

# CITY OF STOCKTON

## Review Report

### ADMINISTRATIVE AND INTERNAL ACCOUNTING CONTROLS

*July 1, 2010, 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:

Enclosed is the report of the State Controller's Office (SCO) review of the City of Stockton's (City) administrative and internal accounting controls. The review was conducted to assess the adequacy of the City's controls to safeguard public assets and to ensure proper use of public funds.

Our review found significant weaknesses with the City's accounting and administrative controls system. We found that the potential for waste, fraud, and abuse of public resources is extremely high due to numerous deficiencies noted in the Findings and Recommendations section of our report.

As a part of the review, we assessed various aspects of the City's internal control components and elements based on guidance by the General Accounting Office. Of the 79 control elements evaluated pertaining to internal control components, we found 48 or 60.8% of those controls were not considered to be adequate. The results of our review and evaluation of the elements of internal control are included in this report as Appendix 1. Our assessments of the elements were based on the conditions that existed during our review period of fiscal (FY) 2010-11. To the extent feasible, we made inquiries to assess whether the control deficiencies have been addressed since the conclusion of FY 2010-11.

The problem with internal controls resulted in a number of decisions that negatively affected the City's financial situation as described in the findings, and many have still not been addressed. The City should develop a comprehensive remedial plan to address these deficiencies. The plan should identify the tasks to be performed, and milestones and time frames for completion. We recommend that the City Council require periodic updates at public meetings of the progress in implementing the remedial plan.

If you have any questions, please contact Steven Mar, Chief, Local Governmental Audits Bureau by telephone at (916) 324-7226, or by email at smar@sco.ca.gov.

Sincerely,

*Original signed by*

JEFFREY V. BROWNFIELD, CPA

Chief, Division of Audits

JVB/nh

cc: Bob Deis, City Manager  
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# Review Report

## Introduction

The State Controller's Office (SCO) reviewed the City of Stockton's (City) system of administrative and internal accounting controls for the period of July 1, 2010, through June 30, 2011. When necessary, we expanded our testing to include current and prior year transactions to follow up on issues identified through interviews of city officials and through our review of the work of the independent auditors and other audit reports.

On April 2, 2012, the SCO notified City Manager Bob Deis that the City and the Stockton Redevelopment Agency (RDA) have not complied with state law regarding the submittal of annual reports and independent audits, as follows:

- City of Stockton—The Annual Report of Financial Transactions of Cities for Fiscal Year 2010-11, required by Government Code section 53891, was not filed. The due date was on or before October 18, 2011.
- City of Stockton—The Annual Street Report for Fiscal Year 2010-11 was not filed. The due date was on or before October 1, 2011.
- Stockton Redevelopment Agency—The Annual Report of Financial Transactions of Redevelopment Agencies for Fiscal Year 2010-11, required by Health and Safety Code section 33080.1, was not filed. The due date of this report was December 31, 2011.

While the City and the RDA submitted the above three reports in a timely manner for fiscal year (FY) 2009-10, several discrepancies raise questions regarding their reliability. Specifically, the City reported a net deficit between revenue and expenditures of approximately \$37 million and the RDA reported a net positive equity position of \$90 million. Yet, the Independent Audit Reports for the City and RDA for the same year disclosed deficit equity balances in the following funds:

- The RDA Capital Projects Fund has a deficit fund balance of \$6.2 million as of June 30, 2010.
- The General Liability Insurance Fund has deficit net assets of \$3.5 million.
- The Worker's Compensation Insurance Fund has deficit net assets of \$32.5 million.
- The Employee Health Insurance Fund has deficit net assets of \$6.0 million.
- The Retiree Health Insurance Fund has deficit net assets of \$75.9 million.
- The Other Benefits and Insurance Fund have deficit net assets of \$3.5 million.

Moreover, the Independent Audit Report for Fiscal Year 2008-09 did not disclose any fund deficits. The emergence of such deficits in such a short time raised concerns about the reliability and accuracy of the information in the FY 2009-10 reports, particularly given the City Council's action to enter a mediation process allowed under Assembly Bill 506 to address severe financial issues that threaten the City with bankruptcy. The City Manager has stated that the City's financial issues were due in part to fiscal mismanagement in recent years. Prior SCO audits of other cities and RDAs have linked mismanagement to significant reporting errors by those agencies.

After considering the above information, the SCO concluded that there is reason to believe that the City's ability to provide reliable and accurate financial information related to the required financial reports is questionable. Therefore, under Government Code section 12464(a), the SCO conducted an investigation to gather the information needed to validate the information provided for those reports for FY 2009-10.

In addition, the SCO reviewed programs with state general or special funding and/or any federal funding passed through the State to the City or the RDA by a state agency. These additional activities were conducted under Government Code section 12468, which authorizes the State Controller to "... regularly audit the apportionment and allocation by counties of property tax revenue..." and under Government Code section 12410, which authorizes the Controller to "... superintend the fiscal concerns of the State. The Controller shall audit all claims against the State, and may audit the disbursement of any state money, for correctness, legality, and for sufficient provisions of law for payment." Our review focused on FY 2009-10 transactions; however, it was later changed to FY 2010-11. (See the Objectives, Scope, and Methodology section of this report.) We also reviewed other period transactions as necessary.

In a letter to the City, dated April 26, 2012, the SCO announced that it will conduct the following audits/reviews:

- Accounting and Administrative Controls (July 1, 2009, through June 30, 2010)
- Special Gas Tax Street Improvement Fund (July 1, 2004, through June 30, 2010)
- State and Federal Funds (passed through by a State agency) (July 1, 2009, through June 30, 2010)
- Mandated Cost for Crime Statistics Report for the Department of Justice Program (July 1, 2001, through June 30, 2011)
- Asset Transfers of the Redevelopment/Successor Agency (January 1, 2011, through January 31, 2012)

This report presents the results of findings and conclusions reached in our review of the City's accounting and administrative controls system. In our test of internal control transactions, we included selected transactions relating to state/federal expenditures. Therefore, we did not issue a separate review report of state and federal funds.

Separate reports will be issued for our audit of the Special Gas Tax Street Improvement Fund and reviews of the RDA's asset transfer to the Successor Agency. The report for our audit of the legislatively mandated Crime Statistics Reports for the Department of Justice Program is temporarily suspended pending resolution by the Commission of State Mandates on a statewide issue identified during the audit. The Commission, which prescribes parameters and guidelines for activities subject to reimbursement by the State, has tentatively scheduled to review this issue during its September 27, 2013 hearing.

## **Background**

The City of Stockton is located in San Joaquin County, California.

With a population of 291,707 at the 2010 census, Stockton ranks as the state's 13<sup>th</sup> largest city in terms of population. It is the State's 17<sup>th</sup> largest city in terms of land mass at 64.75 square miles. Founded in 1849 and incorporated in 1850, the City of Stockton is one of the oldest incorporated cities in California. In 1922, voters approved a City Charter (municipal constitution) with a City Council-Manager form of government, which is still being used today.

In July 2012, Stockton became the largest city ever to file for protection under Chapter 9 of the US Bankruptcy Code.

## **Objectives, Scope, and Methodology**

The scope of our review was changed from FY 2009-10 to FY 2010-11 due to several unforeseen conditions and circumstances caused by the City. The timeline for some of the key conditions are described below:

- During our entrance conference with the City's management team on May 3, 2012, the City requested that we postpone the reviews of accounting and administrative controls and state and federal funds. We granted the city's request and proceeded with audits of the Gas Tax Fund and Mandated Costs and a review of asset transfers from the RDA to the Successor Agency.
- On July 31, 2012, the City requested a 60-day extension to compile and submit information and documentation needed to proceed with review of asset transfers of the RDA/Successor Agency. The City cited insufficient staff resources to produce the needed information and documentation because it had to devote significant staff time to AB 506 mediation process and bankruptcy proceeding.
- On August 7, 2012, the SCO granted the City's extension request. In addition, the SCO notified the City that it had suspended the reviews of the accounting and administrative controls and the state and federal

expenditures. The SCO indicated that it would reassess the situation after the City completed and submitted its FY 2010-11 Comprehensive Annual Financial Report (CAFR) and Single Audit Report.

- On October 17, 2012, the SCO notified the City that the 60-day extension had expired and that we would proceed with the RDA/Successor Agency asset transfers review. The City indicated that its staff was very busy and would schedule a meeting to discuss how to proceed with the review. After repeated prompting, the City finally met with the SCO on November 27, 2012, almost two months after the extension had expired.
- On December 5, 2012, the City released its FY 2010-11 CAFR for review. However, the Single Audit Report was not provided to the SCO until more than three month later on March 31, 2013.
- On December 20, 2012, the City requested that the SCO postpone its reviews of accounting and administrative controls and state and federal funds. In addition to citing inadequate staff resources, the City disclosed that in December 2012 it issued a request for proposals to provide internal audit services to the City. The City requested that we postpone our reviews until the completion of the internal audit by the external auditors, which at the time has yet to be selected.
- On January 17, 2013, the SCO met with City officials and notified them that it would continue with the reviews of accounting and internal controls and state and federal funds effective immediately. Because of the significant time that lapsed between the announcement of the reviews in April 2012 and the decision to proceed with our reviews in January 2013, the review period was changed to FY 2010-11.

The objective of this review was to evaluate the City of Stockton's system of administrative and internal accounting controls to ensure:

- Effectiveness and efficiency of operations;
- Reliability of financial reporting;
- Compliance with applicable laws and regulations; and
- Adequate safeguard of public resources.

To accomplish our objective, we performed the following procedures:

- Evaluated the City's formal written internal policies and procedures.
- Conducted interviews with City employees and observed the City's business operations for the purpose of evaluating City-wide administrative and internal accounting controls.
- Reviewed and assessed the audit reports issued by the Office of City Auditor, which conducted internal audits on behalf of the City.

- Reviewed the San Joaquin County's Grand Jury Report of FY 2009-10 and FY 2010-11 on issues relevant to the City.
- Reviewed and analyzed the "Memorandum of Internal Control and Required Communications," dated November 17, 2012, issued by Maze & Associates, which was the City external auditor for its FY 2010-11 financial statements. To the extent deemed appropriate, we performed additional procedures to quantify the cause and the effect of some of the findings identified by the external auditors.
- Reviewed and analyzed the City's CAFR and its Single Audit Report for FY 2010-11.
- Reviewed the City's documentation and supporting financial records.
- On a limited basis, performed tests of transactions to ensure adherence with prescribed policies and procedures and to validate and test the effectiveness of controls.
- Assessed various aspects of the City's internal control components and elements based on guidance by the General Accounting Office.
- Reviewed selected transactions relating to various grants (state and federal) for FY 2010-11.

## **Conclusion**

Our review found significant weaknesses with the City's accounting and administrative controls system. We found that the potential for waste, fraud, and abuse of public resources is extremely high due to numerous deficiencies. In addition, the City did not comply with reporting requirements relating to Government Code section 12464. The above deficiencies and noncompliance with Government Code section 12464 are noted in the Findings and Recommendations section of our report.

As a part of the review, we assessed various aspects of the City's internal control components and elements based on guidance by the General Accounting Office, Internal Control Management and Evaluation tool. Of the 79 control elements evaluated pertaining to internal control components, we found 48 or 60.8% in which controls were not considered to be adequate. The results of our review and evaluation of the elements of internal control are included in this report as Appendix 1. Our assessments of the elements were based on the conditions that existed during our review period of FY 2010-11. To the extent feasible, we made inquiries to assess whether the control deficiencies have been addressed since the conclusion of FY 2010-11.

The problem with internal controls resulted in a number of decisions that negatively affected the City's financial situation as described in the findings, and many have still not been addressed. The City should develop a comprehensive remedial plan to address these deficiencies. The plan should identify the tasks to be performed, and milestones and time frames for completion. We recommend that the City Council

require periodic updates at public meetings of the progress in implementing the remedial plan.

**Views of  
Responsible  
Officials**

We issued a draft review report on June 24, 2013. Vanessa Burke, Chief Financial Officer responded to the findings in a letter dated July 12, 2013. The City agrees with Findings 1 and 3, partially agrees with Findings 2, 6, and 7, and disagrees with Findings 4, 5, and 8. The City's responses are included in this final review report as an attachment.

**Restricted Use**

This report is solely for the information and use of the City of Stockton, and the SCO; it is not intended to be and should not be used by anyone other than these 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, CPA  
Chief, Division of Audits

August 5, 2013

# Findings and Recommendations

## **Noncompliance with Government Code Section 12464**

With respect to Government Code section 12464, our review determined that:

- The Financial Transaction Report for FY 2009-10 reported in error over \$4 million in revenues as other state grants. This resulted in overstating state grants. These types of revenues should be reported as “other local sources.”
- Failure to submit required reports in a timely manner resulted in withholding of state funds and assessment of fines. (See Finding 3.)

The above issues should be taken into consideration when preparing future Financial Transaction Reports. Also, the City should ensure that internal control findings and recommendations noted in this report are reviewed and evaluated for impact on future reporting.

## **Results of Analysis of City’s Administrative and Internal Control System**

We found significant weaknesses in most aspects of the City of Stockton’s administrative and internal accounting control system. As part of the review, we selected 79 internal control elements based primarily on guidance by the General Accounting Office, Internal Control Management and Evaluation tool. We then assessed the city’s internal control policies and procedures against these internal control elements and found 48 or 60.8% of those controls were not considered to be adequate. (See Appendix 1 for the results of our evaluation of internal control elements.)

In the overarching components under control environment for integrity and ethical value, commitment to competence, audit committee and city council, and management philosophy and operating style, we found only 4 of 23 control elements to be adequate. Under such a weak control environment, the potential for waste, fraud, and abuse is extremely high. The findings described below all resulted, at least in part, from these deficiencies.

The external auditor hired by the City to prepare FY 2010-11 CAFR released its Memorandum on Internal Control dated November 17, 2012. The findings in the report (Appendix 2) are similar to the ones identified through our review.

While there are specific recommendations to address the specific findings described below, we recommend that the City develop a comprehensive remedial plan to address the deficiencies noted by the Controller's review in Appendix 1 and the widespread accounting and reporting deficiencies noted in the external auditor's report in Appendix 2. The plan should identify the tasks to be performed, and milestones and time frames for completion. In addition, we recommend that the City Council require periodic updates at public meetings of the progress in implementing the remedial plan.

**Finding 1—  
The City Auditor's  
Office was inefficient  
and ineffective**

The City Auditor's Office could be an extremely valuable tool if appropriately staffed and properly managed. Internal audits could provide management with independent and objective assessments of the City's policies, systems, and processes, and identify internal control deficiencies and areas or issues in which the City is particularly vulnerable or at risk. However, our review and analysis of the activities of the City Auditor's Office found that most of the planned audit activities were not carried out and few audit reports were issued. Moreover, we found few, if any, of the reports that were released address issues of substance.

The City Auditor's Office, when fully staffed during fiscal year (FY) 2007-08, had a total of seven auditors including the City Auditor. The City Auditor's Office was disbanded in part because of the City's fiscal plight, shortly after the City Auditor's retirement on September 7, 2012. In March 2013, the City retained an outside auditing/consulting firm to conduct a comprehensive risk assessment and internal audit of the City's operations. According to the City's Chief Financial Officer, the City management has yet to reach a decision regarding whether it will reconvene the internal auditing department.

**Review of Internal Audit Results**

Our review of the internal audit activities of the City Auditor's Office found that it was not efficient or effective. Specifically, based on review and analysis of the City Auditor's audit plans and the listing of audits completed during the four-year period of FY 2007-08 through FY 2010-11, we identified the following issues:

- Few of the audits identified in the annual audit plans have been completed. During the four-year period of FY 2007-08 through FY 2010-11, the City Auditor's annual audit plan identified a total of 37 "new" audits and 28 "limited scope" audits to be performed. Review of the City Auditor's website suggests that only eight of the 37 "new" audits (24%) and seven of the 28 "limited scope" audits (21%) had published reports. In reviewing the audit committee's meeting minutes, we found no question or discussion regarding the significant discrepancy between the number of audits identified in the annual audit plans and the number of reports issued.

Comparison of Total Audits in Annual Audit Plan and Total Audit Reports Issued FY 2007-08 through FY 2010-11:<sup>1</sup>

Fiscal Year	New Audits		Limited Scope Audits	
	Planned <sup>2</sup>	Issued	Planned	Issued
FY 2007-08	7	2	12	2
FY 2008-09	11	2	7	1
FY 2009-10	10	3	4	2
FY 2010-11	9	1	5	2
Total	37	8	28	7

<sup>1</sup> Compiled by the SCO based on information and data in the City of Stockton's website

<sup>2</sup> The audit plans also included a category, "Audits in Progress," which represents carryover audits from the prior year. These audits were excluded from planned audits in this table to avoid duplication.

- Few of the audits identified in the audit plan involve issues of substance. Based on the serious challenges confronting the City and the myriad internal control problems identified in this review and by the external auditors in their November 17, 2012 report, there were numerous opportunities where the City Auditor's Office could have added value by proactively focusing on areas of material risk or with significant fiscal impact and identifying issues for consideration by management. Yet, based on the description of audits, we found very few of the planned audits met these criteria.

For example, in the transmittal to the audit committee of the City Council for the FY 2008-09 annual audit plan, the City Auditor identified three main areas—cost savings, revenue enhancement, and internal control—as the year's audit priorities "to provide the greatest possible assistance to the City of Stockton" because "this year is considerably different from any in recent memory." Yet, as disclosed in the table below, only five of the 18 planned audits for FY 2008-09 appear to be directly related with the three key areas identified in the City Auditor's transmittal letter. They include: Accounts Receivable Collection, Burglar Alarm Program Revenue, Citywide Internal Controls, Disbursement Testing, and Gasoline Consumption. Moreover, of these five planned audits in FY 2008-09, only one audit has been issued. The audit was a "limited scope" audit on Disbursement Testing and the report was issued in September 2010.

## FY 2008-09 Audits Planned and Audits Completed:

<b>New Audits</b>	<b>Audit Report Issued</b>
Accounts Receivable Collection	No
Burglar Alarm Program Revenue	No
Citywide Internal Controls	No
Class Registration System	No
Construction & Recycling Permits	Yes (April 2009)
Mutual Aid – Fire Cost Recovery	No
Neighborhood Services	No
Park Safety	No
Police Property Room	No
Risk Services	No
Sub-Recipient Monitoring of Federal Funds	Yes (October 2008)

<b>Limited Scope Audits</b>	<b>Audit Report Issued</b>
Contract Management Assignment	No
Disbursement Testing	Yes (September 2010)
Employee Driver's Licenses	No
Mystery Shopper	No
Ask Stockton Program	No
Gasoline Consumption	No
COBRA Compliance	No

- Management was slow to take action when the City Auditor identified issues of significance. In its final report for FY 2009-10, the San Joaquin County Grand Jury identified an increasing trend of internal audit findings remaining unresolved. The Grand Jury report noted that, prior to 2005, 89% of audit findings were closed. However, the percentage of audit findings that were closed declined to 68% in 2005 and 21% in 2008. Thus, even when the City Auditor identified problems, the issues were not addressed in a timely manner, which further eroded the effectiveness of the internal audit function. Examples include:
  - The City Auditor issued a report in November 2008 that identified control weaknesses over accounting and collection of library fines and fees. One of the issues identified was poor accountability over approximately \$3.4 million in uncollected fines that were billed between 1984 and 2007 — more than \$1.3 million of which was more than four years old. The issue remains unresolved and the external auditors' FY 2009-10 internal control audit report identified it as a “material weakness” because such amount was not recorded in the general ledger for the Library Fund.
  - The City Auditor issued a report in 2006 with findings of internal control weakness over Purchase Cards, which resulted in non-compliance with established procedures. A purchase card is a credit card that an employee may use to make purchases involving

relatively small dollar items. In its response to the report, the City indicated that it will conduct meetings with holders and approvers to review processes and procedures and that training will be provided to new users and signers. In February 2012, the City Auditor issued another report that identified staff using Purchase Cards to circumvent the City's procurement policies and by splitting purchase transactions to circumvent the prescribed limit. One of the problems is the Purchase Card approvers not being provided with adequate training on Purchase Card policies and procedures. The City Auditor staff discussed the audit findings with the City's Administrative Services Department staff in April 2011 and a target date of August 15, 2011 was established for corrective action on the training issue. The issue remains unresolved.

While the issues noted above suggest significant shortcomings in the operations and activities of the City Auditor's Office that resulted from inadequate oversight and poor management, they do not negate the potential benefits of an effective internal auditing department. Given its size and the significant issues and challenges that it faces, a well-managed internal audit department could add great value to the city's operations.

#### Recommendation

The City should re-establish a City Auditor's Office at the conclusion of the current audit engagement by the outside auditing/consulting firm. In addition, the City should follow guidelines published by the Institute of Internal Auditors for establishing an internal audit organization.

The audit committee of the City Council should adopt formal governance processes and procedures to provide appropriate oversight of internal audit functions and activities and respond in a timely manner to recommendations.

#### 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.

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.

#### SCO's Comment

The City agrees with the finding.

However the City also indicates that it will delay a decision on the SCO recommendation in order to review the findings of the Internal Control and Risk Assessment review being performed by Moss Adams, LLP as well as the results from a Grand Jury and the external auditor's special report on internal controls.

The SCO continues to believe that a well-managed City Auditor's Office would add great value to the City's efforts to improve its controls and operations. However, we also agree that the City is attempting to make the best decision on this matter.

The finding remains as stated.

**Finding 2—  
Inadequate  
accountability and  
oversight over fiscal  
management functions  
at the operating  
departments because  
of decentralization**

The City has a decentralized system whereby the operating departments assume responsibility for many of the fiscal management functions related to the department. Without adequate oversight and internal control, this practice could lead to poor accountability and possible abuse of public funds. Many of the findings identified in other sections of this report were caused by poor oversight over the decentralized system.

- The City’s contract process is decentralized to individual departments. Each department assigns a person to perform contract-related duties, but there is no centralized listing showing the name of the contractor, contract amount, key contract terms and conditions, and the circumstances under which the contract was awarded. Without a centralized contract listing, it is very difficult for the City Council, the City Manager’s Office, and the fiscal staff to routinely and closely monitor the departments’ contracting practices (see Finding 5).
- The City’s grant management system is also decentralized. Each operating department is responsible for identifying potential grant opportunities and submitting grant applications. It is not always possible to obtain accurate and reliable fiscal data on a timely basis to produce the required financial reports for grant management purposes (see Finding 4). In addition, opportunities may have been lost from the departments failure to pursue all available grants and seek recoupment of full costs, such as indirect costs (see Finding 7)
- A significant portion of the payment process is also delegated to the operating departments through the Authorization for Payment (AFP) process. AFP is a process that was established to enable the City’s departments to expedite payments for certain types of claims deemed to be routine. During our review period of FY 2010-11, the City’s operating departments purchased approximately \$70 million through the AFP process. Past experiences indicated that there were abuses or circumvention of payment control through the use of AFP process (see Finding 6).
- The procurement and management of the City’s vehicles fleet is also decentralized. According to a recent internal audit finding entitled “Decentralized decision making creates inefficiencies in the system,” the City’s Fleet Division has no authority or input over the fleet management practices of the operating divisions. Thus, while the City has a policy to maintain the fewest number of passenger vehicles feasible, there is no centralized assessment of the City’s overall needs nor to monitoring of vehicle purchases and assignments to ensure that they are necessary and appropriate. The use of public-owned vehicles is a practice that is susceptible to abuse.

### Recommendation

The City should centralize fiscal management functions. The City should also implement additional measures, such as centralized contract listing, to more closely monitor the fiscal practices of the operating departments.

### 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	15. Payments to City Departments
6. Insurance and bond requirements	16. Payments required by Federal, State or local law
7. Property taxes, annual	17. Awards
8. Group insurance, employee	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.

#### SCO's Comment

The City partially agrees with the finding.

The City believes that the SCO recommendation to centralize the fiscal management functions (contracts, grant management, fleet management) is not necessary. Instead they believe that proposed changes to the procedures and oversight will be sufficient to address the problems identified. It is not possible to determine whether the City's changes will address these problems and we recommend that the City evaluate its effectiveness at some time in the future.

The City also contends that the \$70 million in contract payments made using the Authorization for Payment (AFP) process were in compliance with its policy as well as consistent with the allowable uses for AFP. The SCO agrees with the City but contends that the policy had the potential for abuse as demonstrated under this Finding and Finding 6. The criteria under the current AFP process appear to be very broad and easy to meet and we continue to believe that, given the nature and dollar amount of some of these payments, it is prudent to subject them to greater scrutiny from an internal control standpoint.

With respect to the fleet management, the City indicates that it will use the results and recommendations of an audit of the fleet management program by Management Partners to establish new controls. While we support the City's efforts, we would also note that fleet management issues were first identified in a September 2012 report issued by the City Auditors Office. The recommended management action plan was for the Department of Public Works to propose an amendment to the Administrative Directive MAN-16, Assignment of City Vehicles, to explicitly detail the roles of the Fleet Division and other city departments in equipment management including the purchase of new equipment, the replacement of existing equipment, and the optimization of the use of existing equipment. The target date for this amendment proposal was March 31, 2013. As of the end of our fieldwork there was no amendment proposal to the Administrative Directive MAN-16, Assignment of City Vehicles.

We also support the City's efforts to utilize many other sources in its efforts to address the problems identified.

The finding remains as stated.

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

The City has not produced required financial statements and financial transaction reports in a timely manner resulting in delayed information needed to assess the City's financial condition. In addition, the failure to produce these reports resulted or will result in unnecessary withholding of state funds and assessments of penalties. Examples are as follows:

- The City is to file its Annual Street Report (ASR) to the SCO on or before October 1 of each year in order to continue to receive its portion of Highway Users Tax Allocation (HUTA) funds. On January 24, 2013, the SCO formally notified the City that its ASR was more than three months late despite the fact that it repeatedly attempted to work with the City's staff to resolve this issue. The SCO also notified the City that continued failure to submit the required report will result in suspension of the City's HUTA funds. Starting February 2013, the SCO started to withhold HUTA funds due to the City's inability to produce the required reports. As of May 31, 2013, the SCO has withheld approximately \$2.3 million in HUTA funds pursuant to Streets and Highways Code section 2155.
- Pursuant to Government Code section 53895, the City has been assessed fines amounting to \$15,000 for not submitting the FY 2010-11 RDA report, and the FY 2010-11 and FY 2011-12 City Financial Transaction Reports.

In its report of internal control, dated November 17, 2012, the City's external auditors identified eight findings of "material weaknesses" and nine findings of "significant deficiencies" related to financial reporting issues (see Appendix 2).

The following table lists past due reports as of May 31, 2013.

Report Name	Due Date	Number of Months Past Due
FY 2011-12 Annual Street Report	October 1, 2012	8 months
FY 2011-12 Comprehensive Annual Financial Report	December 31, 2012	5 months
FY 2011-12 Single Audit Report	March 31, 2013	2 months
FY 2011-12 City Financial Transaction Report	October 18, 2012	7 months
FY 2010-11 City Financial Transaction Report	October 18, 2011	19 months
FY 2010-11 RDA Audited Financial Statements*	December 31, 2011	17 months
FY 2010-11 RDA Financial Transaction Report*	December 31, 2011	17 months
FY 2010-11 Housing Community Development Report	December 31, 2011	17 months

\*While RDAs have been dissolved, the reports are still due.

The lack of timely Single Audit Reports is troubling because these reports provide critical information that can be used by the City Council and City management to identify upcoming issues and take timely action to address them.

#### Recommendation

The City should assign a higher priority and make plans to direct more resources to address audit and financial reporting deficiencies.

#### 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
June-13	Jun-13	Award of Contract
June-13	June-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

#### SCO's Comments

The City agrees with the finding and has taken steps to produce the eight delinquent financial and audit reports identified and to produce these report on time going forward. However, the City's response also implied that the delays in preparing the financial and audit reports was due to demands of the SCO auditors. As noted, the timeline disclosed in the Objectives, Scope, and Methodology Section of this report clearly shows that the SCO made every attempt to minimize its impact including suspending the audits for several months.

The City also indicated that it preferred to get the City's fiscal house in order before working on these overdue reports. We have no objection to this, but it should be noted that many of the eight reports were delinquent at the time the SCO commenced its fieldwork in May 2012 and that at the time this final report was issued, all of them – nearly fifteen months later – remain outstanding.

The finding remains as stated.

**Finding 4—  
Cash impairment in the  
City’s investment pool**

The General Fund is the main operating fund for the City and its cash is maintained in an investment pool with cash from other funds, including Gas Tax and state and federal funds. During our review, we noted that the City operating costs of the General Fund were paid for by funds from the City’s investment pool, without regard for the source of funds.

The actual General Fund cash balances were negative during FY 2010-11. The General Fund continued to have negative cash balances for the first six months in FY 2011-12. When the General Fund cash balances are negative, cash from the Gas Tax and state and federal funds and other restricted local funds with positive cash balances is being used to pay for General Fund-related expenditures. Thus, any of these Gas Tax and state and federal funds and other restricted local funds that have a positive cash balance are potentially impaired and may not be able to make timely payments of required expenditures that should be made from these funds.

It is clear that General Fund expenditures were charged to funds with positive cash balances, such as the Gas Tax and state and federal funds within the investment pool. However, we could not determine the specific impact to the Gas Tax and state and federal funds or any other funds because the city’s investment pool does not provide information on the balances on each fund or document specific loans to the General Fund from these other funds.

**Recommendation**

The City should develop and implement policies and procedures to ensure that it does not impair the cash of other state, federal or local restricted funds. Additionally, the finance department should determine each fund’s balance in the investment pool and ensure that withdrawals from that pool are only used to address costs that can be paid from each fund. Also, to the extent that it is allowable to borrow cash from one fund to pay for expenditures that should be paid from another, such loans should be documented and ensure that the loan is repaid as soon as required, with interest if required.

**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**

Month	Fiscal Year		
	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	0.07%	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 City claims to be monitoring the available unrestricted fund balances; however, the City did not provide any documentation to support this claim.

The finding remains as stated.

**Finding 5—  
Inadequate City  
Council oversight over  
contracting**

The SCO identified areas in which the City Council and leadership staff have failed to properly manage contract awards.

Competitive bidding requirements are not always followed. City Municipal Code section 3.68.070 authorizes contracts at or above the City Charter limit of \$30,224 (FY 2010-11) to be awarded without competitive bidding “in cases where the City Council has approved findings which support and justify exceptions to the competitive bid process.” Examples of criteria where an exemption may be justifiable include emergencies, sole source vendors, and negotiated contracts following solicitation of competitive proposals.

The City’s contract process is decentralized to individual departments and there is no centralized listing of contracts awarded by the City (see Finding 2). Therefore, we have no means of identifying how many no-bid contracts the city has awarded.

In reviewing the City Council’s meeting minutes we identified a sample of 17 instances in which staff presented proposals to exempt the contracts from competitive bids. For the 17 proposals, we found one instance where the contract was approved on a four-to-two vote, after questions and deliberation during the meeting. The remaining 16 staff proposals were unanimously adopted on consent without any discussion or deliberation. Further analysis of the 16 adopted staff proposals found that four were exempted under the criteria that they were negotiated following solicitation of competitive proposals. Thus, these four contracts did undergo a competitive process before they were fully executed. The other twelve were approved based on staff recommendations without discussion and deliberation.

For instance, on June 29, 2010, the City Council approved on consent a six-year, \$1 million contract with an outside vendor to maintain and update the city’s outdated SunGard HTE software system. The staff justifications for exemption were as follows:

- The vendor was the only software provider in the United States capable of supporting the SunGard system and facilitating the migration to a new system that employs current technology.
- There is an urgent need to replace the current system, as it has exceeded its designed useful life.
- The cost for new software, data migration, and ongoing maintenance and support is the same as being paid for the support of the current system.
- The City does not have the funds to consider and pursue alternative replacement strategies.

Our review of the staff justifications found no support for the conclusion that the vendor was the only software provider in the United States capable of delivering the services called for in the contract. It is also possible that the contract scope was narrowly constructed so that the vendor was the only one eligible. Also the fact that this was a six-year contract should have raised questions about whether there was a valid emergency that necessitated a sole source. The City's information technology staff told the SCO auditors that the system has not yet been updated. All work to date has been devoted to maintaining the antiquated system that was reported to be in urgent need of updating. In response to the external auditors' internal control findings described in Appendix 2, the City cited its antiquated system as one factor that has prevented the City from complying with its financial statements and the reporting requirements mentioned above.

Finally, it should be noted that the City's former Chief Financial Officer, who was instrumentally involved in the contract effort and in the development of the staff proposal for exemption from competitive bidding, accepted a position with the contractor and started to work for the contractor the day after he resigned from the City.

The City Council has delegated critical decisions about other contracts. For example, City staff annually awarded fuel contracts without the City Council's approval. The expenditures for fuel contracts is approximately \$1.73 million for FY 2010-11 and \$1.78 million for FY 2011-12. This practice apparently has been in existence for more than 30 years, as the City staff apparently relied on a City Council resolution that was adopted in 1979 which allows the City Manager to either enter into contracts with the City's two base suppliers or from the open market without the City Council's approval. Approximately ten years later in, 1989, the City Council adopted a resolution delegating its responsibility to approve fuel contracts exceeding the City Charter limit (currently at \$30,224) to the City staff. More than 30 years later, in a report released in May 2012, the City Auditor questioned the City Council's authority to delegate such responsibility to staff under the City Charter. The City Auditor also noted that the same supplier has been awarded the contract for the past three years through separate contracts. The contracts were awarded through a request for quotation process under which quotations were solicited from suppliers and contracts were awarded to the supplier with the lowest quote. Although the practice appears to be sound, the process is susceptible to manipulation. The fact that staff knew the contracts are not subject to City Council oversight raises further concerns about adequacy of controls. Thus, even though the contracts may have been properly awarded, the fact that they were executed without the City Council's scrutiny and approval raised concerns about the adequacy of accountability and oversight over the City's contract procurement process.

#### Recommendation

Revise the current no-bid contract approval process to require approval by the City Council in a non-consent agenda.

## 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.

#### SCO's Comment

The City disagrees with the finding.

Regarding the fuel contract, the City contends that it was following established policy. We do not disagree, however the SCO's finding and recommendation was intended to point out the potential negative consequences of that policy. Also, as noted, the City did not always comply with established policy. For example, the annual fuel purchases for fiscal years 2010-2011 and 2011-2012 of \$1.73 million and \$1.78 million, respectively, were not approved by the City Council. These fuel contracts were bid and awarded at staff level without City Council approval. The City of Stockton Municipal Code No. 3.68.040 requires that contracts in excess of \$30,224 (Fiscal Year 2010-2011) must be approved by the city council. In any case the City apparently agrees with these concerns because in its current plans, the City is to rebid the fuel contract annually

Regarding the SunGuard/HTE contract, the City merely indicates that at the time of the contract, staff believed a waiving of the bid process was justified. However, the SCO report listed several concerns about this justification which the City did not address. Given the many issues that resulted from this contract, it appears that the waiver process was not used properly in this case. The fact that the staff proposed and the City Council agreed to approve a project of this nature on consent and without any question or deliberation demonstrates inadequate accountability and oversight.

The finding remains as stated.

**Finding 6—  
Inadequate City  
Council oversight over  
payments**

The SCO identified that the City failed to properly renew contracts and made payments on expired contracts. For example, the City had contracts with eight temporary help agencies that expired in October 2007. The Human Resource Department failed to take action to renew or issue new contracts for such services, but departments continued to use the agencies' services until 2010. In April 2011, the City Council adopted a resolution retroactively approving more than \$1 million in payments that had been made to these agencies after their contracts had expired. This situation resulted in part because of the decentralization that is described in Finding 2

The SCO identified that the city misused its Authorization For Payments (AFP). Normally, the City's payments for goods and services is through a purchase order processing system (requisition, purchase order, invoices, payment approval, etc.). The City also utilizes an AFP process that was established to enable the City's departments to expedite payments for certain types of claims deemed to be routine. Examples of types of goods and services eligible for the AFP process include dues, newspaper and magazine subscriptions, and utility bills.

We identified examples of AFP misuses as follows:

- The payments to temporary help agencies were made through the use of the AFP process. When the City Council retroactively approved payments in April 2011, they were assured by staff that control measures were installed to prevent recurrence of similar situations. Actions taken to address this issue consisted of sampling 25 AFP transactions each month. This was proven to be grossly insufficient when the City Council directed its Accounts Payable Unit to review 100% of the AFP payments. Accounts Payable identified 667 AFP payments to be non-compliant in the three-month period of July through September 2011. The number of non-compliant AFP payments declined to six one year later, in the three-month period of July through September 2012.
- During 2010-11, the City processed more than 32,000 in transactions, representing more than \$70 million in payments through the AFP process. Further analysis indicates that 36 vendors each received more than \$100,000 in payments through the AFP process during the fiscal year. The highest amount paid was \$2.2 million to a title company. Numerous payments in excess of \$500,000 were made to law firms, investment firms and developers. While such payments may have been proper and legal, it is also possible that the AFP process was used to circumvent the City Charter requirement that contracts exceeding the prescribed limit of \$30,224 must be approved by the City Council.

### Recommendation

See Recommendation under Finding 2.

Also, the City should revise the AFP process to ensure that payments to a single vendor that exceed \$30,224 for a single year are approved by the city council.

### 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.

### SCO's Comment

The City partially agrees with the finding. However, in its comments, the City did not state any specific disagreement.

The finding remains as stated.

**Finding 7—  
Lost Opportunity to  
Claim State/Federal  
funds to offset General  
Fund Expenditures**

Under the current decentralized policy described in Finding 2 the City has three departments that administer a significant number of state and federal grants: the Economic Development Department (EDD), the Department of Public Works (DPW), and the Police Department. For EDD, the City recovered indirect costs because the grantor agencies allow the City to recover indirect costs on a fixed percentage of direct costs. However, in the past, the DPW and the Police Department have not included indirect cost estimates in any of their state and federal grant proposals which resulted in estimated loss of State/Federal funds of approximately \$8.6 million over a five year period. The estimate is based on annual losses of \$1.5 million for DPW and \$225,000 for Police Department (Refer to table on next page). The grant coordinators for these two departments provided explanations that do not appear to be valid.

**Department of Public Works (DPW)**

The DPW grant coordinator explained that the department had not included any indirect costs in any of its grant proposals, believing they could not do so without an indirect cost rate approved by the California Department of Transportation (Caltrans). In actuality, the absence of an approved indirect cost rate does not preclude the City from including an estimated amount or an estimated rate in its grant proposals. The DPW staff also suggested that they did not develop an indirect cost rate proposal because they did not receive any indirect cost reimbursement guidelines or instructions from the Finance Department staff.

For the state and federal grants administered by DPW, the City must have an indirect cost rate approved by the Caltrans in order to claim and receive reimbursement for indirect costs. However, it does not preclude the inclusion of an estimated indirect cost or rate in the City's grant proposals. In general, the indirect cost rate proposals are developed in two phases. The first phase entails allocation of the City's central services (e.g., accounting, budget, procurement) to the operating departments. The second phase includes adding the central costs to the indirect costs of the operating department to arrive at an indirect cost rate.

A survey of seven other cities shows that indirect cost rates fluctuate significantly—from 30% to 120%—with a 75% average indirect cost rate. The indirect costs of 3.42% associated with capital improvement may be significantly understated because it was derived solely on allocation of central services costs and thus did not include any DPW department overheads.

Based on the average rate of 75% for direct labor costs and the rate of 3.42% for all capital improvement, we estimate that the City lost a potential \$1.5 million in indirect cost reimbursements during FY 2010-11 or \$7.5 million over five years. Services, supplies and other are not eligible for indirect costs reimbursement. Unrecovered indirect costs estimates shown in the table below:

<b>Grants/Awards</b>	<b>Direct Labor</b>	<b>Capital Improvements</b>	<b>Services, Supplies, and Other</b>	<b>Total</b>
Federal - Highway Planning and Construction Grants	\$ 942,922	\$ 12,166,549	\$ 4,339,457	\$17,448,928
State Awards - Capital Improvement	<u>336,831</u>	<u>4,092,864</u>	<u>4,444,709</u>	8,874,404
Subtotal	\$ 1,279,753	\$16,259,413	\$ 8,784,166	\$26,323,332
Anticipated indirect cost rate	<u>75.00%</u>	<u>3.42%</u>	N/A	
Unrecovered indirect costs	<u>\$ 959,815</u>	<u>\$ 556,072</u>		<u>\$ 1,515,887</u>

### Police Department

The Police Department staff suggested following two reasons for not including indirect costs in the department's grant proposals:

- Staff believed that many of the federal and state grants do not reimburse indirect support expenses. While that is true, we identified the following grants that do allow reimbursement of indirect costs.
- Staff believed that indirect costs were not needed because the direct costs often exceed the total amount of the grant. However, for FY 2010-11, we identified the following four federal grants in which the direct costs were less than the budgeted amount and all of them allow the City to claim indirect costs. Had the Police Department itemized indirect cost recoveries in its grant application, the City could have recouped approximately \$225,000 for administrative and support expenses during FY 2010-11 or \$1.1 million over a five year period for these four grants. The above estimates are shown in the following table:

<b>Grant Type</b>	<b>Amount Awarded</b>	<b>Costs</b>	<b>Unspent Award</b>
Emergency Management Agency GRIP	\$ 400,000	\$375,508	\$ 24,492
OTS Avoid the 10 Grant	243,000	140,608	102,392
OTS DUI EAP Grant	290,000	193,214	96,786
OTS Click it or Ticket	<u>11,178</u>	<u>10,165</u>	<u>1,013</u>
Total	<u>\$ 944,178</u>	<u>\$719,495</u>	<u>\$ 224,683</u>

The City has retained a consultant who completed the first phase of allocating central services costs to the operating departments. The allocation plan has been used by the City to allocate expenditures between funds and departments. However, the City did not complete the second phase of the process by quantifying the department's indirect costs to arrive at a rate for state and federal reimbursement purposes. However, even if it had developed such a rate and the rate was approved by Caltrans, the City would still be precluded from reimbursement because such costs were not included in the grant proposal or budget.

#### Recommendation

The City should centralize fiscal management functions and implement additional measures, such as centralized contract listing, to more closely monitor the fiscal practices of the operating departments.

We also recommend that the City:

- Complete and implement the cost allocation plan.
- Develop a uniform policy on indirect costs and train and educate staff on the appropriate use of indirect cost plans to charge programs and activities.
- Implement review procedures to ensure all City departments recover indirect costs to the fullest extent permissible under state and federal grant agreements and requirements.

#### 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 its 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 performing 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.

#### SCO's Comment

The City partially agrees with the finding. The City notes that it is currently working with an outside consultant as well as internally to improve its abilities to recover indirect costs.

However, the City objected to the methodology used to estimate the \$1.5 million on uncollected indirect costs for Public Works grants even though it was based on similar activities and accounting practices of other like-kind local government agencies. In any case, it is clear that some amount of state and federal funding was not claimed and that the City's general fund had to make up that shortfall. Also contrary to the City's assertion, the SCO did not determine that the capital improvement indirect cost rate was understated. Instead, we found that capital improvement related indirect costs were not recovered.

Without an effective indirect cost recovery mode, such as an indirect cost rate proposal (ICRP), these costs would remain unrecognized, as the City does not appear to have a process or an accounting system in place that will enable these indirect activities to be recorded and charged directly to the specific cost objectives. If the City had a process to record such indirect activities, these costs, if directly charged to the federal and state programs would be deemed unallowable because indirect costs are eligible for reimbursement provided a claimant, such as the City, has an approved indirect cost rate in place. Furthermore, the City did not include an itemized request for indirect cost recoveries for federal and state awards, thus, even if an approved ICRP was in place, the City would forego such reimbursements.

The estimate of unspent Police Department Grants in the draft report was as of fiscal year ending June 30, 2011, and was compiled and computed by the department's employees. Our finding is based on the revenue and expenditure reports generated by the department's accounting system. We do not disagree with the City that the amount of the unspent grant is lower but we have not verified the City estimates of \$60,775. The fact remains that, for the four grants identified in the finding, for total awards of approximately a million dollars, the grant instructions permitted indirect cost recoveries. However, indirect cost recoveries were not itemized during specific grant requests, resulting in reimbursable amounts were not fully claimed.

The finding remains as stated.

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

The City contracts with a private vendor (a security firm) to collect the cash from its parking meters. Approximately \$500,000 annually is collected through the parking meters. From an internal control standpoint, the handling of cash poses a high risk as it is susceptible to theft and abuse. Thus, it is particularly important to devise and adhere to stringent control procedures to prevent misappropriation of funds.

The City Manager Administrative Directive – Cash handling Policy, Section III – prescribes that cash receipt procedures should include the following:

Departments are responsible for ensuring that every employee, volunteer, vendor or other person whose assigned duties involve handling City cash or funds adheres to the Department’s written cash handling procedures and that they attend the City’s cash handling training and obtain certification within a reasonable time of being assigned cash handling duties. Training and certification will be provided by the Human Resources Department.

Departments will monitor and review the activities performed by the department’s cash handlers to ensure compliance with procedures.

Departments shall review and update their written cash receipt procedures every two years or sooner if requested by the Administrative Services Department. Updated procedures must be submitted to the Finance Division of the Administrative Services Department for approval by the Finance Officer.

Despite the above policy requirements, the City has no written procedures governing cash handling for parking meter receipts. In response to our inquiry, City staff asserted that it has processes and procedures in place to monitor the activities of the contractor, including having the City’s Central Parking Unit staff members randomly follow the contractor’s staff to observe the collection process. The City’s staff acknowledged that the process is undocumented and, as of April 8, 2013, the City was still in the process of documenting it. Thus, the City is in violation of its own policy.

Recommendation

The City should immediately complete written procedures with respect to cash handling of parking meter revenues. The procedures should include oversight and monitoring mechanisms to ensure that the prescribed procedures are followed.

### 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.

### SCO's Comment

The City disagrees with the finding.

The City claimed that it had written procedures for Parking Meter Collections, however our review of the administrative directives (written procedures) that were on the City's website did not relate to parking meter cash collections. Additionally, on April 8, 2013, we received an email from the City's Program Manager II providing cash collection and deposit processes for cash collected from parking meters that do not appear to have been officially formalized.

However, we also agree that the actions the City is taking and will be taking are important to ensure that cash collections are properly accounted for.

The finding remains as stated.

**Observation –  
The City Council and  
other stakeholders may  
not have had access to,  
or may not have  
considered, information  
that could have affected  
critical decisions that  
led to the City’s  
financial distress**

At the June 5, 2012 meeting of the City Council, Bob Deis, City Manager, provided information about the City’s financial situation. The information in this presentation led the City Council to approve a resolution “...authorizing the City Manager to file a petition seeking protection under Chapter 9 of the United States Bankruptcy Code only if the AB 506 mediation process currently underway does not result in agreements that both prevent insolvency for FY 2012-13 and meet the City Council’s objective of fiscal sustainability.”

In Mr. Deis’ presentation, six factors were listed as causes for the City’s financial problems, under the heading “HOW DID WE GET HERE”. While these factors were contributors, in varying degrees, to the city’s financial problems, the presentation failed to address why Stockton officials did not have access to, or worse, did not appropriately respond to downward trending economic indicators that should have warranted a more cautious approach to decisions related to some of the six factors. If the city had taken timely action to address some of the six factors, their negative impact might not have been as significant. The six factors and our analysis follow:

1. **Retiree Health Benefits:** The analysis notes that when the City developed FY 2007-08 budget estimates of health insurance liabilities that were in compliance with Governmental Accounting Standards Board (GASB) Statement 45, they increased dramatically to \$388.3 million. By 2010-11, the liability had increased to \$416.7 million. However, while the provisions of GASB 45 were not required to be adopted until June 30, 2008, the City retained an independent actuary in 2004-05 to assess the potential liability. The actuary estimated that it would be \$250-\$450 million. Thus the City was well aware that increased contributions above those being made would need to be addressed well before other decisions, including new bond debt, were made.
2. **Labor Contract Restructuring:** The analysis notes that decisions were made that were neither transparent nor sustainable. However, it isn’t clear that they weren’t transparent in that the amounts to be incurred each year would have been in the approved budget and the amounts expended would have been in the annual financial audit by an independent audit firm. To the extent this information was not available or understood, the City did not take timely action to address it.
3. **Excessive Debt Burden (A Six-fold Increase in General Funds and Related Debt):** The analysis indicates that the increased debt was based on an expected continuation of high growth in the housing sector. However, indications that this growth was not materializing was available as early as 2006 when housing permits fell from a high of 2,954 the year before to only 1,604. By 2007 the number fell to 680. During this period the City entered into three long term debt obligations, all of which identified the General Fund as the primary source of payment (or the backup source of payment in case the primary was insufficient):

**Taxable Pension Obligation Bonds (\$125 million)**

These bonds were issued pursuant to an Indenture of Trust dated April 1, 2007. The bonds were issued in two series and received an AAA rating and a relatively low interest rate (5.140% to 5.455% for Series A; 5.675% to 5.795% for Series B) because of a bond insurance policy that cost nearly \$520,000 (.0041% of the bond proceeds). While the Indenture of Trust notes in Table A-11 (Appendix 3a) that total revenues between 2002 and 2006 increased by \$35 million, it also indicated that spending on public safety had increased by \$31 million during the same period, virtually wiping out any gains. In addition, Table A-8 (Appendix 3b) shows that housing permits had decreased between 2004 and 2005 by nearly 800. Thus there was information available that, with the information about the impact of GASB 45 described above, could have raised concerns about the decision to issue this bond.

**Variable Rate Demand Lease Revenue Bonds (\$41 million)**

These bonds were issued pursuant to an Indenture of Trust dated November 1, 2007. Like the pension obligation bond, they were issued in two series and received an AAA rating because of a bond insurance policy that cost over \$301,000 (.0073% of the bond proceeds). The Indenture of Trust notes in Table A-11 (Appendix 3c) that total revenues between 2006 and 2007 only increased by about \$3 million but that spending on Public Safety increased by over \$6.6 million and the excess of revenues over expenditures decreased by \$6.2 million. In addition, Table A-8 (Appendix 3d) shows that the number of housing permits went from 2,346 in 2005 to 1,084 indicating that the expected housing growth was clearly not going to happen at the level that the City had expected.

**Lease Revenue Bonds**

These were issued pursuant to an Indenture of Trust dated September 1, 2009. They were issued in one series but only received an A rating apparently because the insurance premium was too high and that it would be less expensive to pay a higher interest rate (7% to 7.15%). Public Impact Fees were identified as the primary source of funding to pay the bonds, however, Table A-9 (Appendix 3e) showed that revenues for such fees had been declining from \$28.4 million in 2003-04 to \$27.6 million in 2007-08. The back-up source of payment for these bonds was the General Fund, but Table A-8 (Appendix 3f) showed that the number of new housing permits had fallen to a new low in 2008 of only 172. By this time, the Health Benefits impact of GASB 45 described above should have been available to the City and any other party to this transaction.

In making decisions to proceed with these three long-term debts, the City may have violated provisions of its own “Capital Financing and Debt Management Policy” as follows:

Page 3: The City will only use debt financing “...where appropriate to match projected revenue streams with facility needs. As noted above, this does not always appear to be the case.

Page 5: The City will only use General Fund as a Back-up Guarantor and only if the General Fund is “...not exposed to significant risk of loss of assets or impairment of liquidity. Again, as noted above, this does not always appear to be the case.

In Addition, consideration of the following should have raised concerns.

Page 4: Revenues available for debt service “are sufficient and reliable such that long-term financing can be marketed with an investment grade credit rating The A rating given to the 2009 bond is considered an “investment grade” rating. However, given that a higher interest rate was needed to obtain even this rating should have raised concerns.

Page 5: “...general purpose supported debt service will not exceed seven percent (7%) of the total General Fund budgeted expenditures...” While this appears to apply to situations in which the general fund is the primary source of funds, it is worth noting that since the primary sources for the first two bonds described above were in trouble at the time the third bond was issued it appears that the prudent course would have been to subject it to this rule.

- 4) **The Impact of National and State Economy Hit Hard Locally:** There is no doubt that this was a major factor. However, as noted above, there were indications as early as 2004 (GASB 45) and 2007 (for the first of the three bonds described above) that sustained growth that was the justification for several major long term commitments were questionable.
- 5) **Elimination of Redevelopment and Financial Adjustments:** The analysis indicates that many of the financial problems described were caused by poor decision making regarding projects and financing sources. While the ultimate result is a legitimate factor in the City’s ability to address its financial issues, the lack of internal controls and effective oversight described elsewhere in this report is the more likely cause of the problems described.

- 6) **Poor fiscal management and bookkeeping errors:** Examples cited include double-counting parking cash, failure to write off uncollectible receivables, redevelopment cash overdrafts, and delayed issuance of the City's FY 2010-11 Comprehensive Annual Financial Report (CAFR). The findings contained in this report and the City's external auditors' report, dated November 17, 2012, further underscore poor fiscal management practices. For example, the City's FY 2011-12 CAFR, due on December 31, 2012, has not been issued as of May 31, 2013.

We agree with the conclusion in the analysis that none of the above factors can be cited as the sole cause of the City's current financial situation. However, it appears that stakeholders in the City's financial condition – City Council, City management, bond advisors and counsels, etc. - could have been able to mitigate the extent of this situation by taking information about revenue and expenditure trends, housing contractions, the impact of GASB 45, and other factors into account earlier than they did. Also, the lack of comprehensive internal controls and appropriate oversight on financial decisions contributed to the City's current financial condition.

The City should address internal control deficiencies identified in this report to reduce or prevent further threat to the City's financial situation.

City's Response

The City did not respond.

## Appendix 1— Evaluation of the Elements of Internal Control

		YES	NO	COMMENTS
<b>Management Oversight and Control (Control Environment)</b>				
<b>A1.</b>	<b>Integrity and Ethical Values</b>			
	a. Are code of conduct and other policies regarding acceptable business practice, conflicts of interest, or expected standards to ethical and moral behavior established and communicated to all city management and employees?		X	<p>Inadequate City Council oversight of non-competitively bid contracts resulted in one former staff member being investigated by the Fair Political Practices Commission for possible conflict of interest. (See Audit Finding 5.)</p> <p>Annual performance evaluations of department heads are not routinely performed (County Grand Jury Report #0909B). The City stated in its response that performance will be reviewed annually; however, there was no information to validate that corrective action was taken.</p> <p>Certain issues identified in the 2009-10 County Grand Jury Report (Case No. 1009, released on June 30, 2010) regarding appointees to the City’s Board, Commissions and Council (BCC appointees) were not adopted or not fully addressed. The Grand Jury Report noted that some BCC appointees have the authority to hire and fire personnel, approve budgets, and set policy.</p> <ul style="list-style-type: none"> <li>• Brown Act and fiduciary training is not routinely provided to BCC appointees;</li> <li>• Criminal and credit background checks are not performed on BCC appointees;</li> <li>• BCC appointee performance is rarely reviewed; and,</li> <li>• Policy for BCC appointee removal is not always defined.</li> </ul> <p>The City does not require its employees to periodically sign documents to acknowledge awareness and familiarity with the codes of conduct or other policies governing ethical behavior.</p>

	b. Is the reasonable management attitude of "Tone at the Top" established and communicated to city management and staff?		X	<p>Management did not take prompt action to implement findings and recommendations from reports completed by internal and external auditors. (See Audit Finding 1.)</p> <p>For fiscal years 2009-10, 2010-11, and 2011-12, no meeting was conducted to emphasize the importance of integrity and ethical values.</p> <p>Turnover of City personnel at key positions such as the department heads was extremely high. For example, from July 1, 2010, through December 31, 2012, four different Chief Financial Officers assumed this position for the City.</p>
	c. Is everyday interaction with vendors, clients, auditors and other parties based on honesty and fairness?	X		We did not identify any material complaints from the public relating to business dealings with the City.
	d. Is appropriate remedial action taken in response to non-compliance?		X	City management was slow to take action when the City Auditor identified issues of significance. (See Audit Finding 1.)
	e. Is management appropriately addressing intervention or overriding established controls?		X	Improper segregation of duties was noted in the City Auditor's audit report, in which an accounts payable staff was able to create new vendors in the Financial System (Internal Audit Finding 2010-08). Management acknowledged that shifting of limited staff resources will be implemented by June 30, 2012, to address this issue. There was no information to validate that applicable corrective action was implemented.

A2.	Commitment to Competence			
	<p>a. Is management identifying and defining the tasks required to accomplish particular jobs and fill - various positions?</p>		<p>X</p>	<p>The City declared two fiscal emergencies, on May 26, 2010, and May 17, 2011. As a result, the City implemented cost-cutting measures which caused turnover of key staff. In addition, a hiring freeze and furlough program were implemented, causing additional workload for many staff.</p> <p>Duty statements are not updated to reflect changes in responsibilities.</p> <p>Department heads in Information Technology, Human Resources, Budget Office, and Administrative Services were new or just rotated to their new positions. Although these City personnel were knowledgeable and experienced, they lacked the time and experience required to properly evaluate tasks. Most of the City departments were understaffed due to budget cuts.</p> <p>The knowledge, skills, and abilities needed for various jobs might be lacking due to understaffing and employee redirection caused by the Voluntary Separation Program and layoffs.</p> <p>Formal job descriptions are not clearly defined for most employees due to the added workload.</p>
	<p>b. Does the city conduct appropriate analysis of the knowledge, skills, and abilities needed to perform job assignments?</p>		<p>X</p>	<p>Cost-cutting measures and budget constraints due to fiscal emergencies are affecting the City's ability to perform job analyses and evaluations. The City is unable to timely address key control deficiencies identified in the external auditors' internal control report of November 2012 raises further questions about the staff's ability to demonstrate proper knowledge, skills and abilities to perform assigned duties. (See Audit Finding 1.)</p>

	c. Is the city providing training and counseling in order to help employees maintain and improve their job competence?		X	<p>The City does not have a formal training plan for its employees. For example purchase card approvers were not provided adequate training on Purchase Card policies and procedures (City Auditor’s Audit Finding 2008-03). Management stated that training sessions for existing approvers were completed as of November 1, 2011. However, City Auditor staff were not provided documentation needed to verify and close this audit finding.</p> <p>The Brown Act and fiduciary training is not routinely offered to BCC appointees. (See A1-a above.)</p>
<b>A3. Audit Committee and City Council</b>				
	a. Does the city have an audit committee that is appropriate for the size and nature of the entity?	X		The number of audit committee members is dictated by the City Charter. The Office of the City Auditor no longer exists as of September 7, 2012. The City Auditor retired and the remaining staff were reassigned to Administrative Services.
	b. Are members of the audit committee independent from the city management?	X		Members of the audit committee were selected by the Mayor with City Council approval. The audit committee is comprised of three City council members and one alternate.
	c. Do audit committee members have sufficient knowledge, experience, and time to serve effectively?	X		Based on each member’s official autobiography, it appears that the members of the audit committee have sufficient knowledge, experience, and time to serve effectively.
	d. Does the audit committee meet regularly to set policies and objectives, review the city’s performance, and take appropriate actions; and are minutes of such meetings prepared and signed on timely basis?		X	<p>The audit committee met four times per year during the period of February 2009 through July 2011. Agenda items included discussion of the audit plans by external auditors and by the Office of the City Auditor, audit findings of internal and external reports, status of audit findings, and other audit and review reports issued by the Office of the City Auditor.</p> <p>The audit committee did not exercise adequate oversight over the activities of the Office of the City Auditor. (See Audit Finding 1.)</p>

	e. Do the members of the audit committee regularly receive the information they need to monitor management's objectives and strategies?		X	The audit committee's oversight of the City Auditor's Office was insufficient. (See Audit Finding 1.)
	f. Does the audit committee review the scope and activities of the internal and external auditors?		X	The audit committee's oversight of the City Auditor's Office was insufficient. (See Audit Finding 1.)
	g. Does the audit committee meet privately with the Chief Financial Officer/and or accounting officers, internal auditors, and external auditors to discuss the reasonableness of the financial reporting process, the system of internal control, significant comments or recommendations, and management performance?		X	Based on review of the audit committee's meeting minutes, we could not find any evidence to suggest that such meetings have taken place.
	h. Does the audit committee take actions as a result of its audit findings?		X	Audit findings were discussed during the quarterly meetings; however, there were no actions from the audit committee to address issues noted in the audit findings. Each City department was responsible for implementing audit finding corrections.
<b>A4.</b>	<b>Management Philosophy and Operating Style</b>			
	a. Is management conservative in accepting risks, and does management move carefully, and proceed only after careful evaluation?		X	Although several meetings were conducted to address risk due to the fiscal emergency; the budget constraints and its effect on several key positions offer no flexibility towards conservative management .
	b. Is management endorsing the use of performance-based management?		X	Although annual performance reviews were conducted for several key positions, performance-based management was not consistently practiced or implemented.

	c. Is personnel turnover in key functions at an acceptable level?		X	<p>There is excessive turnover at almost every level because of the Voluntary Separation Program and layoffs due to the fiscal emergency. This limited staff resource is best exemplified in one of the City Auditor's audit reports, which states that in order to address proper separation of duties staff will be shifted between Purchasing and Accounts Payable.</p> <p>Additionally, the City has implemented a mandatory furlough program which demands additional work from the existing staff.</p>
	d. Does management have a positive and supportive attitude towards internal control and audit functions?		X	<p>Based on its response to the external auditors' November 2012 report on internal controls, the current management team appears to have a positive and supportive attitude toward internal control. However, in light of staff turnover, vacancies, and resources constraints, questions remain regarding the City's ability to make meaningful improvement in a timely manner.</p>
	e. Are valuable assets and information safeguarded from unauthorized access or use?		X	<p>The external auditors' November 2007 report on internal control contains numerous findings on safeguarding of assets and information (i.e., bank reconciliations, tracking of non-capital assets, and information technology). Although the City's response indicated that the issues have been corrected or will be corrected, such assertions have not been validated. Additionally, we noted that the City's electronic system for record retention is antiquated.</p>
	f. Are there frequent interactions of senior management and operation management in both formal and informal settings?		X	<p>There were no documented formal interactions between senior management and operation management. For example, the purchase of City vehicles is based on individual departments without discussion with the City Fleet Division, who possess expertise in managing City vehicles.</p> <p>It should be noted that many senior and operation management are new, which affects management interaction.</p>

	g. Is management attitude appropriate towards financial, budgetary and other operational reporting?		X	<p>Until June 30, 2011, several audit issues noted contradict positive management attitudes. For example, issues noted in the internal and external audit reports during this period were not yet fully corrected and some of the recommendations were not implemented.</p> <p>Several financial reports were not completed or submitted to the State Controller's Office in a timely manner.</p>
<b>A5.</b>	<b>Organizational Structure</b>			
	a. Is the city's organizational structure appropriate for its size and the nature of its operation?		X	<p>The City should re-establish its City Auditor's Office. (See Recommendation under Audit Finding 2.)</p> <p>Management acknowledged in its response to several audit findings, stating that some positions are lacking. For example, in Finding 331-04, direct training of office personnel was curtailed to after hours and weekends due to the transfer of a supervising office assistant to another department. In addition, a Program Manager position was reclassified to fill a position need.</p>
	b. Are key areas of authority and responsibility defined and communicated throughout the organization?		X	<p>Key areas of authority and responsibility are not defined and not communicated throughout the City. For example, according to the Internal Auditor's report, the Fleet Division does not have sufficient authority and responsibility to manage the fleet assets in the best interest of the City. The Fleet Division has not been provided any authority, written or implied, that places the decision-making and asset management with them.</p>
	c. Have appropriate and clear reporting relationships been established?	X		<p>Key areas of authority and responsibility have been established.</p>
	d. Does management periodically evaluate the organization's structure and make changes as necessary in fluctuating conditions?		X	<p>Budget constraints and limited resources affect the implementation of necessary changes. For example, an employee that is no longer with the City was still listed as responsible for the Underground Storage Tank Response Plan. It was also noted that staff turnover, administration oversight, and competing priorities have contributed to the lack of compliance with fuel spill laws and regulations.</p>

	e. Does the city employ an appropriate number of employees, particularly in managerial positions?		X	The City lost a number of experienced employees at the management and staff levels due to the Voluntary Separation Program and layoffs. There is crossover of functions due to inadequate staffing.
<b>A6.</b>	<b>Assignment of Authority and Responsibility</b>			
	a. Is the city appropriately assigning authority and delegating responsibility to the proper personnel to deal with organizational goals and objectives?		X	Several instances were noted in the internal audit reports where personnel were improperly assigned authority and responsibility. For example; <ul style="list-style-type: none"> <li>• The annual fuel contract is bid and awarded at the staff level;</li> <li>• Most employee benefit contracts are renewed at the staff level based on provision made at the time of contract; and,</li> <li>• A property room supervisor in the Police Department has disproportionate authority in relation to responsibility, including having access to modify/edit records while having physical custody of all property.</li> </ul>
	b. Does each employee know how his or her work interrelates to others in the way in which authority and responsibility are assigned, and how duties are related concerning internal control?		X	An accounts payable staff has access to create vendor files and make payments using the City’s electronic financial system, which increases the risk of unauthorized transactions.
	c. Is delegation of authority appropriate in relation to the assignment of responsibility?		X	See A6-a above.
<b>A7.</b>	<b>Human Resources Policies and Practices</b>			
	a. Are policies and procedures established for hiring, training, and promoting employees and management?	X		
	b. Are background checks conducted on candidates for employment?		X	The County Grand Jury report number 1009 reported that the BCC appointees are not subject to criminal and credit checks.
	c. Are employees provided the proper amount of supervision?		X	Employees received guidance and on-the-job training from supervisors to help ensure proper work flow and processing. However, some of the newly hired supervisors lacked experience to properly supervise.

<b>Risk Assessment</b>			
<b>B1.</b>	<b>Establishment of Entity-wide Objectives</b>		
	a. Are there entity-wide objectives that were established by management?	X	City-wide objectives were established by management and published on the City website.
	b. Are city-wide objectives clearly communicated to all employees, and does management obtain feedback signifying that communication has been effective?	X	City-wide objectives were communicated to all employees, and published on the City website.
	c. Is there a relationship and consistency between the department's operational strategies and the city-wide objectives?	X	City department's operational strategies are consistent with the City-wide objectives.
	d. Is there an integrated management strategy and risk assessment plan that considers the city-wide objectives and the relevant sources of risk from internal management factors and external sources, and that establishes a control structure to address those risks?	X	The Risk Services Division under the Department of Human Resources was created for this purpose.
<b>B2.</b>	<b>Risk Identification</b>		
	a. Is management appropriately and comprehensively identifying risk using various methodologies?	X	Budget study sessions and meetings to address risk of losing experienced and knowledgeable employees were conducted.  The Risk Services Division identifies and manages risk associated with activities and projects, reducing the chance of loss, creating greater financial stability, and protecting City resources.
	b. Are there mechanisms in place to anticipate, identify, and react to routine events or acts that affect achievement of objectives?	X	See B2-a above.

	c. Do adequate mechanisms exist to identify risks to the city arising from external factors?	X		See B2-a above.
	d. Is management assessing other factors that may contribute to or increase the risk to which the city is exposed?	X		See B2-a above.
	e. Is management identifying risks city-wide and for each significant activity level of the city?	X		See B2-a above.
<b>B3.</b>	<b>Risk Analysis</b>			
	a. After risks to the city have been identified, does management undertake a thorough and complete analysis of the possible effect?	X		Management has established a formal process of analyzing risks.
	b. Has management developed an approach for risk management and control based on how much risk can be prudently accepted?	X		See B2-a above.
<b>Control Activities</b>				
<b>C1.</b>	<b>Policies and Procedures (General Applications)</b>			
	a. Do appropriate procedures, techniques, and mechanisms exist with respect to each city's activities?		X	<p>Appropriate procedures, techniques and mechanisms exist; however, issues were noted in several audit reports relating to activities such as approvals, authorization, reconciliation, and the production of records and documentation. Some of the issues were noted two or three years prior; however, recommendations to correct some of the issues were not yet fully implemented as of June 30, 2011. For example:</p> <ul style="list-style-type: none"> <li>• Roles and responsibilities ensuring proper authority to expend funds have not been established and documented, thus the accounts payable unit and operating department view each other as responsible for verifying authority;</li> <li>• There are no comprehensive written, City-wide policies and procedures for Payroll processing; and;</li> <li>• Some transaction logs for various purchases were not in compliance with City procedures.</li> </ul>

	b. Are the control activities identified as necessary in place and being applied?		X	See C1-a above.
	c. Are control activities regularly evaluated to ensure that they are still appropriate and working as intended?		X	See C1-a above.
<b>C2.</b>	<b>Common Categories of Control Activities</b>			
	a. Are top level reviews made of actual performance relative to budgets, forecasts, and prior periods?	X		Due to the fiscal emergencies declared by the City, extensive reviews were performed by top level management, especially regarding budgets and forecasts. In addition, regular meetings were conducted with the City Council to discuss budget updates.
	b. Do managers review performance reports?	X		Based on our observation, managers at all activity levels review reports and measure results against targets (Budget Adoption and Pendency Plan).
	c. For information processing, are varieties of controls in place for performing check accuracy, completeness, and authorization of transactions?		X	Various control weaknesses were noted in prior audits relating to accuracy, completeness, and authorization of transactions. For example: <ul style="list-style-type: none"> <li>• Lack of separation of duties in which accounts payable staff were able to create new vendor files and to make payments;</li> <li>• Transactions have been processed without adequate evidence of documented authority; and,</li> <li>• Lack of a process ensuring special revenue funds are expended for intended purposes.</li> </ul>
	d. Are controlled items periodically counted and compared to amounts shown on control records?		X	Annual physical inventories were conducted related to the annual financial audit. However, an internal control weakness due to lack of tracking was noted, related to non-capital assets valued below the City capitalization threshold of \$5,000. In addition, data in the Fleet Module is inaccurate and incomplete in which sold and inactive assets still appear in the inventory as active vehicles.
	e. For performance indicators and measures, does management compare different sets of data and investigate differences?	X		

	f. Are duties properly segregated among different people to reduce the risk of error or inappropriate actions?		X	Several issues regarding lack of proper segregation of duties were noted in audit and review reports. For example: <ul style="list-style-type: none"> <li>Accounts payable staff was able to create new vendor files and to make payments; and,</li> <li>System passwords and profiles are shared by employees in the Fuel Management System.</li> </ul>
	g. Are administrative and operation policies in writing, current, and do they set clear procedures for compliance?		X	There were no comprehensive policies or procedures for some departments (i.e. Payroll). Updates, amendments, and changes to the policy and procedures were documented in a series of administrative directives; however, administrative directives were not reviewed periodically.
<b>Information and Communication</b>				
<b>D1.</b>	<b>Information</b>			
	a. Are mechanisms in place to obtain relevant information on legislative or regulatory developments and program, budget, or economic changes?	X		Information critical to achieving the City objectives (Budget Adoption and Pendency Plan) including information related to legislative and regulatory developments, and economic changes, were reported to management.
	b. Is information provided to the right people in sufficient detail and on time to enable them to carry out their responsibilities efficiently and effectively?	X		It appears from our review of available documents that adequate reporting was made to management and the City Council. Information is summarized and presented appropriately during Council meetings.
	c. Is development or revision of information systems based on the strategic plan linked to the entity's overall strategy, and is it responsive to achieving city-wide objectives?	X		A City-wide strategic plan, adopted by the City Council, is the basis for management and improvements in technology throughout the City.
	d. Does management support the development of necessary information systems and show its support by committing appropriate resources?	X		Several information technology assessment recommendations were slowly implemented due to lack of permanent staffing.

<b>D2. Communications</b>			
	a. Does management ensure that effective internal communications occur?	X	Formal and informal meetings were conducted to communicate important information. Emails, telephone, and in-person meetings are made available to staff to allow easy flow of information throughout the organization.
	b. Does management ensure that effective external communication occurs regarding issues with serious impact on programs, projects and other activities?	X	Citizens are allowed to present complaints and other issues of concern during City Council meetings. In addition, the City's website is available for submitting questions, complaints, and comments from interested parties.
	c. Does the city employ various forms and means of communicating important information with employee and others?	X	See D2-a above.
	d. Does the city manage, develop, and revise its information systems in an effort to continually improve usefulness and reliability?	X	The City is utilizing its website for information purposes. The City's webpage was last reviewed on April 13, 2013.
<b>Monitoring</b>			
<b>E1. On-going Monitoring</b>			
	a. Does management have a strategy to ensure that ongoing monitoring is effective and will trigger separate evaluations?		X There is ongoing monitoring to ensure that findings of audits and other reviews are resolved; however, there were numerous audit findings from prior years in which recommended corrections were not implemented, or were partially completed.  Ongoing monitoring includes insuring that managers and supervisors know their responsibilities for internal control, and the need to make control and control monitoring part of their regular operating processes. Many employees at key positions were new to their jobs; consequently, some of these managers are not performing the ongoing monitoring process. For example, some transactions have been processed without evidence of documented authority.

	b. Do city personnel, in the process of performing their regular duties, obtain information about whether internal control is functioning properly?		X	Based on our observations, some City personnel were aware of internal control functions; however, many of the staff were assigned additional duties and some were new to their assigned tasks.
	c. Are communications from external parties corroborated with internally generated data and able to indicate problems with internal control?	X		Based on our observations, there were no customer complaints to indicate that deficiencies may exist.
	d. Is there appropriate organizational structure and supervision to help provide oversight of internal control functions?		X	Automated edits and checks, as well as clerical activities, are used to help control accuracy and completeness; however, there were several instances where internal control functions failed. For example, payments to temporary employees were made past the contract time limit.
	e. Are data recorded by information and financial systems periodically compared with physical assets and discrepancies?	X		There were no issues noted for annual inventories relative to the preparation of the financial statements.
	f. Are the City Auditor's Office and other auditors regularly providing recommendations for improvements in internal control, and is management taking appropriate follow-up action?		X	The Office of the City Auditor provides recommendations and performs follow-up actions to findings from internal and external audits. However, management was not taking prompt action to implement corrections and recommendations. (See Audit Finding 1.)
	g. Are meetings with employees used to provide management with feedback on whether internal control is effective?		X	We are not aware of any formal meetings between management and employees to determine if internal control is effective. Some of the audit issues were discussed in the audit committee meetings.
	h. Are employees' regularly asked to state explicitly whether they comply with the city's code of conduct?		X	Based on our inquiry there were no evidence to suggest that city personnel were periodically asked whether they comply with the City's code of conduct.

<b>E2. Separate Evaluation</b>				
a.	Are the scope and frequency of separate internal control evaluations appropriate for the city?		X	The City audit staff appear to have the appropriate skills to evaluate portions of internal control. However, during the period of August 2008 through February 2012, only seven audits completed were related to the City's internal control. In addition, the Office of the City Auditor was eliminated after the City Auditor retired September 7, 2012. (See Audit Finding 1.)
b.	Are the methodologies for evaluating the city's internal control logical and appropriate?		X	The Office of the City Auditor did not perform a sufficient number of audits of the City's internal control. (Also, See Audit Finding 1.)
c.	If the evaluations are conducted by the City Auditor's Office, does the office have sufficient resources, ability, and independence?		X	For fiscal year 2010-11, there were four auditors assigned to the office, including the City Auditor. In prior years, the Office of the City Auditor operated with seven auditors including the City Auditor.
d.	Are deficiencies found during separate evaluations promptly resolved?		X	Some deficiencies noted remain outstanding or partially implemented even after several years. For example; an internal audit issue relating to the City's record retention system was issued in 2004. Currently, the target date for correction is December 31, 2016.
<b>E3. Reporting Deficiencies</b>				
a.	Are reports of deficiencies from both internal and external sources easily obtained?		X	Although the general public could request reports under the Public Records Act, it is difficult to identify reports that were issued. Also, some internal audit reports completed by the City's internal audit unit were not available. Of the 25 audit reports completed by internal audit, only five reports are accessible from the City's website.
b.	Is there ongoing monitoring of internal controls?		X	See E2-a above.
c.	Are deficiencies reported to the person directly responsible and to a person at least one level higher?	X		The deficiencies noted in the internal audit reports were communicated with management.
d.	Are the identified transactions or events investigated to determine causes and correct problems?		X	There were several audit issues noted in the reports completed by the City's internal audit department, as well as from the internal control audit report, dated November 12, 2012, in which audit deficiencies were not completely corrected.

## Appendix 2— Widespread Accounting and Reporting Deficiencies

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The City's external auditors conducted a comprehensive assessment of the City's internal control system and released a report, dated November 17, 2012 with 12 findings of "material weaknesses" and 26 findings of "significant deficiencies." Our analysis of the findings disclosed that eight of the 12 "material weaknesses" and nine of the 26 "significant deficiencies" findings have direct impact on the accuracy, reliability, and timeliness of the City's financial statements and financial transactions reports. As of April 30, 2013, the external auditors' key findings have not yet been fully addressed, which led to continuing delay in financial reporting and raises questions about the accuracy and reliability of financial statements.

Moreover, due to the City's inability to submit in a timely manner the Annual Street Report for FY 2011-12, due on or before October 1 of each year, the SCO was compelled to withhold Highway Users Tax Allocations due to the City beginning February 2013. As of May 31, 2013, the amount withheld was approximately \$2.3 million. In addition, pursuant to Government Code section 53895, the SCO assessed the City fines totaling \$15,000 for not submitting the FY 2010-11 RDA report, the FY 2010-1,1 and FY 2011-12 City Financial Transaction Reports, (\$5,000 for each report).

### Material Weaknesses

A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the City's financial statements will not be prevented, or detected and corrected on a timely basis. The following material weaknesses were noted in the external auditor's internal control report that are directly related to the City's financial statements and financial transaction reports:

- Finding 2011-3: Accuracy and timeliness of financial statement information
- Finding 2011-4: Preparation of financial statements – extended reporting
- Finding 2011-5: Maintaining allowances for Doubtful Accounts
- Finding 2011-6: Reconciliation of subsidiary ledgers to general ledger
- Finding 2011-7: Reversal of prior year liabilities
- Finding 2011-8: Marina debt reporting
- Finding 2011-10: Journal entries reviews
- Finding 2011-11: Accrued interest on long term receivables should be recorded

### **Significant Deficiencies**

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention to those charged with governance.

- Finding 2011-13: Investment report timeliness
- Finding 2011-15: Conformity of budgetary reporting in the financial statements to the annual budget
- Finding 2011-16: Completeness of proprietary fund receivable balances
- Finding 2011-19: Accrued compensated absences calculations
- Finding 2011-20: Pollution remediation liability calculations
- Finding 2011-26: Depreciation expense does not recalculate properly
- Finding 2011-27: Redevelopment rental property not capitalized
- Finding 2011-35: Prompt recording of cost disallowances
- Finding 2011-37: Permanent funds

### **City's Response to the External Auditor's Audit Findings**

In its response, the City agreed with the above external auditors' internal control audit findings and indicated that corrective actions were or will be taken to address the control deficiencies. While agreeing with Findings 2011-3 and 2011-4, regarding the accuracy and timeliness of financial reporting, the City indicated that its remedial efforts have been compromised by turnover and shortage in key positions, increased workload demand from its bankruptcy filing, increased workload as a result of SCO audits, and difficulties with its antiquated computer system. Thus, the key issues regarding accuracy and timeliness of financial reports remain unresolved.

**Appendix 3—  
Excerpts from City of Stockton’s Financing Documents**

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Appendix 3a Excerpt from CITY OF STOCKTON  
2007 TAXABLE PENSION OBLIGATION BONDS (\$125,310,000)

Table A-11  
City of Stockton  
General Fund  
Comparable Statement of Revenues, Expenditures and Changes in Fund Balance  
(For Years Ended June 30 of 2001 through 2006)  
(\$ in thousands)

	2002	2003	2004	2005	2006
<b>REVENUES</b>					
Taxes					
Property	\$18,992	\$21,091	\$24,349	\$26,676	\$32,418
Utility	31,462	32,157	33,322	34,908	34,313
Sales and Use	32,489	33,250	36,723	40,639	37,725
Other	14,959	16,716	17,214	22,881	25,666
Licenses and Permits	5,493	431	517	337	346
Federal Grants and Subsidies	121	0	0	0	0
Other Governmental	16,006	16,831	13,384	16,196	18,857
Charges for Services	17,103	10,210	11,005	10,545	10,821
Fines and Forfeitures	1,549	1,461	1,905	3,214	3,900
Use of Money and Property	60	629	607	791	537
Investment Income:					
Interest Income	0	0	734	1,503	586
Net increase (decrease) in fair value of investments	1,461	807	(686)	38	65
Refunds and Reimbursements	2,309	2,645	2,569	5,254	4,020
Miscellaneous	5,432	7,004	5,179	4,860	4,784
<b>TOTAL REVENUES</b>	<b>\$147,977</b>	<b>\$143,232</b>	<b>\$146,822</b>	<b>\$167,392</b>	<b>\$183,312</b>
<b>EXPENDITURES</b>					
Current:					
General Government	\$15,066	\$12,241	\$12,345	\$13,444	\$14,110
Public Safety	100,770	104,145	110,387	121,460	131,689
Public Works	13,347	10,582	11,464	13,426	13,334
Parks and Recreation	12,295	7,167	7,298	7,676	8,027
Capital Outlay	33	102	34	101	6
Debt Service - Costs of Issuance	0	287	41	0	0
<b>TOTAL EXPENDITURES</b>	<b>\$141,511</b>	<b>\$134,524</b>	<b>\$141,569</b>	<b>\$156,107</b>	<b>\$167,166</b>
EXCESS OF REVENUES OVER EXPENDITURES	\$6,466	\$8,708	\$5,253	\$11,285	\$16,146
Other Financing Sources (Uses)					
Transfers In	\$4,651	\$8,374	\$7,482	\$10,633	\$10,848
Transfers Out	(18,851)	(27,348)	(12,913)	(16,303)	(18,992)
Sales of Fixed Assets	0	15	5	2	-
Proceeds of Long-Term Debt	0	13,300	0	0	2
Discounts on Debt Issuances	0	(98)	0	0	-
<b>TOTAL OTHER FINANCING SOURCES (USES)</b>	<b>(\$14,200)</b>	<b>(\$5,757)</b>	<b>(\$5,426)</b>	<b>(\$5,668)</b>	<b>(\$8,142)</b>
NET CHANGE IN FUND BALANCES	(\$7,734)	\$2,951	(\$173)	\$5,617	\$8,004
FUND BALANCES, BEGINNING OF YEAR	\$22,970	\$15,069	\$18,020	\$17,847	23,464
Prior Period Adjustment	13	0	0	0	0
FUND BALANCES (DEFICIT), END OF YEAR	\$15,069	\$18,020	\$17,847	\$23,464	\$31,468

Appendix 3b Excerpt from CITY OF STOCKTON  
 2007 TAXABLE PENSION OBLIGATION BONDS \$125,310,000

Table A-8  
 CITY OF STOCKTON  
 Total Building Permit Valuations  
 (in thousands)

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005†</u>
Permit Valuation					
New Single Family	\$239,673.0	\$408,514.3	\$525,340.1	\$585,834.6	\$532,975.4
New Multiple Family	4,574.6	25,299.5	10,480.8	6,735.1	6,857.5
Residential Alterations/Additions	<u>8,860.6</u>	<u>10,352.6</u>	<u>12,225.9</u>	<u>14,781.1</u>	<u>20,192.0</u>
TOTAL RESIDENTIAL	\$53,108.2	\$444,166.3	\$548,046.8	\$607,350.9	\$560,024.9
New Commercial	\$20,775.0	\$33,853.8	\$62,661.3	\$59,935.1	\$100,896.4
New Industrial	40,458.5	15,808.1	31,087.6	25,704.5	7,124.3
New Other	16,703.5	37,331.0	38,844.0	28,639.5	28,396.9
Commercial Alterations/Additions	<u>39,293.5</u>	<u>54,558.7</u>	<u>73,315.8</u>	<u>42,698.3</u>	<u>40,874.2</u>
TOTAL NONRESIDENTIAL	\$117,230.5	\$141,551.5	\$205,908.8	\$156,977.4	\$177,291.9
New Dwelling Units					
Single Family	1,579	2,564	3,082	3,138	2,312
Multiple Family	<u>112</u>	<u>396</u>	<u>177</u>	<u>136</u>	<u>83</u>
TOTAL	1,691	2,960	3,259	3,274	2,395

† Most recent annual data available.

Source: Construction Industry Research Board, Building Permit Summary.

Appendix 3c Excerpt from STOCKTON PUBLIC FINANCING AUTHORITY  
2007 Series A (\$36,500,000) and Series B (\$4,270,0000)

Table A-11  
City of Stockton  
General Fund  
Comparable Statement of Revenues, Expenditures and Changes in Fund Balance  
(For Years Ended June 30, 2003 through 2007)  
(\$ in thousands)

	2003	2004	2005	2006	2007
<b>REVENUES:</b>					
<b>Taxes:</b>					
Property	\$21,091	\$24,349	\$26,676	\$32,418	\$35,497
In Lieu of sales tax			8,750 <sup>(1)</sup>	9,274 <sup>(1)</sup>	11,070 <sup>(1)</sup>
Utility User	32,157	33,322	34,908	34,313	30,101
Sales – levied by City	<sup>(2)</sup>	<sup>(2)</sup>	<sup>(2)</sup>	<sup>(2)</sup>	
Other	16,716	17,214	22,881	25,666	24,389
Licenses and Permits	431	517	337	346	337
<b>Intergovernmental :</b>					
Federal Grants and Subsidies	0	0	0	0	8
Sales and Use Tax – levied by state	33,250 <sup>(2)</sup>	36,723 <sup>(2)</sup>	31,889 <sup>(2)</sup>	37,725 <sup>(2)</sup>	32,388
Other Governmental	16,831	13,384	16,196	18,857	24,059
Charges for Services	10,210	11,005	10,545	10,821	9,226
Fines and Forfeitures	1,461	1,905	3,214	3,900	3,292
Use of Money and Property	629	607	791	537	2,134
<b>Investment Income:</b>					
Interest Income	894	734	1,053	586	1,616
Net Increase (decrease) in fair value of investments	(87)	(688)	38	65	163
<b>Refunds and Reimbursements</b>					
Miscellaneous	2,645	2,569	5,254	4,020	6,837
	7,004	5,179	4,860	4,784	5,359
<b>TOTAL REVENUES</b>	<b>\$143,232</b>	<b>\$146,822</b>	<b>\$167,392</b>	<b>\$183,312</b>	<b>\$186,476</b>
<b>EXPENDITURES:</b>					
<b>Current:</b>					
General Government	\$12,241	\$12,345	\$13,444	\$14,110	\$14,776
Public Safety	104,145	110,387	121,460	131,689	138,283
Public Works	10,582	11,464	13,426	13,334	14,050
Parks and Recreation	7,167	7,298	7,676	8,027	8,827
Capital Outlay	102	34	101	6	521
Debt Service - Costs of Issuance	287	41	0	0	31
<b>TOTAL EXPENDITURES</b>	<b>\$134,524</b>	<b>\$141,569</b>	<b>\$156,107</b>	<b>\$167,166</b>	<b>\$176,488</b>
<b>EXCESS OF REVENUES OVER EXPENDITURES</b>	<b>\$8,708</b>	<b>\$5,253</b>	<b>\$11,285</b>	<b>\$16,146</b>	<b>\$9,988</b>
<b>Other Financing Sources (Uses)</b>					
Transfers In	\$8,374	\$7,482	\$10,633	\$10,848	\$6,466
Transfers Out	(27,348)	(12,913)	(16,303)	(18,992)	(26,997)
Sales of Fixed Assets	15	5	2	2	5
Proceeds of Long-Term Debt	13,300	0	0	0	0
Discounts on Debt Issuances	(98)	0	0	0	0
<b>TOTAL OTHER FINANCE SOURCES (USES)</b>	<b>(\$5,757)</b>	<b>(\$5,426)</b>	<b>(\$5,668)</b>	<b>\$(8,142)</b>	<b>\$(20,526)</b>
<b>NET CHANGE IN FUND BALANCES</b>	<b>\$2,951</b>	<b>(\$173)</b>	<b>\$5,617</b>	<b>\$8,004</b>	<b>(\$10,538)</b>
<b>FUND BALANCES, BEGINNING OF YEAR</b>	<b>\$15,069</b>	<b>\$18,020</b>	<b>\$17,847</b>	<b>\$23,464</b>	<b>31,468</b>
Prior Period Adjustment	0	0	0	0	0
<b>FUND BALANCES (DEFICIT), END OF YEAR</b>	<b>\$18,020</b>	<b>\$17,847</b>	<b>\$23,464</b>	<b>\$31,468</b>	<b>\$20,930</b>

<sup>(1)</sup> In lieu of sales tax reflects began in FY 2005 as part of a change in allocation of revenues from the State of California.

<sup>(2)</sup> In 2007, City began reporting Sales Tax as Intergovernmental revenue. Years 2003-2006 have been restated for comparison purposes.

Appendix 3d Excerpt from STOCKTON PUBLIC FINANCING AUTHORITY  
 2007 Series A (\$36,500,000) and Series B (\$4,270,0000)

Table A-8  
 CITY OF STOCKTON  
 Total Building Permit Valuations  
 (in thousands)

	<u>2002(1)</u>	<u>2003(1)</u>	<u>2004(1)</u>	<u>2005(2)</u>	<u>2006(2)</u>
Permit Valuation					
New Single Family	\$408,514.3	\$525,340.1	\$585,834.6	\$548,442.8	\$253,066.6
New Multiple Family Residential	25,299.5	10,480.8	6,735.1	8,077.1	11,160.0
Alterations/Additions	<u>10,352.6</u>	<u>12,225.9</u>	<u>14,781.1</u>	<u>20,641.1</u>	<u>18,296.4</u>
TOTAL RESIDENTIAL	\$444,166.3	\$548,046.8	\$607,350.9	\$577,161.0	\$282,523.0
New Commercial	\$33,853.8	\$62,661.3	\$59,935.1	\$66,970.7	\$14,328.4
New Industrial	15,808.1	31,087.6	25,704.5	9,472.1	68,768.4
New Other Commercial	37,331.0	38,844.0	28,639.5	71,334.5	21,999.4
Alterations/Additions	<u>54,558.7</u>	<u>73,315.8</u>	<u>42,698.3</u>	<u>38,888.5</u>	<u>80,429.8</u>
TOTAL NONRESIDENTIAL	\$141,551.5	\$205,908.8	\$156,977.4	\$186,665.8	\$185,526
New Dwelling Units					
Single Family	2,564	3,082	3,138	2,367	1,013
Multiple Family	<u>396</u>	<u>177</u>	<u>136</u>	<u>69</u>	<u>71</u>
TOTAL	2,960	3,259	3,274	2,436	1,084

Source: (1) Construction Industry Research Board, Building Permit Summary.  
 (2) City of Stockton Building Permits Division.

Table A-9  
 CITY OF STOCKTON  
 Statement of Revenues, Expenditures and Charges in Fund Balances  
 Public Facilities Impact Fees  
 Fiscal Years 2003-04 through 2007-08  
 (\$ in thousands)

	<u>2003-04</u>	<u>2004-05</u>	<u>2005-06</u>	<u>2006-07</u>	<u>2007-08</u>
<b>REVENUES:</b>					
Intergovernmental:					
Other government	0	0	0	\$44	0
Charges for services	\$28,122	\$26,141	\$28,179	21,468	\$24,251
Use of money and property	47	67	48	29	86
Investment income:					
Interest income	1,373	1,397	1,313	2,496	2,896
Net increase (decrease) in fair value of investments	(1,111)	107	140	648	450
Refunds and reimbursements	0	1	3	2	3
Miscellaneous	0	88	0	0	0
<b>TOTAL REVENUES</b>	<b>28,431</b>	<b>27,801</b>	<b>29,683</b>	<b>24,687</b>	<b>27,686</b>
<b>EXPENDITURES:</b>					
General government	1,292	2,049	2,194	0	0
Public safety	152	196	144	0	0
Public works	1,761	974	1,060	0	0
Library	255	268	1,042	0	0
Park and recreation	355	123	421	0	0
Capital Outlay	<u>22,096</u>	<u>26,453</u>	<u>16,639</u>	<u>20,847</u>	<u>26,029</u>
<b>TOTAL EXPENDITURES</b>	<b>25,911</b>	<b>30,063</b>	<b>21,500</b>	<b>20,847</b>	<b>26,029</b>
Excess (deficiency) of revenues Over (under) expenditures (Budgetary Basis)	2,520	(2,262)	8,183	3,840	1,657
<b>OTHER FINANCING USES:</b>					
Transfers out	(199)	(146)	(147)	(89)	(137)
Net change in Fund Balance (Budgetary Basis)	2,321	(2,408)	(14,071)	3,751	1,520
<b>BASIS ADJUSTMENT:</b>					
Encumbrances	0	0	22,107	0	0
Net Change in Fund Balance (GAAP Basis)	0	0	8,036	0	0
Fund Balance, Beginning of Year	47,297	49,618	47,210 <sup>†</sup>	55,246	58,997
Fund Balance, End of Year	\$49,618	\$47,210	\$55,246	\$58,997	\$60,517

<sup>†</sup> Restated.

Sources: Comprehensive Annual Financial Reports for the Fiscal Years ended June 30, 2004 through 2008.

Table A-8  
**CITY OF STOCKTON**  
**Total Building Permit Valuations†**  
 (\$ in thousands)

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
<u>Permit Valuation</u>					
New Single Family	\$585,834.6	\$532,975.4	\$233,156.2	\$151,268.0	\$43,049.2
New Multiple Family	6,735.1	6,857.5	9,925.8	10,887.0	708.0
Residential Alterations/Additions	<u>14,781.1</u>	<u>20,192.0</u>	<u>18,172.9</u>	<u>15,224.9</u>	<u>13,773.0</u>
TOTAL RESIDENTIAL	\$607,350.9	\$560,024.9	\$261,254.9	\$177,379.9	\$57,530.1
<u>New Commercial</u>	\$59,935.1	\$100,896.4	\$94,168.5	\$151,461.9	\$153,853.4
New Industrial	25,704.5	7,124.3	27,647.5	73,777.8	37,145.9
New Other	28,639.5	28,396.9	27,823.7	73,051.9	13,264.9
Commercial Alterations/Additions	<u>42,698.3</u>	<u>40,874.2</u>	<u>49,685.5</u>	<u>58,239.2</u>	<u>62,446.4</u>
TOTAL NONRESIDENTIAL	\$156,977.4	\$177,291.9	\$199,325.1	\$356,530.8	\$266,710.6
<u>New Dwelling Units</u>					
Single Family	3,138	2,312	929	617	164
Multiple Family	<u>136</u>	<u>83</u>	<u>91</u>	<u>89</u>	<u>8</u>
TOTAL	3,274	2,395	1,020	706	172

† Certain columns may not total due to rounding.  
 Source: Construction Industry Research Board, Building Permit Summary.

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

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# CITY OF STOCKTON

## ADMINISTRATIVE SERVICES

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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 Stockton selected audit firm was appointed as the Interim City Auditor through the duration of the risk assessment and internal control audit.



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 meetings 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**

Month	Fiscal Year		
	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		Traffic Congestion		All	
	Totals	Gas Tax Fund	Relief Fund	Restricted Fund	% of All Restricted Funds	
	Totals	Totals	Totals	Totals	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%
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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 its 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 performing 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**

Month	Fiscal Year		
	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 left 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		Traffic Congestion		All	
	Totals	Gas Tax Fund	Relief Fund	Restricted Fund	% of All Restricted Funds	
	Totals	Totals	Totals	Totals	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%
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**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.

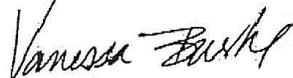
On February 8, 2011, City Council by Resolution No. 11-0030 authorized a transfer from RDA Low and Moderate Income Housing Funds (Low/Mod Funds) for the repayment of the two loans in the amount of \$1,361,531. The actual repayment including principal and interest totaled \$1,261,913.52. The payment was 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](mailto:vanessa.burke@stocktongov.com).



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