, it shall simultaneously serve a copy of the written material on the parties and interested parties to the claim identified on the mailing list provided by the commission. (Cal. Code Regs., tit. 2, § 1181.3.)

Rachelle Anema, Assistant Auditor-Controller, *County of Los Angeles*
Accounting Division, 500 W. Temple Street, Los Angeles, CA 90012
Phone: (213) 974-8321
RANEMA@auditor.lacounty.gov

Lili Apgar, Specialist, *State Controller's Office*
Local Reimbursements Section, 3301 C Street, Suite 740, Sacramento, CA 95816
Phone: (916) 324-0254
lapgar@sco.ca.gov

Socorro Aquino, *State Controller's Office*
Division of Audits, 3301 C Street, Suite 700, Sacramento, CA 95816
Phone: (916) 322-7522
SAquino@sco.ca.gov

Aaron Avery, Legislative Representative, *California Special Districts Association*
1112 I Street Bridge, Suite 200, Sacramento, CA 95814
Phone: (916) 442-7887
Aarona@csda.net

David Bass, Vice Mayor, *City of Rocklin*
3970 Rocklin Road, Rocklin, CA 95677
Phone: (916) 663-8504
David.Bass@rocklin.ca.us

Ginni Bella Navarre, Deputy Legislative Analyst, *Legislative Analyst's Office*
925 L Street, Suite 1000, Sacramento, CA 95814
Phone: (916) 319-8342
Ginni.Bella@lao.ca.gov

Jonathan Borrego, City Manager, *City of Oceanside*
300 North Coast Highway, Oceanside, CA 92054
Phone: (760) 435-3065
citymanager@oceansideca.org

Maz Bozorginia, Director of Public Works/City Engineer, *City of Brisbane*
50 Park Place, Brisbane, CA 94005
Phone: (415) 508-2131
MBozorginia@brisbaneca.gov

Casey Brooksher, Finance and Administrative Services Director, *City of Hesperia*
Claimant Contact
9700 Seventh Street, Hesperia, CA 92345
Phone: (707) 947-1813
cbrooksher@cityofhesperia.us

Allan Burdick,
7525 Myrtle Vista Avenue, Sacramento, CA 95831
Phone: (916) 203-3608
allanburdick@gmail.com

Guy Burdick, Consultant, *MGT Consulting*
2251 Harvard Street, Suite 134, Sacramento, CA 95815
Phone: (916) 833-7775
gburdick@mgtconsulting.com

Rica Mae Cabigas, Chief Accountant, *Auditor-Controller*
Accounting Division, 500 West Temple Street, Los Angeles, CA 90012
Phone: (213) 974-8309
rcabigas@auditor.lacounty.gov

Evelyn Calderon-Yee, Bureau Chief, *State Controller's Office*
Local Government Programs and Services Division, Bureau of Payments, 3301 C Street, Suite 740, Sacramento, CA 95816
Phone: (916) 324-5919
ECalderonYee@sco.ca.gov

Sheri Chapman, General Counsel, *League of California Cities*
1400 K Street, Suite 400, Sacramento, CA 95814
Phone: (916) 658-8267
schapman@calcities.org

Ali Chemkhi, Senior Supervising Accountant/Auditor, *County of San Bernardino*
Office of Auditor-Controller, 268 West Hospitality Lane, Fourth Floor, San Bernardino, CA 92415-0018
Phone: (909) 382-7035
ali.chemkhi@sbcountyatc.gov

Annette Chinn, Consultant, *Cost Recovery Systems, Inc.*
Claimant Representative
705-2 East Bidwell Street, #294, Folsom, CA 95630
Phone: (916) 939-7901
achinncrs@aol.com

Carolyn Chu, Senior Fiscal and Policy Analyst, *Legislative Analyst's Office*
925 L Street, Suite 1000, Sacramento, CA 95814

Phone: (916) 319-8326
Carolyn.Chu@lao.ca.gov

Michael Coleman, Fiscal Policy Advisor, *Coleman Advisory Services*
2217 Isle Royale Lane, Davis, CA 95616
Phone: (530) 758-3952
coleman@muni1.com

Nicole Denow, Chief Deputy City Attorney, *City of San Diego*
Environment Section, 1200 Third Avenue, Suite 1100, San Diego, CA 92101
Phone: (619) 533-6173
NDenow@sandiego.gov

Kevin Fisher, Assistant City Attorney, *City of San Jose*
Environmental Services, 200 East Santa Clara Street, 16th Floor, San Jose, CA 95113
Phone: (408) 535-1987
kevin.fisher@sanjoseca.gov

Juliana Gmur, Executive Director, *Commission on State Mandates*
980 9th Street, Suite 300, Sacramento, CA 95814
Phone: (916) 323-3562
juliana.gmur@csm.ca.gov

Chris Hill, Principal Program Budget Analyst, *Department of Finance*
Local Government Unit, 915 L Street, 8th Floor, Sacramento, CA 95814
Phone: (916) 445-3274
Chris.Hill@dof.ca.gov

Tiffany Hoang, Fiscal Analyst, *State Controller's Office*
Local Government Programs and Services Division, Bureau of Payments, 3301 C Street, Suite 740, Sacramento, CA 95816
Phone: (916) 323-1127
THoang@sco.ca.gov

Ken Howell, Senior Management Auditor, *State Controller's Office*
Audits, Compliance Audits Bureau, 3301 C Street, Suite 725A, Sacramento, CA 95816
Phone: (916) 323-2368
KHowell@sco.ca.gov

Jason Jennings, Director, *Maximus Consulting*
Financial Services, 808 Moorefield Park Drive, Suite 205, Richmond, VA 23236
Phone: (804) 323-3535
SB90@maximus.com

Angelo Joseph, Fiscal Analyst, *State Controller's Office*
Local Government Programs and Services Division, Bureau of Payments, 3301 C Street, Suite 740, Sacramento, CA 95816
Phone: (916) 323-0706
AJoseph@sco.ca.gov

Emma Jungwirth, Senior Legislative Advocate, *California State Association of Counties (CSAC)*
1100 K Street, Ste 101, Sacramento, CA 95814
Phone: (916) 650-8115
ejungwirth@counties.org

Anne Kato, Acting Chief, *State Controller's Office*
Local Government Programs and Services Division, 3301 C Street, Suite 740, Sacramento, CA 95816

Phone: (916) 322-9891
akato@sco.ca.gov

Jevin Kaye, Finance Director, *City of Rancho Cucamonga*
10500 Civic Center Drive, Rancho Cucamonga, CA 91729
Phone: (909) 774-2403
jevin.kaye@cityofrc.us

Anita Kerezsi, Principal Consultant, *AK & Company*
2425 Golden Hill Road, Suite 106, Paso Robles, CA 93446
Phone: (805) 239-7994
akcompanysb90@gmail.com

Joanne Kessler, Fiscal Specialist, *City of Newport Beach*
Revenue Division, 100 Civic Center Drive , Newport Beach, CA 90266
Phone: (949) 644-3199
jkessler@newportbeachca.gov

Nick Kondoleon, Fiscal Analyst, *State Controller's Office*
Local Government Programs & Services Division, 3301 C Street, Suite 740, Sacramento, CA 95816
Phone: (916) 322-2294
NKondoleon@sco.ca.gov

Lisa Kurokawa, Bureau Chief for Audits, *State Controller's Office*
Compliance Audits Bureau, 3301 C Street, Suite 700, Sacramento, CA 95816
Phone: (916) 327-3138
lkurokawa@sco.ca.gov

Government Law Intake, *Department of Justice*
Attorney General's Office, 1300 I Street, Suite 125, PO Box 944255, Sacramento, CA 94244-2550
Phone: (916) 210-6046
governmentlawintake@doj.ca.gov

Fernando Lemus, Principal Accountant - Auditor, *County of Los Angeles*
Auditor-Controller's Office, 500 West Temple Street, Room 603, Los Angeles, CA 90012
Phone: (213) 974-0324
flemus@auditor.lacounty.gov

Lucas Leung, Fiscal Analyst, *State Controller's Office*
Local Government Programs & Services Division, 3301 C Street, Suite 740, Sacramento, CA 95816
Phone: (916) 720-3009
LLeung@sco.ca.gov

Erika Li, Chief Deputy Director, *Department of Finance*
915 L Street, 10th Floor, Sacramento, CA 95814
Phone: (916) 445-3274
erika.li@dof.ca.gov

Kenneth Louie, Chief Counsel , *Department of Finance*
915 L. Street, Sacramento, CA 95814
Phone: (916) 322-0971
Kenny.Louie@dof.ca.gov

Everett Luc, Supervisor, *State Controller's Office*
3301 C Street, Suite 740, Sacramento, CA 95816
Phone: (916) 323-0766
ELuc@sco.ca.gov

Holly Lyon, Finance Supervisor, *City of West Sacramento*
Accounting and Audit, 1110 West Capitol Avenue, 3rd Floor, West Sacramento, CA 95691
Phone: (916) 617-5306
hollyl@cityofwestsacramento.org

Jill Magee, Program Analyst, *Commission on State Mandates*
980 9th Street, Suite 300, Sacramento, CA 95814
Phone: (916) 323-3562
Jill.Magee@csm.ca.gov

Suresh Malkani, Finance Director, *Town of Apple Valley*
14955 Dale Evans Parkway, Apple Valley, CA 92307
Phone: (760) 240-7000
smalkani@applevalley.org

Darryl Mar, Manager, *State Controller's Office*
Local Reimbursements Section, 3301 C Street, Suite 740, Sacramento, CA 95816
Phone: (916) 323-0706
DMar@sco.ca.gov

Frederick Mayo, Water Utilities Director, *City of Oceanside*
300 N. Coast Highway, Oceanside, CA 92054
Phone: (760) 435-5827
fmayo@oceansideca.org

Michelle Mendoza, Business Engineer Lead and Senior Manager, *MAXIMUS*
17310 Red Hill Avenue, Suite 340, Irvine, CA 95403
Phone: (949) 440-0845
michellemendoza@maximus.com

Madlen Minasyan, Senior Accountant, *County of Los Angeles*
Auditor-Controller’s Office, 500 West Temple Street, Room 603, Los Angeles, CA 90012
Phone: (213) 974-2645
mminasyan@auditor.lacounty.gov

Rachel Molina, City Manager, *City of Hesperia*
9700 Seventh Ave. , Hesperia, CA 92345
Phone: (760) 947-1018
rmolina@cityofhesperia.us

Kaleb Neufeld, Assistant Controller, *City of Fresno*
2600 Fresno Street, Fresno, CA 93721
Phone: (559) 621-2489
Kaleb.Neufeld@fresno.gov

Rosanna Nguyen, Program Budget Manager, *Department of Finance*
Local Government Unit, 915 L. Street, Sacramento, CA 95814
Phone: (916) 445-3274
Rosanna.Nguyen@dof.ca.gov

Andy Nichols, Consultant, *Nichols Consulting*
1857 44th Street, Sacramento, CA 95819
Phone: (916) 455-3939
andy@nichols-consulting.com

Erika Opp, Administrative Analyst, *City of St. Helena*
City Clerk, 1480 Main Street, St. Helena, CA 94574

Phone: (707) 968-2743
eopp@cityofsthelena.gov

Steve Oppenheim, Consultant, *Local Government Consultants*
1420 E. Roseville Parkway, Suite 337, Roseville, CA 95661
Phone: (916) 209-8346
steve@lgconsultants.net

Robert Osborne, Program Specialist II, *County of Los Angeles*
Auditor-Controller's Office, 500 West Temple Street, Room 603, Los Angeles, CA 90012
Phone: (213) 974-0200
rosborne@auditor.lacounty.gov

Arthur Palkowitz, Attorney, *Law Offices of Arthur M. Palkowitz*
12807 Calle de la Siena, San Diego, CA 92130
Phone: (858) 259-1055
law@artpalk.onmicrosoft.com

Kirsten Pangilinan, Specialist, *State Controller's Office*
Local Reimbursements Section, 3301 C Street, Suite 740, Sacramento, CA 95816
Phone: (916) 322-2446
KPangilinan@sco.ca.gov

Tammy Pelayes, Assistant to the City Manager, *City of Hesperia*
9700 Seventh Ave, Hesperia, CA 92345
Phone: (760) 947-1014
TPelayes@hesperiaca.gov

Johnnie Pina, Legislative Policy Analyst, *League of Cities*
1400 K Street, Suite 400, Sacramento, CA 95814
Phone: (916) 658-8214
jpina@cacities.org

Trevor Power, Accounting Manager, *City of Newport Beach*
100 Civic Center Drive, Newport Beach , CA 92660
Phone: (949) 644-3085
tpower@newportbeachca.gov

Chad Rinde, Director of Finance, *County of Sacramento*
700 H Street, Room 3650, Sacramento, CA 95814
Phone: (916) 874-7248
RindeC@SacCounty.gov

Becky Robertson, Acting Director of Finance , *City of West Sacramento*
1110 West Capitol Ave, West Sacramento, CA 95691
Phone: (916) 617-4509
beckyr@cityofwestsacramento.org

John Saephan, Fiscal Analyst, *State Controller's Office*
Local Government Programs & Services Division, 3301 C Street, Suite 740, Sacramento, CA 95816
Phone: (916) 324-2664
JSaephan@sco.ca.gov

Cindy Sconce, Director, *Government Consulting Partners*
5016 Brower Court, Granite Bay, CA 95746
Phone: (916) 276-8807
cindysconcegcp@gmail.com

Camille Shelton, Chief Legal Counsel, *Commission on State Mandates*
980 9th Street, Suite 300, Sacramento, CA 95814
Phone: (916) 323-3562
camille.shelton@csm.ca.gov

Paul Steenhausen, Principal Fiscal and Policy Analyst, *Legislative Analyst's Office*
925 L Street, Suite 1000, , Sacramento, CA 95814
Phone: (916) 319-8303
Paul.Steenhausen@lao.ca.gov

Julie Testa, Vice Mayor, *City of Pleasanton*
123 Main Street PO Box520, Pleasanton, CA 94566
Phone: (925) 872-6517
Jtesta@cityofpleasantonca.gov

Jolene Tollenaar, Consultant, *MGT Consulting Group*
2251 Harvard Street, Suite 134, Sacramento, CA 95815
Phone: (916) 243-8913
jolenetollenaar@gmail.com

Robert Torrez, Interim Chief Financial Officer, *City of Huntington Beach*
2000 Main Street, Huntington Beach, CA 92648
Phone: (714) 536-5630
robert.torrez@surfcity-hb.org

Jessica Uzarski, Consultant, *Senate Budget and Fiscal Review Committee*
1020 N Street, Room 502, Sacramento, CA 95814
Phone: (916) 651-4103
Jessica.Uzarski@sen.ca.gov

Edoneia Valdez, Fiscal Analyst, *State Controller's Office*
Local Government Programs & Services Division, 3301 C Street, Suite 740, Sacramento, CA 95816
Phone: (916) 283-7753
EValdez@sco.ca.gov

Alejandra Villalobos, Management Services Manager, *County of San Bernardino*
Office of Auditor-Controller, 222 West Hospitality Lane, Forth Floor, San Bernardino, CA 92415
Phone: (909) 382-3191
alejandra.villalobos@sbcountyatc.gov

Joshua Walden, Deputy County Counsel, *County of Santa Clara*
Office of the County Counsel, 70 West Hedding Street, 9th Floor, San Jose, CA 95110
Phone: (408) 229-9052
joshua.walden@cco.sccgov.org

Renee Wellhouse, President, *David Wellhouse & Associates, Inc.*
3609 Bradshaw Road, H-382, Sacramento, CA 95927
Phone: (916) 797-4883
renee@wellhouseassociates.com

Adam Whelen, Director of Public Works, *City of Anderson*
1887 Howard St., Anderson, CA 96007
Phone: (530) 378-6640
awhelen@ci.anderson.ca.us

Linda Wong, Fiscal Analyst, *State Controller's Office*
Local Government Programs & Services Division, 3301 C Street, Suite 740, Sacramento, CA 95816

Phone: (916) 229-8037
LWong@sco.ca.gov

Arthur Wylene, General Counsel, *Rural County Representatives of California (RCRC)*
1215 K Street, Suite 1650, Sacramento, CA 95814
Phone: (916) 447-4806
awylene@rcrcnet.org

Elisa Wynne, Staff Director, *Senate Budget & Fiscal Review Committee*
California State Senate, State Capitol Room 5019, Sacramento, CA 95814
Phone: (916) 651-4103
elisa.wynne@sen.ca.gov

Kaily Yap, Budget Analyst, *Department of Finance*
Local Government Unit, 915 L Street, Sacramento, CA 95814
Phone: (916) 445-3274
Kaily.Yap@dof.ca.gov

Siew-Chin Yeong, Director of Public Works, *City of Pleasonton*
3333 Busch Road, Pleasonton, CA 94566
Phone: (925) 931-5506
syeong@cityofpleasantonca.gov

Traci Young, IS Project Director, *City and County of San Francisco*
San Francisco Public Utilities Commission (SFPUC), 525 Golden Gate Ave, San Francisco, CA 94102
Phone: (415) 653-2583
tmyoung@sfwater.org

Aly Zimmermann, CIty Manager, *City of Rocklin*
3970 Rocklin Road, Rocklin, CA 95677
Phone: (916) 625-5585
alyz@rocklin.ca.us

Helmholst Zinser-Watkins, Analyst II, *State Controller's Office*
Local Government Programs and Services Division, Bureau of Payments, 3301 C Street, Suite 700, Sacramento, CA 95816
Phone: (916) 324-7876
HZinser-watkins@sco.ca.gov

Marc Zometa, Senior Accountant-Auditor, *County of Los Angeles*
Auditor-Controller’s Office, 500 West Temple Street, Room 603, Los Angeles, CA 90012
Phone: (213) 974-8333
mzometa@auditor.lacounty.gov