

STOCKTON REDEVELOPMENT AGENCY

ASSET TRANSFER REVIEW

Review Report

January 1, 2011, through January 31, 2012



JOHN CHIANG
California State Controller

August 2013



JOHN CHIANG
California State Controller

August 5, 2013

Vanessa Burke, CFO
City of Stockton/Successor Agency
425 North El Dorado
Stockton, CA 95202-1997

Dear Ms. Burke:

Pursuant to Health and Safety (H&S) Code section 34167.5, the State Controller's Office (SCO) reviewed all asset transfers made by the Stockton Redevelopment Agency to the City of Stockton or any other public agency after January 1, 2011. This statutory provision states, "The Legislature hereby finds that a transfer of assets by a redevelopment agency during the period covered in this section is deemed not to be in furtherance of the Community Redevelopment Law and is thereby unauthorized." Therefore, our review included an assessment of whether each asset transfer was allowable and whether the asset should be turned over to the Stockton Redevelopment Successor Agency.

Our review applied to all assets including, but not limited to, real and personal property, cash funds, accounts receivable, deeds of trust and mortgages, contract rights, and rights to payment of any kind. We also reviewed and determined whether any unallowable transfers of assets to the City of Stockton or any other public agencies have been reversed.

Our review found \$1,426,531 in unallowable asset transfers to the City of Stockton (Schedule 1). However, the Successor Agency Oversight Board approved Resolution No. OB 2012-10-10-06 on October 10, 2012, declaring \$65,000 in assets for a governmental purpose. Therefore, no further action is needed regarding these assets (Finding 2).

The outstanding assets totaling \$1,361,531 must be turned over to the Successor Agency for disposition in accordance with H&S Code sections 34177(d) and (e) and 34181.

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

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

JVB/kw

cc: Bob Deis, City Manager
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Asset Transfer Review Report

Summary

The State Controller's Office (SCO) reviewed the asset transfers made by the Stockton Redevelopment Agency (RDA) after January 1, 2011. Our review included, but was not limited to, real and personal property, cash funds, accounts receivable, deeds of trust and mortgages, contract rights, and rights to payments of any kind from any source.

Our review found \$1,426,531 in unallowable asset transfers to the City of Stockton (Schedule 1). However, the Successor Agency Oversight Board approved Resolution No. OB 2012-10-10-06 on October 10, 2012, declaring \$65,000 in assets for a governmental purpose. Therefore, no further action is needed regarding these assets (Finding 2).

The outstanding assets totaling \$1,361,531 must be turned over to the Successor Agency for disposition in accordance with H&S Code sections 34177(d) and (e) and 34181.

Background

In January of 2011, the Governor of the State of California proposed statewide elimination of redevelopment agencies (RDAs) beginning with the fiscal year (FY) 2011-12 State budget. The Governor's proposal was incorporated into Assembly Bill 26 (ABX1 26, Chapter 5, Statutes of 2011, First Extraordinary Session), which was passed by the Legislature, and signed into law by the Governor on June 28, 2011.

ABX1 26 prohibited RDAs from engaging in new business, established mechanisms and timelines for dissolution of the RDAs, and created RDA Successor Agencies to oversee dissolution of the RDAs and redistribution of RDA assets.

A California Supreme Court decision on December 28, 2011 (*California Redevelopment Association et al. v. Matosantos*), upheld ABX1 26 and the Legislature's constitutional authority to dissolve the RDAs.

ABX1 26 was codified in the Health and Safety Code (H&S Code) beginning with section 34161.

In accordance with the requirements of H&S Code section 34167.5, the State Controller is required to review the activities of RDAs, "to determine whether an asset transfer has occurred after January 1, 2011, between the city or county, or city and county that created a redevelopment agency, or any other public agency, and the redevelopment agency," and the date on which the RDA ceases to operate, or January 31, 2012, whichever is earlier.

The SCO has identified transfers of assets that occurred after January 1, 2011, between the Stockton Redevelopment Agency, the City of Stockton, and/or other public agencies. By law, the SCO is required to order that such assets, except those that already had been committed to a third party prior to June 28, 2011, the effective date of ABX1 26, be turned over to the Successor Agency. In addition, the SCO may file a legal order to ensure compliance with this order.

Objectives, Scope, and Methodology

Our review objective was to determine whether asset transfers that occurred after January 1, 2011, and the date upon which the RDA ceased to operate, or January 31, 2012, whichever was earlier, between the city or county, or city and county that created an RDA, or any other public agency, and the RDA, were appropriate.

We performed the following procedures:

- Interviewed Successor Agency personnel to gain an understanding of the Successor Agency operations and procedures.
- Reviewed meeting minutes, resolutions, and ordinances of the Stockton Redevelopment Agency and the City of Stockton.
- Reviewed accounting records relating to the recording of assets.
- Verified the accuracy of the Asset Transfer Assessment Form. This form was sent to all former RDAs to provide a list of all assets transferred between January 1, 2011, and January 31, 2012.
- Reviewed applicable financial reports to verify assets (capital, cash, property, etc.).

Conclusion

Our review found \$1,426,531 in unallowable asset transfers to the City of Stockton (Schedule 1). However, the Successor Agency Oversight Board approved Resolution No. OB 2012-10-10-06 on October 10, 2012, declaring \$65,000 in assets for a governmental purpose. Therefore, no further action is needed regarding these assets (Finding 2).

The outstanding assets totaling \$1,361,531 must be turned over to the Successor Agency for disposition in accordance with H&S Code sections 34177(d) and (e) and 34181.

Details of our findings are in the Findings and Orders of the Controller section of this report.

Views of Responsible Officials

We issued a draft report on June 24, 2013. Vanessa Burke, Chief Financial Officer, responded by a letter dated July 12, 2013, disagreeing with Finding 1 and agreeing with Finding 2. The City's response is 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 as the Successor Agency to the Stockton Redevelopment Agency, the Oversight Board of the Successor Agency, the City of Stockton, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of this report, which is a matter of public record when issued final.

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

August 5, 2013

Findings and Orders of the Controller

FINDING 1— Unallowable low and moderate income housing fund cash transfer to the City

On February 8, 2011, by Resolution No. R11-003, the Stockton Redevelopment Agency (RDA) transferred \$1,361,531 in low and moderate income housing funds to the City of Stockton (City). The City then used the transferred funds to repay two loans to the California Housing Finance Agency (CalHFA). The City entered into the loans with the CalHFA in January 24, 2002, and April 4, 2003.

Because the RDA is not a party to the original agreements with CalHFA, the RDA is not obligated to make the loan payments on behalf of the City; therefore, this is merely a cash transfer from the RDA to the City.

Pursuant to Health and Safety (H&S) Code section 34167.5, any asset transfers by the RDA to a city, county, city and county, or any public agency after January 1, 2011 must be turned over to the Successor Agency for disposition in accordance with H&S Code sections 34117(d).

H&S Code section 34177(d) states that the Successor Agency should forward unencumbered balances of RDA funds to the county auditor-controller, including, but not limited to, the unencumbered balance of the Low and Moderate Income Housing Fund of a former RDA, for distribution to the taxing entities for allocation and distribution in accordance with H&S Code section 34188.

Order of the Controller

Based on H&S Code section 64167.5, the City is ordered to turn over the assets described above to the Successor Agency. The Successor Agency is directed to properly dispose of these assets in accordance with H&S Code sections 34177(d).

City of Stockton's 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".

SCO's Comment

The City disagrees with the finding and stated in their response that \$1,261,913.52 (principal and interest) was made directly from Low/Mod Funds to repay two HELP loans from the California Housing Finance Agency (CalHFA). The City claimed that in loan applications and staff reports, RDA funds, not City funds, were the intended source for repayment for these loans.

However, the City did not provide any evidence that this was an RDA obligation. Also, even if the RDA funds were the intended source, we found that the City paid off the CalHFA loans prior to the maturity dates, which is a violation H&S Code section 34167(a), which states:

This part is intended to preserve, to the maximum extent possible, the revenues and assets of redevelopment agencies so that those assets and revenues that are not needed to pay for enforceable obligations may be used by local governments to fund core governmental services including police and fire protection services and schools. It is the intent of the Legislature that redevelopment agencies take no actions that would further deplete the corpus of the agencies' funds regardless of their original source. All provisions of this part shall be construed as broadly as possible to support this intent and to restrict the expenditure of funds to the fullest extent possible.

Finally, the City is correct that this issue was not discussed at the December 20, 2012 exit interview. However, the auditors made inquiries to City staff regarding this issue in early June 2013, prior to the June 18, 2013 exit conference. In addition, the City was provided an opportunity to respond prior to the issuance of the SCO draft report and after using the 10-day comment period.

The finding remains as stated.

**FINDING 2—
Unallowable
transfer to the City**

On June 7, 2011, the RDA transferred properties for a sanitary pump station, and land known as the Mormon Slough Parkway, by Resolution No. R11-010. The City accepted the transferred properties by Resolution No. 11-0133. In the staff report dated June 7, 2011, the estimated value of the property is between \$59,700 and \$65,000.

Pursuant to H&S Code section 34167.5, any asset transfers by the RDA to a city, county, city and county, or any other local public agency after January 1, 2011, must be turned over to the Successor Agency for disposition in accordance with H&S Code sections 34177(d), (e), and 34181(a).

However it appears that these assets also may be subject to the provisions of H&S Code section 34181(a). H&S Code section 34181(a) states, in part:

The oversight board shall direct the Successor Agency to do all of the following:

- (a) Dispose of all assets and properties of the former redevelopment agency that were funded by tax increment revenues of the dissolved redevelopment agency; provided however, that the oversight board may instead direct the successor agency to transfer ownership of those assets that were constructed and used for a governmental purpose, such as roads, school buildings, parks, and fire stations, to the appropriate public jurisdiction pursuant to any existing agreements related to the construction or use of such an asset . . . [emphasis added]

Order of the Controller

Based on H&S Code section 64167.5, the City would have been ordered to turn over the assets described above to the Successor Agency. The Successor Agency would have been directed to properly dispose of these assets in accordance with H&S Code sections 34177(d), (e), and 34181(a).

However, the Successor Agency Oversight Board approved Resolution No. OB 2012-10-10-06 on October 10, 2012, declaring these assets as for a governmental purpose. Therefore, no further action is needed regarding these assets.

City of Stockton's 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.

SCO's Comment

The City agrees with the finding.

**Schedule 1—
RDA Assets Transferred to
the County of Stockton
January 1, 2011, through January 31, 2012**

Low and Moderate Income Housing Fund Cash	\$ 1,361,531 ¹
Sanitary Pump Station and Land to Update Pump Station	<u>65,000 ²</u>
	<u>\$ 1,426,531</u>

¹ Must be returned to the Successor Agency.

² Not subject to be returned to the Successor Agency.

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



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 Totals	Relief Fund Totals	Restricted Fund Totals	% of All Restricted Funds	
					Gas Tax	TCRF
Jul-08	15,932,712	199,500	27,443	280,237,562	0.071%	0.010%
Aug-08	9,499,858	197,704	(507)	251,844,293	0.079%	0.000%
Sep-08	1,451,377	1,414,918	(43,460)	250,241,603	0.565%	-0.017%
Oct-08	3,380,078	592,754	641,495	239,820,082	0.247%	0.267%
Nov-08	2,320,036	585,628	460,568	224,187,668	0.261%	0.205%
Dec-08	7,211,211	1,381,983	174,928	240,067,960	0.576%	0.073%
Jan-09	9,450,199	536,417	205,974	242,785,314	0.221%	0.085%
Feb-09	22,928,602	536,982	66,248	230,707,210	0.233%	0.029%
Mar-09	19,722,838	537,253	(532,248)	217,117,725	0.247%	-0.245%
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May-11	(2,319,246)	908,890	(142,483)	202,010,258	0.450%	-0.071%
Jun-11	12,977,884	766,167	-	222,920,565	0.344%	0.000%

Finding 5 - Inadequate City Council oversight over contracting

The City of Stockton's Management response:

Management disagrees with the finding.

Fuel Contract:

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

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

Innoprise/HTE:

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

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

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

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

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

Finding 6 - Inadequate City Council oversight over payments

The City of Stockton's Management response:

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

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

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

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

The City of Stockton's Management response:

Management partially agrees with this finding though it is not new news and is related to grants awarded prior to June 2011. We agree improvements need to be implemented in the development and application of indirect costs. We disagree on the lost opportunities. This finding was previously reported in the Memorandum on Internal Control and staff responses for corrective action were provided. We brought this compliance issue to the attention of our audit firm at the beginning of their audit and asked for additional guidance in this area. We are aware of the OMB A-87 requirements and the recovery of indirect costs. The City is working with 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)
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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".

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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%
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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.

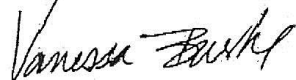
On February 8, 2011, City Council by Resolution No. 11-0030 authorized a transfer from RDA Low and Moderate Income Housing Funds (Low/Mod Funds) for the repayment of the two loans in the amount of \$1,361,531. The actual repayment including principal and interest totaled \$1,261,913.52. The payment was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



VANESSA BURKE
CHIEF FINANCIAL OFFICER

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