

CITY OF HERCULES

Audit Report

SPECIAL GAS TAX STREET IMPROVEMENT FUND

July 1, 2003, through June 30, 2010

PROPOSITION 1B ALLOCATIONS

July 1, 2008, through June 30, 2010



JOHN CHIANG
California State Controller

May 2012



JOHN CHIANG
California State Controller

May 9, 2012

Dan Romero
Mayor of the City of Hercules
111 Civic Drive
Hercules, CA 94547

Dear Mr. Romero:

The State Controller's Office (SCO) audited the City of Hercules' Special Gas Tax Street Improvement Fund for the period of July 1, 2003, through June 30, 2010. We also audited the Traffic Congestion Relief Fund (TCRF) allocations recorded in the Special Gas Tax Street Improvement Fund for the period of July 1, 2003, through June 30, 2010. Finally, we audited the Proposition 1B allocations recorded in the SB 1266 Road Improvement Fund for the period of July 1, 2008, through June 30, 2010.

Our audit disclosed that the city accounted for and expended its Special Gas Tax Street Improvement Fund (Gas Tax Fund) in compliance with requirements, except that it understated the fund balance by \$39,241 as of June 30, 2010. The city understated the fund balance because the city charged negative interest expense to the Gas Tax Fund totaling \$2,085 during fiscal year (FY) 2003-04 and did not calculate and distribute equitable interest earned on investment of Gas Tax funds totaling \$37,156 during FY 2003-04 through FY 2009-10. Our findings require an adjustment of \$39,241 to the city's accounting records.

Although the city generally accounted for and expended its Gas Tax Fund properly, we remain concerned about lack of accountability as monies in the Gas Tax Fund are commingled in an investment pool with other city funds. In our review of the city's Redevelopment Agency funds, we identified significant negative cash balances in excess of \$10 million, a condition that likely exists with other city funds. Thus, it is probable that monies in the Gas Tax Fund may have been diverted to activities unrelated to public streets and roads.

Under Streets and Highways Code section 2118, the State Controller has authority to require a city to deposit money received from the Gas Tax Fund in a separate bank account. The SCO hereby exercises that authority and directs the city to immediately transfer all monies in its Gas Tax Fund to a separate bank account.

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/wm

cc: Myrna de Vera, Council Member
Hercules City Council
Gerald Boulanger, Council Member
Hercules City Council
William Wilkins, Council Member
Hercules City Council
John Delgado
Vice Mayor of the City of Hercules
Steven Duran, City Manager
City of Hercules
Elizabeth Warmerdam, Deputy City Manager
City of Hercules
Nickie Mastay, Finance Director
City of Hercules

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Audit Report

Summary

The State Controller's Office (SCO) audited the City of Hercules' Special Gas Tax Street Improvement Fund (Gas Tax Fund) for the period of July 1, 2003, through June 30, 2010. We also audited the Traffic Congestion Relief Fund (TCRF) allocations recorded in the Gas Tax Fund for the period of July 1, 2003, through June 30, 2010. Finally, we audited the Proposition 1B allocations recorded in the SB 1266 Road Improvement Fund for the period of July 1, 2008, through June 30, 2010.

Our audit disclosed that the city accounted for and expended its Special Gas Tax Street Improvement Fund (Gas Tax Fund) in compliance with requirements, except that it understated the fund balance by \$39,241 as of June 30, 2010. The city understated the fund balance because the city charged negative interest expense to the Gas Tax Fund totaling \$2,085 during fiscal year (FY) 2003-04 and did not calculate and distribute equitable interest earned on investment of Gas Tax funds totaling \$37,156 from FY 2003-04 through FY 2009-10. Our findings require an adjustment of \$39,241 to the city's accounting records.

Although the city generally accounted for and expended its Gas Tax Fund properly, we remain concerned about lack of accountability as monies in the Gas Tax Fund are commingled in an investment pool with other city funds. In our review of the city's Redevelopment Agency funds, we identified significant negative cash balances in excess of \$10 million, a condition that likely exists with other city funds. Thus, it is probable that monies in Gas Tax Fund may have been diverted to activities unrelated to public streets and roads.

Under Streets and Highways Code section 2118, the State Controller has authority to require a city to deposit money received from the Gas Tax Fund in a separate bank account. The SCO hereby exercises that authority and directs the city to immediately transfer all monies in its Gas Tax Fund to a separate bank account.

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 2101, a city must deposit all apportionments of highway users taxes in its 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 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 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 Special Gas Tax Street Improvement Fund. We conducted our audit of the city's TCRF allocations under the authority of Revenue and Taxation Code section 7104.

Senate Bill (SB) 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 SB 1266 Road Improvement Fund. A city also is required to expend its Proposition 1B allocations within three years following the end of the fiscal year in which the allocation was made and 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 its Special Gas Tax Street Improvement Fund in compliance with Article XIX of the California Constitution, the Streets and Highways Code, Revenue and Taxation Code section 7104, and Government Code section 8879.23. 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;
- Expended funds exclusively for authorized street-related purposes; and
- Made available unexpended funds for future expenditures.

We conducted this performance 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 its Special Gas Tax Street Improvement Fund in accordance with the requirements of the Streets and Highways Code and Revenue and Taxation Code section 7104; and the Proposition 1B allocations in accordance with the requirements of Government Code section 8879.23.

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 of Hercules 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, 2003, through June 30, 2010, except as noted in Schedule 1 and described in the Findings and Recommendations section of this report. The findings require an adjustment of \$39,241 to the city's accounting records. In addition to the required adjustment, the SCO directs the city to immediately transfer all monies in the Gas Tax Fund to a separate bank account (see Finding 3 for details).

Our audit also disclosed that the city accounted for and expended its TCRF allocations recorded in the Special Gas Tax Street Improvement 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, 2003, through June 30, 2010.

The Proposition 1B allocations recorded in the SB 1266 Road Improvement Fund were accounted for and expended in compliance with Government Code section 8879.23 for the period of July 1, 2008, through June 30, 2010.

Follow-Up on Prior Audit Findings

Our prior audit report, issued in April 2005, disclosed no findings.

Views of Responsible Official

We issued a draft audit report on April 20, 2012. Steven Duran, City Manager, responded by letter dated April 30, 2012, agreeing with the audit results. 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 the City of Hercules' 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

May 9, 2012

**Schedule 1—
Reconciliation of Fund Balance
July 1, 2003, through June 30, 2010**

	Special Gas Tax Street Improvement Fund		Proposition 1B Allocations ³
	Highway Users Tax Allocations ¹	TCRF Allocations ²	
Beginning fund balance per city	\$ 1,141,363	\$ —	\$ —
Revenues	<u>455,728</u>	<u>221,908</u>	<u>343,273</u>
Total funds available	1,597,091	221,908	343,273
Expenditures	<u>(505,308)</u>	<u>(221,908)</u>	<u>(343,273)</u>
Ending fund balance per city	<u>1,091,783</u>	<u>—</u>	<u>—</u>
SCO adjustments: ⁴			
Finding 1—Negative interest charged (FY 2003-04)	2,085	—	—
Finding 2—Inequitable allocation of interest	<u>37,156</u>	<u>—</u>	<u>—</u>
Total SCO adjustments	<u>39,241</u>	<u>—</u>	<u>—</u>
Ending fund balance per audit	<u>\$ 1,131,024</u>	<u>\$ —</u>	<u>\$ —</u>

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 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.

² 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 Special Gas Tax Street Improvement Fund.

³ 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. The city recorded its Proposition 1B allocations in the SB 1266 Road Improvement Fund. The audit period was July 1, 2008, through June 30, 2010.

⁴ See the Findings and Recommendations section.

Findings and Recommendations

**FINDING 1—
Negative interest
charged**

The city charged negative interest expense to the Special Gas Tax Street Improvement Fund (Gas Tax Fund) totaling \$2,085 during fiscal year (FY) 2003-04.

Streets and Highways Code section 2101 specifies that gas tax funds can be expended only for road and street-related purposes. Negative interest is not an eligible expenditure per the Streets and Highways Code.

Recommendation

The city should reimburse \$2,085 to the Gas Tax Fund for the negative interest charged during FY 2003-04.

City’s Response

The City of Hercules management will research how interest was being allocated for FY2003-04 through FY2009-10. The City of Hercules management will then determine if proper procedures were being followed to allocate interest equitably. If it is determined that the procedures for allocating interest is not equitable, the City of Hercules management will ensure that proper procedures will be established so that correct interest allocations are applied to the appropriate funds.

SCO’s Comment

The city will implement our recommendation if it determines that the procedures for allocating interest are not equitable.

**FINDING 2—
Inequitable allocation
of interest**

During FY 2003-04 through FY 2009-10, the City of Hercules did not equitably allocate interest to the Gas Tax Fund, totaling \$37,156. The city was not able to provide the methodology used to calculate and allocate interest to the fund.

An invested Gas Tax Fund must receive its proportionate share of interest earnings. Additionally, California Streets and Highways Code section 2113 states, “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.”

<u>Fiscal Year</u>	<u>Interest Allocated by City</u>	<u>SCO-Calculated Amount</u>	<u>Interest Deficiency</u>
2003-04	\$ (2,085)*	\$ —	\$ —
2004-05	3,861	5,066	1,205
2005-06	15,491	20,325	4,834
2006-07	25,867	33,940	8,073
2007-08	1,840	2,414	574
2008-09	33,692	44,207	10,515
2009-10	38,307	50,262	11,955
Total	\$ 116,973	\$ 156,214	\$ 37,156

*Negative interest expense; see Finding 1.

Recommendation

The city should reimburse \$37,156 to the Gas Tax Fund. In addition, the city should establish procedures to ensure that interest allocations to the Gas Tax Fund are equitably prorated based on interest income earned on funds invested.

City's Response

See response to Finding 1.

SCO's Comment

See the SCO's comment to Finding 1.

**FINDING 3—
Potential impairment
of cash**

The City of Hercules' cash is maintained in an investment pool with cash from other funds, including General Fund, Redevelopment Agency Fund, and other restricted funds (such as the Gas Tax Fund, which includes highway user's tax and traffic congestion relief). The city uses funds from this investment pool to pay for all of their operating costs.

We have serious concerns that Gas Tax Fund cash is at risk for the following because it is:

- Significant negative cash balances in the Redevelopment Agency funds in excess of \$10 million;
- The city's inability to provide any documentation to substantiate the amount of the city's total cash balance at June 30, 2010;
- Commingling of cash without supporting cash reconciliation schedules; and
- Inequitable allocation of interest to the Gas Tax Fund totaling \$37,156.

Additionally, our review of the city's general operations disclosed serious weaknesses in its internal accounting and administrative controls as well as identified a deteriorating fiscal condition.

Streets and Highways Code section 2101 states:

All moneys in the Highway Users Tax Account in the Transportation Tax Fund and hereafter received in the account are appropriated for all of the following:

- (a) The research, planning, construction, improvement, maintenance, and operation of public streets and highways (and their related public facilities for nonmotorized traffic). . . .
- (b) The research and planning for exclusive public mass transit guideways (and their related fixed facilities). . . .
- (c) The construction and improvement of exclusive public mass transit guideways (and their related fixed facilities). . . .

Streets and Highways Code section 2118 states:

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 Fund in a separate bank account.

Recommendation

The city must immediately establish a separate bank account for the Gas Tax Fund which includes gas tax and Traffic Congestion Relief Fund allocations. This account shall be used only 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 satisfactorily addressed the concerns noted above.

City's Response

The City of Hercules management will establish a separate bank account for the Gas Tax Fund which includes gas tax and Traffic Congestion Relief Fund and will provide the State Controller's Office with proof that a separate bank account has been established.

SCO's Comment

The city will implement our recommendation.

**Attachment—
City's Response to Draft Audit Report**



CITY OF HERCULES
111 CIVIC DRIVE, HERCULES CA 94547
PHONE: (510) 799-8200

April 30, 2012

Steven Mar, Chief
Local Governments Audit Bureau
State Controller's Office
Division of Audits
P.O. Box 942850
Sacramento, CA 94250-5874

Dear Mr. Mar:

The State Controller's Office audited the City of Hercules' Special Gas Tax Street Improvement Fund and the Traffic Congestion Relief Fund (TCRF) for the period of July 1, 2003 through June 30, 2010. The State Controller's Office also audited Proposition 1B allocations for the period July 1, 2008 through June 30, 2010. Below is the City of Hercules management response to the findings in the State Controller's letter dated April 20, 2012.

Finding 1 – Negative Interest Charged

City of Hercules Management Response:

The City of Hercules management will research how interest was being allocated for FY2003-04 through FY2009-10. The City of Hercules management will then determine if proper procedures were being followed to allocate interest equitably. If it is determined that the procedures for allocating interest in not equitable, the City of Hercules management will ensure that proper procedures will be established so that correct interest allocations are applied to the appropriate funds.

Finding 2 – Inequitable Allocation of Interest

City of Hercules Management Response:

See response in Finding 1.

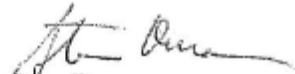
Finding 3 – Potential Impairment of Cash

City of Hercules Management Response:

The City of Hercules management will establish a separate bank account for the Gas Tax Fund which includes gas tax and Traffic Congestion Relief Fund and will provide the State Controller's Office with proof that a separate bank account has been established.

If you have any questions regarding these responses, please call Nickie Mastay, Finance Director at (510) 799-8222.

Sincerely,

A handwritten signature in black ink, appearing to read "Steve Duran", written in a cursive style.

Steve Duran
City Manager
City of Hercules

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

<http://www.sco.ca.gov>