

CITY OF HERCULES

Review Report

ADMINISTRATIVE AND INTERNAL ACCOUNTING CONTROLS

July 1, 2009, through June 30, 2010



JOHN CHIANG
California State Controller

September 2012



JOHN CHIANG
California State Controller

September 12, 2012

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

Dear Mr. Romero:

Enclosed is the report of the State Controller's Office (SCO) review of the City of Hercules' 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 that control deficiencies were serious and pervasive—in effect, non-existent. In addition, the City Council did not appear to exercise any oversight over the city's operations and financial activities. From January 1, 2007, through December 31, 2010, the City Council adopted 40 ordinances, 679 city resolutions, and 360 Hercules Redevelopment Agency (RDA) resolutions. With the exception of one city ordinance, every ordinance, city resolution, and RDA resolution was adopted unanimously with little or no deliberation. In essence, the City Council approved all requests submitted by the former City Manager without question.

We also found that the former City Manager was given broad authority to enter into contracts and authorize disbursements for the city and the RDA. In addition, the city often ignored its competitive bid requirements and had inadequate conflict of interest or nepotism policies. As a result, the potential for waste, abuse, and possible misappropriation of public funds is very high.

We also assessed various aspects of the city's internal controls components and elements in accordance with standards adopted by the American Institute of Certified Public Accountants. Of the 74 control elements evaluated pertaining to internal control components, we found only seven (9%) that were considered adequate. In the overarching components under control environment for integrity and ethical value, commitment to competence, and management and operating style, we found none of the 16 control elements to be adequate. The results of our review and evaluation of elements of internal control are included in this report as an Appendix.

During our fieldwork phase of this review, we encountered considerable difficulties in obtaining sufficient and competent information from the city. The city's Finance Department was downsized from a total of nine to four employees in recent years because of budgetary constraints. When we commenced our review, only one staff member in the Finance Department had worked at the city for more than one year and that individual resigned shortly after our review began. The Finance Department staff members often either ignored our requests for documentation or provided only a fraction of the requested documentation. Our requests for meetings were not honored and, even after meetings had been scheduled, city staff members often failed to attend the meetings. The lack of cooperation unreasonably delayed the completion of our review.

The above findings and lack of access to critical documentation and information were discussed with the City of Hercules management on April 19, 2012, and again on May 29, 2012. Our office provided the city with a further opportunity to gather available documentation. After these meetings, the city's current management agreed to conduct a more thorough search and made it a priority to dedicate more staff time to provide us with additional documents and information as requested.

On June 26, 2012, the city provided our office with all of the documentation and information that they were able to locate and admitted that some of the requested items were not available. While we made some adjustments based on the additional documentation, the substance of the findings essentially remains unchanged.

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

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

JVB/sk

cc: John Delgado
Vice Mayor of the City of Hercules
Myrna de Vera, Council Member
Hercules City Council
Gerald Boulanger, Council Member
Hercules City Council
William Wilkins, Council Member
Hercules City Council
Steven Duran, City Manager
City of Hercules
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Review Report

Introduction

The State Controller's Office (SCO) reviewed the City of Hercules' system of administrative and internal accounting controls for the period of July 1, 2009, through June 30, 2010 (Fiscal Year (FY) 2009-10). As necessary, we expanded our testing to include 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 August 19, 2011, the SCO notified the Interim City Manager, Liz Warmerdam, that the City of Hercules and the Hercules Redevelopment Agency (RDA) have not complied with state law regarding the submittal of annual reports and independent audits, as follows:

- **City of Hercules' Financial Transactions Report for Fiscal Year 2009-10**

Negative amounts of \$11.8 million, \$3.3 million, \$14.2 million, and \$8.5 million of other liabilities are included in the General, Special Revenue, Debt Service, and Enterprise Funds, respectively. Generally, liabilities are presented as positive amounts in the liabilities and fund balance section of a city's financial statements.

- **City of Hercules' Financial Transactions Report for Fiscal Year 2008-09**

Several material entries raise questions about the accuracy and reasonableness of information provided in this report:

- A prior period adjustment to the Retained Earnings in the amount of \$13.7 million was made to the Operating Revenue for Sewer Activity/Enterprise.
- Negative amounts of \$13 million, \$11.9 million, and \$9.6 million of other liabilities are included in the General, Debt Service, and Enterprise Funds, respectively. As noted above, generally, liabilities are presented as positive amounts in the liabilities and fund balance section of a city's financial statements.
- Prior period adjustments for advances in the amount of \$25.7 million are included in the Consolidated Statement of Revenues, Expenditures, and Changes in Fund Balance.

- **Hercules Redevelopment Agency's Financial Transactions Report for Fiscal Year 2009-10**

For the RDA's projects—Hercules Dynamite and Hercules Project 2—no payments were noted in the report relative to its pass-through obligations for FY 2000-01 through FY 2002-03.

We also reviewed the independent audits of the city and financial audits of the RDA, and noted the following regarding the RDA:

- **City of Hercules' Independent Audit Report for Fiscal Year 2009-10**

The city's Independent Audit Report (single audit) was submitted late and was incomplete. The report was required to be submitted by March 31, 2011, but we received nothing until July 28, 2011, when a portion of the single audit was provided. The complete report, including a Management Letter issued by the audit firm, was not received until August 15, 2011. The portion of the report that was submitted on July 28, 2011, and the Management Letter, indicated that there were 23 findings of significant deficiencies in both financial reporting and compliance. Failure to submit a complete audit report on time requires the SCO to notify State agencies that provide the city with federal funds so they may take appropriate actions, including withholding funding.

We also reviewed the FY 2007-08 Independent Audit Report (the city claimed an exemption from the single audit requirement in FY 2008-09) which identified significant deficiencies in the city's internal controls over financial reporting. The audit firm that prepared the FY 2009-10 report did not comment on the findings in the FY 2007-08 report, so we are unable to determine whether they have been corrected in the two years since they were identified.

- **Hercules Redevelopment Agency's Audited Financial Statement for Fiscal Year 2009-10**

The report identified the following issues:

- The report indicated that the Hercules RDA has a "going concern" issue. The factors cited to support this conclusion included: (1) the RDA had suffered a net asset deficit of \$48 million; (2) the Operating Special Revenue Fund and Affordable Housing Special Revenue Fund had deficits of \$8 million and \$2 million, respectively; and (3) the RDA's tax increment revenue was insufficient to pay the current year's debt service.
- The RDA's prior Five-Year Implementation Plan expired on December 31, 2009, and the RDA failed to adopt a new plan within the statutory time limit. Pursuant to Health and Safety Code section 33490, the agency is required to adopt a new implementation plan every five years.

Based on the results of our reviews presented above, we have serious concerns about the reliability and accuracy of the information in the annual financial transactions reports for the city and the RDA, particularly in light of the following additional information about the city's and RDA's financial practices:

- The Hercules Police Department initiated an investigation into city operations concerning deleted files/information.

- In June 2011, the Contra Costa County Grand Jury issued a report entitled *Hercules in Transition* (Report 1110), which urges the City Council to “come together immediately to address several pressing issues” (i.e., the city’s deteriorating finances). At City Council meetings, it has been reported that expenses have exceeded revenues for the past six years, a total of \$6.6 million, and that the city has used bond funding to make up the difference. In addition, the city has been working to reduce a \$5.3 million projected deficit, of which \$1.5 million is related to RDA debt services that the city will need to pay.
- In 2010, the Contra Costa County Grand Jury issued a report entitled *The Crumbling Pillars of Hercules* (Report 1013) which described the appearance of impropriety and/or lack of transparency in the city’s operation of its housing and business loan program(s).
- The Interim City Manager’s Weekly Report dated December 3, 2010, identified several financial issues, specifically, the RDA’s ability to pay its maturing obligation for bond payments and insufficient general fund revenues to continue municipal services.

After considering the above information, the SCO concluded that there is reason to believe that the Annual Report of Financial Transactions submitted by the city and the RDA is false, incomplete, or incorrect. 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 also 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, we also reviewed prior period transactions as necessary.

This report presents the results of findings and conclusions reached in our review of the city’s administrative and internal accounting controls system.

Separate reports were issued for our audit of the Special Gas Tax Street Improvement Fund and reviews of the Hercules Redevelopment Agency, and the City of Hercules state and federal expenditures.

Background

The City of Hercules is located in Contra Costa County, California. The city covers a total area of 18.2 square miles along southeast shore of San Pablo Bay. The city has a population of 24,060 according to the 2010 U.S. Census.

Objective, Scope, and Methodology

The objective of this review was to evaluate the City of Hercules' 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 safeguarding 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 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; and
- Assessed various aspects of the city's internal control components and elements in accordance with guidelines adopted by the American Institute of Certified Public Accountants.

Conclusion

We found the City of Hercules' administrative and internal accounting control deficiencies to be serious and pervasive; in effect, non-existent. We noted there was no oversight by the City Council over the city's financial and operational activities. From January 1, 2007, through December 31, 2010, the City Council adopted 40 ordinances, 679 city resolutions, and 360 Redevelopment Agency resolutions. With the exception of one city ordinance, every ordinance, city resolution, and RDA resolution was adopted unanimously. In essence, the City Council approved all requests submitted by the former City Manager. The former City Manager was given broad authority to enter into contracts and authorized disbursements for the city and the RDA. In addition, the city often ignored its competitive bid policy and had inadequate conflict of interest and nepotism policies. As a result, the potential for waste, abuse, and misappropriation of public funds is very high.

As part of our review, we made an assessment of various aspects of the city's internal control components and elements in accordance with standards adopted by the American Institute of Certified Public Accountants. Of the 74 elements evaluated pertaining to internal control components, we found only seven (9%) where controls were considered to be adequate. The results of our review and evaluation of elements of internal control are included in this report as the Appendix.

During our fieldwork phase of this review, we encountered considerable difficulties in obtaining sufficient and competent information from the city. The city's Finance Department was downsized from a total of nine to four employees in recent years because of budgetary constraints. When we commenced our review, only one staff member in the Finance Department had worked at the city for more than one year and that individual resigned shortly after our review began. The Finance Department staff members often either ignored our requests for documentation or provided only a fraction of the requested documentation. Our requests for meetings were not honored and, even after meetings had been scheduled, city staff members often failed to attend the meetings. The lack of cooperation unreasonably delayed the completion of our review.

After the completion of our fieldwork in April 2012, we met with the Hercules' City Manager, the Assistant City Manager, and the Director of Finance on May 29, 2012 to discuss our preliminary findings that were derived based on the limited amount of information and documentation that was provided to us. A decision was made to provide the city staff with a further opportunity to gather available documentation. It was agreed that city staff would conduct another search and provide available documents to us by June 25, 2012. On June 26, 2012, we again met with city officials, who were able to locate additional documentation. While we made some adjustments based on the additional documentation, the substance of the findings essentially remains unchanged.

The city should develop a comprehensive remedial plan to address these deficiencies. The plan should identify the tasks to be performed, and milestones and timelines for completion. The City Council should require that periodic updates of the progress in implementing the remedial plan be reported in public meetings.

**Views of
Responsible
Official**

We issued a draft review report on August 10, 2012. Steven Duran, City Manager, responded by a letter dated August 20, 2012. The city did not dispute the findings and is in the process of implementing most of our recommendations. 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 Hercules, 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
Chief, Division of Audits

September 12, 2012

Findings and Recommendations

Results of Analysis of City's Administrative and Internal Control System

We found the City of Hercules' administrative and internal accounting control deficiencies to be serious and pervasive—in effect, non-existent. We noted lack of oversight by the City Council over the city's financial and operational activities. From January 1, 2007, through December 31, 2010, with the exception of one city ordinance, every ordinance, city resolution, and RDA resolution was adopted unanimously. In essence, the City Council approved all requests submitted by the former City Manager. The former City Manager was given broad authority to enter into contracts and authorized disbursements for the city and the RDA. In addition, the city often ignored its competitive bid requirements and had inadequate conflict of interest and nepotism policies. As a result, the potential for waste, abuse, and misappropriation of public funds was, and is, very high.

We also assessed various aspects of the city's internal control components and elements in accordance with standards adopted by the American Institute of Certified Public Accountants. Of the 74 control elements evaluated pertaining to internal control components, we found only 7 (9%) that were considered adequate. In the overarching components under control environment for integrity and ethical value, commitment to competence, and management and operating style, we found none of the 16 control elements to be adequate.

While there are specific recommendations to address the findings described below, from a broader perspective, we recommend that the city develop a comprehensive remedial plan to address the deficiencies noted in the Appendix. The plan should identify the tasks to be performed, and milestones and timelines 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 Council failed to exercise oversight over the city's financial and operational activities.

From January 1, 2007, through December 31, 2010, the City Council adopted 40 ordinances, 679 city resolutions, and 360 RDA resolutions. With the exception of one city ordinance, every ordinance, city resolution, and RDA resolution was adopted unanimously. Only Ordinance No. 452, which increased the monthly salary of council members, was enacted with one dissenting vote.

On July 14, 2009, the City Council adopted Ordinance No. 452 that increased the monthly salary of council members from \$792 to \$831.60. In addition, each council member continued to receive \$30 for each meeting of the RDA, which was held in conjunction with the bi-weekly City Council meetings. On average, the City Council/RDA meetings last approximately 90 minutes.

Our review of the meeting minutes found no analysis, discussion, or deliberation of any of the resolutions presented to the City Council for approval. From January 1, 2007, through December 31, 2010, with the exception of one city ordinance, every ordinance, city resolution, and RDA resolution was adopted unanimously. In essence, the City Council approved all requests submitted by the former City Manager without question or scrutiny. Many of the ordinances and resolutions contained significant fiscal and control implications. For example, the former City Manager submitted resolutions 09-088 and 10-089 for the City's Budget Plans for FY 2009-10 and FY 2010-11 totaling \$43.89 million and \$61.9 million, respectively. Both measures were adopted unanimously by the City Council without any discussion. Later, an interim City Manager reviewed the budget plans and found material flaws and inaccuracies including:

- The city's General Fund revenue estimate of \$25.6 million in the FY 2010-11 budget was overstated by about \$12 million.
- The city's redevelopment revenues were insufficient to make bond payments.
- The city was making payments from the RDA funds in excess of available funds, which resulted in negative fund balances.

The magnitude and the severity of the above discrepancies demonstrate that the City Council was not exercising sufficient oversight in the city's fiscal affairs. Moreover, the City Council granted the former City Manager broad authority to enter into contracts and authorize disbursements for the city and the RDA. We found numerous contracts that were executed without competitive bid and, in one case, the contract process was circumvented through issuance of purchase orders. In addition, the city's conflict of interest policy, which only applies to a few individuals, is insufficient, and its nepotism policy is very limited. A comprehensive policy on nepotism apparently has been developed, but had not yet been adopted by the City Council as of June 8, 2012.

As a result of insufficient oversight by the City Council and inadequate policies and procedures to control spending, we identified numerous contracts and transactions that, at least in appearance, raised questions about potential conflicts of interest and favoritism.

NEO Consulting, Inc./Affordable Housing Solutions Group (NEO/AHSG)—2003 through December 2010

The first contract between the city and NEO/AHSG was executed in 2003. City staff asserted that the first contract went through an informal competitive bid process and NEO/AHSG was the only company that submitted a proposal. The City Council Agenda document provided to us by the city was referring to the Montebello Housing Development Corporation, not to NEO/AHSG. Moreover, city staff could not produce any documentation to show that the contract was competitively bid. All subsequent contracts and amendments to extend the terms and increase the contract amounts were made without competitive bid or any other process to provide objective evaluation of the contractor's performance. The principal and owner of NEO/AHSG was the city's Assistant City Manager prior to his appointment as City Manager/RDA Executive Director in April 2007. From April 2007 through December 2010, the city/RDA paid more than \$3 million to NEO/AHSG through various funding sources.

Municipal Management Enterprises (MME)—November 25, 2008, through June 30, 2010

For the period of November 25, 2008, through June 30, 2010, the City Council authorized a total of \$166,000 in monthly installment payments of \$8,300 to MME, a company owned by an individual who retired as the Hercules City Manager in April 2007. Further, there is no evidence or documentation as to what services, if any, MME actually performed because the billing invoices merely identified that payments were for professional services. In addition, the city used purchase orders to make payments for the professional services contract. This does not constitute good accounting practice because purchase orders are not normally used to pay for professional services due under contract provisions, and circumvents the city's contract process.

Physcle Pair-A-Dimes, LLC—June 2003 through December 2010

The city approved a series of resolutions (Resolution No. 03-071, No. 04-054, No. 05-073, No. 06-080, No. 07-082 and No. 08-81) to execute contracts with this company for professional services. From records that were available for our review, we determined that the city paid this company a total of \$950,558 for financial services provided from June 2003 through July 2009, at billing rates that ranged from \$60 per hour in 2003 to \$90 per hour in 2009. This company was owned by an individual who was the Interim Finance Director/Treasurer for the city from December 2, 2002 to June 15, 2003. It is unclear as to what services the consultant was to provide as the "Consulting Services Agreement" states that "The City and Consultant agree that it is difficult to specify each and every specific Service the Consultant will be asked to perform during the term of this Agreement." A review of invoices shows only hours charged with no description as to what services this company performed for the city. It was suggested that the individual actually served as the Finance Director/Treasurer during the entire contract period. If that is indeed the case, the contractor should have been classified as an employee of the city.

Independent Contractor—April 24, 2006, through June 30, 2008, and May 2009 through June 30, 2010

The City Council approved a series of resolutions (Resolution No. 06-056, No. 07-083, No. 08-012 No. 08-025, No. 09-053, and No. 09-073) to execute contract agreements with an individual to provide consulting services related to the RDA and other city services from April 2006 through June 30, 2010. Payments to this individual totaled \$277,112 based on hourly rates that ranged from \$65 in 2006 to \$75 in 2010. Pursuant to a review by CalPERS' Office of Audit Services, this individual was misclassified as an independent contractor and should have been classified as an employee of the city. The same individual entered into an "Employment Agreement" with the city effective July 1, 2011 to serve as the Interim City Manager while the city was recruiting for a permanent City Manager. The individual became the Assistant City Manager when the permanent City Manager was appointed on October 10, 2011.

Former City Manager/RDA Executive Director's Compensation—April 15, 2007, through June 30, 2009

Although the city was encountering severe financial difficulties, the City Council approved increases in the former City Manager/RDA Executive Director's compensation by more than 45% over a period of less than three years. The starting salary was \$185,000 on April 15, 2007, and increased to \$225,000 plus a bonus of \$40,000 and a car allowance of \$4,322 for total compensation of \$269,322 by July 1, 2009. It is not clear what criteria was used to determine the pay raises because the city did not provide us with any documentation such as personnel records, council meeting minutes, performance evaluations, etc., to justify the compensation package and/or the salary increases.

Recommendation

The City Council should fulfill its fiduciary responsibility by engaging in meaningful oversight over the city's affairs and by developing policies and procedures to ensure that city staff members have sufficient direction regarding city expenditures and management of contracts.

In addition, the city should conduct a review of the above contracts to ensure that the contractors provided appropriate services and seek recoupment where appropriate.

City's Response

The City of Hercules has undergone structural changes resulting in improved financial oversight and administration:

- a. Two City Council seats were changed in the November 2010 election.
- b. [The] Mayor resigned in January 2011; [two] Council Members were recalled in June 2011. Three new Council Members were elected in June 2011.
- c. [The] City Attorney was hired in September 2011.

- d. City Manager was hired in October 2011.
- e. A new Consultant Project Manager for the Hercules Intermodal Transit Center Project. . . , was hired in November 2011.
- f. [A consulting company] was retained by the City in December 2011 to help coordinate. . . and focus the implementation aspects of the ITC Project funding and the related State and Federal requirements for project delivery.
- g. [The] City Finance Director was hired in March 2012.

The new City Council together with the Community, formed two key Ad Hoc Committees: Citizens Legal Issue Ad Hoc Committee and the Citizens Finance Ad Hoc Committee. These two committees reflect a deep seated civic desire to improve the quality and transparency of City Government by defining policies designed to direct city employees as well as elected and appointed officials regarding proper related practices.

The new City Council on June 19, 2012 adopted a Nepotism and Cronyism policy, via Resolution proposed by the Citizens Legal Issue Ad Hoc Committee.

The new City Council and staff will continue to update and improve policies and procedures.

SCO's Comments

The City did not dispute this finding. The city has started to implement our recommendations and is taking steps to improve oversight of its financial and operational activities. Although the city is moving forward, it still needs to review the contracts cited in the finding and ensure that these services were appropriately provided.

FINDING 2—
The city’s contracts with school principals were vague regarding scope of services and whether services were necessary.

During the period of November 1, 2006, through June 30, 2010, the city entered into four different contract agreements for professional services with four principals of schools within the city. In total, \$197,500 was paid by the city to the four school principals during which time they continued to receive their full salaries. The contract dated November 1, 2007, required the consultant (the high school principal for the Hercules Middle/High School) to provide the following professional services:

1. Serve as the staff liaison to the Hercules Education Commission and attend Hercules Education Commission’ meetings as requested;
2. Work with the city to expand the utilization of facilities at the Hercules Middle/High School for recreational programs for the City of Hercules;
3. Provide assistance and consulting services to the City of Hercules SPOT program to enhance the programs;
4. Meet with members of the City of Hercules Education sub-committee to discuss educational issues of the city, more specifically, the Middle/High School;
5. Attend quarterly meetings of the Hercules Education sub-committees, and meet with principals of other elementary schools in Hercules, representatives of the Hercules Education Commission, representatives of the Office of the City Manager and the Police Chief; and
6. Meet with the principals of the schools in Hercules to provide support and to report issues to the Office of the City Manager.

Subsequently, the city entered into three additional contracts, one dated January 1, 2008, and two dated November 1, 2008, requiring three principals of other schools in Hercules to provide essentially the same consulting services as stated above, except for item number 2.

The following table provides a summary of payments made to the four school principals paid in the form of a monthly retainer in fixed amounts:

<u>School Principal</u>	<u>Total Received</u>
Hercules Middle/High School	\$ 110,000
Ohlone Elementary School	33,750
Lupine Hills Elementary School	33,750
Hanna Ranch Elementary School	<u>20,000</u>
Total	<u>\$ 197,500</u>

It is unclear as to how these contracts benefitted the city or what services the consultants actually provided. The services described above are vague and some of the services, such as “meet with other school principals,” seem to be what a school principal would do as part of the regular duties for which he/she already was being paid. In addition, even though the Hercules Education Commission became dormant after June 8, 2008, the two contracts executed on November 1, 2008, still were required as part of contract item number 5 (to attend Commission meetings).

At our request, city staff provided the invoices of each of the school principals requesting payments under their contracts. Most of the invoices merely requested monthly payments of \$2,500 for the Hercules Middle/High School Principal and \$1,250 for the elementary school principals without any indication as to what services, if any, had been provided. The middle/high and elementary school principals were receiving more than \$9,000 and \$7,650 respectively in monthly salaries. For invoices that included a description of activities performed, we found some of the activities within the scope of the normal duties of the principals. For example, on the June 2010 invoice, the Principal of Lupine Hills Elementary School billed for activities such as "Reclassification ceremony for Lupine Hills English Learner Students," and for "grade promotional ceremony, last day of students at school." On the same invoice, the principal also listed "Phone banking to promote yes on Measure D to help support new Science lab and theater for Hercules Middle High." It is not appropriate for the city to pay an individual for engaging in political activities.

Recommendation

The city should develop and implement policies and procedures to ensure that responsible city officials perform a detailed review and gain full understanding of the professional services to be provided before entering into an agreement. Agreements should be presented to the city council with full explanation of the services to be provided and benefits to the city prior to approval and before formal execution. The contracts should specify services to be delivered and such services need to be definitive and measurable. Finally, proper oversight should be made to ensure that services are delivered as required.

In addition, the city should notify the school districts about these specific contracts and request that the districts provide an explanation of how the services under these contracts differed from services the principals perform as a part of their normal duties.

City's Response

On June 5, 2012, the City of Hercules has updated its Purchasing Guidelines and will continue to enhance these guidelines. The Purchasing Guidelines state that the City Council shall approve all contracts in excess of \$20,000. This includes all expenditures that have been appropriated through the budget process. The Purchasing Guidelines also include a bidding procedure:

- a) Supplies or equipment that exceeds \$1,000 will require telephone quotes or informal bids from a minimum of three vendors.
- b) Supplies or equipment that exceeds \$10,000 shall require a competitive bid process.

Contracts shall be awarded by the City Council if over \$20,000, and by the City Manager up to \$20,000, to the lowest responsive bidder except as otherwise provided in this section. However, if a Public Works project is planned to use or using State or Federal funds, then the City Council must approve contracts over \$5,000.

Although the above is only an excerpt from the City of Hercules Purchasing Guidelines, the City of Hercules has implemented policies and procedure to ensure that responsible city officials perform a detailed review and have full understanding of the services to be provided before entering into an agreement.

SCO's Comments

The City did not dispute this finding. The City has updated its purchasing guidelines and has implemented policies and procedures to ensure that city officials have an adequate understanding of contracts and agreements before they are entered into. However, the city did not respond to whether it notified school districts about services provided by school principals and how these services differ from services ordinarily performed by school principals as part of their regular duties. We continue to recommend that the City notify the school districts about those specific contracts and to request that districts provide an explanation of how the services under these contracts differ from services the principals perform as a part of their regular duties.

FINDING 3—
The city exercised inadequate control over expenses charged to city-issued credit cards.

From July 1, 2009, through June 30, 2010, city employees and City Council members charged a total of \$254,101 in expenses on city-issued credit cards. According to the city's Credit Card Usage Administrative Policy #26, the "City-issued credit cards are to be used exclusively for direct and legitimate City activities" and are "primarily intended to be used for small purchases, business meals and authorized travel expenses."

The city does not have a formal written travel policy. After making repeated requests, we were provided with a "Personnel Office Memorandum" that apparently was released in 2007 to provide guidelines to city officials and employees until a formal policy could be adopted. The memorandum appears to be advisory in nature, such as the language "we desire our employees to adhere to rate maximum \$55 dollars per day with the exception of those cities that are in high-priced locations. . . ."

Our review found that many of the charges, particularly those incurred by the former City Manager/RDA Executive Director and some city council members, are questionable. None of the current city officials or employees could provide an explanation or rationale for the charges. Specifically, we found that:

- There were numerous examples of city officials incurring more than \$55 per day for meal expenses. Most of these excessive charges appear to have been incurred by the former City Manager/RDA Executive Director and City Council members. For example, the former City Manager/RDA Executive Director incurred meal charges of \$154.44 on March 11, 2010, and \$90.51 on March 12, 2010, while attending a conference in Pasadena, California. The \$154.44 charged on March 11, 2010, supposedly was for three individuals, two of whom were not city employees, and thus should not have been charged against the city. Another example is a City Council member who incurred \$109.09 for three meals while attending a conference in San Antonio, Texas on November 11, 2009. It is unclear as to whether the \$55 daily maximum is enforceable in the absence of a formal policy. However, the fact that the elected officials and top managers repeatedly ignored guidelines shows a lack of fiscal control, accountability, and integrity.
- The purposes of some expenses are unclear and undocumented. For example, on June 30, 2009, a City Council member charged \$303 for a one-night stay at the Resort at Squaw Creek in Olympic Valley, California, without identifying why the expense was necessary. In addition, the former City Manager/RDA Executive Director used his city-issued credit card for expenses related to 18 trips in FY 2009-10. There was no documentation as to the purpose for nine of the trips. Some of the trips were to resorts such as:
 - The Renaissance Esmeralda Indian Wells Resorts and Spa in Indian Wells, California, from November 4, 2009, to November 6, 2009, at a cost of \$99 per night plus applicable taxes. The former City Manager/RDA Executive Director also charged a resort fee of \$40 and ordered in-room movie that cost \$14.99.

- The Mission Inn Hotel and Spa in Riverside, California, from December 6, 2009, to December 7, 2009, at \$239 per night.
- Other examples of undocumented trips and related expenses include:
 - During another trip from March 11, 2010, to March 12, 2010, to attend the CRA conference in Pasadena, California, the former City Manager/RDA Executive Director charged \$59.58 for breakfast for two individuals and \$154.44 for dinner for three individuals without any explanation or documentation as to why such expenses were necessary.
 - In another case, on September 16, 2009, the former City Manager/RDA Executive Director made a one-day trip to Burbank, California. Even though he returned on the same day, he charged hotel expenses for two hotels in the same evening of September 16, 2009—one in Burbank, California, for \$95.69 and another one in San Jose, California, for \$170.00 per night plus movie rental for \$13.99. No explanation was given as to why he needed two hotel rooms in two different cities on the same night for a one-day trip.
- Some of the expenses appeared to be higher than necessary, suggesting a lack of concern over fiscal constraint when using public funds. We found that the former City Manager/RDA Executive Director, in many instances, paid regular hotel rates when much lower government rates were available. Examples include:
 - From May 13, 2010, to May 16, 2010, the former City Manager/RDA Executive Director attended a seminar at the Renaissance Esmeralda Resort and Spa in Indian Wells and charged \$821 for a three-night stay that ranged from \$199 to \$299 per night. The government rate was \$84 per night for that hotel.
 - In the aforementioned trip to the Mission Inn Hotel and Spa in Riverside, from December 6, 2009, to December 7, 2009, the former City Manager/RDA Executive Director paid \$239 for the room when the government rate was \$133.

In both instances, as well as other instances concerning lodging expenses, there was no indication that the former City Manager/RDA Executive Director even considered using government rates.

- The city has no policy governing business meals, which increased the potential for possible abuse. During FY 2009-10, city employees and City Council members charged a total of \$11,787 to various restaurants within the city as well as outside of the city. Some of the charges apparently were for Council Members' dinners during council meetings, staff meetings, and business lunches. No reasons were provided for many of the charges. We found that some of the charges appear to be unreasonable or excessive. Some examples include:

- An employee from the Planning Department charged \$787 for what appears to be a Planning Commission lunch for 16 individuals at a restaurant in Berkeley, California. The expense was approved by the former City Manager/RDA Executive Director.
- A former Vice Mayor charged \$495 for a luncheon for 21 individuals at a restaurant in Sacramento, California. The purpose of the luncheon is unclear and the expense was approved by the former City Manager/RDA Executive Director.

Recommendation

The city should implement appropriate control measures to ensure proper review of travel expenses (including meals) and credit card charges. We further recommend that the city establish a travel policy which sets limits on lodging rates, meals, and other travel expenses.

The city should adopt a policy governing circumstances for which business meals are authorized and prescribe the maximum amount allowable for business meals.

With regard to the examples above, the city should review them and determine whether the individuals should be required to refund unallowable charges. The city also should consider performing a review of travel and meal expenses of other city employees for the period of our review to determine whether additional refunds should be sought.

City's Response

The City of Hercules currently has a Professional Memberships, Meetings, Expense Report Policy (this policy includes the travel policy) and a Credit Card Usage Policy. The City of Hercules is in the process of updating and improving these policies. The updates will include limits on lodging rates, meals, and other travel expenses.

SCO's Comments

The City did not dispute this finding. The City is in the process of implementing our recommendations except for reviewing prior questionable expenses cited in the Finding and requesting refunds for unallowable charges. We continue to recommend that the City review expenses charged to the city issued credit cards and determine whether the individuals should be required to refund unallowable charges. The city also should consider performing a review of travel and meal expenses of other city employees for the period of our review to determine whether additional refunds should be sought.

FINDING 4—
The city lacked proper approval for real property purchases.

During the period of July 2007 through August 2009, the city used RDA bond funds to purchase five real estate properties in the amount of \$44,119,638. The properties were to be used for redevelopment purposes. In order to use RDA bond funds, the RDA governing board must adopt a resolution authorizing and justifying the purchase. There is no evidence that the City Council or the RDA governing board had adopted such resolutions for four out of the five property purchases. Furthermore, for three of the five properties, there is no evidence that independent appraisals had taken place to establish the legitimacy and reasonableness of the amounts paid for these properties. Without an independent appraisal, the potential for abuse is very high. Due to lack of proper approval and in the absence of appraisals and other documentation to support the purchase amounts, the legality of \$32,769,638 in properties purchased through the use of RDA bond funds is questionable.

Moreover, in the absence of documentation to identify the purpose of the purchases, it is unclear as to whether any of the purchases are of any benefit to the project areas. This issue also is discussed under Finding 4 of the SCO's review report of the Hercules Redevelopment Agency.

Recommendation

The SCO currently is developing a review program to ensure proper transfer of RDA assets to the successor agency in accordance with ABX1 26, which dissolved all redevelopment agencies in California. We will further examine this issue to ensure proper transfer and disposition of assets acquired through RDA funds.

City's Response

The purpose of the property purchase(s) are for economic development that are included in the Central Hercules Plan, the Implementation Plan and the zoning of the parcels for residential, retail and mixed use. The Central Hercules Plan is located on the city website: City of Hercules www.ci.hercules.ca.us; click on Departments and Services; click on Planning; double click on Central Hercules Plan. The Implementation plan is located on the city website: ww.ci.hercules.ca.us; click on Departments and Services; click on Redevelopment; double click on Implementation Plan. The State Controller's Office - Division of Audits is currently conducting the Asset Transfer Review of all redevelopment assets transferred to the successor agency for the City of Hercules former Redevelopment Agency in the month of August 2012.

SCO's Comments

The City did not dispute this finding. The SCO currently is in the process of completing a review of assets transferred from the former Hercules Redevelopment Agency.

FINDING 5—
Related-party transactions existed between the City of Hercules and the Hercules Redevelopment Agency.

During our review of the City Council/Redevelopment Agency meeting minutes and resolutions, we noted instances of transfers/sale of property from the RDA to the city. These transfers/sales were unanimously approved by the City Council by resolution and are as follows:

- City Resolution No. 08-162, dated November 25, 2008, authorized the city to purchase a property (203-295 Linus Pauling Drive, Hercules, California) owned by the Hercules Redevelopment Agency (RDA) for an amount not to exceed \$1. This property was acquired by the Redevelopment Agency for a total cost of \$15,049,884 (purchase price of \$13,449,884 plus \$1,600,000 for acquisition, closing, and improvement costs). See Finding 4.
- City Resolution No. 11-027, dated March 8, 2011, authorized the transfer of four real properties owned by the RDA to the city. These properties were valued at \$33,684,180, the total amount paid by the RDA. The city council accepted conveyance of the properties from the RDA as payment for debt owed under the Reimbursement Agreement, dated January 13, 2009, between the city and the RDA. According to the Reimbursement Agreement, the total combined outstanding indebtedness due the city by the RDA as of January 13, 2009, was \$34,917,736.
- City Resolution No. 11-037, dated March 22, 2011, authorized the City Manager to execute a lease agreement with Oak Harbor Freight Lines, Inc. for city-owned property (Yellow Freight Trucking Yard) located at 3001 Franklin Canyon Road, Rodeo, California. Under this lease agreement, the city will receive a net lease payment of \$12,000 per month for three years with the option of two additional years (total of up to five years). It was included in the properties transferred under City Resolution No. 11-027. Based on the documentation subsequently provided by the City, we could not determine the reasonableness of the transfer, which further led us to question the lack of accountability between the city and the RDA.

Based on the above related-party transactions, it appears that the City Council, which also functioned as the RDA governing board, transferred RDA assets to the city to subsidize the city's financial operations. There is no evidence that appraisals were performed on all properties to establish the reasonableness of the value assigned to the transferred property. These related-party transactions between the city and the RDA are questionable as they were not arm's-length transactions, and lacked appraisals to determine current property values.

Recommendation

The city should establish a policy that all related-party transactions between the city and other entities will be conducted at arm's length, and on terms generally available to other unaffiliated third-parties under the same or similar circumstances.

City's Response

The City of Hercules will establish a policy that all related-party transactions between the city and other entities will be conducted at arm's length, and on terms generally available to other unaffiliated third-parties under the same or similar circumstances.

SCO's Comments

The City did not dispute this finding. The City is in the process of implementing the SCO's recommendation.

**FINDING 6—
The city had unrecorded
budget adjustments,
revised revenue
estimates, and financing
sources.**

Our review of the very limited documents that were provided to us showed the city had not recorded budget expenditure appropriation adjustments, revised revenue estimates or other financing sources, and uses of budget items authorized by the City Council to its financial system. Without the assurance that budget amendments are timely recorded to the financial accounting system, there is high probability that expenditures may exceed budgeted amounts without management's knowledge. Moreover, it may result in significant misstatement of the accounting records and financial reports. From a control standpoint, this is a significant deficiency of the city's administrative and internal accounting control system.

Our review of an "Error and Warning Detail Report" generated by the city's computerized payroll system (SunGard HTE system) found that the two weekly payroll periods ending August 28, 2009, and September 25, 2009, exceeded the account budgeted amounts by \$24,046 and \$26,756, respectively. No action was taken to resolve the apparent discrepancies. Based upon our inquiry with city staff, we were informed that these errors will not be addressed until the end of the fiscal year, which is unacceptable from a control standpoint. Further review of the "Errors and Warning Detail Report" found invalid accounts, users not authorized to access the account, invalid employee names, and other informational errors. There was no evidence to suggest that the city had taken appropriate and timely action to address these discrepancies.

Recommendation

We recommend that errors affecting established budget amounts be corrected timely; and that adjustment to keep the budget balanced should be done as soon as the city council approves the resolution.

City's Response

Currently, the City of Hercules Finance Director attends all council meetings (if the Finance Director does not attend the council meetings, council meetings can be viewed on the city website) and communicates to Finance staff in the weekly Finance meeting the outcome(s) of the council meetings. The City Attorney, Finance Director and City Manager now review and sign off on all staff reports that go to the City Council for approval and all recommended expenditures must have an approved budget and source of funds. Any budget adjustments will need the proper resolution and supporting documentation (such as signed contracts) to be recorded in the Financial system in a timely manner.

SCO's Comments

The City did not dispute this finding. The City has implemented procedures to authorize, support, and review expenditures and budget adjustments.

**FINDING 7—
The city’s Administrative
Policy Manual has not
been updated and is not
current.**

The city’s Administrative Policy Manual (Finance and Budget) is dated November 1991. Except for 11 administrative policies (clarifications, guidelines, outlines, etc.) that were approved subsequent to our review period, there is no evidence it has been updated since then to reflect current processes and procedures. The city does not have a process in place to routinely review and update its Administrative Policy Manual. Therefore, documentation for completeness, accuracy, and consistency with existing processes is lacking.

This resulted in significant internal control weaknesses over the city’s financial transactions and business cycles. For example:

- Purchase order procedures for competitive bids for capital items and professional services are not included in the manual.
- Budget and planning is not included in the manual; accordingly, budget estimates and expenditures are not monitored throughout the appropriation cycle.
- The computerized accounting system sections of the manual have not been updated since September 11, 1991. Several updates to the city’s computerized accounting system have been implemented since that time.

Documentation provides guidance for implementing controls and serves as a basis for training new personnel in implementing them, and provides evidence the controls have operated effectively. Undocumented and outdated policies and related internal controls result in unclear roles and responsibilities and lead to improper handling of transactions. An essential element of internal control is monitoring, which includes verification by management that policies and procedures are updated to adequately address new challenges identified by ongoing risk assessments.

Recommendation

The city should review and update its Administrative Policy Manual to ensure consistency with current processes and organizational structure, and perform periodic and ongoing reviews to ensure proper documentation, accuracy, and completeness in its financial transactions and records.

City’s Response

The City of Hercules has since updated a variety of policies in its Administrative Policy Manual and will continue to update, implement, and do ongoing reviews of the policies in the Administrative Policy Manual to ensure proper documentation, accuracy and completeness in its financial transactions and records.

SCO’s Comments

The City did not dispute this finding. According to the City, it has updated a variety of its policies in its Administrative Policy Manual and will continue to implement and update its policies on a regular basis.

Appendix— City of Hercules Evaluation of Elements of Internal Control

Control Environment		Yes	No	Comments
A1.	Integrity and Ethical Values			
	a. Are code of conduct and other policies regarding acceptable business practices, conflicts of interest, or expected standards of ethical and moral behavior in existence and communicated to all city management and employees?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<p>The city's Administrative Policy Manual (Finance and Budget) is obsolete. Except for 11 administrative policies that were approved subsequent to our review period, the manual was last updated in November 1991.</p> <p>The city has no definitive policy governing competitive bidding. Whether a procurement transaction is subject to competitive bid is arbitrarily determined on a case-by-case basis, which is susceptible to abuse. The city has an outdated policy governing favoritism or nepotism.</p> <p>Resolution No. 10-142, dated November 9, 2009, amended Resolution 10-133 relative to the City of Hercules' conflict of interest policy. This is inadequate as the requirement is only limited to a few designated management positions.</p> <p>Staff members interviewed stated they were not aware of any ethics and behavior standards.</p>
	b. Does management foster, encourage, and emphasize the importance of integrity and ethical values?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There are instances of management decisions that raised questions about conflicts of interest and lack of regard for accountability and control. See Findings 1, 3, and 4 in this report and Redevelopment Agency's Review Report Findings 1 and 2.
	c. Is everyday dealing with vendors, clients, auditors and other parties based on honesty and fairness?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Based on limited information and documentation provided by staff, the city has no mechanism in place to ensure honesty and fairness in its dealings.
	d. Does management takes action when violations of policies, procedures, or the code(s) of conduct occur?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	No evidence that management takes appropriate actions regarding violations and misconduct.
	e. Are instances of override of internal controls, if any, properly documented?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There was no need to override internal controls, as controls were virtually non-existent.
A2.	Commitment to Competence			
	a. Is management analyzing tasks relative to a particular job regarding need and extent of supervision?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There were no evaluations performed by management relative to a particular job or task. For example, city management is acutely aware that its Department of Finance is severely understaffed but there were no plans to rectify this issue.
	b. Is management evaluating and determining the knowledge and skills needed to perform key functions?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Staff assigned to the Department of Finance are performing incompatible duties and no one is trained to back up the staff.
	c. Do employees have the competence and training necessary for their assigned level of responsibility or the nature and complexity of the entity's activities?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Despite high staff turnover, there is no plan to provide new staff with needed training. Staff members were assigned to duties that are incompatible for control purposes.
	d. All departments are appropriately staffed.	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Some key positions currently are vacant. Insufficient staffing is contributing to the lack of segregation of duties.

Appendix (continued)

Control Environment (continued)	Yes	No	Comments
A3. Management and Operating Style			
a. Is management conservative in accepting risks, moves carefully, and proceeds only after careful evaluation?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Based on review of City Council minutes, there is no evidence of any evaluation or deliberation of risk prior to making decisions with significant policy or fiscal implications.
b. Is personnel turnover in key functions at an acceptable level and not excessive?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<p>For the period of July 1, 2009, through present, the city experienced severe turnover of personnel at key management positions and staffing at the Finance Department. These losses of personnel occurred through City Council actions and/or by employees' voluntarily resigning from city employment.</p> <p>The employees turnover occurred by position as follows:</p> <ul style="list-style-type: none"> • City Manager – five different people filled this position. • Assistant City Manager – Assistant City Manager resigned December 14, 2010 and this position has been vacant since that time. On January 21, 2011, a Deputy City Manager was appointed to this position; however, she also was concurrently performing the duties of the Finance Director. • Finance/Human Resources Director – Four different people filled this position. • Finance Department – lost 3 knowledgeable employees – one senior accountant and two journey-level accountants.
c. Is management's attitude positive towards internal control and audit function?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	The city does not have an audit unit or audit committee. All of these audits were completed by consultants. The city repeatedly failed to address prior audits issues identified in the external audit reports.
d. Are there frequent interactions of senior management and operation management in both formal and informal settings?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There is no evidence of any interaction between senior management and staff at the Finance Department. Most staff in the Finance Department are overloaded with work and only the senior accountant is providing guidance and help in performing their assigned tasks. On October 21, 2011, the senior accountant left the city for another job.
e. Is management's attitude appropriate towards financial reporting and other operational reporting?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	The city's audited financial statements are due to the SCO on December 31 st of each year. For FY 2009-10, the city's audited financial statements and the RDA's financial statements were not released until May 10, 2011, and April 11, 2011, respectively. For FY 2010-11, the city and RDA's audited financial statements were still in process as of April 18, 2012. See Findings 5 and 6; and RDA report Findings 5, 6, 7, and 8; and State and Federal Expenditures Review Report's Finding 1 and 2.
f. Are procedures or activities in place to regularly educate and communicate to management and employees the importance of internal controls and to raise their level of understanding of controls?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Except for the senior accountant who is no longer employed by the city, staff interviewed expressed little appreciation about the importance of internal controls. The staff have not received any city-provided training relative to internal controls.
g. Management gives appropriate attention to internal controls and corrects any known weaknesses in internal controls on a timely basis.	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There were multiple issues regarding weaknesses of internal controls noted in several audit reports. Some these issues were not properly addressed by the city, such as lack of cost analysis and competitive bidding on bond issues, improper usage of credit cards, deficiency in inventory monitoring, deposits of money not made timely, and lack of documentation on administration charges.

Appendix (continued)

Control Environment (continued)	Yes	No	Comments
A4. Organizational Structure			
a. Is the organization structured to facilitate the flow of information throughout the entity?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	There are organizational charts that clearly define the lines of management authority and responsibilities. Flow of information within the city normally flows from management to staff.
b. Are key managers' responsibilities adequately defined and communicated?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Department Heads' responsibilities appear to be adequately defined and communicated, however, for some key staff in the Finance Department, it appears that their responsibilities are undefined, resulting in a performance of incompatible duties.
c. Do managers in charge have the required knowledge, experience, and training?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Significant turnover at key management positions and at the Finance Department. These losses of personnel caused negative impact in the city's ability to operate effectively; thus, severely weakening the effectiveness of administrative and internal accounting controls. For example, as of April 18, 2012, Finance Department staff still are in the process of closing the books for fiscal year 2010-11. As a result, financial audit reports were not submitted to the State Controller's Office in timely manner.
d. Does the city's established reporting relationships ensure effective communication between employees, supervisors, managers, and officers?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	The city lacks proper communication between city departments and staff within departments due to staff turnover at key positions.
e. Does a process exist supporting the identification and disclosure of related-party transactions?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	The city has no process for the identification and disclosure of related-party transactions. We noted transfer/sale of several properties between the RDA and the city that raised questions about lack of arm's-length transaction. No disclosure made on these transactions.
A5. Assignment of Authority and Responsibility			
a. Is proper information considered in determining the level of authority and scope of responsibility to an employee?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Finance Department has been operating without full staffing at key positions resulting in the performance of incompatible duties.
b. Are responsibilities for decision-making clearly linked to the assignment of authority and individuals are held accountable accordingly?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	City council is not doing an adequate job in reviewing, approving, and monitoring city operations and activities. See Finding 1
c. Are employees at the right level empowered to correct problems or implement improvements?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Responsibilities of some key employees are undefined resulting in uncertainty regarding performance of duties. In addition, the lack of adequate documentation of the city's policies and procedures results in unclear employee responsibilities.
d. Do job descriptions exist and contain specific references to control-related responsibilities?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Job descriptions exist; however, staff within the Finance Department appear to be performing incompatible duties due to employee turnover and lack of staffing.
e. Are employees empowered to correct problems or implement improvements in their assigned processes?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Staff in low-level positions and their immediate supervisors appear to feel uncomfortable deviating from their normal processes and therefore do not make any corrections or improvements to the existing process.

Appendix (continued)

Control Environment (continued)		Yes	No	Comments
A6.	Human Resources Policies and Practices			
	a. Are policies and procedures established for hiring, training, and promoting employees and management particularly in hiring and training?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	The city could not provide any policies or procedures for hiring, training, and promoting employees. The Municipal Code contains some broad guidelines that lack specificity. During our review, the Human Resources Director position was vacant.
	b. Are employees made aware of their responsibilities and expectations of them?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Due to severe understaffing in the Finance Department, staff are more concerned about completing an assigned task rather than performing specific duties of their respective positions.
	c. Is management's response to failure to carry out assigned responsibilities appropriate?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Management seems to be more concerned about meeting deadlines and less concerned about proper assignment of responsibilities.
Risk Assessment				
B1.	Goals and Objectives			
	a. Are there entity-wide objectives that were established by management?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Risk assessment goals and objectives were not established in any of the city's key functions.
	b. Does information relating to objectives disseminated to all city employees?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There is no documentation or evidence of procedural process for disseminating objectives to all city employees.
	c. Are goals (with specific targets and deadlines) established and relate to objectives?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	No evidence of any goals having been established related to the objectives.
	d. Are measurement data included in the objectives?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	The city could not produce any measurement data.
	e. Is there a process in place to periodically review and update strategic plans? Is the strategic plan reviewed and approved by those charged with governance?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There is no evidence of any periodic reviews. For example, as noted in the RDA report, the RDA budget was approved despite being incomplete and missing required elements.
	f. Are managers involved in establishing objectives for which they are responsible?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Managers' involvement appears to be isolated to their departmental goals and objectives.
B2.	Risk			
	a. Does the risk-assessment process in place consider the extent and internal factors affecting objectives?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Severe turnover of personnel at key management positions and inadequate staffing city-wide due to budget constraints may have affected the risk-assessment in place, if any. It appears that staff were more concerned with completing a specified task or objective without regard to risk-assessment.
	b. Does the risk assessment process include estimated significance of risks, assessing likelihood of occurrence, and determining the needed actions to prevent risks?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There is no evidence that risk assessment was taking place. It appears that this lack of risk assessment contributed to the current financial crisis of the city.
	c. Is management considering the risks related to Human Resources, budgeting, labor relations, and Information Systems?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There is no evidence suggesting management's consideration of risks in these areas. During our review, the position for Human Resources Director was vacant due to the resignation of the Finance/Human Resources Director.
	d. Are risks related to the ability of an employee to initiate and process unauthorized transactions appropriately identified?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	No. Staff in the Finance Department were performing functions/tasks that were incompatible for internal control purposes.

Appendix (continued)

Risk Assessment (continued)		Yes	No	Comments
	e. When risks are identified, are existing controls examined to determine whether there has been a failure in controls and action has been taken to address them?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Refer to B2b.
	f. Is fraud assessment an integral part of the risk identification process?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Refer to B2b.
	g. Does the entity's assessment of fraud risk consider incentives and pressures, attitudes, and rationalizations as well as the opportunity to commit fraud?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Refer to B2b.
	h. Does management identify all significant relationships including service providers, suppliers, citizen groups, creditors, etc.?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Refer to A4e.
B3. Managing Change				
	a. Are there mechanisms in place to anticipate, identify, and react to routine events or acts that affect achievement of objectives?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There does not appear to be a mechanism in place to identify and manage change affecting the city. The failure to manage change may be one of the contributing factors to the current financial crisis faced by the city. In addition, turnover at key management positions is affecting the city in achieving its objectives.
	b. Are there mechanisms in place to identify and react to changes that can have dramatic and pervasive effect on the City?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	See B3a.
	c. Does the governing body adopt a budget for all funds in accordance with state statutory or other requirements?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Several discrepancies were noted in the Adopted Budget for FY 2010-11. See Findings 1 and 6.
	d. Is there a process in place to ensure that the accounting department and those charged with governance are sufficiently aware of significant related party transactions to ensure they are appropriately accounted for and disclosed?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Refer to A4e.
Control Activities				
C1. Management Reviews				
	a. Are administrative and operation policies for each of the entity's activities in writing and do they set clear procedures for compliance?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	The city's Administrative Policy Manual, - (Finance and Budget) is obsolete. Except for 11 administrative policies that were approved subsequent to our review period, the manual was last updated in November 1991.
	c. Are controls performed to check for reasonableness, allowability, and validity of transactions?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Severe turnover at key positions (City Manager, Assistant City Manager, Finance Director, and Senior Accountant) might have affected these controls. Refer to A5a
	b. Are control activities regularly evaluated to ensure they are still appropriate and working as intended?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	As previously noted, the city's Administrative Policy and Procedures Manual is obsolete.
	c. Does management compare different sets of data and investigate variances?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	As noted in Finding 6, the city does not record budget amendments timely. Generally, quarterly review between budgeted amounts and actual amounts should be conducted. If there are material variances, additional funding should be authorized by the City Council through a resolution. There were no quarterly budget reviews noted during our review.
	d. Are duties properly segregated?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	No. Incompatible functions are not properly segregated.

Appendix (continued)

Information and Communication		Yes	No	Comments
D1.	Information			
	a. Are mechanisms in place to obtain relevant information on program, legislative or regulatory developments, budget, or economic changes?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	The city's website is open for access to interested parties.
	b. Have long-range information technology plans been developed and linked with strategic initiatives?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Due to staff turnover within the Finance Department, no one within the department currently has complete knowledge on the flow of transactions as a whole.
	c. Are process procedures sufficiently formal such that management can determine whether the control objective is met, documentation supporting the procedures is in place, and personnel routinely know the procedures that need to be performed?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There is no evidence of such processes in place. The city also lacks adequate internal control documentation.
	d. Is data underlying financial statements captured completely, accurately, and timely, in accordance with the entity's policies and procedures and in compliance with laws and regulations?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	City's financial reports are late, inaccurate, and incomplete. As of April 19, 2012, the city had not yet closed its books for FY 2011. External auditor for FY 2010-11 is still in the process of completing its audit. As of April 19, 2012, the City and RDA's audited financial statements, due to the State Controller's Office last December 31, 2011, still had not been completed.
Communications				
D2.	Communications			
	a. Are communication vehicles sufficient in effecting communications?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Refer to A3(d) and A4(d).
	b. Do employees know the objectives of their own activity and how their duties contribute to achieving objectives and others goals?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	The payroll and accounts payable clerks appear to know the objectives of their own activities. However, it does not appear that this knowledge extends to other employees' objectives and goals, and overall objectives of the city.
	c. Are communications channels in place for people to report suspected acts and is appropriate feedback provided?	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Online reporting by citizen is available through the city website. There is no complaint policy included in the city's Administrative Policy Manual. A complaint received will be reviewed and assigned to an investigator. The investigator will interview the involved parties, collect and evaluate all evidence and complete a written report which will be reviewed by the Chief of Police for a final determination. The complainant will be notified of the final disposition through a letter.
	d. Does adequate communication exist across the organization? Is information complete, timely, and sufficient?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There is lack of communication within the city due to severe turnover of key personnel.
	e. Are feedback mechanism for external parties (suggestions, input, complaints) directed to relevant internal parties?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	The staff we interviewed were not aware of any feedback mechanism for external parties.
	f. Does management makes certain that the advice and recommendations of oversight agencies and other auditors are fully considered and takes action to correct any problems and weaknesses they identify?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	City has repeatedly failed to address several of the external auditor's repeat findings.

Appendix (continued)

Monitoring		Yes	No	Comments
E1.	Ongoing Monitoring			
	a. Are operating reports integrated or reconciled with financial and budgetary reporting system data?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Departmental operating reports are not reconciled with the financial data.
	b. Are operation personnel required to “sign off” on the accuracy of their unit’s records?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	The “sign-off” on the accuracy of records appears to be more of a process rather than a control.
	c. Are communications with outside parties and monthly statements of accounts payable used as control monitoring technique?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	No evidence of the city staff making inquiries or questioning external parties as a monitoring technique.
	d. Are periodic comparisons of amounts recorded by accounting system compared with physical assets?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	A deficiency in inventory monitoring was noted in a management report. There are no policies or procedures in place to monitor and control city inventories.
	e. Does a policy exist to adopt an Incompatible Activities Statement of Conduct?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	The city’s Administrative Policy Manual does not contain a provision regarding incompatible activities.
E2.	Separate Evaluation			
	a. Do employees with appropriate skills evaluate portions of the internal control?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There is no evaluation of internal controls by staff and management.
	b. Do city staff members gain sufficient understanding of internal controls?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There is no evidence that city staff understand or appreciate the important of internal controls.
	c. Are policy manuals, organization charts, and operational instructions available for review?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	City Administrative Policy Manual, departmental policies, and organization charts were available for review. However, the city’s Administrative Policy Manual is out of date.
E3.	Reporting Deficiencies			
	a. Are means of obtaining reports of deficiencies from both internal and external sources exist?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	There are no internal report of deficiencies. Audit reports disclosing deficiencies noted by external auditors are available on the city website.
	b. Is there ongoing monitoring of internal controls?	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Refer to E2b.
	c. Are the transactions or event identified investigated, causes determined, and problem corrected.	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Issues such as inventory controls, cash/checks deposits were not timely, improper usage of credit cards and others were identified. These problems were not corrected by the city staff in a timely manner.
	c. Reports from external sources (e.g., external auditors, regulators) are considered for their internal control implications, and timely corrective actions are identified and taken.	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Audit findings from external auditors are not corrected in a timely manner.

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



August 20, 2012

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

Dear Mr. Mar:

The State Controller's Office performed a review of the City of Hercules administrative and internal accounting controls for the period of July 1, 2009 through June 30, 2010. Below is the City of Hercules management response to the findings in the State Controller's letter dated August 10, 2012.

Finding 1 – The City Council failed to exercise oversight over the city's financial and operational activities.

City of Hercules Management Response:

The City of Hercules has undergone structural changes resulting in improved financial oversight and administration:

- a. Two City Council seats were changed in the November 2010 election (Council Members McDonald & Valstad were replaced by Council Members Delgado & DeVera)
- b. Mayor Balico resigned in January 2011; Council Members Khuene and Ward, the remaining two council members were recalled in June 2011. Three new Council Members were elected in June 2011, Council Members Romero, Wilkins, and Boulanger
- c. City Attorney Patrick Tang was hired in September 2011
- d. City Manager Steve Duran was hired in October 2011
- e. A new Consultant Project Manager for the Hercules Intermodal Transit Center Project, William Silva, was hired in November 2011
- f. Gray Bowen was retained by the City in December 2011 to help coordinate the and focus the implementation aspects of the ITC Project funding and the related State and Federal requirements for project delivery
- g. City Finance Director, Nickie Mastay was hired in March 2012

The new City Council, together with the Community, formed two key Ad Hoc Committees: Citizens Legal Issue Ad Hoc Committee and the Citizens Finance Ad Hoc Committee. These two committees reflect a deep seated civic desire to improve the quality and transparency of City

Government by defining policies designed to direct city employees as well as elected and appointed officials regarding proper related practices.

The new City Council on June 19, 2012 adopted a Nepotism and Cronyism policy, via Resolution proposed by the Citizens Legal Issue Ad Hoc Committee.

The new City Council and staff will continue to update and improve policies and procedures.

Finding 2 – The city’s contracts with school principals were vague regarding scope of services and whether services were necessary.

City of Hercules Management Response:

On June 5, 2012, the City of Hercules has updated its Purchasing Guidelines and will continue to enhance these guidelines. The Purchasing Guidelines state that the City Council shall approve all contracts in excess of \$20,000. This includes all expenditures that have been appropriated through the budget process. The Purchasing Guidelines also include a bidding procedure:

- a. Supplies or equipment that exceeds \$1,000 will require telephone quotes or informal bids from a minimum of three vendors.
- b. Supplies or equipment that exceeds \$10,000 shall require a competitive bid process. Award of Contract. Contracts shall be awarded by the City Council if over \$20,000, and by the City Manager up to \$20,000, to the lowest responsive bidder except as otherwise provided in this section. However, if a Public Works project is planned to use or using State or Federal funds, then the City Council must approve contracts over \$5,000.

Although the above is only an excerpt from the City of Hercules Purchasing Guidelines, the City of Hercules has implemented policies and procedure to ensure that responsible city officials perform a detailed review and have full understanding of the services to be provided before entering into an agreement.

Finding 3 – The city exercised inadequate control over expenses charged to city issued credit cards.

City of Hercules Management Response:

The City of Hercules currently has a Professional Memberships, Meetings, Expense Report Policy (this policy includes the travel policy) and a Credit Card Usage Policy. The City of Hercules is in the process of updating and improving these policies. The updates will include limits on lodging rates, meals, and other travel expenses.

Finding 4 – The city lacked proper approval for real property purchases.

In the paragraph of this finding, it is stated that “in the absence of documentation to identify the purpose of the purchases, it is unclear as to whether any of the purchases are of any benefit to the project areas.”

City of Hercules Management Response:

The purpose of the property purchase(s) are for economic development that are included in the Central Hercules Plan, the Implementation Plan and the zoning of the parcels for residential, retail and mixed use. The Central Hercules Plan is located on the city website: City of Hercules www.ci.hercules.ca.us; click on Departments and Services; click on Planning; double click on Central Hercules Plan. The Implementation plan is located on the city website: www.ci.hercules.ca.us; click on Departments and Services; click on Redevelopment; double click on Implementation Plan. The State Controller’s Office – Division of Audits is currently

conducting the Asset Transfer Review of all redevelopment assets transferred to the successor agency for the City of Hercules former Redevelopment Agency in the month of August 2012.

Finding 5 – Related party transactions existed between the City of Hercules and the Hercules Redevelopment Agency.

City of Hercules Management Response:

The City of Hercules will establish a policy that all related-party transactions between the city and other entities will be conducted at arm's length, and on terms generally available to other unaffiliated third-parties under the same or similar circumstances.

Finding 6 – The city has unrecorded budget adjustments, revised revenue estimates, and financing sources.

City of Hercules Management Response:

Currently, the City of Hercules Finance Director attends all council meetings (if the Finance Director does not attend the council meetings, council meetings can be viewed on the city website) and communicates to Finance staff in the weekly Finance meeting the outcome(s) of the council meetings. The City Attorney, Finance Director and City Manager now review and sign off on all staff reports that go to the City Council for approval and all recommended expenditures must have an approved budget and source of funds. Any budget adjustments will need the proper resolution and supporting documentation (such as signed contracts) to be recorded in the Financial system in a timely manner.

Finding 7 – The city Administrative Policy Manual has not been updated and is not current.

City of Hercules Management Response:

The City of Hercules has since updated a variety of policies in its Administrative Policy Manual and will continue to update, implement, and do ongoing reviews of the policies in the Administrative Policy Manual to ensure proper documentation, accuracy and completeness in its financial transactions and records.

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

Sincerely,



Steve Duran
City Manager
City of Hercules

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

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