

CITY OF SACRAMENTO

Reissued Audit Report

SPECIAL GAS TAX STREET IMPROVEMENT FUND

July 1, 2007, through June 30, 2014

TRAFFIC CONGESTION RELIEF FUND ALLOCATIONS

July 1, 2007, through June 30, 2012

PROPOSITION 1B FUND ALLOCATIONS

July 1, 2008, through June 30, 2014



BETTY T. YEE
California State Controller

January 2020



BETTY T. YEE
California State Controller

January 17, 2020

The Honorable Darrell Steinberg
Mayor of the City of Sacramento
915 I Street, 5th Floor
Sacramento, CA 95814

Dear Mayor Steinberg:

This report is a reissuance of the November 10, 2016 report to revise the Summary, Conclusion, and Views of Responsible Officials sections, and remove the Findings and Recommendations section and replace it with an Observation and Recommendation section.

The State Controller's Office audited the City of Sacramento's Special Gas Tax Street Improvement Fund for the period of July 1, 2007, through June 30, 2014. We also audited the Traffic Congestion Relief Fund allocations recorded in its Traffic Congestion Relief Fund for the period of July 1, 2007, through June 30, 2012; and the Proposition 1B Fund allocations recorded in its Proposition 1B Fund for the period of July 1, 2008, through June 30, 2014.

Our original audit, dated November 10, 2016, found that the city accounted for and expended its Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund allocations, and Proposition 1B Fund allocations in compliance with requirements, except that the city understated the fund balance in the Special Gas Tax Street Improvement Fund by \$2,087,067 because it charged the Special Gas Tax Street Improvement Fund for unallowable debt service payments and ineligible expenditures. The city's Director of Finance responded to the original audit findings by letter dated September 27, 2016, agreeing with our audit results.

The city has since appealed the original audit results because the Sacramento Superior Court issued a judgment validating the city's use of gas tax revenues to pay its obligations under the installment sale agreement it entered into with the Sacramento City Financing Authority, which issued the bonds. The city contends that because the time for challenging the judgment has passed, SCO is barred from asserting that the city improperly used gas tax revenues to pay debt service and arbitrage rebates on the bonds. SCO acknowledges the validation action as being properly noticed and approved by the Court without objection or substantive challenge. As a result, we are reissuing the original report to change previously reported findings to an observation, as described in the Observation and Recommendation section of this reissued report. Although SCO acknowledges the Court's validation action, we maintain our position that the use of gas tax funds for debt service and arbitrage rebate payments on bonds that have not been approved by voters is impermissible. We reserve the right to challenge any future validation actions related to such use of the gas tax funds.

The Honorable Darrell Steinberg
Mayor of the City of Sacramento

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January 17, 2020

If you have any questions, please contact Efren Loste, Chief, Local Government Audits Bureau, by telephone at (916) 324-7226.

Sincerely,

Original signed by

JIM L. SPANO, CPA
Chief, Division of Audits

JLS/hf

cc: Leyne Milstein, Assistant City Manager
City of Sacramento

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Revised Audit Report

Revised Summary

The State Controller's Office (SCO) audited the City of Sacramento's:

- Special Gas Tax Street Improvement Fund for the period of July 1, 2007, through June 30, 2014;
- Traffic Congestion Relief Fund allocations recorded in its Traffic Congestion Relief Fund for the period of July 1, 2007, through June 30, 2012; and
- Proposition 1B Fund allocations recorded in its Proposition 1B Fund for the period of July 1, 2008, through June 30, 2014.

Our original audit, dated November 10, 2016, found that the city accounted for and expended its Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund allocations, and Proposition 1B Fund allocations in compliance with requirements, except that the city understated the fund balance in the Special Gas Tax Street Improvement Fund by \$2,087,067 because it charged the Special Gas Tax Street Improvement Fund for unallowable debt service payments and ineligible expenditures. The city's Director of Finance responded to the original audit findings by letter dated September 27, 2016, agreeing with our audit results.

The city has since appealed the original audit results because the Sacramento Superior Court issued a judgment validating the city's use of gas tax revenues to pay its obligations under the installment sale agreement it entered into with the Sacramento City Financing Authority, which issued the bonds. The city contends that because the time for challenging the judgment has passed, SCO is barred from asserting that the city improperly used gas tax revenues to pay debt service and arbitrage rebates on the bonds. As a result, we are reissuing the original report to change previously reported findings to an observation, as described in the Observation and Recommendation section of this reissued report. Although SCO acknowledges the Court's validation action, we maintain our position that the use of gas tax funds for debt service and arbitrage rebate payments on bonds that have not been approved by voters is impermissible. We reserve the right to challenge any future validation actions related to such use of the gas tax funds.

Background

The State apportions funds monthly from the Highway Users Tax Account (HUTA) in the Transportation Tax Fund to cities and counties for the construction, maintenance, and operation of local streets and roads. The highway users taxes derive from State taxes on the sale of motor vehicle fuels. In accordance with Article XIX of the California Constitution and Streets and Highways Code, a city must deposit all apportionments of highway users taxes in its Special Gas Tax Street Improvement Fund. A city must expend gas tax funds only for street-related purposes. We

conducted our audit of the city's Special Gas Tax Street Improvement Fund under the authority of Government Code section 12410.

Chapter 91, Statutes of 2000, (Assembly Bill 2928) as amended by Chapter 636, Statutes of 2000, (Senate Bill 1662) and Government Code section 14556.5, created a Traffic Congestion Relief Fund in the State Treasury for allocating funds quarterly to cities and counties for street or road maintenance, reconstruction, and storm damage repair. Cities must deposit funds received into the city account designated for the receipt of State funds allocated for transportation purposes. The city recorded its Traffic Congestion Relief Fund allocations in its Traffic Congestion Relief Fund. We conducted our audit of the city's Traffic Congestion Relief Fund allocations under the authority of Revenue and Taxation Code section 7104.

Senate Bill 1266, Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006, was introduced as Proposition 1B and approved by the voters on November 7, 2006, for a variety of transportation priorities, including the maintenance and improvement of local transportation facilities. Proposition 1B funds transferred to cities and counties must be deposited into an account that is designated for the receipt of State funds allocated for streets and roads. The city recorded its Proposition 1B Fund allocations in its Proposition 1B Fund. A city also must expend its allocations within four years following the end of the fiscal year in which the allocation was made and to expend the funds in compliance with Government Code section 8879.23. We conducted our audit of the city's Proposition 1B Fund allocations under the authority of Government Code section 12410.

Objectives, Scope, and Methodology

Our audit objectives were to determine whether the city accounted for and expended its Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund allocations, and Proposition 1B Fund allocations in compliance with Article XIX of the California Constitution, the Streets and Highways Code, Revenue and Taxation Code section 7104, and Government Code section 8879.23.

We audited the city's Special Gas Tax Street Improvement Fund for the period of July 1, 2007, through June 30, 2014. We also audited its Traffic Congestion Relief Fund allocations for the period of July 1, 2007, through June 30, 2012; and its Proposition 1B Fund allocations for the period of July 1, 2008, through June 30, 2014.

To achieve our objectives, we:

- Gained a limited understanding of internal controls that would have an effect on the reliability of the accounting records of the Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund allocations, and Proposition 1B Fund allocations, by interviewing key personnel, completing the internal control questionnaire, reviewing the city's organization chart, and assessing the reliability of computer-processed data;

- Conducted a risk assessment to determine the nature, timing, and extent of substantive testing;
- Performed analytical procedures to determine and explain the existence of unusual or unexpected account balances;
- Verified the accuracy of the fund balances by recalculating the trial balances of the Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund allocations, and Proposition 1B Fund allocations;
- Verified that the components of and changes to the fund balances were properly computed, described, classified, and disclosed by scheduling and analyzing the Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund allocations, and Proposition 1B Fund allocations fund balances;
- Reconciled the fund revenue recorded in the city ledger to the balance reported in the SCO's apportionment schedules to determine whether HUTA apportionments, Traffic Congestion Relief Fund allocations, and Proposition 1B Fund allocations received by the city were completely accounted for;
- Reviewed city accruals and adjustments for validity and eligibility;
- Analyzed the system used to allocate interest and determined whether the interest revenue allocated to the Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund allocations, and Proposition 1B Fund allocations was fair and equitable, by interviewing key personnel and recalculating a sample of interest allocations;
- Reviewed the fund cash and liabilities accounts for unauthorized borrowing to determine whether unexpended HUTA funds were available for future street-related expenditures and protected from impairment;
- Verified that the expenditures incurred during the audit period were supported by proper documentation and eligible in accordance with applicable criteria by testing 100% of the expenditure transactions that were equal to or greater than the significant item amount (calculated based on materiality threshold), and selecting samples of other transactions based on our judgment;
- Verified that the city expended the Traffic Congestion Relief Fund revenues within the required time limit by analyzing and scheduling the city's Traffic Congestion Relief Fund expenditures;
- Verified city's compliance with the maintenance-of-effort requirement of the Traffic Congestion Relief Fund by computing the city's annual expenditures of its discretionary funds for street purposes; and

- Verified that the city expended the Proposition 1B revenues within the required time limit by analyzing and scheduling the city's Proposition 1B expenditures.

We did not audit the city's financial statements. We limited our audit scope to planning and performing audit procedures necessary to obtain reasonable assurance that the city accounted for and expended its Special Gas Tax Street Improvement Fund, Traffic Congestion Relief Fund allocations, and Proposition 1B Fund allocations in compliance with requirements. We considered the city's internal controls only to the extent necessary to plan the audit.

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

Revised Conclusion

Our audit found that the City of Sacramento accounted for and expended its:

- Special Gas Tax Street Improvement Fund in compliance with Article XIX of the California Constitution and the Streets and Highways Code for the period of July 1, 2007, through June 30, 2014. Our original audit, dated November 10, 2016, found that the city accounted for and expended its Special Gas Tax Street Improvement Fund, except that the city understated the fund balance in the Special Gas Tax Street Improvement Fund by \$2,087,067 because it charged the Special Gas Tax Street Improvement Fund for unallowable debt service payments and ineligible expenditures.

The city has since appealed the original audit results because the Sacramento Superior Court issued a judgment validating the city's use of gas tax revenues to pay its obligations under the installment sale agreement it entered into with the Sacramento City Financing Authority, which issued the bonds. The city contends that because the time for challenging the judgment has passed, SCO is barred from asserting that the city improperly used gas tax revenues to pay debt service and arbitrage rebates on the bonds. SCO acknowledges the validation action as being properly noticed and approved by the Court without objection or substantive challenge. As a result, this reissued audit report changes previously reported findings to an observation, as described in the Observation and Recommendation section.

- Traffic Congestion Relief Fund allocations recorded in its Traffic Congestion Relief Fund in compliance with Article XIX of the California Constitution, the Streets and Highways Code, and Revenue and Taxation Code section 7104 for the period of July 1, 2007, through June 30, 2012.

- Proposition 1B Fund allocations recorded in its Proposition 1B Fund in compliance with Government Code section 8879.23 for the period of July 1, 2008, through June 30, 2014.

Follow-Up on Prior Audit Findings

The city satisfactorily resolved the findings noted in our prior audit report, issued on June 11, 1999.

Revised Views of Responsible Officials

The city’s Director of Finance, responded to our original audit findings by letter dated September 27, 2016, agreeing with our audit results. Subsequent to the issuance of the original final audit report on November 10, 2016, the city appealed the findings noted in the report, resulting in the reissuance of the report.

Reason for Reissuance

This report is being reissued to revise the Summary, Conclusion, and Views of Responsible Officials sections, and to remove the Findings and Recommendations section and replace it with an Observation and Recommendation section.

Restricted Use

This report is intended for the information and use of the City of Sacramento 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 audit report, which is a matter of public record and is available on the SCO website at www.sco.ca.gov.

Original signed by

JIM L. SPANO, CPA
Chief, Division of Audits

January 17, 2020

**Revised Schedule—
Reconciliation of Fund Balance
July 1, 2013, through June 30, 2014**

	Special Gas Tax Street Improvement Fund ^{1,2,4}	Proposition 1B Fund ³
Beginning fund balance per city	\$ 17,659,737	\$ 175,702
Revenues	<u>14,927,496</u>	<u>2,431</u>
Total funds available	32,587,233	178,133
Expenditures	<u>(15,837,930)</u>	<u>(178,133)</u>
Ending fund balance per city	<u>\$ 16,749,303</u>	<u>\$ —</u>
Ending fund balance per audit	<u>\$ 16,749,303</u>	<u>\$ —</u>

¹ The city receives apportionments from the State HUTA, pursuant to Streets and Highways Code sections 2103, 2105, 2106, 2107, and 2107.5. The basis of the apportionments varies, but the money may be used for any street-related purpose. Streets and Highways Code section 2107.5 restricts apportionments to administration and engineering expenditures, except for cities with populations of fewer than 10,000 inhabitants. Those cities may use the funds for rights-of-way and for the construction of street systems. The city must deposit its HUTA apportionments in its Special Gas Tax Street Improvement Fund. The audit period was July 1, 2007, through June 30, 2014; however, this schedule includes only the period of July 1, 2013, through June 30, 2014.

² Government Code section 14556.5 created a Traffic Congestion Relief Fund in the State Treasury for allocating funds quarterly to cities and counties for street and road maintenance, reconstruction, and storm damage repair. The city recorded its Traffic Congestion Relief Fund allocations in its Traffic Congestion Relief Fund. The audit period was July 1, 2007, through June 30, 2012. The city did not receive any Traffic Congestion Relief Fund revenues and did not incur any Traffic Congestion Relief Fund expenditures during FY 2013-14; therefore, it is not included in this schedule.

³ Senate Bill 1266, Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006, introduced as Proposition 1B, provided funds for a variety of transportation priorities. The city recorded its Proposition 1B Fund allocations in its Proposition 1B Fund. The audit period was July 1, 2008, through June 30, 2014; however, this schedule includes only the period of July 1, 2013, through June 30, 2014.

⁴ See the Observation and Recommendation section.

Observation and Recommendation

**OBSERVATION—
Debt service and
arbitrage rebate
payments**

The city charged debt service payments (principal and interest) of \$1,405,226 to the Special Gas Tax Street Improvement Fund for the period of July 1, 2007, through June 30, 2009. The debt service payments were for the Sacramento City Financing Authority Gas Tax Revenue Bonds (Series 1995A).

On May 1, 1995, the city entered into an installment sale agreement with the Authority to purchase the street improvements of the 1995 Street Improvement Project with gas tax revenue. The Authority financed the project with proceeds from the sale of the bonds, and used the gas tax revenue received from the sale of the project for debt service on the bonds.

The Streets and Highways Code allows for Gas Tax funding of principal and interest when bonds are voter-approved, the terms of the bonds do not exceed 25 years, and the bonds are limited to 25% of the annual gas tax allocation. However, the city did not obtain the required voter approval for payments of principal and interest from the Special Gas Tax Street Improvement Fund.

Streets and Highways Code section 2107.4 states:

Not more than one-quarter of the funds allocated to a city or county from the Highway Users Tax Account in the Transportation Tax Fund for the construction of Streets therein may be used to make principal and interest payment on bonds issued for such construction, if the issuance of such bonds is authorized by a proposition approved by a majority of the votes cast thereon. The term of any such bonds shall not exceed 25 years.

Our audit found the following debt service charges to the Special Gas Tax Street Improvement Fund:

Fiscal Year	Amount
2008-09	\$ (126,037)
2007-08	1,531,263
	<u>\$ 1,405,226</u>

The city also charged expenditures of \$681,841 to the Special Gas Tax Street Improvement Fund for the period of July 1, 2009, through June 30, 2011. The expenditures were for an arbitrage rebate due the Internal Revenue Service (IRS). Arbitrage is the profit that stems from borrowing money in a tax-exempt market and investing the proceeds in higher-yielding markets. The city is required to give the arbitrage to the IRS. In this case, the city invested the proceeds from Sacramento City Financing Authority Gas Tax Revenue Bonds (Series 1995A) and earned a profit that it was required to remit to the IRS.

The city received a judgement from the Sacramento Superior Court validating the city's use of gas tax revenues to pay its obligations under the installment sale agreement. The city contends that because the time for challenging the judgment has passed, SCO is now barred from asserting that the city improperly used gas tax revenues to pay debt service and arbitrage rebates on the bonds.

SCO acknowledges the validation action as being properly noticed and approved by the Court without objection or substantive challenge. However, we maintain our position that the use of gas tax funds for debt service and arbitrage rebate payments on bonds that have not been approved by the voters is impermissible. We reserve the right to challenge any future validation actions related to such use of the gas tax funds.

Recommendation

In the future, we recommend that the city ensure that all debt service payments charged to the Special Gas Tax Street Improvement Fund are for voter-approved bonds, that the debt service payments do not exceed one-quarter of the annual gas tax allocations, and that the terms of the bonds do not exceed 25 years, in accordance with Streets and Highways Code section 2107.4.

**State Controller's Office
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