

CITY OF HAWTHORNE

Audit Report

GAS TAX FUND AND TRAFFIC CONGESTION RELIEF FUNDS

July 1, 2004, through June 30, 2005



JOHN CHIANG
California State Controller

May 2007



JOHN CHIANG
California State Controller

May 25, 2007

Jag Pathirana
City Manager and Director of Finance
City of Hawthorne
4455 West 126th Street
Hawthorne, CA 90250

Dear Mr. Pathirana:

The State Controller's Office audited the City of Hawthorne's Gas Tax Fund for the period of July 1, 2004, through June 30, 2005. We also audited the Traffic Congestion Relief Fund (TCRF) allocations recorded in the AB 2928 TCRF Fund for the period of July 1, 2000, through June 30, 2004.

The city accounted for and expended its Gas Tax Fund and TCRF allocations recorded in the AB 2928 TCRF Fund in compliance with Article XIX of the California Constitution and the *Streets and Highways Code*, except for our adjustments to the Gas Tax Fund. Our audit disclosed that the city understated the fund balance in the Gas Tax Fund by \$590,685 as of June 30, 2005. This understatement occurred because the city did not reimburse the Gas Tax Fund \$370,220 for unsupported liability insurance allocation charges for fiscal year (FY) 1994-95 through FY 1996-97. Additionally, during FY 2004-05, the Gas Tax Fund incurred expenditures in excess of available funds, resulting in a deficit fund balance of \$220,465 on June 30, 2005.

If you have any questions, please contact Steven Mar, Chief, Local Government Audits Bureau, at (916) 324-7226.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

JVB/vb:jj

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Audit Report

Summary

The State Controller's Office (SCO) audited the City of Hawthorne's Gas Tax Fund for the period of July 1, 2004, through June 30, 2005. We also audited the Traffic Congestion Relief Fund (TCRF) allocations recorded in the AB 2928 Fund for the period of July 1, 2000, through June 30, 2004. The last day of fieldwork was November 7, 2005.

Our audit disclosed that the city understated the fund balance in the Gas Tax Fund by \$590,685 as of June 30, 2005. This understatement occurred because the city did not reimburse the Gas Tax Fund \$370,220 for unsupported liability insurance allocation charges for fiscal year (FY) 1994-95 through FY 1996-97. In addition, during FY 2004-05, the Gas Tax Fund incurred expenditures in excess of available funds, resulting in a deficit fund balance of \$220,465 on June 30, 2005.

Our audit disclosed that no adjustment to the TCRF allocations, recorded in the AB 2928 TCRF Fund, is required.

Background

The State apportions funds monthly from the highway users tax account in the transportation tax fund to cities and counties for the construction, maintenance, and operation of local streets and roads. The highway users taxes are derived from state taxes on the sale of motor vehicle fuels. In accordance with *Streets and Highways Code* Section 2101 and Article XIX of the California Constitution, a city must deposit all apportionments of highway users taxes in its Gas Tax Fund (also known as the Special Gas Tax Street Improvement Fund). A city must expend gas tax funds only for street-related purposes. We conducted our audit of the city's Gas Tax Fund under the authority of *Government Code* Section 12410.

Chapter 91, Statutes of 2000 (Assembly Bill 2928), as amended by Chapter 656, Statutes of 2000 (Senate Bill 1662), established a Traffic Congestion Relief Fund in the State Treasury for allocating funds quarterly to cities and counties for street or road maintenance, reconstruction, and storm damage repair. Cities must deposit funds received into the city account designated for the receipt of state funds allocated for transportation purposes. The city recorded the TCRF in the AB 2928 TCRF Fund. We conducted our audit of the city's TCRF under the authority of *Streets and Highways Code* Sections 2182 and 2182.1.

Objective, Scope, and Methodology

Our audit objective was to determine whether the city accounted for and expended the Gas Tax Fund and the TCRF, recorded in the AB 2928 TCRF Fund, in compliance with Article XIX of the California Constitution and the *Streets and Highways Code*. To meet the audit objective, we determined whether the city:

- Properly deposited highway users tax apportionments and other appropriate revenues in the Gas Tax Fund;

- Properly deposited TCRF allocations into an account designated for the receipt of state funds allocated for transportation purposes;
- Expended funds exclusively for authorized street-related purposes; and
- Made available unexpended funds for future expenditures.

We conducted our audit according to *Government Auditing Standards*, issued by the Comptroller General of the United States. We did not audit the city's financial statements. We limited our audit scope to planning and performing the audit procedures necessary to obtain reasonable assurance that the city accounted for and expended the Gas Tax Fund and the TCRF allocations recorded in the AB 2928 Fund in accordance with the requirements of the *Streets and Highways Code*. Accordingly, we examined transactions, on a test basis, to determine whether the city expended funds for street purposes. We considered the city's internal controls only to the extent necessary to plan the audit.

Conclusion

Our audit disclosed that the city accounted for and expended its Gas Tax Fund in compliance with Article XIX of the California Constitution and the *Streets and Highways Code* for the period of July 1, 2004, through June 30, 2005, except as noted in Schedule 1 and described in the Findings and Recommendations section of this report. The findings required an adjustment of \$590,685 to the city's accounting records. Our audit also disclosed that the city accounted for and expended its TCRF allocations recorded in the AB 2928 Fund in compliance with Article XIX of the California Constitution and the *Streets and Highways Code* for the period of July 1, 2000, through June 30, 2004.

Follow-Up on Prior Audit Findings

The city did not satisfactorily resolve the findings noted in our prior audit report, issued on October 30, 1998. This finding is described in Attachment B.

Views of Responsible Official

We issued a draft audit report on February 28, 2007. Jag Pathirana, City Manager and Director of Finance, responded by letter dated April 11, 2007, agreeing with the audit results with the exception of Finding 1. The city's response is included in this final audit report as an attachment.

Restricted Use

This report is intended for the information and use of city management and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of this report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

**Schedule 1—
Reconciliation of Fund Balance
July 1, 2004, through June 30, 2005**

	Gas Tax Fund ¹
Beginning fund balance per city	\$ 295,614
Revenues	1,837,469
Total funds available	2,133,083
Expenditures	(2,353,548)
Ending fund balance per city	(220,465)
SCO adjustments: ²	
Finding 1—Unsupported liability insurance allocation	370,220
Finding 2—Deficit Gas Tax Fund balance	220,465
Total SCO adjustments	590,685
Ending fund balance per audit	\$ 370,220

NOTE: Chapter 91, Statutes of 2000 (Assembly Bill 2928), as amended by Chapter 656, Statutes of 2000 (Senate Bill 1662), established the State Traffic Congestion Relief Fund (TCRF), which allocates funds to cities and counties for street or road maintenance and reconstruction from FY 2000-01 through FY 2002-03. TCRF allocations were suspended during FY 2003-04 and FY 2004-05.

¹ The city receives apportionments from the state highway users tax account, pursuant to *Streets and Highways Code* Sections 2105, 2106, 2107, and 2107.5. The basis of the apportionments for Sections 2105, 2106, and 2107 varies, but the money may be used for any street purpose. *Streets and Highways Code* Section 2107.5 apportionments are restricted to administration and engineering expenditures, except for cities with populations of fewer than 10,000 inhabitants. Those cities may use the funds for rights-of-way and for the construction of street systems.

² See the Findings and Recommendations section.

Findings and Recommendations

FINDING 1— Unsupported liability insurance allocation

Liability insurance allocations charged to the Gas Tax Fund during fiscal year (FY) 1994-95 through FY 1996-97 were not supported by city records. Additionally, these charges were based upon estimates of costs, rather than actual costs. The unsupported charges totaled \$370,220.

Streets and Highways Code Section 2101 specifies that gas tax moneys are to be expended for construction, maintenance, and operation of public streets and roads, and related administrative costs. Additionally, expenditures should be supported with actual costs.

Recommendation

This finding was disclosed in our audit report dated October 30, 1998; the city has not made the required reimbursement to the Gas Tax Fund as of June 30, 2005. The city should reimburse \$370,220 to the Gas Tax Fund.

City's Response

The claims of the \$370,220 charged to the Gas Tax Fund represent amount for liability and workers compensation insurance allocations specific to city staff assigned to the Street Fund who carryout the construction and maintenance of public streets. As such we believe the charges are legitimate and supporting documentation to that effect were provided to the auditor during the audit for fiscal years 1994-95 through 1996-97.

SCO's Comment

As stated in the previous audit report (Attachment B), the amounts claimed for liability and workers' compensation insurance were estimated, and were not supported by documentation. Future highway apportionments may be withheld if the city does not make the requested audit correction within 30 days.

FINDING 2— Deficit Gas Tax Fund balance

As of June 30, 2005, the city's recorded fund balance in the Gas Tax Fund was a deficit \$220,465. This resulted from the city incurring expenditures in excess of available funds during FY 2004-05.

Pursuant to California *Government Code* Section 12440, warrants may be drawn only from an unexhausted specific appropriation provided by law. As the city's Gas Tax Fund allocations were exhausted at June 30, 2005, there were no funds available in the Gas Tax Fund to meet those warrants. Additionally, the city may not carry forward a deficit fund balance to the subsequent fiscal year.

Recommendation

The city should eliminate the \$220,465 deficit fund balance in the Gas Tax Fund. Additionally, the city should adopt a balanced budget that limits expenditures to the funds available.

City's Response

The deficit arose as a result of spending in excess of budgeted amounts; controls have been placed to ensure that occurrences of this nature are eliminated.

SCO's Comment

We agree with the city's response.

**Attachment A—
City’s Response to
Draft Audit Report**

CITY OF HAWTHORNE



4455 West 126th Street • Hawthorne, California 90250-4482

Paul R Criss
Chief – Financial Related Audits Bureau
State Controllers Office
Division of Audits
P O Box 942850
Sacramento, CA 94250-5874

April 11, 2007

Dear Sir:

Ref: City of Hawthorne Audit report July 1st 2004 through June 30th 2005

The following are in response to the findings and recommendations noted in the above referenced report.

Finding 1- Unsupported claims of \$370,220 as a result of prior years audits

The claims of the \$370,220 charged to the Gas Tax fund represent amounts for liability and workers compensation insurance allocations specific to city staff assigned to the Street Fund who carryout the construction and maintenance of public streets. As such we believe the charges are legitimate and supporting documentation to that effect were provided to the auditor during the audit for fiscal years 1994-95 through 1996-97.

Finding 2 – Deficit of \$220,465 in the Gas Tax fund at 6/30/05

The deficit arose as result of spending in excess of budgeted amounts; controls have been placed to ensure that occurrences of this nature are eliminated.

Please do not hesitate to contact us if you need further details.

Yours truly,

Jag Pathirana
City Manager & Director of Finance

Attachment B— Excerpt from SCO’s Prior Audit Report Issued October 30, 1998

**FINDING—
Unsupported liability
insurance allocation**

Liability insurance allocations charged to the Gas Tax Fund, in the three fiscal years ended June 30, 1997, were not adequately supported by available city records. In addition, the charges were based significantly upon estimates of costs, rather than actual costs.

The SCO’s *Guidelines Relating to Gas Tax Expenditures* requires that expenditures charged to the Gas Tax Fund must be actual and street-related costs. The guidelines also require that overhead costs are distributed by either: (1) an approved cost allocation plan; or (2) an equitable and well-documented distribution plan that includes all city departments.

Budgeted liability insurance allocations were charged to various city funds based upon a five-year history of indemnity payments, reservations for indemnity, defense payments and costs, and reservations for defense payments and costs. However, documents provided by the City Attorney’s Office did not adequately support amounts reflected in the history. A review of a sample of case files revealed no support for specific payment amounts.

Since the amounts reflected in the five-year history are not adequately supported, the allocations to the Gas Tax Fund are disallowed. Payments made from the fund are as follows:

<u>Fiscal Year</u>	<u>Amount</u>
1994-95	\$(291,963)
1995-96	(40,108)
1996-97	<u>(38,149)</u>
Total	<u>\$(370,220)</u>

During the audit of the city’s Gas Tax Fund for fiscal year 1994-95, the SCO auditors questioned the city’s practice of allowing litigation and indemnity reserves costs in the liability costs allocations. The issue was discussed with the city’s former Finance Director who provided a letter from the City Attorney’s Office in support of the city’s practice. It was decided that any review and verification of the supporting documentation related to the allocation process would be postponed to the next audit.

Since the release of the fiscal year 1994-95 audit report, the SCO Legal Office has issued a legal opinion agreeing with the city’s position that the Gas Tax Fund could be used for litigation costs incurred in defending claims of defective street design and inadequate maintenance, signage, and other traffic control devices. However, although such expenditures are allowable, they still must have been actually incurred and must be supported by appropriate documentation. To date, the city has not been able to provide such documentation.

Recommendation

The city should reimburse \$370,220 to the Gas Tax Fund. In addition, the city's Finance Department should ensure that future allocations of liability insurance costs are equitable and fully supported by documentation.

- 1) The State is questioning 1994-95 liability insurance allocations to the State Gas Tax Fund in the amount of \$291,963. We believe this was resolved prior to the issuance of the 1994-95 Gas Tax audit report. Ed Stafford indicated that he had a conversation with the City's then Director of Finance, Julia James, where the pending nature of the liability insurance allocations were discussed; however, the City has no documentation supporting his allegation. Moreover, there is no finding or noted exception in the 1994-95 Audit Report regarding the insurance allocations. The Audit Report indicates "accounted for, expended, and safeguarded funds in the Special Gas Tax Street Improvement Fund in accordance with the State Constitution and the Streets and Highways Code for the year ended June 30, 1995."
- 2) The State is questioning \$40,108 (1995-96) and \$38,149 (1996-97) liability insurance allocations. Ed Stafford and Bill Harkness indicated the schedule of claims was not auditable as most of the numbers were estimates by the City Attorney without documents tying to the precise dollar amount of the estimate. Bill indicated that no files were provided for several of the claims; however, he indicated that he had only specified he was looking for "support" for the estimates. We suspect that he was not sure as to what he needed to document the costs.

The City Attorney estimates the amounts based upon the facts of the case and the Attorney's years of experience. The case estimates are used to determine the percentage of the claims expense to be allocated to each department; the amount allocated to each department is based on total payments (claims and defense) rounded to the nearest \$100,000. Although the allocations are based on estimates, they are auditable; OMB A87 allows accounting estimates for use in the allocation of costs.

As previously stated, the SCO had decided to postpone review and verification of supporting documentation related to the allocation process pending resolution of the legal question concerning this issue.

The fact that this issue was not reported in the prior audit report does not preclude the SCO from questioning the city's past and ongoing practice of charging the gas tax fund estimated costs that are not adjusted to actual.

OMB Circular A-87, Attachment B, states that estimates or other distribution percentages determined before the services are performed do not qualify as support for charges but may be used for interim accounting purposes. The estimates are allowed only if at least annual comparisons of actual costs to budgeted distributions are made by the local agency.

The city has not provided work sheets or other relevant data that documents annual actual liability insurance cost for the prior or current audit periods. Therefore, the audit finding remains unchanged.

**State Controller's Office
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