

City of Watsonville
Finance Department

MEMORANDUM



DATE: January 15, 2013

TO: Carlos J. Palacios, City Manager

FROM: Ezequiel Vega, Administrative Services Director

SUBJECT: Receive a Report Regarding the Performance Audit Conducted by Harvey M. Rose Associates, LLC (HMR), a Firm Retained by the Santa Cruz County Grand Jury, and Approve the City's Response to the Report.

AGENDA ITEM: January 22, 2013 City Council

RECOMMENDATION: It is recommended that the City Council of the City of Watsonville receive a report regarding the Performance Audit conducted by Harvey M. Rose Associates, LLC (HMR), a firm retained by the Santa Cruz County Grand Jury, and approve the City's response to the Report.

DISCUSSION: The Harvey M. Rose Associates, LLC (HMR) firm was retained by the Santa Cruz County Grand Jury to conduct a performance audit of the City of Watsonville. Performance audits are a special type of audit designed to provide assurance or conclusions based on an evaluation of sufficient, appropriate evidence against stated criteria such as specific requirements, measures, or defined business practices.

The objective of a performance audit is to improve program operations & facilitate decision making. A performance audit typically asks questions such as:

- Was organization running in economical manner?
- Did organization achieve objectives?
- Did costs under federal grant conform to grant requirements?
- Was program operated in accordance with laws and regulations?

Accordingly, HMR performed the audit with the objective "to assess the risk to the City's assets due to its policies and internal controls; assess accountability and transparency in City decision making; and, to evaluate the City's compliance with changes in State redevelopment law." As part of their report, HMR made findings and recommendations in five areas of City's operations:

1. Financial Condition, Reporting and Controls
2. Inter-fund Loans and Transfers

3. Budget and Expenditure Controls
4. Capital Budget and Impact Fees
5. Procurement

The City appreciates the work performed by HMR and acknowledges there are some valid and useful recommendations in the report; however, the City staff disagrees with certain parts of the report as they do not fully represent the actual situation of City operations in comparison to the audit objectives.

City's Accomplishments

As part of assessing the Financial Condition of the City, HMR tested grants and asset management and found no significant risks with these components of the audit. In addition, the City believes a true performance audit would acknowledge the City's significant achievements during the time period under study including major projects such as the 1.3 billion gallon Water Recycling Plant, the LEED Platinum Water Operations Center, the 131,000 square-foot Civic Plaza Building including the new Main Library, new Superior Courts and 460 car Parking Structure, over six miles of scenic nature trails, an 850,000 KWH Solar Panel installation, the Contigo Gang Prevention and Intervention Program, the Urban Greening Plan and the Watsonville Vista 2030 General Plan. The City actively pursued and was awarded millions of dollars in grant funding to support these projects which leveraged our limited local funding.

The report attached to this staff report details the findings and recommendations made by HMR. The summary below shows the City's response to this audit report. Although the findings are not numbered in the audit report, this staff report assigns a finding number to each finding for ease of reference. The numbers were assigned in order of appearance in the report; the first finding in the report was assigned number 1, the second one number, 2, and so on. There are a total of 27 findings and 22 recommendations.

1. Financial Condition, Reporting and Controls

Finding 1: "Like most cities, the financial condition of the City of Watsonville has been negatively affected by national economic conditions that started in approximately 2008. However, the economy does not fully explain the City's current poor financial condition. A pattern of spending beyond the City's means, particularly in the case of the General Fund, has contributed to a depletion of the City's reserves and net assets, two key indicators of financial well-being."

The City agrees that the depletion of reserves has occurred in the General Fund during the time period encompassed by the Great Recession affecting the entire Nation; however, net assets in governmental activities have not decreased significantly over the last five fiscal years. In fact, net assets have increased by 42% during that period. Exhibit 1.1 below shows the overall increase in net assets with small decreases in FY 2009-10 and 2010-11.

Exhibit 1.1

Change in Net Assets					
Governmental Activities, City of Watsonville					
FY2006-07 through 2010-11					
	FY				
	2006-07	2007-08	2008-09	2009-10	2010-11
Net Assets Start of the Year	\$99,690,040	\$ 133,326,823	\$ 147,275,010	\$ 153,202,385	\$ 141,343,459
Net Assets End of the Year	130,994,449	146,776,579	153,773,207	148,106,795	140,987,616
Change in Net Assets	31,304,409	13,449,756	6,498,197	(5,095,590)	(355,843)
Percent Change	31.40%	10.09%	4.41%	-3.33%	-0.25%
Cumulative Increases / (Decreases)		45.90%		-3.58%	
Net Increase / (Decrease)	42.32%				
* Source: City Audited Financial Statements					

The City's Governmental Activities net assets increased from a low of \$99.6 million in FY 2006-07 to the most current \$140.9 million. This represents a 42% increase over a five year span with net assets decreasing 3.58% during FY 2009-10 through 2010-11. This small percentage decrease can be directly correlated to the period of economic recession. Given these figures the City generally disagrees with finding 1. Although the decrease in net assets was not significant over the two last fiscal years, the City staff recognized the financial challenges facing the City and made proactive changes to improve its financial condition. Some of these changes include:

- Refinancing of the PERS Side fund saving the City financing and PERS retirement costs by accessing lower interest rates;
- Implemented a two-tier pension plan and increases in employee's PERS contributions;
- Increases in employees' health insurance contribution;
- 10% reduction in salary through the reduced work week;
- Freezing of employee step increases for non-public safety staff;
- Limited layoffs of administrative staff.

These saving measures helped the City achieve a balanced budget; however, revenue decreases in major categories such as property taxes outpaced the savings achieved from these actions, creating a 3.58% decrease in net assets over the last two fiscal years.

Finding 2: "While the City has made significant reductions in its General Fund expenditures since Fiscal Year 2009-10, the reductions have not been sufficient to offset the impacts of General Fund spending in excess of revenues, particularly since the City was in weak financial condition for several years prior."

The City agrees with this finding but feels it is important to provide the context in which these decisions were made. Unlike other cities, Watsonville has not implemented layoffs to public safety. During the last three challenging years of the Great Recession, not one Police Officer or Fire Fighter has been laid off. This was done as a policy decision by the Council who recognized the importance of public safety as one of the vital services in the community. Nevertheless, the City has made significant reductions in General Fund expenditures and has consistently

communicated these reductions with the Council and the public. Even with these changes, the General Fund reserves have been reduced significantly over the last few years. The City Council approved a balanced budget for FY 2011-12 and 2012-13. This is the continuation of efforts to get the City's General Fund back on track and in recovery after absorbing the blow to our major revenue sources after the Great Recession. In addition, the City is currently working on refining its long term plan to bring the City's reserves to a more acceptable level. More details will be presented during the mid-year budget report in late February.

Finding 3: "A comparison of Watsonville's financial condition with other California cities of comparable size and characteristics shows that the City is worse off based on a number of key indicators."

City staff agrees that the City's General Fund end-of-year fund balance is lower compared to some other cities. However, the City disagrees with the expenditure amount shown in the report, the cities being used for comparison, the cash situation of the General Fund, and the debt to assets ratio.

The audit report includes an expenditure level of \$39.9 million in FY2010-11. When viewed out of context, this amount presents an inaccurate view of the City's true financial position. This figure includes a \$6.4 million loan as expenditure (This is an internal loan from the City's pooled investment account used to pay off the PERS Public Safety Side Fund. See attachment 4). The City believes showing this is inappropriate for the purposes of this report as the expense to repay the loan will be incurred in the fiscal year when the payments on the loan are due. In addition, most of the cities used as comparison in the report are not cities in the region facing similar labor cost, cost of living, and other economic constraints. The City prepared the following Exhibit comparing to cities closer geographically to Watsonville (see Exhibit 1.2 below).

Exhibit 1.2: Watsonville vs. Comparable Cities FY2010-11								
	Salinas	Scotts Valley	Santa Cruz	Gilroy	Monterey	Morgan Hill	Median	Watsonville
Population ³	150,441	11,580	59,684	52,027	27,810	38,477	45,252	52,543
GF Revenues	\$80,459,293	\$ 7,703,123	\$ 77,912,927	\$36,063,731	\$59,012,204	\$23,493,281	\$47,537,968	\$31,077,410
GF Expenditures	78,804,888	7,833,807	95,908,015	32,215,955	57,806,922	25,479,076	45,011,439	33,487,519 (1)
GF Fund Balance	11,059,380	6,749,955	25,531,855	25,220,668	33,249,674	7,282,162	18,140,024	1,598,588
Fund Bal. % GF Exp	14.03%	86.16%	26.62%	78.29%	57.52%	28.58%	40.30%	4.77%
General Fund Cash	11,378,862	4,005,490	18,126,982	20,450,350	13,615,450	6,231,090	12,497,156	9,001,593 (2)
Mos. Cash Avail.	1.73	6.14	2.27	7.62	2.83	2.93	3.33	3.23
GF Assets	23,618,275	7,265,822	28,204,289	25,935,077	55,969,477	9,906,919	24,776,676	12,303,252
GF Liabilities	12,558,895	515,867	2,672,414	714,409	22,719,803	2,624,757	2,648,586	5,343,842 (4)
Liabilities/Assets	53.2%	7.1%	9.5%	2.8%	40.6%	26.5%	10.7%	43.4%
Sources: FY2010-11 Comprehensive Annual Financial Reports for each City								
Notes								
(1) Excludes \$6.4 million shown in the CAFR as expenditure since amount represents a loan for this amount, not an expense								
(2) It includes \$7.2 million for one day loan in CAFR shown as due from other funds								
(3) 2010 Census Data								
(4) This figure includes long term debt amount which should not be included in the liabilities								

Regarding the debt to assets ratio, the City partially disagrees with the audit finding. Typically, a long term portion of a loan should not be included in the Governmental balance sheet as required by Generally Accepted Accounting Principles (GAAP). However, GAAP also has an exception for internal loans which must be shown in the balance sheet, regardless of the time horizon on the loan. If the City had chosen to obtain an outside loan such as a bond to pay this debt, the long term portion of the loan would not show in this statement but would cost the City almost double in interest payments. Therefore, the City is excluding \$5.3 million for the liabilities shown in the audit report which brings the debt to assets ratio to 43.4%.

The General Fund cash balance for fiscal year end is artificially low due to year end closing activities. GAAP for governments, indicate funds cannot be presented with negative cash balances. Accordingly, the General Fund cash has been used in the past to help other funds with negative cash show a zero cash balance for one day at the end of the fiscal year. This is attained by performing a one day transfer on June 30 and reversing the transfer the next day. Without this reporting requirement, cash balance for the general fund at the end of FY 2010-11 was \$9 million or 3.23 months of General Fund expenditures. As mentioned in the audit report, the Government Finance Officers Association (GFOA) believes a standard for cash balances is typically 2 months. The City's General Fund cash balance is almost one and half times better than the standard.

While there are many factors contributing to Watsonville's expenditure levels and those of the comparable cities; including the \$6.4 million CalPERS side fund loan as part of the analysis artificially inflates the total expenditure level for the City of Watsonville. Excluding this amount, and comparing with cities with more similar cost constraints characteristics, the total costs per capita decreases and shows a more realistic picture than presented in the audit report (see Exhibit 1.3 below).

Exhibit 1.3 General Fund 2010-11 Expenditures per Capita								
	Salinas	Scotts Valley	Santa Cruz	Gilroy	Monterey	Morgan Hill	Median	Watsonville
GF Expenditures	\$ 78,804,888	\$ 7,833,807	\$ 95,908,015	\$ 32,215,955	\$ 57,806,922	\$ 25,479,076	\$ 45,011,439	\$ 33,487,519 (1)
Population ³	150,441	11,580	59,684	52,027	27,810	38,477	45,252	52,543
Expend. per capita	\$ 524	\$ 676	\$ 1,607	\$ 619	\$ 2,079	\$ 662	\$ 995	\$ 637

(1) Excludes \$6.4 million shown in the CAFR as expenditure since amount represents a loan for this amount, not an expense

Finding 4: "While information on the City's financial condition can be distilled from reviewing publically available City documents, such as the City budget and the Comprehensive Annual Financial Report (CAFR), these documents alone do not include either sufficiently accurate or sufficiently analyzed and summarized data to enable the City Council and public to have a full accurate picture of the City's financial state and trends."

Finding 5: "More accurate summarized information needs to be regularly presented to the City Council on the overall financial position of the City to better assess the impacts of its decisions on expenditures, revenues, loans, transfers on the City's short- and long-term financial position."

The City disagrees with findings 4 and 5. The City staff has continually presented accurate, summarized data to Council during the Mid-Year budget review and during budget public

sessions. The auditor's report correctly indicates that General Fund revenues have been decreasing over the last five fiscal years. However, the assumption that City staff has not presented sufficiently analyzed and summarized data nor kept the Council and the public informed is incorrect. As demonstrated in attachment 1; the City implemented several cost savings measures over the review period while maintaining constant communication with the Council and the public. The City's staff has prepared and presented numerous, accurate summarized data presentations via staff report and power point presentations at public City Council meetings. Former Administrative Services Director did an excellent job keeping the City Council and public informed.

Copies of these reports and presentations were provided to the auditors. Although, there is always room for improvement and the findings represent more a subjective opinion than one based on facts, the City will explore additional ways to present more summarized data to the City Council and the public.

2. Inter-fund Loans and Transfers

Finding 6: "Like most municipalities, the City of Watsonville loans and transfers cash between its funds each year. At any point in time, a fund may have idle cash balances that can be used for short- or long-term loans to another fund to cover the costs of services or a project until expected revenues have been obtained."

Finding 7: "Risks associated with inter-fund loans and transfers are that the loans will not be repaid in full with appropriate interest if revenues do not materialize as expected, that repeated loans mask the loan recipient fund's inability to meet its costs, and that tying up certain fund monies in loans may prevent the accomplishment of planned projects and services."

The City agrees with these findings (6 & 7). These are general statements about loans and transfers commonly known in financial governmental accounting.

Finding 8: "Some City of Watsonville inter-fund loans reviewed have resulted in lessening monies available in the loaning fund because some loans do not require interest payments. In other instances, the full terms and conditions of inter-fund loans are not fully disclosed in City Council resolutions or CAFFs. Further, the impact of issuing inter-fund loans on the loaning fund, such as delays in planned projects or services, is not formally reported to the City Council and public."

Finding 9: "The recurring provision of short-term General Fund loans to the City's Airport and Parking Garages, including the garage adjacent to the Civic Center, reflects ongoing operating losses at those facilities that are being supported by the General Fund. The City has plans in place for both operations but the impact on the limited General Fund of supporting these operations in recent years could have been better reported to the City Council."

The City partially disagrees with findings 8 and 9. The City generally charges interest for inter-fund loans. In specific situations, the City Council made the policy decision to approve zero interest loans as this would benefit economic development within the City in the long run.

While some of the loans reviewed did not require interest payments, this was done with presentation and approval by the City Council at a public meeting; therefore providing an opportunity for the public and Council to ask questions about the transaction. The terms of the loans were always disclosed in the loan agreements which were approved by the Council.

Other transfers characterized as loans by the audit report are not loans and are not presented to the Council for approval. These include one day transfers of cash for financial reporting purposes. For example, some City operations, such as the airport, have experienced negative cash balances and the General Fund cash has been used for financial reporting purposes to bring the cash balance to zero on June 30 and the transaction is reversed the next day. This is done in order to meet accounting reporting requirements. The City Council has had extensive public discussions on the City's Parking Fund and raised Parking Fees and Parking Ticket amounts in recent years.

The Airport, despite running short-term deficits, is in good financial condition and has consistently paid down its debt which was incurred to fund needed aircraft Hangars. A portion of that debt will be completely paid off in 2014.

Finding 10: "At least three inter-fund loans and reimbursements reviewed between FYs 2008-09 and 2010-11 did not include interest payments, resulting in a loss to the General Fund of an estimated \$740,000, an estimated loss to the City's Impact Fee Funds of \$111,492, and an estimated loss of \$36,597 in interest earnings for a loan issued by the Low-income Housing Set-aside Fund. Two of these loans were approved by the City Council as interest-free, though staff reports to the Council about these loans did not present the fiscal impact of the interest-free loans. The sources of a multi-fund loan to the General Fund to pay off a City debt to CalPERS was disclosed as the City's pooled money investment account in the City Council resolution authorizing the loan. However, neither the resolution nor the related staff report disclosed the individual funds that would be impacted by the loan."

The City partially disagrees. The loans that resulted in no interest payments (\$740,000 and \$111,492) were associated with the construction of the Civic Plaza Building and were presented to the Council for approval with the terms of the loan clearly indicating there was no interest being charged on this loan. This was a policy decision made by Council to encourage economic development in the downtown area.

The audit report also makes reference to a loan and its corresponding interest in the amount of \$36,597 not been credited to the loaning fund. This characterization is incorrect. The item in question is not a loan but a reserve which was established pursuant to a grant requirement. The grant required the City to set aside \$250,000 in reserve as a condition to receive grant funding. Any interest earned by this deposit set aside for the benefit of the housing fund receives its share of interest earned by the pooled investments.

Regarding the investment in a Public Employee Retirement System side fund loan; the auditor's report indicates the City did not disclose the funding sources for this loan. However, the City presented this information to the City Council on June of 2011 to be as follows (see attachment 5): "That the City Council adopts a resolution authorizing and setting forth the terms and conditions between the General Fund and the City's pooled money investment account for an

internal loan of up to \$6,454,697 with the City's 12-month average pooled money portfolio rate for 13 years and authorize the defeasance of the CalPERS Side Fund Public Safety plans." The terms and funding were clearly indicated in the action approved by the Council and the staff report. Furthermore, this is an investment made following the City's investment policy which indicates: "Investments shall be diversified among institutions, type of securities and maturities to maximize safety and yield with changing market conditions; investments with a maturity at purchase of more than 5 years shall be approved by City Council."

This investment was made following the City's investment policy. Staff explained this to the auditors; however, the auditors chose to continue to characterize this as a loan and not an investment.

3. Budget and Expenditure Controls

Finding 11: "Expenditures for the majority of the City's General Fund departments exceeded their approved budgets for each of the three fiscal years ending June 30, 2012. The Fire and Police Department exceeded their collective budgets by \$1.8 and \$1.2 million in FY 2009-10 and FY 2010-11, respectively, and the majority of other departments did likewise. While unforeseen needs can develop in any year that require budget adjustments, the number of departments that have exceeded their budgets and the absence of a clear process for amending the approved budget indicate a lack of cost control mechanisms and department management accountability for controlling costs."

The City partially disagrees. The audit report is comparing the original adopted budget to the final actual audited expenditures ignoring any amendments to the budget throughout the year approved by the City Council. While some departments have exceeded their departmental budgets, the overall total General Fund budget has not been exceeded. The auditor also ignored City Manager approved intra-fund departmental budget adjustments as allowed by the City Council Budget Resolution. The primary area of over-expenditure during these years occurred in Public Safety overtime. This was partly due to very ambitious budget goals for overtime control in the original adopted budget. Police overtime has been brought under control. Fire Department overtime expenditure amounts remain an ongoing concern.

The City staff understands the importance of having good processes in place to monitor the budget. To that end, Department Directors have received monthly expenditure reports to track their expenditures and make adjustments to their operations. In addition, City staff has recently worked to implement a new policy and procedure to track department costs against budget which requires corrective action plans by departments to bring their costs within budget. Part of the challenge with implementing these reports is the City's outdated financial management computer system. The City has planned to update it for many years, but has been unable to do so because of budget constraints.

Exhibits 3.1 and 3.2 below show audited financial data for FY 2009-10 and 2010-11 respectively. These exhibits derived from audited data demonstrate that while some Departments exceeded their budget in FY 2009-10 the General Fund budget was not exceeded. To correct for some department over-budget expenditures, the City Manager authorized intra-fund budget

adjustments as allowed by Council Resolution. Nevertheless, the City recognizes there are some departments, particularly public safety, exceeding their approved budget and the City has identified these problems and potential solutions in the past as part of the budget and mid-year budget presentations to the Council.

City staff will again present some options to the City Council during this year's mid-year budget presentation.

Exhibit 3.1: FY 2009-10 Budget vs. Actual				
Department	Final Budget	Actual	Variance	Percent Variance (over)/under
Capital Improvement Program	\$ 28,711.64	\$ 10,099.04	\$ 18,612.60	64.8%
Community Development	\$ 1,408,059.72	\$ 1,249,465.47	\$ 158,594.25	11.3%
Finance	\$ 2,164,606.66	\$ 2,336,867.03	\$ (172,260.37)	-8.0%
Fire	\$ 5,395,397.00	\$ 6,290,471.28	\$ (895,074.28)	-16.6%
General Government	\$ 1,739,906.00	\$ 1,840,303.64	\$ (100,397.64)	-5.8%
Library	\$ 3,515,931.85	\$ 561,817.41	\$ 2,954,114.44	84.0%
Non Departmental	\$ 485,412.60	\$ 722,119.78	\$ (236,707.18)	-48.8%
Parks & Community Services	\$ 3,682,591.32	\$ 3,567,518.94	\$ 115,072.38	3.1%
Police	\$ 14,648,242.16	\$ 15,171,181.29	\$ (522,939.13)	-3.6%
Public Works	\$ 4,068,777.01	\$ 3,446,946.97	\$ 621,830.04	15.3%
Grand Total	\$37,137,635.96	\$ 35,196,790.85	\$ 1,940,845.11	5.2%

Sources: FY 2009-10 City Audited Financial Data and Comprehensive Annual Financial Report

Exhibit 3.2: FY 2010-11 Budget vs. Actual				
Department	Final Budget	Actual	Variance	Percent Variance (over)/under
Capital Improvement Program	\$ 1,607,380	\$ 61,357	\$ 1,546,023	96.18%
Community Development	\$ 1,285,578	\$ 1,150,403	\$ 135,175	10.51%
Finance	\$ 2,032,959	\$ 2,152,956	\$ (119,997)	-5.90%
Fire	\$ 5,316,187	\$ 6,148,924	\$ (832,737)	-15.66%
General Government	\$ 1,673,849	\$ 1,104,820	\$ 569,029	34.00%
Library	\$ 541,484	\$ 541,484	\$ -	0.00%
Non Departmental	\$ 372,718	\$ 754,416	\$ (381,698)	-102.41%
Parks & Community Services	\$ 4,172,497	\$ 3,140,084	\$ 1,032,414	24.74%
Police	\$ 14,928,277	\$ 14,966,519	\$ (38,241)	-0.26%
Public Works	\$ 3,733,704	\$ 3,466,555	\$ 267,149	7.16%
Grand Total	\$ 35,664,634	\$ 33,487,519	\$ 2,177,115	6.10%

Sources: FY 2010-11 City Audited Financial Data and Comprehensive Annual Financial Report

In addition, it is worth noting that a trend of expenditures vs. budget over the last five fiscal years shows the City has not overspent its approved budget. Exhibit 3.3 shows this data taken from audited financial statements.

Exhibit 3.3: General Fund Five Year Trend of Expenditure vs. Budget

	CAFR Year				
	2010-11	2009-10	2008-09	2007-08	2006-07
Budgeted Appropriations	\$35,664,633	\$37,101,636	\$41,508,725	\$42,522,315	\$39,323,387
Actual Expenditures	\$33,487,519	\$35,196,791	\$38,068,719	\$38,897,712	\$36,464,073
Variance	\$ 2,177,114	\$ 1,904,845	\$ 3,440,006	\$ 3,624,603	\$ 2,859,314

Sources: CAFR for each fiscal year

Further analysis of expenditures by Department indicates the largest component for over expenditure in Fire and Police departments was overtime. This situation had already been reported to the Council in the mid-year report presented to the Council in February of 2012 and prior budget status reports. More details about overtime will be presented in a separate section below.

Finding 12: "Appropriation authority for General Fund expenditures in excess of originally budgeted amounts was covered partially by carrying forward approximately \$2.8 million in unexpended prior year capital project appropriations in FY 2009-10 and \$1.8 million in FY 2010-11. These appropriations were added midyear without City Council re-appropriation or approval of new uses of these funds."

The City disagrees with this finding. The re-appropriation of encumbrances is presented to the Council and approved by them. This was also the case in FY 2009-10 and 2010-11 as demonstrated on pages 21-27 of the biennial 2009-10 and 2010-11 budget and on pages 2-8 of the revised biennial budget.

Finding 13: "While some overtime is unavoidable for public safety agencies and can even be cost effective, the extent of the variance between budgeted and actual overtime, particularly for the Fire Department, is extensive."

Finding 14: "The City of Watsonville's public safety costs, measured in costs per resident, are higher than the median costs for public safety among seven comparable cities."

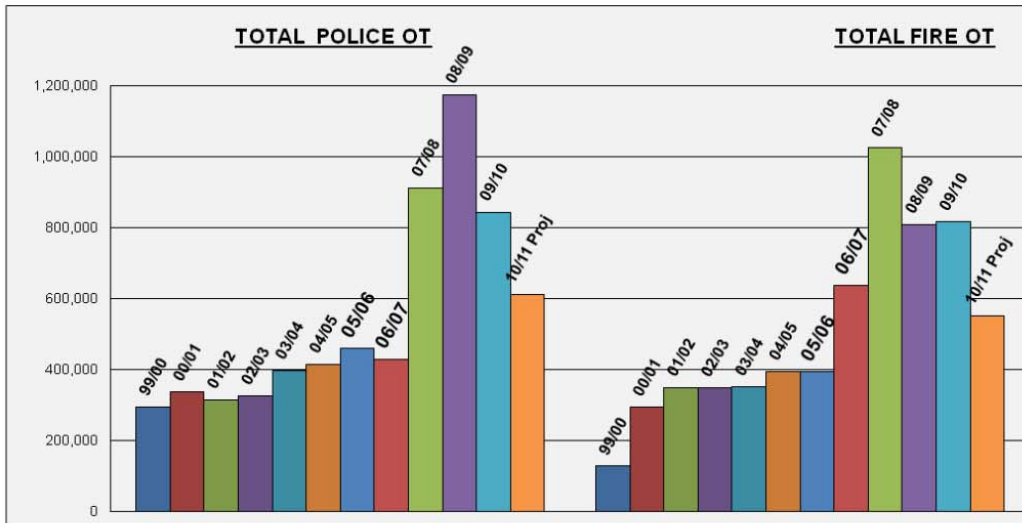
The City partially disagrees with the comparison cities being used and agrees that overtime has been high. A comparative analysis with local cities (Exhibit 3.4) indicates Watsonville is below the median in public safety expenditures per capita, lower than other communities with similar characteristics but with more resources such as Santa Cruz and Monterey, and higher than other similar communities such as Gilroy, Morgan Hill, and Salinas.

City	Public Safety Expenditures	Population	Cost per Person
Salinas	\$ 55,943,707	150,441	\$ 372
Scotts Valley	\$ 4,545,261	11,580	\$ 393
Santa Cruz	\$ 34,376,692	59,684	\$ 576
Gilroy	\$ 22,005,580	52,027	\$ 423
Monterey	\$ 24,479,714	27,810	\$ 880
Morgan Hill	\$ 16,139,261	38,477	\$ 419
Median	\$ 23,242,647	45,252	\$ 514
Watsonville	\$ 22,258,470	52,543	\$ 424

Regarding overtime costs in public safety, City staff has identified this issue in the past, and has made presentations to the Council about the problem and provided some recommendations to improve the situation, and began implementing changes that have generated modest savings estimated at \$100,000 per year. An example of a summary table discussed with the Council in FY 2009-10 is shown in (Exhibit 3.5).

However, City staff recognizes more has to be done to alleviate this problem and is working to identify alternative solutions to resolve this problem, particularly with the Fire Department. More details will be presented during the mid-year budget review.

Exhibit 3.5



Finding 15: “The City lacks adequate management tools, reports, and resources to ensure expenditures are controlled and that all variances with the budget are clearly disclosed. The City’s finance and accounting system is outdated, lacks flexibility and does not provide sufficient

timely information for department managers to be able to keep abreast of their budget variances.”

Finding 16: “The City reports it has implemented a new budget monitoring process since audit field work was completed.”

The City partially agrees with finding 15 and fully agrees with finding 16. In general, the City has management tools, reports, and resources to ensure expenditures are controlled and that all variances with the budget are clearly disclosed. However, the finance and accounting system is outdated as it uses older, complicated technology which is not easily supported by existing resources. Due to the current system’s complexity and the lack of expert resources for training, development of new reports is extremely challenging. Therefore, the system lacks flexibility for modifying reports easily at the department level. Acquiring a new basic financial system would cost between \$300,000 to \$500,000 plus any internal costs for implementation. A more comprehensive system could cost from \$500,000 to \$1,000,000 plus internal implementation costs.

Even with these challenges, City staff has developed a new budget reporting policy and procedure which helps departments better manage their budget. This practice was previously in place and has now been formalized and improved. A copy of the policies and procedures, and a sample report has been provided to the auditors and is included as attachment 2.

Finding 17: “The cash disbursement report provided to the City Council for approval at every meeting is not an effective cost control mechanism. The reports contain little explanation, are not tied to baselines, and lack roll-ups by department or function.”

The City partially agrees with this finding. The cash disbursements report is not intended to provide cost control information. The report is provided based on the requirements by the City’s municipal code requiring that “all claims and demands, except fined salaries and wages, against the City” shall be presented to the Council for approval. However, the “Guide to Government Finance in California” indicates this practice is outdated and inefficient and recommends eliminating the practice. Accordingly, City staff will work in developing new reports that may provide summarized information with rollups by Department. This will likely require a modification of the City’s municipal code but it is something which is supported by Government Code Section 37208 (adopted in 1978 and amended in 1986). This legal code allows local agencies adopting their budget by resolution not to receive governing body approval before issuing checks to vendors.

Finding 18: “The City’s cost allocation plan for services provided to multiple departments is based on allocation assumptions from FY 2000-01, or more than ten years ago.”

The City agrees with this finding. The City had identified this as an item that needed attention and will continue to move forward with its original plan to develop a new cost allocation plan during the upcoming budget cycle.

Finding 19: "The City established formal, written cash handling policies and procedures in the summer of 2012. Prior to that, such policies and procedures were not in place, in spite of the fact that tens of millions of dollars are collected each year Citywide. City staff reports that more such written procedures will be prepared in the near future."

The City disagrees. Prior to the summer of 2012, the City did have policies and procedures in each department for cash handling. The City implemented a city-wide comprehensive cash handling policy in the summer of 2012 which included a refinement of current practices and policies at the department level. In addition, departmental practices and policies are currently being reviewed to be aligned with the comprehensive city-wide cash handling policy.

4. Capital Budget and Impact Fees

Finding 20: "In addition to its operating budget, the City maintains a five year capital improvement project budget that is subject to approval by the City Council as part of the annual budget approval process."

The City agrees with this finding as it merely states the City's capital budgeting practice.

Finding 21: "The City's capital improvement project budget provides some important details for each project including a brief project description, planned expenditures, department, fund, and name of project manager. However, it is not possible to tell from the document how long previously approved projects or equipment acquisitions have been underway and how much or how little has been expended on them. Since timing and costs frequently change over the course of a capital project, it is critical that the City's governance board maintain the ability to oversee progress and costs on capital expenditures."

The City partially agrees with this finding and will work in implementing a short term and long term solution to capital projects reporting. The City has always tracked capital improvement projects in the financial system by assigning a project number which allows for tracking of costs on the project over time. In addition, the City always tracks capital projects progress by showing a list of these projects in the budget documents. However, the antiquated financial system the City owns poses a challenge in easily obtaining reports for these projects and present additional information other than the details currently provided. In the short term, the City will continue the current time consuming elaborate process in place. In the long run, the City will seek a solution tied to the acquisition of a new financial system which will allow for tracking of capital projects over multiple fiscal years with less time and resource intensive processes.

Finding 22: "One source of City funding for capital projects is development impact fees. These fees, paid for by developers, are used to cover the costs of new infrastructure and equipment needed due to development. The bases of many of these fees have not been updated since they were established in the 1980s. Many are not tied to clearly established standards or clearly linked to documented development-related costs. Some of the uses of these fees do not appear to be growth-related, as required by State law."

Finding 23: "Required annual reports on the City's development impact fees, presented to the City Council on consent agenda each year, do not contain all information required by State law to enable the City Council and public to determine how these funds are being used. Projects that can be funded with these fees are limited to growth-induced needs and some projects funded do not appear to be appropriate."

Requirements for the establishment and reporting on development impact fees are set by government code sections 66000 et seq. The ordinances the City adopted meet the requirements of this section. The City will evaluate the past reports and present a separate report on impact fees to the Council once the evaluation is completed.

5. Procurement

Finding 24: "Adherence to City of Watsonville policies and procedures for procurement is inconsistent. For instance, a review of purchase order files demonstrated that 11 out of a sample of 20 purchase orders in FY 2011-12 did not obtain three sources of pricing, either through quotes or competitive bids, when policies encourage or require them to do so. Seven of these 11 purchase orders were for professional services. Existing policies and procedures for the procurement of professional services through competitive bidding are vague and conflicting."

City staff reviewed the same sample of purchase orders for compliance with the purchasing policies and procedures and found compliance with purchasing policies and procedures for 18 out of the 20 sampled orders. The backup to each purchase order is with each file reviewed. The auditor is aware purchases for professional services are different from buying materials and the purchasing requirements are different for those services according to State law and City procedures; this accounts for 7 of the 11 purchases the auditor indicates are out of compliance.

Exhibit 3.1: Purchasing Samples City of Watsonville

P.O. #	Amount	Explanations documented on PO request	P/W Projects	Professional Services	3 vendors documented	Explanation for less than 3 vendors documented	CCRESO	Quick Bid	Formal Bid	Sole Source - documented
S004210	\$2,255,839.49	Documented	yes				74-10		yes	
S004293	\$50,000.00	Documented		yes			29-11			
S004472	\$25,000.00	Documented		yes			20-11			
S004478	\$134,332.42	Documented	yes				131-11			
S004479	\$27,325.03	Only two vendors make these that can be used by our trucks. Both gave us quotes. Documented				yes				
S004497	\$99,500.00	Documented		yes			160-11			
S004498	\$15,318.04	Only vendor that sell this product								yes
S004501	\$15,634.00	2 vendors documented	yes							
S004506	\$64,000.00	Signed contract by city		yes						
S004517	\$21,665.16	Only vendor that sell this product in CA								yes
S004525	\$22,450.00	Bid & Vendors documented	yes					yes		
S004535	\$45,000.00	Documented					46-09			
S004709	\$11,102.02	Documented			yes					
S004712	\$40,000.00	Documented					76-11			
S004714	\$127,000.00	Bid documented					131-12		yes	
S004724	\$173,725.00	Documented and am approved					18-12			
S004730	\$25,000.00	Documented		yes			11-12			
S004747	\$70,034.58	Bid documented			yes			yes		
S004757	\$800.00					under limit for required written documentation				
S004803	\$6,539.50	City signed contract attached		yes						

This is an incorrect interpretation of the purchasing policies. Of the remaining four, only two did not have all the required documentation required for competitive bidding (see Exhibit 3.1).

Finding 25: "The City Council does not always approve purchase orders or agreements that are greater than \$50,000, though City policies and procedures require such approval. A review of 21 purchase orders with funds encumbered in FY 2010-11 that were subject to City Council approval found that eleven were approved by the City Council but ten were not. Those approved represented most of the dollar value of the 21 purchase orders, but the ten that were not approved by the City Council had an aggregate value of \$1,486,070 or an average value of \$148,607 each."

The City disagrees with this finding. Not all purchase orders in excess of \$50,000 must be approved by City Council. The purchasing policy indicates purchases of non-personal services, services and supplies, and equipment must follow competitive bidding which requires Council approval. However, Public Works projects have different rules as approved by the Council. In accordance with the purchasing policies, Public Works projects can be awarded up to \$175,000 without obtaining Council approval or conducting formal bidding. Some of the items analyzed by the auditor fell in this category but the auditor insisted in applying the \$50,000 limit on all purchases. The summary below (Exhibit 5.2) shows two out of 27 sampled purchases did not fully meet the purchasing requirements. One of those samples is being counted twice; once under finding 24 and the second time in this sample.

Exhibit 5.2: Purchasing Samples in Excess of \$50,000

PO #	Amount	P/W Projects	Professional Services	Pluggback agreement approved by CM per reso	3 vendors documented	Explanation for less than 3 vendors documented	CCRESO	Quick Bid	Formal Bid	Sole Source - documented	Explanations documented on PO request
S004497	99,500						160-11				documented
S004504	2,954,000						153-1				documented
S004506	64,000		yes								Signed contract by city
S004507	70,767		yes								3 vendors documented - 1 will not reply
S004514	1,256,075	yes					167-11				documented
S004515	74,501	yes									only two vendors documented
S004522	192,252						187-09				renewal processed in approved contract - documented
S004523	95,269						186-09				renewal processed in approved contract - documented
S004534	246,500	yes					184-11				documented
S004690	124,000	yes						yes			Bid in 2011 extension in contract documented
S004698	85,000		yes								City signed contract attached
S004703	82,533										
S004708	252,733			Yes							Documented and cm approved
S004714	127,000						131-12		yes		bid documented
S004716	90,888	yes						yes			winning bid included
S004719	406,212		yes				18-12				Documented and cm approved
S004724	173,725						170-11				documented
S004727	100,000						13-12				documented
S004729	193,000						21-12				documented
S004733	328,732			Yes							Documented and cm approved
S004736	89,938	yes						yes			winning bid included
S004739	50,891							yes			only two local vendors - 1 refused to respond documented
S004750	70,035							yes			bids from 3 vendors
S004752	387,450	yes					193-11		yes		documented
S004755	148,189	yes						yes			3 vendors documented
S004761	62,908	yes						yes			3 vendors documented
S004800	321,100									yes	Only vendor to haul biosolids documented
S004802	115,812							yes			bid documented

Finding 26: “Though the City Council adopted contract change order policies in 1996, those policies are not included in the City’s Administrative Rules and Regulations. Further, they do not provide sufficient mechanisms to control contract costs increases resulting from change orders. For example, a construction agreement for \$1,888,429 was approved by the City Council

because it was the lowest price out of seven bids. However, a change order of \$374,162, or a 19.8 percent increase, was approved by the department director and the Purchasing Division without having to go back to the City Council for approval. The change order amount is more than twice the \$175,001 threshold for City Council approval of new public works contracts.”

The City disagrees with this finding. The City Council designated change order authority up to 25% of the original order to department directors and City Manager according to resolution 91-96 CM. All change orders follow the authority provided under this resolution. Staff have been trained and informed about this policy. In addition, the original contract amount was approved by the Council; so having the change order approved by Council again as the finding suggests would be irrelevant.

Finding 27: “Formal policies and procedures for Open Purchase Orders for small, repetitive purchases do not exist. In FY 2011-12 there were 159 Open Purchase Orders, of which 136 incurred expenditures totaling \$3,081,502. However, a majority of these Open Purchase Orders have not been competitively bid within the past 20 years and most do not have a negotiated contract with the City to ensure consistent prices and discounts for goods and services.”

The City partially agrees with this finding. The City has had controls in open purchase orders; however, there is an issue on how purchase orders are tracked in the financial system which does not allow for clear monitoring of purchase orders. The City has recently formally placed a policy for dealing with recurring purchase orders and will explore the acquisition of a new financial system. The acquisition of a new system will cost in the range of \$300,000 to \$1,000,000 depending on the modules purchased.

In connection with the findings outlined in this report, there are also 22 recommendations presented in the performance audit report. Some of these recommendations are valid and useful and can be implemented quickly, while others could be significantly impactful to implement given the limited City’s resources. The summary below shows a summarized and condensed view of the recommendations, their estimated potential impact and feasibility of implementation by the City. For a complete description of the recommendations, please refer to the Grand Jury Report Executive Summary.

Recomm. #	Estimated Staff Hours	Estimated		Estimated Total Cost	City Agrees	Recommendation
		Internal Cost	External Cost			
1.1	200	\$ 10,000	\$ -	\$ 10,000	Yes	Annual Summary reports of CAFR
1.2	5	\$ 250	\$ -	\$ 250	Yes	Annual Report comparing to other Cities
1.3	124	\$ 6,200	\$ -	\$ 6,200	Yes	Establish Finance sub-committee
2.1	102	\$ 5,100	\$ -	\$ 5,100	Yes	Interfund Loans policy
2.2	20	\$ 1,000	\$ -	\$ 1,000	Yes	Report on impact of interfund loans to other funds
2.3	10	\$ 500	\$ -	\$ 500	Yes	Report on impact of interfund loans to other funds
2.4	-	\$ -	\$ -	\$ -	No	Interfund loans paid with interest (repeat of 2.1)
3.1	102	\$ 5,100	\$ -	\$ 5,100	Yes	Policy governing budget changes
3.2	253	\$ 12,650	\$ -	\$ 12,650	Yes	Review of Fire and Police expenditure
3.3	150	\$ 7,500	\$ -	\$ 7,500	Yes	Report reconciling original budget to approved budget and CAFR
3.4	125	\$ 6,250	\$ -	\$ 6,250	Yes	Revise municipal code and streamline disbursements report
3.5	500	\$ 25,000	\$ 25,000	\$ 50,000	Yes	Update Cost allocation plan and update annually (costs are annual)
3.6	150	\$ 7,500	\$ 25,000	\$ 32,500	Yes	Obtain actuarial reports for internal service funds
3.7	-	\$ -	\$ -	\$ -	Yes	Charge sufficient rates for health costs (related to 3.7)
3.8	300	\$ 15,000	\$ -	\$ 15,000	Yes	Continue preparing and updating written policies/procedures
4.1	150	\$ 7,500	\$ -	\$ 7,500	Yes	Modify capital budget document to include multi-year presentations (annual)
4.2	250	\$ 12,500	\$ 25,000	\$ 37,500	Yes	Review all impact fees for compliance with requirements
4.3	300	\$ 15,000	\$ 15,000	\$ 30,000	Yes	Establish service level standards for each impact fee
4.4	150	\$ 7,500	\$ -	\$ 7,500	Partially	Prepare annual impact fee reports that are fully compliant with requirements
5.1	100	\$ 5,000	\$ -	\$ 5,000	Yes	Revise administrative rules to improve purchasing procedures (annual)
5.2	500	\$ 25,000	\$ -	\$ 25,000	Yes	Train City staff involved in purchase process
5.3	200	\$ 10,000	\$ -	\$ 10,000	Yes	Annual reports summarizing purchase order activity
Totals	3,691	\$ 184,550	\$ 90,000	\$ 274,550		

While City staff recognizes it is always prudent to have policies and procedures in place to aid in the operations of an organization, it is also true that it is not feasible or practical to have a policy for every single aspect of running an organization. Cost and resource constraints will always be present, and Council Members and City staff must be aware of those constraints in order to prioritize resources to the most critical areas of operations.

Although the City disagrees with some material presented in the findings outlined in the audit report, the City staff reiterates its appreciation for the work done by HMR and values the potential positive impact their recommendations may have on the City.

FINANCIAL IMPACT:

There is no financial impact of receiving and approving the response to the report, but it is estimated City staff spent 500 staff hours to respond to the Auditor's requests at an estimated cost of \$25,000. Implementation of all the recommendations is estimated at \$275,000; plus an additional \$300,000 to \$1,000,000 for purchasing a new financial system in the long term. Potential savings from implementing recommendations is still undetermined at the time of writing this report.

ALTERNATIVES: The City Council can choose not to accept the report and direct staff to provide more information or the Council can approve the report as recommended, or it can approve the report with suggested modifications.

ATTACHMENTS:

- 1) Summary of Information presented to Council
- 2) Budget Monitoring Policy and Procedure
- 3) Performance Audit of the City of Watsonville
- 4) PERS Side Loan Resolution

- 5) PERS Side Loan Staff Report
- 6) Response to Recommendations

cc: City Attorney