CITY OF STOCKTON

Audit Report

SPECIAL GAS TAX STREET IMPROVEMENT FUND

July 1, 2004, through June 30, 2011

TRAFFIC CONGESTION RELIEF FUND

July 1, 2004, through June 30, 2011

PROPOSITION 1B FUND

July 1, 2007, through June 30, 2011

JOHN CHIANG
California State Controller

August 2013

JOHN CHIANG
California State Controller

August 5, 2013

Anthony Silva, Mayor
City of Stockton
425 N. El Dorado Street
Stockton, CA 95202

Dear Mayor Silva:

The State Controller's Office audited the City of Stockton's Special Gas Tax Street Improvement Fund and Traffic Congestion Relief Fund for the period of July 1, 2004, through June 30, 2011. In addition, we audited the Proposition 1B Fund for the period of July 1, 2007, through June 30, 2011.

Our audit found that the City accounted for and expended its Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund, and Proposition 1B Fund in compliance with requirements, except that:

- The City charged ineligible interest expense of $10,686 to the Gas Tax Fund, through negative interest allocation, and thereby understated the fund balance of the Gas Tax Fund by $10,686.
- The City charged ineligible interest expense of $45,469 to the Traffic Congestion Relief Fund, through negative interest allocation, and understated other eligible expenditures by $45,469. Therefore, the overall Traffic Congestion Relief Fund balance is unchanged.
- The Gas Tax Fund cash was impaired because it was pooled with other funds and was used for general operating costs of the City.

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, CPA
Chief, Division of Audits

JVB/kw

cc: Bob Deis, City Manager
City of Stockton
Vanessa Burke, CFO, Administrative Services
City of Stockton
Laurie Montes, Deputy City Manager
City of Stockton
Kurt Wilson, Deputy City Manager
City of Stockton
Elena Adair, Assistant Director, Administrative Services Department
City of Stockton
Paul Canepa, Vice Mayor
City of Stockton
Elbert H. Holman, Jr., Council Member
City of Stockton
Kathy Miller, Council Member
City of Stockton
Moses Zapien, Council Member
City of Stockton
Dyane Burgos, Council Member
City of Stockton
Michael Tubbs, Council Member
City of Stockton
Steven Mar, Bureau Chief
Division of Audits, State Controller's Office
Mike Spalj, Audit Manager
Division of Audits, State Controller's Office
Chris Lek, Audit Manager
Division of Audits, State Controller's Office
Daniel Finau, Auditor–in–Charge
Division of Audits, State Controller's Office

Contents

Audit Report

Summary 1

Background 1

Objective, Scope, and Methodology 2

Conclusion 2

Follow-Up on Prior Audit Findings 3

Views of Responsible Officials 3

Restricted Use 3

Schedule 1—Reconciliation of Fund Balance 4

Findings and Recommendations 5

Attachment—City's Response to Draft Audit Report

Audit Report

Summary

The State Controller's Office audited the City of Stockton's Special Gas Tax Street Improvement Fund for the period of July 1, 2004, through June 30, 2011. We also audited the Traffic Congestion Relief Fund for the period of July 1, 2004, through June 30, 2011. In addition, we audited the Proposition 1B Fund for the period of July 1, 2007, through June 30, 2011.

Our audit found that the City accounted for and expended its Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund, and Proposition 1B Fund in compliance with requirements, except the City charged ineligible interest expense of $10,686 to the Gas Tax Fund, through negative interest allocation, and thereby understated the fund balance of the Gas Tax Fund by $10,686. The City also charged ineligible interest expense of $45,469 to the Traffic Congestion Relief Fund, through negative interest allocation, but understated other eligible expenditures by $45,469. Overall, the Traffic Congestion Relief Fund balance is unchanged. In addition, the Gas Tax Fund cash was impaired because it was pooled with other funds and was used for general operating costs of the City.

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 derive from state taxes on the sale of motor vehicle fuels. In accordance with Article XIX of the California Constitution and Streets and Highways Code section 2113, a city must deposit all apportionments of highway users taxes in its Special Gas Tax Street Improvement Fund. In addition, a city must expend gas tax funds only for street-related purposes pursuant to Streets and Highways Code section 2101. We conducted our audit of the City's Special Gas Tax Street Improvement Fund under the authority of Government Code section 12410.

Government Code section 14556.5 created a Traffic Congestion Relief Fund (TCRF) 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 its TCRF allocations in the Traffic Congestion Relief Fund. We conducted our audit of the City's Traffic Congestion Relief Fund under the authority of Revenue and Taxation Code section 7104.

Senate Bill 1266, Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006, was introduced as Proposition 1B and approved by the voters on November 7, 2006, for a variety of transportation priorities, including the maintenance and improvement of local transportation facilities. Proposition 1B funds transferred to cities and counties shall be deposited into an account that is designated for the receipt of state funds allocated for streets and roads. The City recorded its Proposition 1B allocations in the Proposition 1B Fund. A city also is

required to expend its allocations within three years following the end of the fiscal year in which the allocation was made and to be expended in compliance with Government Code section 8879.23. We conducted our audit of the City's Proposition 1B allocations under the authority of Government Code section 12410.

Objective, Scope, and Methodology

Our audit objective was to determine whether the City accounted for and expended the Special Gas Tax Street Improvement Fund, the Traffic Congestion Relief Fund, and the Proposition 1B 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 Special Gas Tax Street Improvement 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;
- Proposition 1B funds expended in compliance with Government Code section 8879.23; and
- Made available unexpended funds for future expenditures.

We conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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 Special Gas Tax Street Improvement Fund and the Traffic Congestion Relief Fund in accordance with the requirements of the Streets and Highways Code and Revenue and Taxation Code section 7104.

Conclusion

Our audit found that the City of Stockton accounted for and expended its Special Gas Tax Street Improvement 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, 2011, except as noted in Schedule 1 and described in the Findings and Recommendations section of this report. The findings required an adjustment of $10,686 to the City's accounting records.

Our audit also found that the City accounted for and expended its Traffic Congestion Relief Fund in compliance with Article XIX of the California Constitution, the Streets and Highways Code, and Revenue and Taxation Code section 7104 for the period of July 1, 2004, through June 30, 2011, except as noted in Schedule 1 and described in the Findings and Recommendations section of this report. The findings require a reclassification adjustment of $45,469 to the City's accounting records.

Furthermore, Proposition 1B allocations recorded in the Proposition 1B Fund were accounted for and expended in compliance with Government Code section 8879.23 for the period July 1, 2007, through June 30, 2011.

Follow-Up on Prior Audit Findings

The City satisfactorily resolved the findings noted in our prior audit report, issued in September 2006.

Views of Responsible Officials

We issued a draft on June 24, 2013. Vanessa Burke, Chief Financial Officer, responded by a letter dated July 12, 2013, disagreeing with the audit results. The City's response (refer to pages 11-14) is included in this final report as an attachment.

Restricted Use

This report is intended for the information and use of the City of Stockton's 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

August 5, 2013

Schedule 1—
Reconciliation of Fund Balance
July 1, 2010, through June 30, 2011

	Special Gas Tax Street Improvement Fund [1]	Proposition 1B Fund [2]	Traffic Congestion Relief Fund [3]
Beginning fund balance per city	$ 786,410	$ 4,210,235	$ 371,674
Revenues	9,003,613	—	147,563
Total funds available	9,790,023	4,210,235	519,237
Expenditures	(8,798,675)	97,778	(519,237)
Ending fund balance per city	991,348	4,308,013	—
SCO adjustments: [4]			
Finding 1—Negative interest charged–GTF	10,686	—	—
Finding 2—Negative interest charged–TCRF	—	—	45,469
Other TCRF eligible expenditures	—	—	(45,469)
Total SCO adjustments	10,686	—	—
Ending fund balance per audit	$ 1,002,034	$ 4,308,013	$ —

[1] The City receives apportionments from the State highway users tax account, pursuant to Streets and Highways Code sections 2103, 2105, 2106, 2107, and 2107.5. The basis of the apportionments for sections 2103, 2105, 2106, and 2107 varies, but the money may be used for any street purpose. Streets and Highways Code section 2107.5 restricts apportionments 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. The audit period was July 1, 2004, through June 30, 2011; however, this schedule includes only the period of July 1, 2010, through June 30, 2011.

[2] Senate Bill 1266, Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006, introduced as Proposition 1B, provided funds for a variety of transportation priorities.

[3] Government Code section 14556.5 created a Traffic Congestion Relief Fund (TCRF) in the State Treasury for allocating funds quarterly to cities and counties for street and road maintenance, reconstruction, and storm damage repair. The TCRF allocations were recorded in the Traffic Congestion Relief Fund. The audit period was July 1, 2004, through June 30, 2011.

[4] See the Findings and Recommendations section.

Findings and Recommendations

FINDING 1— Negative interest charged – Gas Tax Fund

The City of Stockton's Special Gas Tax Street Improvement Fund (Gas Tax Fund) had negative cash balances at various times during fiscal year (FY) 2004-05 through FY 2010-11. The negative cash balances caused the City to charge interest expense through negative interest allocation to the Gas Tax Fund.

Streets and Highways Code section 2101 specifies that highway users tax apportionments are to be expended only for the construction, maintenance, and operation of public streets and roads, construction of exclusive public mass transit guide ways, and related administrative costs. Negative interest is not an eligible expenditure per the Streets and Highways Code.

Recommendation

The City should transfer $10,686 into the Gas Tax Fund. In addition, the City should establish procedures to ensure that interest allocations to the Gas Tax Fund are not computed with negative cash balances.

City of Stockton's Management Response

> Management disagrees with this finding. The reference made in the Audit Findings and Recommendations to the Streets and Highways Code section 2101 does not preclude negative interest as an eligible expenditure per the Streets and Highways Code. In fact, the code indicates that interest from investment of the funds should be deposited into the fund on a rational and equitable basis. As disclosed in Table B, the fund typically runs negative, which is a cost to the City for the operation of the fund due to delay in the receipt of appropriations as compared to spending patterns. We believe that the model is equitable and rational and supports the charges to the fund.
>
> In addition, upon review of the Guidelines Relating to Gas Tax Expenditures for Cities and Counties (Guidelines), issued by the California State Controller, May 2004, negative interest (interest charge) is not cited as one of the ineligible expenditures.
>
> Section 2113 of the Streets and Highways Code states that "Interest received by a city from the investment of money in its special gas tax street improvement fund shall be deposited in the fund and shall be used for street purposes". Reference is also made in the Guidelines under Special Accounting Requirements for Cities that interest received by a city from the investment of money in its Special Gas Tax Street Improvement Fund shall be deposited in the fund and shall be used for street purposes. In the SCO supporting analysis, interest earnings activities in the Gas Tax Fund were reviewed from FY 2005 through FY 2011. It appears the SCO selectively chose only months in which this fund was allocated negative earnings to calculate the amount, while failing to take into account that these are entirely offset with positive allocation months during those same periods to arrive at the $10,686 amount of negative interest allocation. Overall during the audit period from FY 2005 through 2011, on an annual basis the Gas Tax Fund received a net positive interest allocation of $179,152.

> For the pooled cash concept to work, funds must be charged appropriately when they rely on other funds for cash flow and be credited fairly when the funds contribute to interest earnings. This is accomplished by following the practice of pooling cash and investments of all funds, except for funds required to be held by fiscal agents under the provisions of bond indentures. Prior to July 1, 2011, interest income earned on pooled cash and investments was allocated on a monthly basis to the various funds based on average daily cash balances and a fair market value at year end. Effective July 1, 2011, the City changed its accounting policy and method to a quarterly allocation of accrued interest and fair market valuation adjustments on the basis of average daily cash balances. This change was made on a prospective basis.
>
> The City's position is that the Gas Tax Fund received its equitable proration of interest earned, positive or negative, and is used for street purposes.

SCO's Comment

The City disagrees with the finding.

The Gas Tax fund is a restricted Special Revenue Fund and does not allow for borrowing, therefore cash balances should never be negative and negative interest should not be allocated.

Article XIX of the California Constitution, Streets and Highways Code, and Guidelines Relating to Gas Tax Expenditures for Cities and Counties provides for allowable uses of gas tax funds such as research, planning, construction, improvement, maintenance, and operation of public streets and highways. Negative interest charges do not fall under any of the above categories.

Although the gas tax cash balance at times run negative, due to the timing of apportionments as compared to spending patterns, this is done at the City's discretion.

The finding remains as stated.

FINDING 2—Negative interest charged – TCRF

The City's Traffic Congestion Relief Fund (TCRF) had negative cash balances at various times during FY 2004-05 through FY 2010-11. The negative cash balances caused the City to charge interest expense through negative interest allocation to the Traffic Congestion Relief Fund.

Streets and Highways Code section 2101 specifies that highway users tax apportionments are to be expended only for the construction, maintenance, and operation of public streets and roads, construction of exclusive public mass transit guide ways, and related administrative costs. Negative interest is not an eligible expenditure per the Streets and Highways Code.

Recommendation

The City should transfer $45,469 into the Traffic Congestion Relief Fund. As there are other eligible TCRF expenditures, the City should increase the TCRF expenditures by $45,469. Overall, the Traffic Congestion Relief Fund balance should remain the same. In addition, the City should establish procedures to ensure that interest allocations to the Traffic Congestion Relief Fund are not computed with negative cash balances.

City of Stockton's Management Response

> Management disagrees with this finding. The reference made in the Audit Findings and Recommendations to the Streets and Highways Code section 2101 does not state that negative interest is not an eligible expenditure per the Streets and Highways Code. Please see responses to Finding 1.

SCO's Comment

Please refer to SCO's comments to Finding 1.

FINDING 3— Impairment of cash

The City's Gas Tax Fund was impaired by the General Fund at various times during FY 2008-09, FY 2009-10, and FY 2010-11. The General Fund is the main operating fund and its cash is maintained in an investment pool with cash from other funds, including restricted funds (such as the Gas Tax Fund). During our review, we noted that the General Fund was reporting negative cash balances at various times during FY 2008-09, FY 2009-10, and FY 2010-11. The negative cash balances were impairing and affecting the integrity of the Gas Tax Fund.

	Fiscal Year		
Month	FY 2008-09 General Fund	FY 2009-10 General Fund	FY 2010-11 General Fund
July	(25,248,914)	(21,548,014)	(1,799,496)
August	(29,519,630)	(24,594,681)	(6,622,644)
September	(25,943,960)	(23,400,406)	(11,971,146)
October	(22,203,955)	(19,418,317)	(18,752,254)
November	(28,492,716)	(20,487,250)	(24,153,512)
December	(18,596,701)	(11,235,036)	(16,849,320)
January	(30,251,371)	(24,614,562)	(16,723,166)
February	(17,703,463)	(16,566,645)	(8,917,656)
March	(21,114,495)	(18,455,345)	(11,334,763)
April	(16,200,957)	(12,368,716)	(10,415,417)
May	(16,430,315)	(14,040,656)	(13,225,742)
June	2,276,869	(390,947)	(9,213,475)

Streets and Highways Code section 2101 specifies that highway users tax apportionments are to be expended only for the construction, maintenance, and operation of public streets and roads, construction of exclusive public mass transit guide ways, and related administrative costs.

California Streets and Highways Code section 2118 states that:

> When the State Controller determines it to be necessary, he may require a county or city to deposit money received from the highway users tax allocations in a separate bank account.

Recommendation

The City should develop and implement policies and procedures to ensure that it does not impair other funds' cash, especially the restricted funds, for general operating costs.

The City must establish a separate bank account for the Gas Tax Fund. This account shall be used to record all deposits and expenditures against these moneys. The City must provide the State Controller's Office with proof that a separate bank account has been established. The bank account shall remain open until the City provides evidence that it has restored the financial health of the General Fund.

The City of Stockton's Management Response

> Management disagrees with the Finding. The SCO in their analysis failed to include funds that are unrestricted that are included in the General Fund for the Comprehensive Annual Financial Report (CAFR) but segregated in the accounting system for tracking purposes. These funds consist of the Library, Recreation, Entertainment Venues, and other auxiliary fee and general funded operations.
>
> When including these funds the general fund cash position is reported as follows:

Table A

	Fiscal Year		
Month	FY 2008-09 General Fund	FY 2009-10 General Fund	FY 2010-11 General Fund
July	15,932,712	(12,755,358)	8,414,340
August	9,499,858	17,756,413	4,295,118
September	1,451,377	19,734,058	(1,039,616)
October	3,380,078	13,040,522	(7,960,241)
November	2,320,036	7,178,133	(11,600,274)
December	7,211,211	15,702,056	(5,967,707)
January	9,450,199	17,654,537	(7,840,504)
February	22,928,602	25,219,403	1,229,409
March	19,722,838	29,224,060	(613,797)
April	23,889,817	30,280,001	153,760
May	23,640,387	28,699,751	(2,319,246)
June	11,496,667	11,406,061	12,977,884

In addition, in FY 2009-2010, the SCO failed to consider that the City had access and utilized a $32,180,000 2009 CSCDA Tax Revenue Anticipation Note {TRAN) to fund cash flow deficiencies. In the table below, the months in which the corrected general fund cash deficits arose, there was sufficient cash in the TRAN, the borrowing funds established per accounting policy (e.g. self-insurance funds) that was sufficient to cover any shortfall in the general fund. In addition, in most months the Gas Tax Fund had a cash deficit and wouldn't have been a fund to borrow from but was borrowing in reverse from the General Fund to cover cost incurred prior to receipt of the apportionments from the State of California. The Gas Tax Fund cash position as a percentage of the total restricted cash position is less than 1% on average and would not be impaired and is a fund of last resort not a fund of first resort.

Based on the review of the Article XIX of the California Constitution, Streets and Highway Code Sections 2100-2128.1 and Sections 2150-5157, and Guidelines Relating to Gas Tax Expenditures for Cities and Counties issued by the State Controller's Office in May 2004, none of the publications discuss impairment of cash in the pooled cash system. In addition, there is no guidance about whether deficit cash balances in funds participating in the pooled cash arrangement create "impairment."

The City's policy is to use City's Workers Compensation and General Liability Internal Service Funds as the lending funds to other City funds with negative cash position at the end of each fiscal year as reported in Note 3 to the City's CAFR. The same policy is applied during any given fiscal year. The monthly cash balance reports for all City funds covering fiscal years 2008-09, 2009-10 and 2010-11 that were provided for your review, show that there were sufficient cash balances in the Workers' Compensation and General Liability Internal Service Funds every month in which General Fund cash balance went negative, except for November 2011. However, in that same month both the Gas Tax Fund and Traffic Congestion Relief Fund cash balances were negative, making it impossible for the General Fund to borrow money from them.

In reviewing the month end cash balances of the gas tax/federal funds as compared to the restricted funds in total and applying the established City policy, the SCO has lept to an incorrect conclusion. Our analysis shows that the gas tax funds, as a percentage to the total of all other restricted funds, during the period of the audit are insignificant to be a borrowing fund and in fact are a borrowing fund themselves. See Table B below.

The City carefully monitors its available unrestricted fund balances to assure that there is no draw on the restricted funds cash that the City is not able to repay by the end of the fiscal year. The City actually sought bankruptcy protection because of its general fund insolvency and to avoid any chance that the general fund would not be balanced and begin implicitly borrowing from restricted funds. To emphasize the matter further, the City has been vigorously defending its position in the bankruptcy court of not using restricted funds cash for the operations of the City's General Fund.

Table B

	General Fund Totals	Gas Tax Fund Totals	Traffic Congestion Relief Fund Totals	All Restricted Fund Totals	% of All Restricted Funds Gas Tax	% of All Restricted Funds TCRF
Jul-08	15,932,712	199,500	27,443	280,237,562	0.07%	0.01%
Aug-08	9,499,858	197,704	(507)	251,844,293	0.08%	0.00%
Sep-08	1,451,377	1,414,918	(43,460)	250,241,603	0.57%	-0.02%
Oct-08	3,380,078	592,754	641,495	239,820,082	0.25%	0.27%
Nov-08	2,320,036	585,628	460,568	224,187,668	0.26%	0.21%
Dec-08	7,211,211	1,381,983	174,928	240,067,960	0.58%	0.07%
Jan-09	9,450,199	536,417	205,974	242,785,314	0.22%	0.09%
Feb-09	22,928,602	536,982	66,248	230,707,210	0.23%	0.03%
Mar-09	19,722,838	537,253	(532,248)	217,117,725	0.25%	-0.25%
Apr-09	23,889,817	224,495	(158,979)	226,183,694	0.10%	-0.07%
May-09	23,640,387	225,103	(160,194)	239,539,563	0.09%	-0.07%
Jun-09	11,496,667	2,182,944	(160,857)	256,420,068	0.85%	-0.06%
Jul-09	(12,755,358)	(127,952)	422,373	244,953,050	-0.05%	0.17%
Aug-09	17,756,413	(562,012)	422,373	220,645,661	-0.26%	0.19%
Sep-09	19,734,058	(707,045)	423,991	228,142,310	-0.31%	0.19%
Oct-09	13,040,522	(635,138)	368,440)	230,964,027	-0.28%	-0.160%
Nov-09	7,178,133	112,710	(1,627,909)	221,399,297	0.05%	-0.74%
Dec-09	15,702,056	(258,122)	(2,429,013)	225,051,732	-0.12%	-1.08%
Jan-10	17,654,537	(562,775)	(2,738,858)	227,766,330	-0.25%	-1.20%
Feb-10	25,219,403	(867,609)	(2,746,250)	215,177,205	-0.40%	-1.28%
Mar-10	29,224,060	(982,387)	(1,652,004)	205,273,229	-0.48%	-0.81%
Apr-10	30,280,001	924,360	(947,762)	228,873,441	0.40%	-0.41%
May-10	28,699,751	713,098	(949,883)	218,088,904	0.33%	-0.44%
Jun-10	11,406,061	1,041,534	(201,770)	231,186,393	0.45%	-0.09%
Jul-10	8,414,340	625,728	529,822	242,967,128	0.26%	0.22%
Aug-10	4,295,118	(19,249)	377,776	198,796,802	-0.01%	0.19%
Sep-10	(1,039,616)	(414,064)	380,195	195,745,663	-0.21%	0.19%
Oct-10	(7,960,241)	(619,399)	(60,550)	217,309,059	-0.29%	-0.03%
Nov-10	(11,600,274)	(80,843)	(139,179)	205,636,212	-0.04%	-0.07%
Dec-10	(5,967,707)	(271,438)	(140,598)	209,296,338	-0.13%	-0.07%
Jan-11	(7,840,504)	(13,753)	(141,552)	220,681,557	-0.01%	-0.06%
Feb-11	1,229,409	271,661	(141,698)	214,154,905	0.13%	-0.07%
Mar-11	(613,797)	487,110	(141,917)	191,293,614	0.26%	-0.07%
Apr-11	153,760	131,613	(142,157)	204,055,521	0.06%	-0.07%
May-11	(2,319,246)	908,890	(142,483)	202,010,258	0.45%	-0.07%
Jun-11	12,977,884	766,167	—	222,920,565	0.34%	0.00%

SCO's Comment

The City disagrees with the finding.

The City's General Fund cash position in the FY 2010-11 Comprehensive Annual Financial Report (CAFR), included other unrestricted funds such as Library, Recreation, Entertainment Venues, and other auxiliary fee and general funded operations. Even with the inclusion of those funds, there are still negative cash balances for a number of months, therefore impairing other funds with positive balances.

The City claims to have access to and can utilize a 2009 CSCDA Tax Revenue Anticipation Note (TRAN) to fund cash flow deficiencies, but this was not utilized. The City also claims to have a policy to use City's Workers Compensation and General Liability Internal Service Funds as lending funds (Note 3 - CAFR). This is incorrect. Note 3 does not define a policy and the funds noted above were not used.

Finally, the fact that Gas Tax cash represents a small percentage of the cash investment pool and also has some months of negative balances does not prevent it from being potentially impaired when its balances are positive. Also, as discussed under SCO's response to Finding 1, the Gas Tax Fund is a restricted Special Revenue Fund and does not allow for borrowing from other funds, therefore cash balances should never be negative.

The finding remains as stated.

Attachment—
City's Response to Draft Review Report

CITY OF STOCKTON

ADMINISTRATIVE SERVICES
City Hall • 425 N. El Dorado Street • Stockton, CA 95202-1997 • 209 / 937-8460 • Fax 209 / 937-8844
www.stocktongov.com

July 12, 2013

Jeffrey V. Brownfield, Chief, Division of Audits
Local Governments Audit Bureau
California State Controller's Office
Division of Audits
P.O. Box 942850
Sacramento, CA 94250

RE: CITY OF STOCKTON – MANAGEMENT RESPONSES

The California State Controller's Office (SCO) audited the City of Stockton's Administrative and Internal Accounting Controls for the period of July 1, 2010 through June 30, 2011, Special Gas Tax Street Improvement and Traffic Congestion Relief Funds for the period of July 1, 2004 through June 30, 2011, and Asset Transfers by the Redevelopment Agency made after January 1, 2011. Below is the City of Stockton's management response to the findings in the State Controller's reports dated June 24, 2013.

Administrative and Internal Accounting Controls

Finding 1 - The City Auditor's Office was ineffective and inefficient
The City of Stockton's Management response:
Management agrees with this finding though it is not new information. It was the City Manager that asked the City Auditor's Office to conduct a more robust and improved risk assessment process. It was identified by new management as one of the City's 37 Strategic Initiatives.

Similar findings were issued by the City's external financial auditors, Maze & Associates, in November 2012 and then by the San Joaquin County Grand Jury in May 2013 after new management brought this to their attention. With the departure of the City Auditor and Assistant City Auditor in September 2012, the City was presented with an opportunity to consider other options for staffing the internal audit function. The City Attorney has provided an opinion that under the City's charter the City Auditor function can be performed by a contractor appointed by the City Council. The contractor would report directly to the City Council through the Council Audit Committee. After researching the different options, the City Manager recommended the City Council on October 9, 2012, approve a request for proposal to recruit an outside audit firm to conduct an Internal Control and Risk Assessment audit. The results of that audit will be used to determine a work plan to address the high risk areas needing further scrutiny or they might conduct further assessments. The selected audit firm was appointed as the Interim City Auditor through the duration of the risk assessment and internal control audit.

Stockton All-America City 1999

On March 5, 2013, the City Council approved a contract with Moss Adams, LLP, who possesses extensive experience providing local government internal audit services and audit services. The contract provides the City with the option to either continue the contract after the first six month period or to terminate the contract upon completion of the risk assessment and internal control audit. Following completion of this initial 6 month project, staff will work with the Audit Committee and City Council in preparing an analysis of performance under this arrangement and recommend future direction of the internal audit function. The City has not eliminated the Office of the Auditor as the recommendation by the SCO appears to indicate.

Moss Adams, LLP first met with the Council Audit Committee on April 9, 2013 and again on June 11, 2013 and July 8, 2013. They emphasized the importance of regular interactions. Protocols will include monthly meetings with the Council Audit Committee, quarterly meetings with the City Council, and status reports will be provided at each of these meeting which conform to practices recommended by the Institute of Internal Auditors.

Finding 2 - Inaccurate accountability and oversight over fiscal management functions at the operating departments because of decentralization
The City of Stockton's Management response:
Management partially agrees with this finding though these findings are not new information to the City. Management does disagree with the SCO recommendation to centralize all fiscal management functions for a large local government like the City of Stockton. In contrast, decentralization can provide improved efficiencies and accountability when the financial measures are monitored and performance tracked for operations. The removal of the management of the fiscal function as recommended serves to take away substantial information needed at that division level to understand the business needs and operations of the City. What is required is improvement to the financial systems and monitoring tools that enable the process rather than a transfer to a centralized process. Plans are already underway and tools are in development in various areas as follows:

Contract Process:
The City follows the current City's Administrative Directive on Management of Contracts No. CONTRACTS 25.2, which assigns responsibility for administration and monitoring of the contracts to individual departments. Nevertheless, management is aware of improvements needed for the citywide contract management function and has taken initial steps in securing a contract to reengineer the purchasing and supply chain management functions. The Administrative Services Department (ASD) is in the process of identifying a resource/vendor that will, among other things, evaluate the City's contract management process, procurement process, purchasing policies/procedures, staffing skills and levels; identify deficiencies and rewrite outdated purchasing policies. After the evaluation is complete, staff will evaluate the options of purchasing contract management software to improve monitoring and provide greater accountability and visibility. This software purchase was previously identified by management in the Citywide Technology Strategic Plan adopted by Council in June 2012.

The City's current Administrative Directive No. CONTRACTS 25.1.b offers a choice of four methods of procurement: purchase order, confirming purchase order, blanket purchase order and authorization for payment. Authorization for payment (AFP) can be used to

expedite payment of claims for goods and services provided they fall within one of twenty one (21) allowable categories. Those categories are:

1. Dues	11. Payments from assessment or trust funds
2. Newspapers and publications	12. Escrow deposits or payments
3. Utilities	13. Loans and grant payments and related disbursements
4. Contingency fees and commissions	14. Authorized outside legal costs and settlements
5. Transportation and freight charges	15. Payments to City Departments
6. Insurance and bond requirements	16. Payments required by Federal, State or local law
7. Property taxes, annual assessment fees	17. Awards
8. Group insurance, employee benefits	18. Postage and mail delivery services
9. Payroll related disbursements	19. Maintenance costs of City owned property
10. Petty cash reimbursements	20. Lease payments
	21. Construction and professional services agreements and other authorized agreements

The Administrative Directive does not have requirement for claims to be "routine" when using authorization for payment option. In addition, there is no specific dollar threshold that is applied to the authorizations for payment. The purpose of this policy is to expedite and improve efficiencies when processing payments that may already be under contract, which may or may not include City Council approval depending on the dollar purchase threshold, or are routine, high volume, low dollar purchases. The SCO's characterization that the AFP process is used to circumvent the purchasing thresholds is not the intent of the policy, however management had already identified the misuse in prior years. For example, the temporary agency contracting problem was identified by the City Manager himself as part of his review of all contracts and City Council agenda items. This issue brought to light the AFP misuse. This is not new news. Where the SCO identified the $70.0 million in payments to law firms, investment firms, and developers, these payments meet one of the twenty-one categories above and are in compliance with the City's policy.

The City did document misuse of the AFP process. Now, Accounts Payable reviews each disbursement request for completeness of information: approval signatures, correct account number, acceptable "Authorization for Payment" (AFP) category, and whether disbursement amount falls within Council limit. All AFPs with missing/inappropriate information are returned to the departments for correction. However, non-compliance surrounding inappropriate category use is submitted to Purchasing for second round internal control and compliance determination. During the period from July through September 2011, 667 AFPs were identified to be non-compliant. After these process improvements were implemented the number of non-compliant AFPs was reduced from 667 to just six when compared to the same period the following year (July through September 2012). Currently all non-compliant AFPs are returned to the departments for correction to the appropriate method of procurement before payment is made.

City's Grant Management System:
The City currently has a hybrid model with certain functions centralized while others are decentralized. Since as early as 2009, the City Manager's Office has designated a Program Manager to serve as the central point of contact for Federal, State, and private grants. This function includes providing departments with technical assistance and advice in preparing and submitting grant applications. The function also includes reviewing departmental Notice of Intent Memorandums seeking approval of the City Manager, to ensure that potential grant applications meet the goals and objectives set-forth by the City Council. The Program Manager also provides assistance to staff in the reporting of grant performance measurements. The City has been very successful in competing for grants. We do not see the City "missing opportunities".

Given the City's 43% reduction of non-safety personnel, the establishment of a more centralized grants administration process would require additional funding. This will be evaluated after the emergence from bankruptcy at a time when additional resources may become available to the City to provide more assistance in the City's grant management function.

With respect to financial reporting issues, we agree with this finding though this is not new information and was reported by our auditors in the Single Audit and the Memorandum of Internal Controls. To prevent this problem from occurring in the future the City issued in December 2012 an amended Grant Administration Guideline in Police Fiscal Affairs which includes a reconciliation of the draw down claims to the general ledger and a second level of review of those claims. Additional training on reconciliations is being given and reviews are being performed prior to submission of the reports. In Public Works, a review process has been established to ensure accuracy of reimbursement requests.

Fleet Management:
Improvements to the management and utilization of the City's fleet have been a recognized priority for the City in the past two years and were identified first by the City's own Internal Auditors in September 2012. That report confirmed the City's centralized fleet management had not performed at an optimum level in past years and oversight historically has not been strong.

The State Controller's audit finding inaccurately characterized the City's internal audit of the Fleet as stating that the Fleet Division has (present tense) no authority or input over the fleet management practices of the operating divisions. While the City's internal audit did bring to light the question of level of authority in the past, it is very clear from the Management Response to that audit that the City Manager's Office has the complete expectation that the Fleet Division has the responsibility and authority to manage the City's fleet division according to industry and professional standards. The implementation of the management responses to this internal audit has taken important steps to increasing the accountability of operating departments for their vehicles and fleet assets.

In addition, the City Manager felt the City Auditor did not go far enough. So we took it upon ourselves to contract for an independent fleet management and utilization assessment prior to the SCO audits. Management Partners, Inc. over the past six months, has conducted an exhaustive study of our fleet function and developed a series of recommendations and

implementation plan that will dramatically increase efficiencies and centralized accountability in fleet operations. The implementation plan will create a fleet operation that is current with best practices in the industry. The implementation plan also calls for the reduction of 39 vehicles in the fleet to optimize utilization. All other vehicles and vehicle assignments have been thoroughly reviewed for appropriateness. The estimated cost savings for this project, that the City self-initiated, total nearly half a million dollars annually. The report outlining this assessment and recommendations was published on July 2, 2013 as advance material for the July 9, 2013 City Council meeting.

Finding 3 - Inability to produce financial statements and financial transaction reports on a timely basis

The City of Stockton's Management response:

Management agrees with this finding though it is not new information and actions are already in place to address these late reports. As was previously reported to City Council, additional responsibilities and staffing shortages in Administrative Services, the AB 506 process, the chapter 9 bankruptcy filing and discovery requests, a lengthy court battle on eligibility, RDA wind down, and the five State Controller's Audits all collectively created competing priorities. As our external auditor stated in their written report in December 2012, "the department remains under intense strain and pressure to respond" to these demands. However, these multiple demands were met by staff. This was done in spite of our requests to the SCO to delay their audits due to these enormous burdens. Instead of honoring our request to delay the audits, the SCO chose to audit the City and add additional and costly burden at an inopportune time.

Factors that have affected our timely financial reporting were accuracy of prior year data, staffing turnover, employee performance issues, archaic civil service rules, increased workload due to the information requests and responses to the bankruptcy demands, five SCO audits initiated at the same time, and an antiquated computer system that is costly to replace. Disclosure of financial information in the State mandated reports is typically released prior to the audited financials, but caution is necessary as they can be relied upon by the financial market and bondholders. Rather than disclose inaccurate financial data in the State mandated reports at such a critical time in the City's history that could be misused or misunderstood, the priority was to get the City's fiscal house in order and prepare accurate and reliable audited financials. This came at a cost of timeliness.

The CFO and Assistant Director of Administrative Services have begun the recovery process and are developing plans for the future that includes evaluating staffing needs, technological capabilities, and accountability for timely financial reporting. We have established a schedule to bring the City's audited CAFR for the Fiscal Years 2011-12 and 2012-13 back on time by no later than the end of calendar year 2013. We have added a new Accounting Supervisor position in the 2013/14 Adopted Budget to assist with the backlog of work. We have hired a new audit firm to assist with the filing of the delinquent State mandated reports from FY 2010-11 and FY 2011-12. This change will aide in filing the Annual Street Report for FY 2012 as early as this month.

The proposed schedule for the audits is as follows:

FY 2012 Audit	FY 2013 Audit	Audit Tasks
Jun – 13	Jun – 13	Award of Contract
Jun – 13	Jun – 13	Interim Audit Procedures
Aug – 13	Sep – 13	Year End Audit Procedures
Aug – 13	Oct – 13	Issue Draft Audit Reports
Sep – 13	Dec – 13	Final Audit Reports, Financial Statements, Management Letter, and Single Audit Reports Delivered

Finding 4 - Cash impairment in the City's investment pool
The City of Stockton's Management response:
Management disagrees with the Finding. The SCO in their analysis failed to include funds that are unrestricted that are included in the General Fund for the Comprehensive Annual Financial Report (CAFR) but segregated in the accounting system for tracking purposes. These funds consist of the Library, Recreation, Entertainment Venues, and other auxiliary fee and general funded operations. When including these funds the general fund cash position is reported as follows:

TABLE A

	Fiscal Year		
Month	FY 2008-09 General Fund	FY 2009-10 General Fund	FY 2010-11 General Fund
July	15,932,712	(12,755,358)	8,414,340
August	9,499,858	17,756,413	4,295,118
September	1,451,377	19,734,058	(1,039,616)
October	3,380,078	13,040,522	(7,960,241)
November	2,320,036	7,178,133	(11,600,274)
December	7,211,211	15,702,056	(5,967,707)
January	9,450,199	17,654,537	(7,840,504)
February	22,928,602	25,219,403	1,229,409
March	19,722,838	29,224,060	(613,797)
April	23,889,817	30,280,001	153,760
May	23,640,387	28,699,751	(2,319,246)
June	11,496,667	11,406,061	12,977,884

In addition, in FY 2009-2010, the SCO failed to consider that the City had access and utilized a $32,180,000 2009 CSCDA Tax Revenue Anticipation Note (TRAN) to fund cash flow deficiencies. In the table below, the months in which the corrected general fund cash deficits arose, there was sufficient cash in the TRAN, the borrowing funds established per accounting policy (e.g. self-insurance funds) that was sufficient to cover any shortfall in the general fund. In addition, in most months the Gas Tax Fund had a cash deficit and wouldn't have been a fund to borrow from but was borrowing in reverse from the General Fund to cover cost incurred prior to receipt of the apportionments from the State of California. The Gas Tax Fund cash position as a percentage of the total restricted cash position is less than

1% on average and would not be impaired and is a fund of last resort not a fund of first resort.

Based on the review of the Article XIX of the California Constitution, Streets and Highway Code Sections 2100-2128.1 and Sections 2150-5157, and Guidelines Relating to Gas Tax Expenditures for Cities and Counties issued by the State Controller's Office in May 2004, none of the publications discuss impairment of cash in the pooled cash system. In addition, there is no guidance about whether deficit cash balances in funds participating in the pooled cash arrangement create "impairment".

The City's policy is to use City's Workers Compensation and General Liability Internal Service Funds as the lending funds to other City funds with negative cash position at the end of each fiscal year as reported in Note 3 to the City's CAFR. The same policy is applied during any given fiscal year. The monthly cash balance reports for all City funds covering fiscal years 2008-09, 2009-10 and 2010-11 that were provided for your review, show that there were sufficient cash balances in the Workers' Compensation and General Liability Internal Service Funds every month in which General Fund cash balance went negative, except for November 2011. However, in that same month both the Gas Tax Fund and Traffic Congestion Relief Fund cash balances were negative, making it impossible for the General Fund to borrow money from them.

In reviewing the month end cash balances of the gas tax/federal funds as compared to the restricted funds in total and applying the established City policy, the SCO has leapt to an incorrect conclusion. Our analysis shows that the gas tax funds, as a percentage to the total of all other restricted funds, during the period of the audit are insignificant to be a borrowing fund and in fact are a borrowing fund themselves. See Table B below.

The City carefully monitors its available unrestricted fund balances to assure that there is no draw on the restricted funds cash that the City is not able to repay by the end of the fiscal year. The City actually sought bankruptcy protection because of its general fund insolvency and to avoid any chance that the general fund would not be balanced and begin implicitly borrowing from restricted funds.

TABLE B

	General Fund Totals	Gas Tax Fund Totals	Traffic Congestion Relief Fund Totals	All Restricted Fund Totals	% of All Restricted Funds	
					Gas Tax	TCRF
Jul-08	15,932,712	199,500	27,443	280,237,562	0.071%	0.010%
Aug-08	9,499,858	197,704	(507)	251,844,293	0.079%	0.000%
Sep-08	1,451,377	1,414,918	(43,460)	250,241,603	0.565%	-0.017%
Oct-08	3,380,078	592,754	641,495	239,820,082	0.247%	0.267%
Nov-08	2,320,036	585,628	460,568	224,187,668	0.261%	0.205%
Dec-08	7,211,211	1,381,983	174,928	240,067,960	0.576%	0.073%
Jan-09	9,450,199	536,417	205,974	242,785,314	0.221%	0.085%
Feb-09	22,928,602	536,982	66,248	230,707,210	0.233%	0.029%
Mar-09	19,722,838	537,253	(532,248)	217,117,725	0.247%	-0.245%
Apr-09	23,889,817	224,495	(158,979)	226,183,694	0.099%	-0.070%
May-09	23,640,387	225,103	(160,194)	239,539,563	0.094%	-0.067%
Jun-09	11,496,667	2,182,944	(160,857)	256,420,068	0.851%	-0.063%
Jul-09	(12,755,358)	(127,952)	422,373	244,953,050	-0.052%	0.172%
Aug-09	17,756,413	(562,012)	422,373	220,645,661	-0.255%	0.191%
Sep-09	19,734,058	(707,045)	423,991	228,142,310	-0.310%	0.186%
Oct-09	13,040,522	(635,138)	(368,440)	230,964,027	-0.275%	-0.160%
Nov-09	7,178,133	112,710	(1,627,909)	221,399,297	0.051%	-0.735%
Dec-09	15,702,056	(258,122)	(2,429,013)	225,051,732	-0.115%	-1.079%
Jan-10	17,654,537	(562,775)	(2,738,858)	227,766,330	-0.247%	-1.202%
Feb-10	25,219,403	(867,609)	(2,746,250)	215,177,205	-0.403%	-1.276%
Mar-10	29,224,060	(982,387)	(1,652,004)	205,273,229	-0.479%	-0.805%
Apr-10	30,280,001	924,360	(947,762)	228,873,441	0.404%	-0.414%
May-10	28,699,751	713,098	(949,883)	218,088,904	0.327%	-0.436%
Jun-10	11,406,061	1,041,534	(201,770)	231,186,393	0.451%	-0.087%
Jul-10	8,414,340	625,728	529,822	242,967,128	0.258%	0.218%
Aug-10	4,295,118	(19,249)	377,776	198,796,802	-0.010%	0.190%
Sep-10	(1,039,616)	(414,064)	380,195	195,745,663	-0.212%	0.194%
Oct-10	(7,960,241)	(619,399)	(60,550)	217,309,059	-0.285%	-0.028%
Nov-10	(11,600,274)	(80,843)	(139,179)	205,636,212	-0.039%	-0.068%
Dec-10	(5,967,707)	(271,438)	(140,598)	209,296,338	-0.130%	-0.067%
Jan-11	(7,840,504)	(13,753)	(141,552)	220,681,557	-0.006%	-0.064%
Feb-11	1,229,409	271,661	(141,698)	214,154,905	0.127%	-0.066%
Mar-11	(613,797)	487,110	(141,917)	191,293,614	0.255%	-0.074%
Apr-11	153,760	131,613	(142,157)	204,055,521	0.064%	-0.070%
May-11	(2,319,246)	908,890	(142,483)	202,010,258	0.450%	-0.071%
Jun-11	12,977,884	766,167	-	222,920,565	0.344%	0.000%

Finding 5 - Inadequate City Council oversight over contracting
The City of Stockton's Management response:
Management disagrees with the finding.

Fuel Contract:
We disagree with this finding. The City has been following the current policy for fuel purchases and approved delegation of authority. City Council Resolution #36,851 dated December 17, 1979, which authorized and directed the City Manager to enter into agreements with the fuel suppliers and authorize payments as may be necessary to continue City's fuel supply. Staff utilized competitive quotes from fuel suppliers as the way to get best prices. Recognizing that following an old policy may not be a best practice, in 2012 staff followed the City's contracting guidelines by bidding the fuel contract out, which resulted in the change of fuel vendor. This was originally brought to our attention in an

internal audit from September 2012. In this process, the contract was subjected to City Manager, Risk Manager, Chief Financial Officer and City Attorney's review. The fuel contract is now rebid annually.

Innoprise/HTE:
We do not agree with your finding. The SCO Audit findings states City Staff placed on the consent agenda the request to forgo the competitive bidding process for contracting with Innoprise to support the SunGard/HTE financial systems. The audit concludes the justification to forgo (waive, actually) the competitive bidding process for these services was not supported. The audit provides no facts or findings to support that conclusion. We disagree with the conclusion.

The overall goal of the project was to migrate from the use of an outdated HTE/SunGard system to the newer Innoprise systems. This plan involved replacing the most needed systems first with full replacement over the six-year term.

Based on the best information available to staff at the time, Innoprise Inc., was the only vendor with the expertise necessary to migrate the data from the HTE/SunGard software into a new system while continuing to maintain the old and new software. This expertise was uniquely available to Innoprise because the programming staff at Innoprise were former employees of HTE/SunGard. Moreover, based on the information in the staff report, the City Council made the necessary findings to warrant waiving the competitive bidding process in this circumstance. That is what the City Charter requires.

The SCO suggests that contracts where competitive bidding is waived should be placed on the regular agenda rather than the consent agenda. That would serve no purpose but to unnecessarily lengthen City Council meetings or take away from other policy matters. The justification to waive competitive bidding is either present or is not at the time the decision to waive the requirement is presented to City Council. If the City Council concludes the staff report is lacking in evidentiary support to justify waiving the competitive bidding requirements, it can make that determination regardless of where the item is on the agenda. They retain the right to "pull" a consent item and specifically speak to it. If the City Council concludes the staff report is lacking in evidentiary support subsequent to the bid process and upon approval of the contract, it can make that determination regardless of where the item is on the agenda.

Nevertheless, to insure the exceptions to the formal bid process are granted in only the justifiable situations, all staff reports, including those requesting an exception to the competitive bidding requirement are reviewed to ensure proper justification is provided.

Finding 6 - Inadequate City Council oversight over payments
The City of Stockton's Management response:
Management partially agrees with this finding though this is not new information. Contracts with a single vendor over the City Manager's spending threshold of $30,224 do go before the Council. Staff reports are provided and discussions are held in a public setting to answer all questions. We agree that the Authorization for Payment (AFP) and contract monitoring process do need stronger controls. Please see response and plan in Finding 2.

Management has already corrected the issue with the temporary agency contracts that had expired. On April 26, 2012, Council ratified the expenditures and management presented a

corrective action plan to prevent future occurrences of lapsed contracts. Nevertheless, management is aware of improvements needed for the citywide contract management function. Administrative Services Department is in the process of identifying a resource/vendor that will, among other things, evaluate the City's contract management process, procurement process, purchasing policies/procedures, staffing skills and levels; identify deficiencies and rewrite outdated purchasing policies. After the evaluation is complete, staff will evaluate the options of purchasing contract management software to improve monitoring and provide greater accountability and visibility.

Finding 7 - Lost opportunity to claim State/Federal funds to offset General Fund Expenditures

The City of Stockton's Management response:

Management partially agrees with this finding though it is not new news and is related to grants awarded prior to June 2011. We agree improvements need to be implemented in the development and application of indirect costs. We disagree on the lost opportunities. This finding was previously reported in the Memorandum on Internal Control and staff responses for corrective action were provided. We brought this compliance issue to the attention of our audit firm at the beginning of their audit and asked for additional guidance in this area. We are aware of the OMB A-87 requirements and the recovery of indirect costs. The City is working with it's Indirect Cost Plan consultant, City's Internal Auditor, budget, Human Resources and others in order to improve the activity based costing currently used by the City. Information on the specific programs cited by the SCO are as follows:

Public Works Department: We are not convinced that the City left $1.5 million on the table. It is not appropriate to equate City of Stockton to some generic rate from a survey of other cities without ensuring that those cities utilize similar cost allocation structures and activity charges. Some cities spend less time identifying direct costs and rely on a higher indirect recovery. It is misleading to say that the City's indirect cost reimbursement of 3.42% is significantly understated when City staff directly charge their time to projects which is already taken into account in the City's cost allocation plan.

Police Department: At the time the SCO Audit staff was preforming their audit, grant funds were still being utilized. To this end, the actual unspent grants identified in the SCO Audit is $60,775 not the stated $224,683. The primary reason that the City of Stockton was not able to fully expend the $60,775 was a direct result of the City of Stockton's Police Department experiencing a mass "exodus" of seasoned police officers as a direct result of the City's fiscal crisis which lead to reduction in salary and benefit levels; thus, making it extremely difficult to staff the activities supported by the grants. The four federal grants awarded to the City were mostly used to fund overtime expenses directly related to the delivery of the main objectives of the grant requirements such as the DUI enforcements, seat belt enforcement, gang prevention missions, etc.

Finding 8 – Lack of written procedures for the handling of cash from parking meters

The City of Stockton's Management response:

Management disagrees with this finding. The City had written procedures for Parking Meter Collections. Staff revised the written procedures in October 2008 and July 2013. In addition, detailed written procedures, effective 2009, are maintained and followed by the City's parking meter collection vendor Universal Protection Services. These procedures are detailed to include the handling of cash such as checking out the deposit bags, labeling the

bags, how far to fill the bags, where to obtain and return the bags, how many individuals are present at the collection point among other procedures. We believe the SCO had the ability to review these procedures as part of our contract with All Phase Security, Inc. and our internal policy.

Management is focused on continuous improvement to ensure all cash handling procedures from departments are current and periodically reviewed. As an example in May 2013, the Administrative Services Department (ASD) conducted a review of the City's cash handling policy and procedures and a comprehensive revision of them was made. This was implemented in ASD as a pilot program. It will be fully implemented citywide in the 2nd quarter of FY 2013-2014 along with unannounced cash receipt audits for the city's thirty nine (39) cash handling locations to ensure compliance with the new procedures. ASD will continue to update the City's procedures on a bi-annual basis. Since FY 2010-2011, ASD has been working with the Human Resources Department to conduct citywide cash handling training classes and certification for over 70 employees. Additional trainings will be provided to the rest of the group in the 2nd quarter of FY 2013-2014.

Special Gas Tax Street Improvement Fund Audit

Finding 1 – Negative Interest charged – Gas Tax Fund
The City of Stockton's Management response:
Management disagrees with this finding. The reference made in the Audit Findings and Recommendations to the Streets and Highways Code section 2101 does not preclude negative interest as an eligible expenditure per the Streets and Highways Code. In fact, the code indicates that interest from investment of the funds should be deposited into the fund on a rational and equitable basis. As disclosed in Table B, the fund typically runs negative, which is a cost to the City for the operation of the fund due to delay in the receipt of appropriations as compared to spending patterns. We believe that the model is equitable and rational and supports the charges to the fund.

In addition, upon review of the Guidelines Relating to Gas Tax Expenditures for Cities and Counties (Guidelines), issued by the California State Controller, May 2004, negative interest (interest charge) is not cited as one of the ineligible expenditures.

Section 2113 of the Streets and Highways Code states that "Interest received by a city from the investment of money in its special gas tax street improvement fund shall be deposited in the fund and shall be used for street purposes". Reference is also made in the Guidelines under Special Accounting Requirements for Cities that interest received by a city from the investment of money in its Special Gas Tax Street Improvement Fund shall be deposited in the fund and shall be used for street purposes. In the SCO supporting analysis, interest earnings activities in the Gas Tax Fund were reviewed from FY 2005 through FY 2011. It appears the SCO selectively chose only months in which this fund was allocated negative earnings to calculate the amount, while failing to take into account that these are entirely offset with positive allocation months during those same periods to arrive at the $10,686 amount of negative interest allocation. Overall during the audit period from FY 2005 through 2011, on an annual basis the Gas Tax Fund received a net positive interest allocation of $179,152.

For the pooled cash concept to work, funds must be charged appropriately when they rely on other funds for cash flow and be credited fairly when the funds contribute to interest

earnings. This is accomplished by following the practice of pooling cash and investments of all funds, except for funds required to be held by fiscal agents under the provisions of bond indentures. Prior to July 1, 2011, interest income earned on pooled cash and investments was allocated on a monthly basis to the various funds based on average daily cash balances and a fair market value at year end. Effective July 1, 2011, the City changed its accounting policy and method to a quarterly allocation of accrued interest and fair market valuation adjustments on the basis of average daily cash balances. This change was made on a prospective basis.

The City's position is that the Gas Tax Fund received its equitable pro-ration of interest earned, positive or negative, and is used for street purposes.

Finding 2 – Negative interest charged – TCRF
The City of Stockton's Management response:
Management disagrees with this finding. The reference made in the Audit Findings and Recommendations to the Streets and Highways Code section 2101 does not state that negative interest is not an eligible expenditure per the Streets and Highways Code. Please see responses to Finding 1.

Finding 3 – Impairment of Cash
The City of Stockton's Management response:
Management disagrees with the Finding. The SCO in their analysis failed to include funds that are unrestricted that are included in the General Fund for the Comprehensive Annual Financial Report (CAFR) but segregated in the accounting system for tracking purposes. These funds consist of the Library, Recreation, Entertainment Venues, and other auxiliary fee and general funded operations.

When including these funds the general fund cash position is reported as follows:

TABLE A

	Fiscal Year		
Month	FY 2008-09 General Fund	FY 2009-10 General Fund	FY 2010-11 General Fund
July	15,932,712	(12,755,358)	8,414,340
August	9,499,858	17,756,413	4,295,118
September	1,451,377	19,734,058	(1,039,616)
October	3,380,078	13,040,522	(7,960,241)
November	2,320,036	7,178,133	(11,600,274)
December	7,211,211	15,702,056	(5,967,707)
January	9,450,199	17,654,537	(7,840,504)
February	22,928,602	25,219,403	1,229,409
March	19,722,838	29,224,060	(613,797)
April	23,889,817	30,280,001	153,760
May	23,640,387	28,699,751	(2,319,246)
June	11,496,667	11,406,061	12,977,884

In addition, in FY 2009-2010, the SCO failed to consider that the City had access and utilized a $32,180,000 2009 CSCDA Tax Revenue Anticipation Note (TRAN) to fund cash flow deficiencies. In the table below, the months in which the corrected general fund cash deficits arose, there was sufficient cash in the TRAN, the borrowing funds established per accounting policy (e.g. self-insurance funds) that was sufficient to cover any shortfall in the general fund. In addition, in most months the Gas Tax Fund had a cash deficit and wouldn't have been a fund to borrow from but was borrowing in reverse from the General Fund to cover cost incurred prior to receipt of the apportionments from the State of California. The Gas Tax Fund cash position as a percentage of the total restricted cash position is less than 1% on average and would not be impaired and is a fund of last resort not a fund of first resort.

Based on the review of the Article XIX of the California Constitution, Streets and Highway Code Sections 2100-2128.1 and Sections 2150-5157, and Guidelines Relating to Gas Tax Expenditures for Cities and Counties issued by the State Controller's Office in May 2004, none of the publications discuss impairment of cash in the pooled cash system. In addition, there is no guidance about whether deficit cash balances in funds participating in the pooled cash arrangement create "impairment".

The City's policy is to use City's Workers Compensation and General Liability Internal Service Funds as the lending funds to other City funds with negative cash position at the end of each fiscal year as reported in Note 3 to the City's CAFR. The same policy is applied during any given fiscal year. The monthly cash balance reports for all City funds covering fiscal years 2008-09, 2009-10 and 2010-11 that were provided for your review, show that there were sufficient cash balances in the Workers' Compensation and General Liability Internal Service Funds every month in which General Fund cash balance went negative, except for November 2011. However, in that same month both the Gas Tax Fund and Traffic Congestion Relief Fund cash balances were negative, making it impossible for the General Fund to borrow money from them.

In reviewing the month end cash balances of the gas tax/federal funds as compared to the restricted funds in total and applying the established City policy, the SCO has lept to an incorrect conclusion. Our analysis shows that the gas tax funds, as a percentage to the total of all other restricted funds, during the period of the audit are insignificant to be a borrowing fund and in fact are a borrowing fund themselves. See Table B below.

The City carefully monitors its available unrestricted fund balances to assure that there is no draw on the restricted funds cash that the City is not able to repay by the end of the fiscal year. The City actually sought bankruptcy protection because of its general fund insolvency and to avoid any chance that the general fund would not be balanced and begin implicitly borrowing from restricted funds. To emphasize the matter further, the City has been vigorously defending its position in the bankruptcy court of not using restricted funds cash for the operations of the City's General Fund.

TABLE B

	General Fund Totals	Gas Tax Fund Totals	Traffic Congestion Relief Fund Totals	All Restricted Fund Totals	% of All Restricted Funds	
					Gas Tax	TCRF
Jul-08	15,932,712	199,500	27,443	280,237,562	0.071%	0.010%
Aug-08	9,499,858	197,704	(507)	251,844,293	0.079%	0.000%
Sep-08	1,451,377	1,414,918	(43,460)	250,241,603	0.565%	-0.017%
Oct-08	3,380,078	592,754	641,495	239,820,082	0.247%	0.267%
Nov-08	2,320,036	585,628	460,568	224,187,668	0.261%	0.205%
Dec-08	7,211,211	1,381,983	174,928	240,067,960	0.576%	0.073%
Jan-09	9,450,199	536,417	205,974	242,785,314	0.221%	0.085%
Feb-09	22,928,602	536,982	66,248	230,707,210	0.233%	0.029%
Mar-09	19,722,838	537,253	(532,248)	217,117,725	0.247%	-0.245%
Apr-09	23,889,817	224,495	(158,979)	226,183,694	0.099%	-0.070%
May-09	23,640,387	225,103	(160,194)	239,539,563	0.094%	-0.067%
Jun-09	11,496,667	2,182,944	(160,857)	256,420,068	0.851%	-0.063%
Jul-09	(12,755,358)	(127,952)	422,373	244,953,050	-0.052%	0.172%
Aug-09	17,756,413	(562,012)	422,373	220,645,661	-0.255%	0.191%
Sep-09	19,734,058	(707,045)	423,991	228,142,310	-0.310%	0.186%
Oct-09	13,040,522	(635,138)	(368,440)	230,964,027	-0.275%	-0.160%
Nov-09	7,178,133	112,710	(1,627,909)	221,399,297	0.051%	-0.735%
Dec-09	15,702,056	(258,122)	(2,429,013)	225,051,732	-0.115%	-1.079%
Jan-10	17,654,537	(562,775)	(2,738,858)	227,766,330	-0.247%	-1.202%
Feb-10	25,219,403	(867,609)	(2,746,250)	215,177,205	-0.403%	-1.276%
Mar-10	29,224,060	(982,387)	(1,652,004)	205,273,229	-0.479%	-0.805%
Apr-10	30,280,001	924,360	(947,762)	228,873,441	0.404%	-0.414%
May-10	28,699,751	713,098	(949,883)	218,088,904	0.327%	-0.436%
Jun-10	11,406,061	1,041,534	(201,770)	231,186,393	0.451%	-0.087%
Jul-10	8,414,340	625,728	529,822	242,967,128	0.258%	0.218%
Aug-10	4,295,118	(19,249)	377,776	198,796,802	-0.010%	0.190%
Sep-10	(1,039,616)	(414,064)	380,195	195,745,663	-0.212%	0.194%
Oct-10	(7,960,241)	(619,399)	(60,550)	217,309,059	-0.285%	-0.028%
Nov-10	(11,600,274)	(80,843)	(139,179)	205,636,212	-0.039%	-0.068%
Dec-10	(5,967,707)	(271,438)	(140,598)	209,296,338	-0.130%	-0.067%
Jan-11	(7,840,504)	(13,753)	(141,552)	220,681,557	-0.006%	-0.064%
Feb-11	1,229,409	271,661	(141,698)	214,154,905	0.127%	-0.066%
Mar-11	(613,797)	487,110	(141,917)	191,293,614	0.255%	-0.074%
Apr-11	153,760	131,613	(142,157)	204,055,521	0.064%	-0.070%
May-11	(2,319,246)	908,890	(142,483)	202,010,258	0.450%	-0.071%
Jun-11	12,977,884	766,167	-	222,920,565	0.344%	0.000%

Redevelopment Agency

Finding 1 – Unallowable low and moderate income housing fund transfer to the City of Stockton

The City of Stockton Management response:

Management disagrees with this finding. SCO auditors were onsite and held an exit conference for the RDA Asset Transfer Review on December 20, 2012. This item was not an issue and did not result in a finding during the original review. As a result of SCO staff turnover, a second review was conducted and City staff was required to resubmit documentation several months after the initial review was completed. We were not aware this transaction was in question and would have submitted supporting documentation had it been brought to our attention beforehand.

On February 8, 2011, City Council by Resolution No. 11-0030 authorized a transfer from RDA Low and Moderate Income Housing Funds (Low/Mod Funds) for the repayment of the two loans in the amount of $1,361,531. The actual repayment including principal and interest totaled $1,261,913.52. The payment was made directly from Low/Mod Funds to repay two HELP loans from the California Housing Finance Agency (CalHFA), a State of California agency. This loan was made by CalHFA to the City of Stockton as the borrower. However, the only way the loan could have been a valid agreement under article XVI, section 18 of the state constitution is if it were payable from a special fund such as the Low and moderate income housing fund. The general fund of the city could not be obligated without 2/3 voter approval. This was not the intent of the loan as the repayment source was a pledge of low/mod program income, which is in fact how the city repaid the loan.

As background, the HELP funds were only used for low and moderate income housing projects. Therefore, Low/Mod Funds were an appropriate source of repayment. In fact, Low/Mod Funds were listed as the repayment source in the original loan applications submitted to CalHFA and in the staff reports presented to City Council on September 18, 2001 and September 24, 2002. In addition, the loan agreement states that "the source of funds utilized for repayment shall not be limited to any particular asset(s) of the Borrower." This comports with the application and staff report, as RDA funds, not City funds, were the intended source for repayment. This loan has been paid in full to CalHFA, a State of California Agency. The City requests that the SCO revise the report and remove the "order".

Finding 2 – Unallowable transfer to the City of Stockton
The City of Stockton Management response:
Management concurs with the Order of the Controller. Management had previously identified prior to the SCO audit that the properties transferred to the City fall within the guidelines of H&S Code section 34181(a); the assets are for a governmental purpose. Accordingly, the original transfer was completed prior to RDA dissolution on June 7, 2011, and reauthorized by the Oversight Board to the Stockton Successor Agency on October 10, 2012, by Resolution No. OB 2012-10-10-06. No additional action will be taken.

Should you have any questions, you may contact Vanessa Burke at (209) 937-8908 or via email at vanessa.burke@stocktongov.com.

Vanessa Burke

VANESSA BURKE
CHIEF FINANCIAL OFFICER

VB:EA:jl

CC: Steven Mar, California State Controller's Office
Mike Spalj, California State Controller's Office
Christopher Lek, California State Controller's Office
Bob Deis, City Manager
Laurie Montes, Deputy City Manager
Kurt Wilson, Deputy City Manager
Elena Adair, Assistant Director, Administrative Services Department

State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, CA 94250-5874

http://www.sco.ca.gov