

# **Performance Audit of The City of Watsonville**

**Prepared for:**

**Fiscal Year 2012-13  
Santa Cruz County Grand Jury**

**January, 2013**

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January 3, 2013

Ms. Lise Peterson, Foreperson  
and Members of the FY 2012-13 Santa Cruz County Grand Jury  
701 Ocean Street, Room 318i  
Santa Cruz, CA 95060

Dear Ms. Peterson and Members of the FY 2012-13 Santa Cruz County Grand Jury:

Harvey M. Rose Associates, LLC is pleased to present this report on our *Performance Audit of the City of Watsonville*. The report contains findings and 22 recommendations in five areas pertaining to the City's financial policies, controls and decision-making.

Thank you for providing our firm with the opportunity to conduct this performance audit for the Santa Cruz County Grand Jury. We are available at any time to respond to any questions about this report.

Sincerely,

A handwritten signature in blue ink that reads 'Fred Brousseau'. The signature is fluid and cursive, with a long, sweeping underline.

Fred Brousseau  
Project Manager

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# Executive Summary

Harvey M. Rose Associates, LLC (HMR) was retained to conduct a performance audit of the City of Watsonville by the Fiscal Year 2011-12 Santa Cruz County Grand Jury. The objectives of the audit were: to assess risk to the City's assets and resources 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.

The results of this performance audit engagement are presented in five report sections, each containing findings, conclusions and recommendations. Altogether, there are 22 recommendations in this performance audit report. A summary of the findings and the recommendations from each report section are as follows.

## 1. Financial Condition, Reporting and Controls

### Summary of findings:

- 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.
- While the City has made significant reductions in its General Fund expenditures since Fiscal Year 2009-10 (July 1, 2009 through June 30, 2010), 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.
- 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.
- 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.
- 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 fiscal impacts of its decisions on expenditures, revenues, loans and transfers.

Based on the above findings, the following recommendations are submitted:

The City Council should direct the City Manager to:

- 1.1 Prepare annual reports summarizing and distilling the Comprehensive Annual Financial Report (CAFR) to provide the City Council with a complete and candid assessment of the City's financial position including past and future multi-year trend data and a comparison of actual audited revenue and expenditure data with budgeted and projected revenues and expenditures.
- 1.2 Prepare an annual report comparing the City of Watsonville's financial position with other comparable cities, measured in key areas such as net assets, General Fund net revenues, General Fund balance as a percentage of General Fund expenditures, liabilities relative to assets, cash on hand relative to monthly expenditures, and other measures.
- 1.3 Consider establishment of a City Council audit or finance sub-committee to ensure that the City's financial condition receives concentrated attention from the governing board and that a worsening of current financial conditions is prevented to the extent possible.

## **2. Inter-fund loans and Transfers**

### **Summary of findings:**

- 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.
- 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.
- 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 CAFRs. 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.
- 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.

- 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.

Based on the above findings, the following recommendations are submitted:

The City Council should:

- 2.1 Direct the City Manager to prepare formal written policies and procedures regarding inter-fund loans and transfers requiring that the repayment schedules, principal and interest amounts, loaning fund(s) and all other terms and conditions of such transactions be fully disclosed in required City Council resolutions authorizing any loan of more than one year.
- 2.2 Direct the City Manager to report the service or program impact on the loaning funds of having some or all of their resources tied up for the term of the loan as part of the staff report accompanying all inter-fund loan authorizing resolutions.
- 2.3 Direct the City Manager to prepare an annual report on all short-term inter-fund loans at the end of each year, including past year loans and disclosure of any funds repeatedly receiving loans due to chronic revenue shortfalls or expenses in excess of revenues.
- 2.4 Establish a policy requiring that all inter-fund loans be repaid with interest at the same rate as earned by the City's pooled investment fund.

### **3. Budget and Expenditure Controls**

#### **Summary of findings:**

- 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.

- 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.
- 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.
- 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 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.
- The City reports it has implemented a new budget monitoring process since audit field work was completed.
- 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'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 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.

Based on the above findings, the following recommendations are submitted:

The City Council should direct the City Manager to:

- 3.1 Establish a mechanism to ensure adherence to City policies dictating levels of authority for making changes to the budget in the interest of controlling costs to the budget, to include the level of authority department directors have for shifting funds within their budget, the authority of the City Manager to make budget changes, and the criteria that would trigger further review and action by the City Council.

- 3.2 Conduct further review of expenditures in the Fire and Police Departments and assess and report on alternative cost saving plans and structures to reduce public safety expenditures comparable to similar sized and neighboring cities, including consideration of contracting with other firefighting agencies if more cost-effective to do so.
- 3.3 Revise the annual budget document and Mid-Year Financial Reports to include year-to-date actual revenues and expenditures, a distinction between management proposed and City Council adopted budgets, a clear summary of the fiscal results of past actions taken by the City Council to increase revenues or reduce/increase expenditures, and an explanation of the difference between actual amounts reported in the budget and the amounts reported in the City's Comprehensive Annual Financial Reports.
- 3.4 Revise the Municipal Code and streamline information provided in disbursement reports for City Council review to include only:
  - a) New disbursements not tied to items previously reviewed by the City Council, such as approved budgets, expenditure plans and contracts;
  - b) Disbursements representing significant changes to previously approved budgets, expenditure plans, contracts, and purchase orders, defined as a flat threshold amount determined by the City Council, a percentage threshold based on the previously approved amount, or changes in the scope of the project or program; and,
  - c) Significant expenditures on Open Purchase Orders.
- 3.5 Conduct a new cost allocation study and develop a new plan to appropriately allocate City costs to departments, and update the plan annually.
- 3.6 Obtain actuarial reports for its Internal Service Funds that more adequately estimate expected costs.
- 3.7 Charge insurance rates that are sufficient for (a) meeting expected costs and (b) increasing the assets and fund balance for Internal Service Funds to build sufficient reserves for a 50% to 80% confidence level of funding, as practiced by many public jurisdictions.
- 3.8 Continue preparing and updating written policies and procedures in all areas of financial management and internal controls.



## 4. Capital Budget and Impact Fees

### Summary of findings:

- 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'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.
- 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-induced, as required by State law.
- 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.

Based on the above findings, the following recommendations are submitted:

The City Council should direct the City Manager to:

- 4.1 Modify the capital budget document to include multi-year presentations of all capital projects including:
  - a. Funds already spent on previously approved projects and date of project commencement;
  - b. Funds budgeted in the current and future years on previously approved projects;
  - c. Identification of changes in previously approved project budgets;
  - d. Funds proposed for current and future years on projects for which approval is requested;

- e. Funding sources and an indication of whether or not funding has been obtained yet;
  - f. Brief explanations of any changes in project timing.
- 4.2 Review the bases of all development impact fees and report back to the City Council on whether or not the fees are in compliance with State Mitigation Fee Act requirements including the bases of the fees and the projects for which they have been used.
- 4.3 Establish service level standards to serve as the basis of each development impact fee such as acres of park per resident, fire department response time, etc.
- 4.4 Prepare annual impact fee reports that are fully compliant with all reporting requirements in State law.

## 5. Procurement

### Summary of findings:

- Adherence to City of Watsonville policies and procedures for procurement is inconsistent. For instance, a review of purchase order files demonstrated that 14 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. Six of these 14 purchase orders were for professional services. Existing policies and procedures for the procurement of professional services through competitive bidding are vague and conflicting.
- 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, or earmarked as financial obligations, 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.
- 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 cost 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.

- 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

Based on the above findings, the following recommendations are submitted:

The City Council should direct the City Manager to:

- 5.1 Revise the City's written Administrative Rules and Regulations to include the following:
  - (a) Requirement for competitive bidding for all professional service contracts above a designated amount such as \$15,000 without requiring that contracts be awarded to the lowest responsible bidder (qualified contractor or vendor that meets bid specifications at the lowest cost), but rather, the most qualified if the lowest responsible and most qualified bidder are not the same;
  - (b) Require executed contracts for all Open Purchase Orders that include: a) contract term; b) annual or contract term limit for expenditures, prices, and discounts; c) mechanisms to approve changes in prices and discounts; and, d) City Council approval for all Open Purchase Orders estimated to exceed \$50,000;
  - (c) Clear procedures for approving change orders to all purchase orders, including Open Purchase Orders, such as requiring City Council approval for change orders that (i) result in a total purchase order greater than \$50,000 (or \$175,001 for public works), including the sum of previous change orders, or (ii) exceed a ten percent increase over the original purchase order amount;
  - (d) Monitoring and reporting procedures for Open Purchase Order expenditures, such as monthly reports by the Purchasing Division, that could result in requesting change orders for approval by City Council, or halting ongoing expenditures for the remainder of the year; and,
  - (e) Examples of when the City Council should approve purchase orders that are \$50,000 or less.
- 5.2 Train all City staff involved in purchase orders on the revised Administrative Rules and Regulations to ensure proper and consistent implementation of policies and procedures, including City Council approval of all purchase orders greater than \$50,000.
- 5.3 Provide annual reports to the City Council summarizing purchase order and contract activity for the past year, including original contracts and amounts, number and

value of change orders, and number and value of purchases from Open Purchase Orders.

# Introduction

Harvey M. Rose Associates, LLC (HMR) was retained by the FY 2011-12 Santa Cruz County Grand Jury to conduct a *Performance Audit of the City of Watsonville*. This performance audit was conducted for the Santa Cruz County Grand Jury pursuant to its authorities defined in California Penal Code Section 925, et seq.<sup>1</sup>

## Project Purpose and Scope

The Performance Audit of the City of Watsonville was designed to accomplish the following objectives:

- Assess risk to the City’s assets and resources due to its policies and internal controls, particularly in the areas of financial and grants management and controls over procurement, contracts and cash management.
- Assess accountability and transparency in City decision making, including an analysis of information flow between City management and the City Council, other City policy makers and the public.
- Evaluate the City’s compliance with changes in State redevelopment law, including its processes for determining its redevelopment obligations and financial commitments as successor agency.

## Methodology

This Performance Audit was conducted in accordance with Government Auditing Standards, prepared by the United States Comptroller General and promulgated by the United States Government Accountability Office (USGAO). Also known as generally accepted government auditing standards (GAGAS), these standards provide a framework for performing high-quality audit work with competence, integrity, objectivity, and independence.

This Performance Audit was conducted in two phases. Phase 1 involved an initial assessment and profile of the state of the City of Watsonville to identify areas of high risk of to the City’s assets and resources. Phase 2 consisted of detailed field work to evaluate financial management and internal controls, accountability and transparency in City decision making, and the City’s compliance with changes in State redevelopment law. Specific field work activities included:

- Entrance conference with representatives from the City of Watsonville.
- Compilation of key documents to profile the City finances and organization.

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<sup>1</sup> California Penal Code Section 925 states, “The grand jury shall investigate and report on the operations, accounts, and records of the officers, departments, or functions of the county including those operations, accounts, and records of any special legislative district or other district in the county created pursuant to state law for which the officers of the county are serving in their ex officio capacity as officers of the districts.”

- Interviews with City Councilmembers and managers.
- Presentation of a profile of the current state of the City and risk assessment to the Grand Jury.
- Evaluation of financial management and internal controls, including a review of the City's audited financial statements and budget documents.
- Evaluation of comparable cities' audited financial statements and analysis.
- Transaction testing and file review for purchase orders, payments, contracts, bidding process, grants, and assets.
- Evaluation of the current state of the City's former redevelopment agency efforts.
- Evaluation of financial and other relations between the City General Fund and other City funds.
- Evaluation of the use, deferral, and reporting of development impact fees.
- Evaluation of agendas, minutes, and reports for City Council meetings.

Though transaction testing was completed to assess grants and assets management, no significant risks were identified. Therefore, these analyses were excluded in the report.

A draft version of this report was provided to the City of Watsonville for review, factual clarifications, and comments, and a performance audit exit conference was conducted November 26, 2012. Revisions to the report were then made and the final document submitted to the Santa Cruz County Grand Jury.

## **Acknowledgements**

Harvey M. Rose Associates, LLC would like to thank the Santa Cruz County Grand Jury, City Councilmembers, the City Manager and his management staff for their time and assistance. City of Watsonville staff, particularly the Administrative Services Director and the Assistant Finance Officer, were extremely helpful and professional and took the time necessary to provide detailed information to the project team.

# 1. Financial condition, reporting and controls

- 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. While the City has made significant reductions in its General Fund expenditures since Fiscal Year 2009-10 (July 1, 2009 through June 30, 2010), 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.
- 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. The City's General Fund end-of-year fund balance for FY 2010-11, the last date for which audited data is available, was only 4 percent of City expenditures, compared to 42.8 percent for the comparison cities. The City had only one half of a month's worth of cash on hand compared to 2.3 months' worth in the other cities. Watsonville's General Fund level of indebtedness as of June 30, 2011 amounted to 87 percent of its assets, compared to only 10.7 percent in the other cities.
- 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.
- To ensure that the City Council can fulfill their obligation as fiscal stewards, 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 fiscal impacts of its decisions on expenditures, revenues, loans and transfers.

To provide the City Council with assurance that adequate financial controls are in place, comprehensive written financial policies and procedures are needed detailing tools and methods governing all financial transactions. A review of the City of Watsonville's prepared Comprehensive Annual Financial Reports for the five fiscal years ending June 30, 2011 (the most recent available) shows that the City's financial condition was worsening during that time, as measured by key indicators of financial position such as net assets, level of indebtedness,

**1. Financial condition, reporting and controls**

reserves and fund balances. Exhibit 1.1, which presents the City’s net assets for government activities<sup>1</sup> during that period, shows that net assets declined for each of the last three years shown, from approximately \$153.8 million in Fiscal Year (FY) 2008-09 to \$141 million in FY 2010-11. A decrease in net assets can be an indicator of a city’s worsening financial position, whether due to a reduction in assets, an increase in liabilities, or a combination of the two.

Exhibit 1.1 shows a decline in the City’s overall financial position during the period covered. What is most significant about the decline is that it was largely due to a decrease in cash, leaving the City with fewer liquid assets to cover its operational costs.

<b>Exhibit 1.1 Change in Net Assets, Government Activities, City of Watsonville FYs 2006-07 – 2010-11</b>					
	<b>2006-07</b>	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>
Net assets, start of yr.	\$99,690,040	\$133,326,823	\$147,275,010	\$153,202,385	\$141,343,459
Net assets, end of yr.	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
	31.40%	10.09%	4.41%	-3.33%	-0.25%

Source: City Comprehensive Annual Financial Reports, FYs 2006-07 – 2011-11

Exhibit 1.2 presents expenses and revenues for the City’s government activities for the five year period between FY 2006-07 and 2010-11. The five year trend has been that revenues have declined while expenditures have gone up and down. Revenues were less than expenditures for two of the last three fiscal years shown. This means that the fund balance had to be used to cover expenses for those two years.

<b>Exhibit 1.2 Revenues and Expenditures Government Activities, City of Watsonville FYs 2006-07 – 2010-11</b>					
	<b>2006-07</b>	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>
Government Activities Revenue	\$74,420,729	\$64,752,117	\$54,583,012	\$53,678,487	\$54,392,929
Government Activities Expends	\$47,178,104	\$55,979,833	\$50,124,903	\$57,904,273	\$54,748,771
Net Revenue	\$27,242,625	\$8,772,284	\$4,458,109	(\$4,225,786)	(\$355,842)

Source: City Comprehensive Annual Financial Reports, FYs 2006-07 – 2011-11

<sup>1</sup> Net assets are defined as City assets less liabilities. Government activities, as defined in the CAFR, includes all financial transactions and funds except for the City’s enterprise activities (i.e., utilities, airport).



## **1. Financial condition, reporting and controls**

While the City has been affected by the decline in economic conditions nationwide, which particularly affected property tax revenues, it also experienced a significant decline in grant revenue between FY 2007-08 and 2008-09 which did not come back during the five year period (2006 through 2011). Expenditures decreased in FY 2010-11, primarily in the area of redevelopment and housing expenditures and also due to the City reducing the number of positions Citywide. City management points out that the City took other actions during this period to reduce costs such as requiring higher employee PERS and health insurance contributions. However, even with these decreases, expenses still outpaced revenues for the City's government activities.

The trend of expenditures outpacing revenues was more pronounced within the City's General Fund. Exhibit 1.3 shows that General Fund expenditures outpaced revenues (before transfers-in) for each of the five years through FY 2010-11. Besides base General Fund revenues such as property, sales and utility users tax revenue, the General Fund also receives transfers from other funds which support General Fund activities. These include transfers from the City's Retirement Tax Fund, which is used to support City employee retirement benefits, and Gas Tax Fund monies, which, consistent with State law, are transferred to the General Fund to pay for street improvements,.

However, as shown in Exhibit 1.3, even after transfers to cover certain General Fund costs, the General Fund was still in a deficit situation for four of the five years reviewed. The size of the deficit was reduced in FY 2010-11 compared to the prior two years as a result of reductions in General Fund expenditures and higher transfers in, though approximately half of the transfers represent one-time monies. However, net revenues for the year were still negative and unaudited FY 2011-12 records show the General Fund deficit trend likely to continue when the final audited numbers are prepared.

<b>Exhibit 1.3: General Fund Trends, FYs 2006-07 – 2010-11</b>					
	<b>2006-07</b>	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>
GF Revenues	\$33,348,718	\$32,684,775	\$30,714,756	\$31,400,184	\$31,077,410
GF Expenditures	<u>36,464,073</u>	<u>38,897,712</u>	<u>38,068,719</u>	<u>35,196,791</u>	<u>39,971,715</u>
Subtotal: net revenues	<b>(3,115,355)</b>	<b>(6,212,937)</b>	<b>(7,353,963)</b>	<b>(3,796,607)</b>	<b>(8,894,305)</b>
Other Financing:					
Transfers in	<u>4,800,025</u>	<u>3,266,674</u>	<u>3,131,186</u>	<u>2,711,000</u>	<u>8,256,955</u>
Total net revenues	\$1,684,670	<b>(\$2,946,263)</b>	<b>(\$4,222,777)</b>	<b>(\$1,085,607)</b>	<b>(\$637,350)</b>
GF Fund Balance, year-end	\$6,983,724	\$6,651,312	\$2,820,710	\$1,896,570	\$1,598,588
Fund Balance as %					
Expends	19.2%	17.1%	7.4%	5.4%	4.0%
Cash	2,171,811	1,136,890	363,731	1,902,722	1,714,477
Months cash available	0.71	0.35	0.11	0.65	0.51

Source: City Comprehensive Annual Financial Reports, FYs 2006-07 – 2011-11

Note: The City paid a \$6.5 million loan to CALPERS in FY 2010-11 to cover certain retirement costs for some Fire and Police Department employees in FY 2010-11. This is a one-time General Fund expense funded by a loan from other City funds. The City did not have that expense in FY 2011-12.

**Harvey M. Rose Associates, LLC**

## 1. Financial condition, reporting and controls

Exhibit 1.3 shows that the General Fund year-end fund balance decreased each year of the five years reviewed, starting at nearly \$7 million in FY 2006-07, or 19.2 percent of General Fund expenditures, and decreasing to approximately \$1.6 million in FY 2010-11, or 4 percent of General Fund expenditures for that year. The smaller this amount is, the less flexibility the City has for meeting increased or unexpected costs.

As another measure of its weak financial position, the City's CAFRs show that the General Fund had very low amounts of cash available in each of the five years reviewed. Exhibit 1.3 shows that the cash position of the General Fund over the five year period reviewed was poor relative to best practices. Specifically, the Government Finance Officers Association recommends that two months' worth of expenditures be maintained in cash to cover unexpected costs and/or downturns in revenue. As shown in Exhibit 1.3, the City has had under one month's worth of expenditures in cash as of June 30 of each year for the last five years. Having such a small amount of cash on hand may have had less impact in the years prior to the national economic recession but the combination of low cash balances and low fund balances during the five year period made it difficult for the City to maintain all of its positions and services when revenues decreased and redevelopment funds became no longer available with the State-mandated dissolution of redevelopment agencies in California.

City management states that actual cash available for the General Fund is greater than reported in the CAFRs because, to comply with CAFR protocols, additional cash had to be temporarily loaned to other funds with negative cash balances. However, this situation indicates that there were weaknesses in those other City funds, for which the General Fund is ultimately responsible. This situation was either not true in the comparison cities or, if any of the comparison cities did loan General Fund cash to other funds, they still had more reported General Fund cash available than the City of Watsonville.

More details on General Fund expenditures and revenues are provided in Section 3 of this report.

A final measure of the City's financial position is its level of General Fund indebtedness, or liabilities. Exhibit 1.4 presents General Fund liabilities relative to its assets for the five fiscal years ending June 30, 2011 as reported on the balance sheet in the City's CAFRs. As can be seen, the City's General Fund has maintained high liabilities relative to its assets in all five years. Further, its liabilities have increased substantially in each of the last three fiscal years, ending in an amount equal to 87 percent of General Fund assets.

<b>Exhibit 1.4: General Fund Trends, FYs 2006-07 – 2010-11</b>					
	<b>2006-07</b>	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>
GF Assets	13,411,298	11,450,149	7,565,639	6,866,753	12,303,252
GF Liabilities	6,427,974	4,798,837	4,744,929	4,970,183	10,704,664
Liabilities % Assets	47.9%	41.9%	62.7%	72.4%	87.0%

Source: City Comprehensive Annual Financial Reports, FYs 2006-07 – 2011-11

The General Fund did not have a strong base of assets during the five years reviewed. During that period, its assets have consisted mostly of a small amount of cash, as described above, and balances due to the General Fund from short-term loans to other funds. Liabilities have consisted primarily of accrued personnel costs such as vacation leave balances owed to employees in the future and, for FY 2010-11, loan payments due to other funds (discussed further in Section 2).

The information in Exhibits 1.1 through 1.4 is available in the City's Comprehensive Annual Financial Reports, all of which are public documents, accessible to the City Council and the public. However, the information in those audit reports is not formally summarized or presented to the City Council and public by City staff to provide an understanding on the implications of decisions with fiscal impacts. The document on its own does not lend itself to a quick understanding of the City's financial position and multi-year trends. Similarly, the City's budget documents and report contain a great deal of useful detailed information but the information is not summarized to provide an accessible picture of the City's budget situation.

**Comparison with other cities**

While many of the poor financial indicators above are tied to national economic conditions in recent years, a comparison with other California cities that have also been affected by economic conditions shows that the City of Watsonville is worse off in many respects. As a result, Watsonville has had to reduce its workforce and service levels in recent years and is still in a precarious state in terms of its ability to meet ongoing regular expenditures, maintain services levels and cover any unexpected costs.

Exhibit 1.5 presents comparisons of key financial measures with other cities. All the cities are of comparable size as Watsonville, though the City of Santa Cruz has fewer characteristics in common with Watsonville than the other comparison cities because it has a stronger economic base. Though it has a larger population, the City of Salinas was added to the comparison group at the request of City of Watsonville management.

**1. Financial condition, reporting and controls**

<b>Exhibit 1.5: Watsonville vs. Comparable Cities, FY 2010-11</b>									
	<b>Cathedral City</b>	<b>Colton</b>	<b>Gilroy</b>	<b>Hanford</b>	<b>Porterville</b>	<b>Salinas</b>	<b>Santa Cruz</b>	<b>Median</b>	<b>Watsonville</b>
Population	52,381	52,940	49,582	54,284	55,023	152,994	60,342	54,284	51,586
GF Revenue	27,732,595	25,143,393	36,063,731	20,444,156	22,080,187	80,459,293	77,912,927	27,732,595	31,077,410
GF Expenditures	32,202,922	27,641,201	32,215,955	20,392,760	21,341,142	78,804,888	95,908,015	32,202,922	39,971,715
GF Fund Balance Year-end	13,791,984	3,287,230	25,220,668	13,843,789	21,841,056	11,059,380	25,531,855	13,843,789	1,598,588
Fund Balance, % GF Expenditures	42.8%	11.9%	78.3%	67.9%	102.3%	14.0%	26.6%	42.8%	4.0%
General Fund Cash	9,560,263	3,917,115	20,450,350	6,776,398	142,264	11,378,862	18,126,982	9,560,263	1,598,588
Months Cash Available	3.56	1.70	7.62	3.99	0.08	1.73	2.27	2.3	0.48
GF Assets	17,023,101	6,694,847	25,935,077	15,482,986	23,622,719	23,618,275	28,204,269	23,618,275	12,303,252
GF Liabilities/Assets	3,231,117	3,407,617	714,409	1,649,197	1,781,663	12,558,895	2,672,414	2,672,414	10,704,664
	19.0%	50.9%	2.8%	10.7%	7.5%	53.2%	9.5%	10.7%	87.0%

Sources: FY 2011-11 Comprehensive Annual Financial Reports for each city. Population estimates for each city as of July 1, 2011 from U.S. Census Bureau EST 2011-03-06.

As shown in Exhibit 1.5, Watsonville’s General Fund end-of-year fund balance, at approximately \$1.6 million, is extremely low compared to the median of \$13.8 million in the comparison cities. As a percentage of expenditures, Watsonville’s end-of-year fund balance amounted to 4 percent of General Fund expenditures compared to a median of 42.8 percent in the other cities. The comparison cities had cash available that would cover a median of 2.3 months of their General Fund expenditures compared to only one-half of a month’s worth of expenditures in cash in Watsonville. At 87 percent, the City of Watsonville has a high level of liabilities relative to its assets compared to a median of 10.7 percent in the comparison cities.

While there are undoubtedly many factors contributing to the disparity between Watsonville’s financial condition and that of the comparison cities, Exhibit 1.6 shows that at \$775, Watsonville’s General Fund expenditures per capita are higher than the \$522 median of the comparison cities. In fact, the City of Watsonville’s expenditures per capita are higher than all of the other cities except the City of Santa Cruz, which also has a much higher revenue base as shown above in Exhibit 1.5. The same information is presented for FY 2009-10 in Exhibit 1.7, when the City did not have the one-time expense for paying off its PERS loan as it did in FY 2010-11. As can be seen, at \$686 per capita, the City of Watsonville was still above the median amount of the comparison cities, though the difference was not as great as in FY 2010-11. Only two other cities, Santa Cruz and Cathedral City, had higher per capita General Fund expenditure levels in FY 2009-10 than the City of Watsonville.

## 1. Financial condition, reporting and controls

Exhibit 1.6: General Fund FY 2010-11 Expenditures Per Capita									
	Cathedral City	Colton	Gilroy	Hanford	Porterville	Salinas	Santa Cruz	Median	Watsonville
GF Expenditures	\$32,202,922	\$27,641,201	\$32,215,955	\$20,392,760	\$21,341,142	\$78,804,888	\$95,908,015	\$32,202,922	\$39,971,715
Population	52,381	52,940	49,582	54,284	55,023	152,994	60,342	54,284	51,586
Expenditures per capita	\$ 615	\$ 522	\$ 650	\$ 376	\$ 388	\$ 515	\$ 1,589	\$ 522	\$ 775

Sources: FY 2011-11 Comprehensive Annual Financial Reports for each city. Population estimates for each city as of July 1, 2011 from U.S. Census Bureau EST 2011-03-06.

Exhibit 1.7: General Fund FY 2009-10 Expenditures Per Capita									
	Cathedral City	Colton	Gilroy	Hanford	Porterville	Salinas	Santa Cruz	Median	Watsonville
GF Expenditures	\$35,431,227	\$31,333,606	n/a	\$20,346,682	\$21,185,526	\$83,768,355	\$97,605,583	33,382,417	\$35,196,791
Population	51,515	52,331	48,946	54,050	54,326	150,829	60,049	54,050	51,300
Expenditures per capita	\$ 688	\$ 599		\$ 376	\$ 390	\$ 555	\$ 1,625	\$ 577	\$ 686

Sources: FY 2009-10 Comprehensive Annual Financial Reports for each city. Population estimates for each city as of July 1, 2010 from U.S. Census Bureau EST 2011-03-06.

### Accurate, well summarized public information key to effective financial control environment

The City's Comprehensive Annual Financial Reports (CAFRs) contain much of the key information presented above though the document, like CAFRs for most cities, is not summarized to present key factors and measures that should be of concern to the City Council and public. The CAFR is a public document and provided to Councilmembers, but it is not formally presented and summarized at City Council sessions as a control measure to ensure that a candid assessment of the City's financial position is provided to the governing board. Further, the City Council does not have an audit or finance sub-committee, as some city councils do, to focus on financial matters exclusively and to receive more in-depth analyses and information about the City's audits and finances. This can be a more efficient structure than attempting to present and discuss often complex financial matters at a full City Council session.

City staff does prepare and present financial information about the City in conjunction with the annual budget proposal and the midyear budget report. Staff presentations in recent years have identified declining revenues and alternative approaches to reducing expenditures. The budget document itself includes detailed information about each City fund's revenues, expenditures and fund balance projections. However, the discussion and City Council sessions at those times is also about making decisions on funding levels for each department and services to be provided in the coming year and less about assessing trends and prospects for the City's overall financial position.

Further, the fund analyses contained in the budget are prepared before the official audited amounts have been identified by the City's external auditor. As a result, certain values are projected or estimated, and not actual. This leaves the City Council with a not always accurate picture of the City's financial position at a time when they are making spending decisions. While the timing for approving the annual budget and having actual audited expenditures and revenues does not coincide, the City Council should formally receive and be briefed on the

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actual amounts at another point in the year, after the CAFR is complete, and provided with financial trend and context information.

Exhibit 1.8 presents some differences between General Fund information presented in the Fund Analysis section of the proposed Fiscal Year 2010-11 budget and actual amounts as presented in the FY 2010-11 CAFR. While it is not possible to have final actual revenue and expenditure amounts available at the time the budget is being considered in May and June of each year, the discrepancies in these amounts show the need for the City to have a separate public discussion and presentation to the City Council and/or an audit committee of audited final amounts compared to budgeted amounts at a point in the year when final audited amounts are available.

<b>Exhibit 1.8: Differences between General Fund Amounts Presented in Budgets vs. Audited Actual Amounts</b>					
	<b>Original Budget</b>	<b>Projected in FY 2011-12 Budget Document</b>	<b>Audited Actual</b>	<b>Difference Budgeted vs. Actual</b>	<b>Percent Difference</b>
Start-of-year fund balance	\$5,643,022	n.a.	\$2,235,938	(\$3,407,084)	-60.38%
General Fund Revenues	29,780,956	29,279,643	31,077,410	\$1,296,454	4.35%
Transfers in	2,749,219	3,298,000	8,256,955	\$5,507,736	200.34%
Revenues + transfers in	32,530,175	32,577,643	39,334,365	\$6,804,190	20.92%
General Fund Expenditures	32,530,175	32,857,210	39,971,715	\$7,441,540	22.88%
Net Revenues	0	-279,567	-637,350	(\$637,350)	
End-of-year-end fund balance	\$5,643,022	n.a.	\$1,598,588	(\$4,044,434)	-71.67%

Sources: City of Watsonville’s FY 2010-11 Comprehensive Annual Financial Report and FY 2011-12 Proposed Budget

As can be seen in Exhibit 1.8, there were some significant differences in fund information reported in the FY 2010-11 budget document and the actual audited amounts reported in the CAFR. In many cases, the actual results were worse for the City than those reported in the budget document.

Actual General Fund balance available at the start of the year, for example, was \$3.4 million less than the \$5.6 million amount reported in the budget document. Actual revenues and transfers to the General Fund were \$6.8 million higher, and expenditures were \$7.4 million higher than presented in the budget document. As a result of these differences, the actual FY 2010-11 year-end fund balance was approximately \$4 million less than the amount included in the FY 2010-11 budget.

## **Conclusions**

The City of Watsonville’s financial position is poor, has worsened over the five fiscal years through FY 2010-11 and General Fund expenditures appear to be outpacing revenues for FY

2011-12. Though information about this situation can be extracted from the City's Comprehensive Annual Financial Reports (CAFRs) and budget documents, such information is not being routinely summarized by staff and provided to the City Council in a way that provides a full picture of the current financial position and trends over time. Presentations to the City Council are needed summarizing the annual CAFRs, reconciling actual revenues and expenditures with budgeted and projected amounts, and providing multi-year trend analyses.

Even though complete audited final revenue and expenditure information on the current fiscal year cannot be available at the time the subsequent year's budget is being decided, more current estimates should be provided to the City Council. When the final audited amounts are available, they should be provided to the City Council and the public, with comparisons to what was assumed in the originally adopted budget so adjustments can be made as necessary and long-range plans adopted to achieve the City's financial goals.

The City's poor financial position is due in part to national economic conditions but a comparison of Watsonville's financial indicators with those of other comparable cities shows that the City of Watsonville is in worse condition than the other jurisdictions that have also been affected by economic conditions.

## **Recommendations**

The City Council should direct the City Manager to:

- 1.1 Prepare annual reports summarizing and distilling the Comprehensive Annual Financial Report (CAFR) to provide the City Council with a complete and candid assessment of the City's financial position including past and future multi-year trend data and a comparison of actual audited revenue and expenditure data with budgeted and projected revenues and expenditures.
- 1.2 Prepare an annual report comparing the City of Watsonville's financial position with other comparable cities, measured in key areas such as net assets, General Fund net revenues, General Fund balance as a percentage of General Fund expenditures, liabilities relative to assets, cash on hand relative to monthly expenditures, and other measures.
- 1.3 Consider establishment of a City Council audit or finance sub-committee to ensure that the City's financial condition receives concentrated attention from the governing board and that a worsening of current financial conditions is prevented to the extent possible.

## **Costs and Benefits**

The City will have more information and analysis at its disposal for management and the City Council to use in making decisions and controlling costs. The Council can better achieve goals such as improving the City's financial position if it has a regular source of reliable, clear

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***1. Financial condition, reporting and controls***

information on current and past conditions to use in making decisions for the future. Key information on fund balance, reserves and City indebtedness will be presented to the City Council. Preparation of this information will require staff time but the Administrative Services Manager and other staff are already allocating time to preparing financial and budget reports so this should not result in a significant additional staff time requirement.



## 2. Inter-fund Loans and Transfers

- 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. Transfers between funds are a mechanism for one fund to pay another for legitimate purposes, either with or without the expectation of repayment.
- 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. To minimize such risks, it is critical that the City of Watsonville have clear policies and procedures governing such loans and that the terms and conditions are clearly disclosed in authorizing resolutions approved by the City Council as well as fully reported in the City's Comprehensive Annual Financial Report (CAFR).
- 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 CAFRs. 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.
- 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.
- 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.

## ***2. Inter-fund Loans and Transfers***

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Loans and transfers between the General Fund and other City funds are classified in one of three ways for financial reporting purposes: 1) short-term loans expected to be paid back within one fiscal year; 2) long-term loans not expected to be paid back within one year; and 3) transfers where monies are moved from one fund to another, without payback expected, to pay for services provided or to make debt service payments through an appropriate fund (e.g., a transfer from the General Fund to the Debt Service fund to make a payment on bond debt). The City of Watsonville, like most cities, executes inter-fund loans and transfers each year. In some cases, these transactions provide temporary cash flow for a fund so it can meet its expenses before expected revenues have been received. These transactions can also be a routine reimbursement such as transferring Gas Tax Fund money to the General Fund to cover the latter fund's costs incurred for street repair and improvement, consistent with the legally restricted use of Gas Tax Fund monies.

To ensure proper control, it is critical that inter-fund loans and transfers be treated like formal loans from private lenders, with clear documentation of the term of the loan, a repayment schedule detailing the principal and interest amounts and payment dates, and any other conditions to ensure that the fund granting the loan is kept whole over time. This is particularly important for special revenue funds such as the Gas Tax and Impact Fee funds whose uses are legally restricted and cannot be used for other purposes, though they can be temporarily loaned to other funds.

What is critical about inter-fund loans and transfers from a management perspective is that loans are not masking structural problems such as excessive costs and/or insufficient revenues in the fund receiving the loan and that programs and services of the funds providing the loan are not being reduced or delayed due to their full resources not being available while they are loaned out.

In reviewing the City's financial audits and budgets from the past several years, the City has issued short- and long-term General Fund loans for a variety of purposes, some of which have worsened the General Fund's weak position, as discussed in Section 1. Some of the General Fund loans represent long-term or ongoing commitments of General Fund resources at the same time as many core City services and positions have been cut back and as General Fund reserves have been depleted.

The City's CAFRs show that the General Fund and other City funds have been covering deficit operations at two departments that were established and should be operating as self-supporting enterprise departments. These funds are the Airport and the Parking Garages, including the garage adjacent to City Hall. In addition, General Fund resources have been used to cover costs that would normally have been paid by development impact fees and some costs associated with the downtown redevelopment activities. City management reports that funds with negative cash balances are charged interest to make up the difference of any reductions in the City's pooled investment fund's interest earnings caused by the negative balance funds. While this will keep the pooled investment fund whole, the situation is still problematic when there are certain funds with chronic deficits because General Fund resources must be used to

support the deficit fund operations. Further, the financial position of the funds with chronic negative balances is worsened because they have to pay interest on their negative balances.

Agreements were executed for eventual reimbursement of General Fund expenditures from redevelopment property tax increment monies, but not for a minimum of five years, and with no interest payments, leaving the General Fund with less buying power when reimbursed. Loans between other City funds have also been issued without interest payments or without clear documentation and disclosure of their impact on the loaning funds. These loans include the \$250,000 Low-Income Housing Set-aside Fund loan for insurance, Redevelopment Agency obligations to the General Fund and Impact Fee Fund, and the PERS loan pre-payment from individual funds in the pooled money investment account.

**Short-term loans from General Fund supporting enterprises with deficits**

Short-term loans between funds are most typically made to cover cash shortages in other funds. For example, a grant funded project may commence using monies borrowed from another fund to cover initial costs until the committed grant funds are received. Such loans should be documented in the City’s CAFR but do not go through a formal loan process with a loan repayment schedule and City Council approval, since they are short-term transfers of cash only. Other short-term loans are shown in the CAFR for reporting purposes only to comply with accounting practices that do not allow funds to report certain negative balances.

Exhibit 2.1 shows short-term loans made by the General Fund for the three fiscal years ending June 30, 2011.

<b>Exhibit 2.1: Short-Term Loans from the General Fund to Other Funds, FY 2008-09 through FY 2010-11</b>			
	<b>FY 2008-09</b>	<b>FY 2009-10</b>	<b>FY 2010-11</b>
<i>Airport</i>	\$3,714,967	\$27,000	\$2,882,023
<i>Parking Garages</i>		\$738,069	\$855,832
Abandoned Vehicle		\$32,051	\$71,883
Internal Service Fund			\$1,153,414
Redevelopment Special Revenue			\$1,528,764
Retirement Tax	\$806,130	\$979,341	\$795,200
<b>Total</b>	<b>\$4,521,097</b>	<b>\$1,776,461</b>	<b>\$7,287,116</b>

Sources: City of Watsonville FY 2008-09 through FY 2010-11 CAFRs

Of the short-term loans made from the General Fund and shown in Exhibit 2.1, those issued to the Airport and Parking Garages present financial management issues for the City. The loans to

those two enterprises have been made each year because the two enterprises are not generating enough revenue to meet their costs. Though classified as short-term loans in the CAFR so that the two enterprise departments are not reported with negative cash balances, they actually represent operating subsidies from the General Fund because the two enterprises have not been able to meet all of their obligations.

At present, the Airport is developing a business plan to improve its revenues through better management of its properties and possible adjustment to hangar rates. Additionally, the Airport was issued a separate long-term loan from the General Fund that should be paid off by 2014, which will further improve the Airport's financial position and should at least break even at that point. The management issue is how the Airport continued to operate at a deficit for a number of years without the City taking actions to improve the financial position of the Airport. Airport operations have produced a deficit every year since at least FY 2009-10. A review of budget documents, staff reports and PowerPoint presentations from FY 2006-07 through FY 2011-12 indicate that City staff either reported projected positive net revenues each fiscal year or omitted projections of net revenues. However, the implications of annual operating deficits, where actual audited expenditures exceeded actual audited revenues were not presented to City Council. Better reporting on the City's and Airport's financial condition, including multi-year trend data and specific staff proposals for improvement, were needed to avoid the ongoing deficit operations that occurred at the Airport. City staff did report proposals for increased hangar rates and consolidation of management in a presentation to City Council in FY 2011-12, even though the Airport had operating deficits in multiple prior fiscal years.

Similarly, the parking garages fund, including the one garage built near City Hall in 2009, has operated at a deficit since its opening and has required General Fund subsidies to cover its costs. The City is presently considering options such as making the Garages a general government City department rather than continuing its status as a self-supporting enterprise department. If that occurs, a portion of its operations will become a regular General Fund cost. As with the Airport, better reporting of multi-year trend data and the consequences to the General Fund of continually subsidizing this operation should have been presented to the City Council and public. Such reporting could be accomplished with CAFR summary and distillation reports, recommended in Section 1 of this report.

### **Long-term loans not always adequately documented and some repaid without interest**

Long-term inter-fund loans<sup>1</sup> should be documented with City Council resolutions approving the loan and a detailed repayment schedule showing the amounts of principal and interest due on each payment date. The loan amount and repayment schedule should also be presented in the City's CAFRs. This serves as a control for ensuring that the lending fund is not harmed through

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<sup>1</sup> Long-term inter-fund loans are defined as those not expected to be repaid within a year.

the transaction and that any borrowed funds will be repaid as opposed to becoming permanent, subsidizing contributions to the borrowing fund.

A review of outstanding loans between the General Fund and other City funds reported between FY 2008-09 and FY 2010-11 showed that such documentation is not always in place and that interest is not always included in the loan terms and conditions. The loans in question are:

- 1) a \$250,000 loan from the Low-income Housing Set Aside Fund to the City's Internal Service Fund for an insurance reserve;
- 2) a \$4.4 million reimbursement agreement between the Redevelopment Agency and the General Fund to reimburse General Fund costs associated with the Civic Center building and parking garage redevelopment project;
- 3) a \$700,000 reimbursement agreement between the Redevelopment Agency and the Development Impact Fee Funds for deferred impact fee payments associated with the Civic Center building and parking garage redevelopment project; and
- 4) A loan for \$5.4 million in total obtained, according to the City's FY 2010-11 CAFR, from each of the City's utility's funds, the Impact Fee Fund, the Parks Development Fund, the Gas Tax Fund and the Library Fund to the General Fund to pre-pay a loan to CalPERS for public safety employee retirement benefits.

**\$250,000 Low-Income Housing Set-aside Fund Loan for Insurance**

Though posted in the City's CAFR as a long-term loan, the City has not provided the audit team with requested loan agreements or other documentation pertaining to a \$250,000 loan from the Low-income Housing Set-aside Fund to the City's Internal Service Fund. City staff has explained that the funds are for an insurance reserve required for the Youth Build project.

While the CAFRs show that \$250,000 is being held in cash in the Internal Service Fund, documentation of the terms and conditions upon which it will be repaid to the Low-income Housing Set-aside Fund have not been provided. According to City staff, the funds are technically in a pooled investment and are not part of a loan. However, the \$250,000 cannot be used by the Housing Set-aside Fund during the ten year term while they are on reserve for the insurance requirement.

Formal documentation of the repayment schedule and the interest to be paid back to the Housing Set-aside Fund should have been approved by the City Council and maintained in City records. Interest earnings on the \$250,000 in funds during the ten year loan term should be tracked and paid to the Low-income Housing Set-aside Fund when the funds are paid back. If \$250,000 is returned to the Low-Income Housing Set-aside Fund, without any interest, then the funds will have less purchasing power when reimbursed than when it was first transferred into

the Internal Service Fund. Assuming an interest rate of 3 percent per year, the Low-income Housing Set-aside Fund would be owed an additional \$36,597 at the end of the ten year term.

**\$4.4 Million Redevelopment Agency obligation to General Fund not posted in CAFR and not reimbursed with interest, depriving the General Fund of an estimated \$740,000**

The Redevelopment Agency transferred approximately \$4.4 million to the City's General Fund in FY 2010-11, pursuant to reimbursement agreements from 2004, as amended in 2006 and 2011. The purpose of the transfer was to reimburse the City for General Fund costs associated with the Civic Center building and parking garage redevelopment projects. Most of the costs of the projects were funded by a \$20 million bond issue but these General Fund costs were apparently not covered by bond proceeds. The City has not provided documentation to the audit team of the \$4.4 million of General Fund costs incurred on these projects.

This \$4.4 million reimbursement obligation was not reported as a Redevelopment Agency liability in the Agency's CAFRs after the agreements with the City were executed, nor was it posted as an asset in the City's CAFRs. Such reporting serves as a control to ensure that inter-fund loan repayment occurs in the event that other City financial records are incomplete or accidentally modified or destroyed. The absence of CAFR reporting presents the risk that if staff did not execute the repayment provision, the General Fund might not have been repaid.

The 2006 agreement called for reimbursement of the loaned funds on either July 1, 2011 or any July 1 in years thereafter, depending on the City's request for payment. There was no provision for interest payments in the reimbursement agreements. While the City Council approved of the reimbursement agreement without interest, a review of the staff report provided to City Council on June 23, 2006, prior to City Council approval, revealed a lack of information regarding interest rates for the reimbursement agreements. In contrast, an agreement for the deferral of \$242,305 in impact fees did include interest charges. The interest rate charged was clearly disclosed in staff reports to the City Council dated June 13 and 23, 2006. It is not clear from the staff reports why one agreement included interest payments and the other did not. At 3 percent per year, interest earned on the \$4.4 million between 2006 and 2011 would have been approximately \$740,000 for the General Fund.

When the Governor's proposal to abolish redevelopment agencies became known in 2011, the City amended its reimbursement agreements with the Redevelopment Agency to allow for immediate repayment to the General Fund. This repayment occurred in FY 2010-11.

State legislation adopted in June 2011 that dissolved redevelopment agencies does not allow for modifications to redevelopment agency obligation agreements. However, because the amendments to the agreements between the City and its Redevelopment Agency occurred in March 2011 and the full obligation was paid off shortly thereafter, the amendment does not appear to be a violation of this provision of State law. Further, the agreements were therefore not subject to a determination of whether or not they qualified as enforceable obligations, as

was required by State law for all other outstanding redevelopment agency debt and obligations as of June 27, 2011.

Another provision of State law related to redevelopment agency dissolution prohibits asset transfers from redevelopment agencies to sponsoring cities after January 1, 2011 unless the agency that received the assets is contractually committed to a third party for expenditure or encumbrance (legal claim) of those assets. Transferred is defined as instances where the transmission of money is not in consideration for goods or services received.

The State Controller is required by State law to review all asset transfers that took place after January, 2011 between redevelopment agencies and sponsoring cities. When such a review is eventually conducted for the City of Watsonville, the State Controller will have to determine if the amounts transferred to the City General Fund represented legitimate redevelopment costs. For the transfer to be confirmed as legitimate, the City will likely need to document that it incurred \$4,429,230 in General Fund costs for the Civic Center building and parking garage redevelopment projects since that was the amount in the reimbursement agreement that was transferred from the Redevelopment Agency to the General Fund. As mentioned above, the City has not provided documentation of these costs to this audit team.

The \$4.4 million repayment to the General Fund from redevelopment funds provided much needed revenue in FY 2010-11. Without it, negative General Fund net revenues of \$637,350 would have been \$4.4 million worse, or approximately a negative \$5 million.

**Reimbursement from redevelopment funds to Impact Fee Fund in 2011 for deferred impact fees on Civic Center projects did not include interest, depriving the Impact Fee Fund of an estimated \$114,492**

A reimbursement similar to the General Fund reimbursement described above took place in FY 2010-11 with redevelopment funds reimbursing the City's Impact Fee Fund \$700,000 for deferred development impact fees related to the downtown Civic Center redevelopment projects. Unlike the General Fund reimbursement agreement, these obligations were reported in City and Agency CAFRs and documented in the City Council resolution approving the reimbursement agreements.

However, like the General Fund reimbursement agreement, the Impact Fee Funds reimbursement agreements did not call for interest payments along with the reimbursement also scheduled for five or more years later. As a result, the Impact Fee Fund was left with less buying power for its restricted purpose: growth-related public improvements. The Impact Fee Fund would have received an additional \$114,492 in reimbursement from the redevelopment funds in addition to the \$700,000 reimbursement in deferred impact fees, assuming 3 percent interest and a five year term.

While the downtown Civic Center redevelopment project may have been perceived as very beneficial to the City and worthy of contributions from other City funds, the decision to



subsidize it with General Fund and Impact Fee Fund monies has resulted in fewer resources for the purposes intended for those funds.

**PERS loan pre-payment resolution did not document source of loan to General Fund or that General Fund would also be contributing to the payment**

A loan was made to the General Fund in FY 2010-11 from a variety of other City funds for up to \$6.5 million to pay off what is known as the “PERS side loan”. The purpose of the loan was to prepay PERS for pension benefits for the City’s uniformed public safety employees.

As shown in Exhibit 2.2, the City’s FY 2010-11 CAFR reports that \$5.4 million was borrowed from a number of City funds, including each City utility fund, the Gas Tax Fund, the Library Fund, and the Parks Development and Impact Fee Funds. The source of the \$1.1 million difference between the \$6.5 million payment to CalPERS (which was the loan amount approved by the City Council) compared to the \$5.4 million loan reported in the CAFR is not disclosed in the CAFR or the resolution authorizing the loan, but was presumably the General Fund itself.

Unlike the three loans discussed above, the resolution adopted by the City Council approving the CalPERS loan includes a 13 year repayment schedule detailing the principal and interest payments by payment date at 3 percent interest per year. However, the schedule does not disclose which specific funds are providing the loan, though that information is detailed in the CAFR. The resolution only shows that the funds will be repaid to the City’s investment pool, which is where all City monies are kept to earn interest until they are needed (with their balances and interest earnings tracked separately).

<b>Exhibit 2.2: Sources of Loan to General Fund to Pre-pay CalPERS Loan</b>	
<b>Source</b>	<b>\$ Amount</b>
Solid Waste Utility Fund	\$1,496,579
Sewer Utility Fund	910,956
Gas Tax	825,802
Impact Fee Fund	730,795
Library Fund	615,425
Water Utility Fund	570,286
Parks Development Fund	210,979
<b>Total Borrowed</b>	<b>\$5,360,822</b>
Loan authorized by City Council	\$6,454,697
Difference ( <i>assumed General Fund contribution</i> )	\$1,093,875

Source: FY 2010-11 CAFR

While the approach to paying off the PERS loan saved the City from paying the 7.75 percent annual interest rate that CalPERS was charging on the loan, the process did not fully disclose to



the City Council and the public which funds were going to be used and what the impact would be on the planned uses of those funds over the 13 year period. According to City staff, the funds listed in Exhibit 2.2 represent a one day snapshot prepared for the FY 2010-11 CAFR , and the actual funds covering the loan are taken from the pooled investment in general rather than any specific funds. However, this could be problematic for any fund that would require immediate cash held in the pooled investment fund. For example, the loan sources on June 30, 2011 included the City's Parks and other Impact Fees funds. Those funds are collected and held in reserve to pay for public improvements needed due to growth in the City. Similarly, any impacts of loaning the funds on operations and activities of the City's utilities should have been identified to ensure that the City Council and public were fully informed of the impacts of approving the inter-fund loan on delays or deferrals of planned projects over the 13 year loan term. Although City staff state that the City has sufficient cash in the pooled investment fund, the City is exposed to the risk of insufficient cash if several funds require immediate cash at one time. In addition, Department heads and managers should be able to know how much funds are available to them and is at their immediate disposal, which is impossible to do without full disclosure of the sources of funds and interest payment for the PERS loan.

## **Conclusion**

The City does not follow consistent policies and procedures regarding inter-fund loans and transfers. Since there is a risk of funds being inappropriately depleted of resources if loans are not structured and reported properly, it is critical the City establish and adhere to a consistent approach to inter-fund loans and transfers. Specifically, all such loans should be treated formally, with a documented repayment schedule and a fair interest rate. The City Council should be required to approve all inter-fund loans of one year or more, with all repayment details fully disclosed. Finally, the impact of inter-fund loans and transfers on the fund providing the resources should be summarized by staff and presented to the City Council in conjunction with any proposed loan. Short-term loans reflecting chronic shortfalls in other funds should be disclosed.

## **Recommendations**

The City Council should:

- 2.1 Direct the City Manager to prepare formal written policies and procedures regarding inter-fund loans and transfers requiring that the repayment schedules, principal and interest amounts, loaning fund(s) and all other terms and conditions of such transactions be fully disclosed in required City Council resolutions authorizing any loan of more than one year.
- 2.2 Direct the City Manager to report the service or program impact on the loaning funds of having some or all of their resources tied up for the term of the loan as part of the staff report accompanying all inter-fund loan authorizing resolutions.

- 2.3 Direct the City Manager to prepare an annual report on all short-term inter-fund loans at the end of each year, including past year loans and disclosure of any funds repeatedly receiving loans due to chronic revenue shortfalls or expenses in excess of revenues.
- 2.4 Establish a policy requiring that all inter-fund loans be repaid with interest at the same rate as earned by the City's pooled investment fund.

### **Costs and Benefits**

We estimate that developing and establishing policies will require less than .25 full-time position equivalents (FTE) for one year or less. Producing annual reports on all short-term loans could be efficiently accomplished if they are done in conjunction with preparation of the annual CAFRs. If the recommendations are implemented, then all City funds will be kept whole by consistently requiring that interest be included in all inter-fund loan repayments at the rate that they would have otherwise earned from the City's pooled investment fund. In the case of the General Fund reimbursement agreement with the Redevelopment Agency, this would have meant payment of an estimated additional \$740,000 along with the \$4.4 million reimbursed to the General Fund in FY 2010-11 for costs associated with the Civic Center redevelopment project, if the City Council had a consistent policy on interest rates. The City Council will receive more complete information on all proposed inter-fund loans and the City's Comprehensive Annual Financial Reports (CAFRs) will include more complete information on such loans. The risk to all City funds of losing some of their resources or delaying their programs and services due to inter-fund loans will be reduced.

### **3. Budget and Expenditure Controls**

- 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.
- 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.
- 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. 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 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. The City reports it has implemented a new budget monitoring process since audit field work was completed.
- 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'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. Based on restructuring and reductions in staff in recent years, the cost allocation plan may be inapplicable. Departments may be inappropriately overcharged for citywide services, impacting their ability to provide core services that are aligned with the departments' functions, and potentially violating State laws.
- 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.

As discussed in Section 1, General Fund expenditures have exceeded revenues over the last four fiscal years. Contributing to this trend is the lack of adequate management tools and resources to control City expenditures. During the course of this audit, City management has implemented new budget monitoring procedures, the results of which cannot be assessed as part of this audit since they are still so recent.

#### **Actual Expenditures Exceed Approved Budget**

The City budget cites provisions from the City's budget ordinance that require City Council approval before actual expenditures can exceed budgeted expenditures for any fund. The City Manager may transfer appropriations within a fund provided that doesn't increase total fund expenditures (e.g., from one department to another) and the Administrative Services Director may transfer appropriations within a department except for salary and capital accounts. In spite of these codified controls, most General Fund departments exceeded their budgeted appropriations in the three fiscal years ending June 30, 2012. City management reports that these expenditures were allowed because total General Fund expenditures did not exceed the total General Fund appropriation approved by the City Council. As long as the total fund appropriation is not exceeded, City policy allows the City Manager to move funds between departments and budget line items.

However, the final General Fund appropriation that City management classifies as approved by the City Council includes \$2,958,448 for FY 2009-10 and \$1,280,539 for FY 2010-11 in unexpended funds carried forward from prior fiscal years. These funds were reportedly encumbered (earmarked as financial obligations) for Civic Center capital projects<sup>1</sup> but were subject to being carried forward to FY 2009-10 and FY 2010-11 since they were not fully expended in prior years. These appropriation authorities were added to the revised FY 2009-10 and FY 2010-11 General Fund budgets midyear by City management. The City Council did not re-appropriate the funds in the FY 2009-10 and FY 2010-11 capital improvement plan budgets, consistent with the City practice for capital projects that span multiple years.

While the transfer of approved General Fund appropriations approved in prior fiscal years from capital projects to other uses may have been generally consistent with City budget policy, it is problematic in that: 1) the funds were not included for re-appropriation by the City Council in the capital improvement plan budgets for FY 2009-10 and FY 2010-11; and 2) the funds were not included in the original FY 2009-10 and FY 2010-11 operating budgets to show they were being unencumbered from their original purpose to be used for other purposes in FY 2009-10 and FY 2010-11. As a result, \$2,958,448 and \$1,280,539 in appropriations were included in the FY 2009-10 and FY 2010-11 General Fund budgets, respectively, without explicit City Council review or approval.

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<sup>1</sup> City Council had approved a City contract with Griffin Structures, Inc. for up to \$13,288,789 for improvements to the Civic Center structure in FY 2006-07.

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### ***3. Budget and Expenditure Controls***

To ensure proper controls and City Council oversight of the General Fund, the carryover funds previously appropriated for capital project purposes should have either been re-appropriated by the City Council in the FY 2009-10 and FY 2010-11 capital budgets for the Civic Center project, as originally approved, or included in the original FY 2009-10 and FY 2010-11 operating budgets for approval by the City Council for new purposes if management no longer intended to use funds appropriated in prior years for their originally approved purposes.

The unexpended capital project funds included midyear as carryover encumbrances represent a significant portion of the increase between the original budget approved by City Council and the revised budget presented by City management to the City Council midyear. For example, the \$2,958,448 in carryover encumbrances for the Civic Center structure in FY 2009-10 represented 72.8 percent of the \$4,065,505 increase between the original and final budget. In FY 2010-11, the \$1,280,539 in carryover encumbrances represented 14.9 percent of the \$8,583,639 increase between the original and final budget. Excluding the City Council approved expenditure of \$6,484,196 for the PERS side loan, discussed in Section 2, the carryover encumbrances in FY 2010-11 represented 61 percent of the \$2,099,443 (\$8,583,639 less \$6,484,196) increase between the original and final budget.

The inclusion of carryover encumbrances in revised General Fund expenditure budgets results in General Fund actual expenditures appearing to be less than the total revised budget. This is problematic, particularly because there were no actual expenditures tied to the originally approved expenditures, while other departments were significantly over budget (as further discussed below). Therefore, carrying forward appropriation authority from prior years masks over-expenditures in other departments relative to the originally approved budget. Therefore, this report compares actual expenditures to the original budgets of each fiscal year, which are the only comprehensive budgets approved by City Council.

Though written budget control policies appear to be in place, the City needs to ensure that it has the adequate management tools and resources to control City expenditures and that clear responsibility and accountability for staying within approved budgets is delegated to every department director.

Most individual departments have consistently incurred expenditures that exceed their approved budgets. While some departments have been able to spend less than their budgets, the overall result is that the City General Fund continues to incur expenditures that exceed the approved budget, on top of decreasing revenue. As a result, the City has been depleting General Fund reserves to meet expenditure needs, as discussed in Section 1. Exhibits 3.1 and 3.2 below illustrate which departments exceeded their budgets in FY 2009-10 and FY 2010-11.

### 3. Budget and Expenditure Controls

<b>Exhibit 3.1: Budget vs. Actual Expenditures, FY 2009-10</b>				
<b>Department</b>	<b>Orig. Budget Approved by Council</b>	<b>Actual Expenditures Reported in GEMS</b>	<b>Over/(Under) Approved Orig. Budget</b>	<b>% Over/(Under) Approved Orig. Budget</b>
Police	\$13,967,316	\$14,920,510	\$953,194	6.8%
Fire	\$5,395,397	\$6,290,470	\$895,073	16.6%
City Council/General Gov't	\$1,366,865	\$1,599,487	\$232,622	17.0%
Finance	\$2,107,515	\$2,336,867	\$229,352	10.9%
Non-Departmental <sup>1</sup>	\$171,806	\$311,867	\$140,061	81.5%
City Clerk	\$577,115	\$651,069	\$73,954	12.8%
Library	\$541,484	\$561,817	\$20,333	3.8%
Capital Improvement Program	\$0	\$10,099	\$10,099	N/A
Parks and Community Services	\$3,530,795	\$3,534,419	\$3,624	0.1%
Community Development	\$1,334,055	\$1,251,274	(\$82,781)	(6.2%)
Public Works	\$3,803,126	\$3,445,138	(\$357,988)	(9.4%)
<b>Grand Total</b>	<b>\$32,795,474</b>	<b>\$34,913,019</b>	<b>\$2,117,545</b>	<b>6.5%</b>

Sources: City of Watsonville FY 2009-10 approved budget and actual expenditures provided by Finance Department

<sup>1</sup> Non-departmental expenditures are those that cannot be easily assigned to one department. Examples include dues and fees for associations, such as the California League of Cities, and pre-payment of PERS obligations.

<b>Exhibit 3.2: Budget vs. Actual Expenditures, FY 2010-11</b>				
<b>Department</b>	<b>Orig. Budget Approved by Council</b>	<b>Actual Expenditures Reported in GEMS</b>	<b>Over/(Under) Approved Orig. Budget</b>	<b>% Over/(Under) Approved Orig. Budget</b>
Non-Departmental <sup>1</sup>	\$71,804	\$6,208,480	\$6,136,676	8,546.4%
Fire	\$5,267,196	\$6,148,924	\$881,728	16.7%
Police	\$14,599,489	\$14,962,047	\$362,558	2.5%
City Council/General Gov't	\$1,361,396	\$1,574,294	\$212,898	15.6%
Finance	\$2,041,919	\$2,152,956	\$111,037	5.4%
City Clerk	\$592,821	\$629,571	\$36,750	6.2%
Library	\$541,484	\$561,971	\$20,487	3.8%
Capital Improvement Program	\$0	\$3,693	\$3,693	N/A
Community Development	\$1,243,098	\$1,162,338	(\$80,760)	(6.5%)
Public Works	\$3,551,680	\$3,466,555	(\$85,125)	(2.4%)
Parks and Community Services	\$3,259,288	\$3,096,413	(\$162,875)	(5.0%)
<b>Grand Total</b>	<b>\$32,530,175</b>	<b>\$39,967,243</b>	<b>\$7,437,068</b>	<b>22.9%</b>
<i>Total Excluding PERS loan</i>	<i>\$32,530,175</i>	<i>\$33,483,047</i>	<i>\$952,872</i>	<i>2.9%</i>

Sources: City of Watsonville FY 2010-11 approved budget and actual expenditures provided by Finance Department

<sup>1</sup> Non-departmental expenditures are those that cannot be easily assigned to one department. Examples include dues and fees for associations, such as the California League of Cities, and pre-payment of PERS obligations.

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### **3. Budget and Expenditure Controls**

As shown in Exhibits 3.1 and 3.2 above, at \$32,530,175, the City budgeted a lower level of General Fund expenditures in FY 2010-11 than in FY 2009-10, when budgeted General Fund expenditures were \$32,795,474. However, in both fiscal years, General Fund expenditures exceeded the approved budget. In FY 2010-11, the City incurred \$6,484,196 in expenditures for the PERS side loan, discussed in Section 2. Excluding the unbudgeted PERS loan from actual expenditures, the City's actual expenditures in FY 2010-11 were \$33,483,047, still more than the \$32,530,175 budgeted for that year. Although the City has been able to reduce budgeted and expected expenditures over time, it could achieve more cost savings if departments consistently remained within their budget. Or, if circumstances change so midyear budget increases are necessary, such increases should be made through formal amendment to the budget by the City Council.

In October of 2012, during the course of this audit, City management implemented a new policy for monthly reporting, reviewing, monitoring, and correcting of financial activity at the department level. This policy requires departments to report to City management when total expenditures or total revenue varies five percent or greater (above or below) from the approved budget and develop a corrective action plan. While the new policy represents an improvement in City management budgetary oversight and may help address the problems developed over multiple years and identified in this report, the impact of the new policy could not be reviewed as part of this audit since it was implemented after the audit field work was completed.

A more in-depth review of two departments' budget versus actual expenditures demonstrates the type of analysis department directors and City management should conduct to control City expenditures.

#### **Fire and Police Over-expenditures**

Fire and Police department expenditures exceeded their budgets in FYs 2009-10 and 2010-11, as shown in the exhibits above. The following exhibits display what factors contributed to the over-expenditures in each fiscal year.

**Exhibit 3.3: Fire Department Personnel & Operations Expenditures,  
FY 2009-10 and FY 2010-11**

	Original Approved Budget	Actual Expenditures	Over (under) Budget	Percent Variance
<i>FY 2009-10</i>				
Personnel	\$4,920,614	\$5,681,824	\$761,210	15.5%
Operations	\$474,783	\$608,646	\$133,863	28.2%
Total	\$5,395,397	\$6,290,470	\$895,073	16.6%
<i>FY 2010-11</i>				
Personnel	\$4,781,213	\$5,496,620	\$715,407	15.0%
Operations	\$485,983	\$652,305	\$166,322	34.2%
Total	\$5,267,196	\$6,148,925	\$881,729	16.7%

Sources: City of Watsonville FY 2009-10 and FY 2010-11 approved budgets. Actual expenditures provided by Finance Department.

As shown in Exhibit 3.3 above, the Fire Department exceeded both its original personnel and operations budget in FY 2009-10 and FY 2010-11, though most of the variance was in its personnel budget. In FY 2009-10, \$761,210, or 85 percent of the Fire Department’s \$895,073 over expenditures, was attributed to personnel costs, while \$715,407, or 81 percent of its \$881,728 in over-expenditures in FY 2010-11 was due to personnel expenditures. As shown in Exhibit 3.4 below, the specific personnel expenditure that most appears to lack adequate controls is overtime, though salaries and wages were also over budget in FY 2010-11.

Although City staff has reported overtime expenditures to City Council and has tried to implement various measures to reduce overtime, including hiring part time firefighters, these efforts have thus far not been successful.



**Exhibit 3.4: Fire Department Key Personnel Expenditures,  
FY 2009-10 and FY 2010-11**

	<b>Original Approved Budget</b>	<b>Actual Expenditures</b>	<b>Over (under) Budget</b>	<b>Percent Variance</b>
<i>FY 2009-10</i>				
Salaries & Wages <sup>2</sup>	\$3,643,234	\$3,683,328	\$40,094	1.1%
Overtime	\$115,000	\$815,907	\$700,907	609.5%
Total	\$3,758,234	\$4,499,235	\$741,001	19.7%
<i>FY 2010-11</i>				
Salaries & Wages <sup>1</sup>	\$3,490,519	\$3,700,453	\$209,934	6.0%
Overtime	\$115,000	\$595,948	\$480,948	418.2%
Total	\$3,605,519	\$4,296,401	\$690,882	19.2%

Sources: City of Watsonville FY 2009-10 and FY 2010-11 approved budgets and actual expenditures provided by Finance Department

Actual combined expenditures for salaries, wages and overtime for the Fire Department in FY 2010-11 were \$202,834 less than for the prior fiscal year. This was largely due to a reduction in overtime expenditures in FY 2010-11, while actual expenditures on salaries and wages ended up more than actual FY 2009-10 expenditures. However, actual overtime expenditures were still \$480,984, or 418.2 percent, more than budgeted.

The City of Watsonville should explore alternative cost saving plans and staffing structures to minimize Fire Department personnel and overtime expenditures. The City needs to review and agree to minimum staffing needs for the Department and a reasonable overtime budget amount. The \$115,000 budgeted for Fire Department overtime in FYs 2009-2010 and 2010-11 may also be an unrealistically low amount as it represents approximately 3 percent of budgeted payroll when 6 to 10 percent of payroll is a common benchmark. However, actual overtime expenditures in FYs 2009-10 and 2010-11 amounted to 22.2 percent and 16 percent of payroll respectively, so overtime expenses incurred may also reflect an overuse of overtime in lieu of management control of staff absences for vacations, sick leave and training.

<sup>2</sup> According to the Finance Department, sick pay for the Fire Department is included in the budgeted salaries and wages. However, actual sick pay expenditures are recorded in a separate line item. Therefore, the actual expenditures for salaries and wages in the table above include actual expenditures in sick pay and salaries and wages, as reported by the Finance Department.

**Exhibit 3.5: Police Department Personnel & Operations Expenditures,  
FY 2009-10 and FY 2010-11**

	Original Approved Budget	Actual Expenditures	Over (under) Budget	Percent Variance
<i>FY 2009-10</i>				
Personnel	\$11,046,181	\$11,981,004	\$934,823	8.5%
Operations	\$2,918,462	\$2,939,506	\$21,044	0.7%
Total	\$13,964,643	\$14,920,510	\$955,867	6.8%
<i>FY 2010-11</i>				
Personnel	\$11,828,725	\$11,669,444	(\$159,281)	-1.3%
Operations	\$2,770,764	\$3,292,603	\$521,839	18.8%
Total	\$14,599,489	\$14,962,047	\$362,558	2.5%

Sources: City of Watsonville FY 2009-10 and FY 2010-11 approved budgets and actual expenditures provided by Finance Department

In contrast to the Fire Department, factors contributing to Police Department over-expenditures are inconsistent. For example, actual personnel expenditures in FY 2009-10 were 8.5 percent *more* than budgeted, yet the Police Department achieved *savings* of 1.3 percent in their personnel costs in FY 2010-11, as shown in Exhibit 3.5 above. Over-expenditures in operations were only 0.7 percent more than budgeted in FY 2009-10, but 18.8 percent more in FY 2010-11.

**Exhibit 3.6: Key Areas of Police Department Over-expenditures,  
FY 2009-10 and FY 2010-11**

	Original Approved Budget	Actual Expenditures	Over (under) Budget	Percent Variance
<i>FY 2009-10</i>				
Salaries & Wages <sup>3</sup>	\$7,437,394	\$7,905,216	\$467,822	6.3%
Overtime	\$471,782	\$843,338	\$371,556	78.8%
Total	\$7,909,176	\$8,748,554	\$839,378	10.6%
<i>FY 2010-11</i>				
Salaries & Wages <sup>2</sup>	\$8,076,794	\$7,933,631	(\$143,163)	-1.8%
Overtime	\$401,523	\$463,439	\$61,916	15.4%
Total	\$8,478,317	\$8,397,070	(\$81,247)	-1.0%

Sources: City of Watsonville FY 2009-10 and FY 2010-11 approved budgets and actual expenditures provided by Finance Department

<sup>3</sup> According to the Finance Department, sick pay for the Police Department is included in the budgeted salaries and wages. However, actual sick pay expenditures are recorded in a separate line item. Therefore, the actual expenditures for salaries and wages in the table above include actual expenditures in sick pay and salaries and wages, as reported by the Finance Department.

Similar to the Fire Department, overtime and sick pay contribute to over expenditures in the Police Department, as illustrated in Exhibit 3.6 above. However, miscellaneous other charges not shown in the exhibits above also contributed to over expenditures in the Police Department, resulting in \$106,590 in expenditures over the FY 2009-10 original budget and \$233,743 over the FY 2010-11 original budget. The Finance Department reports that miscellaneous expenditures are those that were not accounted for in the original budget. In these particular fiscal years, the miscellaneous charges were for fleet services and parts provided to the Police Department.

**Public Safety Expenditures in Comparable Cities**

While personnel and overtime costs comprise most of the expenditures of all police and fire departments, a comparison of total public safety costs per person among comparable cities suggests that other cities may have found ways to better budget and control public safety expenditures such as overtime. As shown in Exhibit 3.7 below, the City of Watsonville spends more than the median of \$366 per resident for public safety than found in six comparable cities. In fact, only the Cities of Santa Cruz and Gilroy have higher public safety expenditures per capita than the City of Watsonville.

<b>Exhibit 3.7: Comparison of Public Safety Costs per Capita</b>			
<b>Fiscal Year 2010-11</b>			
<b>City</b>	<b>Public Safety Expenditures</b>	<b>Population</b>	<b>Cost per Capita</b>
Cathedral City	\$22,153,417	52,381	\$423
Colton	\$19,379,791	52,940	\$366
Gilroy	\$22,005,580	49,582	\$444
Hanford	\$13,277,169	54,284	\$245
Porterville	\$14,289,727	55,023	\$260
Salinas	\$49,255,020	152,994	\$322
Santa Cruz	\$34,376,692	60,342	\$570
<i>MEDIAN</i>	<i>\$20,692,686</i>	<i>54,284</i>	<i>\$366</i>
Watsonville	\$22,258,470	51,586	\$431

Sources: City CAFRs for Fiscal Year ending June 30, 2011 and California State Controller’s website. Population estimates for each city as of July 1, 2010 from U.S. Census Bureau EST 2011-03-06.

The City of Watsonville should further review expenditures in the Fire and Police Departments. The City should assess alternative cost saving plans and structures to reduce public safety expenditures to comparable levels of similar sized and neighboring cities. This will include City management analyzing and determining minimum staffing levels for the two departments, using the benchmark target of between six and ten percent of payroll for overtime expenses and considering cost-saving options such as contracting with the County or other firefighting agencies.

### **Budget Information Provided to City Council**

The key information provided to the City Council pertaining to the City budget is the proposed budget document in May and the Mid-Year Financial report, usually presented to the City Council in February. Budget documents, study sessions and Mid-Year Financial reports available online and provided by City staff were reviewed by the audit team. The budget document includes a great deal of detailed information pertaining to the City's finances as a whole and each department's revenues and expenditures. It also includes a section providing an analysis of each City fund's revenues and expenditures.

What the City budget document lacks is summaries of the detailed information to enable the City Council and public to obtain a rapid understanding of the financial status of the City and what is being proposed for the ensuing fiscal year. Specifically, there is no clear distinction between what is proposed by the City Manager and what is approved by the City Council, after they have made any changes. The document should include both sets of numbers.

The annual budget documents show projected revenues and expenditures for the current budget year but a comparison to subsequently audited amounts for the same years show variances between what is presented in the budget document and actual amounts reported in the City's financial system and Comprehensive Annual Financial Reports (CAFRs). While this is partly a matter of timing since final amounts for the current year are not all known at the time the budget document is prepared, some of the variances between budgeted and actual amounts should be known at the time the budget documents are prepared and should be reported. Further, some of the prior years' actual revenues and expenditures reported in the budget document do not match actual amounts reported in the City's CAFRs (e.g., actual FY 2008-09 General Fund expenditures and revenues). Such discrepancies should be either corrected or explained in the budget document and separately explained in a budget/CAFR reconciliation City Council presentation at another point in the year, as recommended in Section 1.

The Mid-Year Financial Report provides very detailed information about the City's overall financial state and presents tables with the adopted budget vs. projected revenues for each fund for the year and the adopted budget vs. projected expenditures for each department. What the document is lacking is actual year-to-date expenditures for the current year to allow the City Council and public to understand where changes have occurred and to assess the reasonableness of the year-end projections. Since actual expenditures for FYs 2009-10 and 2010-11 were substantially more than the amounts projected in their respective Mid-Year Financial Reports, it is important to disclose as much current information as possible to minimize the number of unexpected variances in revenues and expenditures at year-end.

The Mid-Year Budget Reports for FYs 2010-11 and 2011-12 both present summaries of proposed cost reductions and revenue increases to the General Fund, and noted they were adopted by the City Council in 2007. The two reports provide estimated annual savings, but actual savings are not presented and it is not clear from the document when the reductions

were actually implemented. It is also not clear which reductions were one-time changes and which were ongoing. For example, the FY 2010-11 Mid-Year Financial Report shows cost reductions and revenue increases that together amount to over \$10 million. Since General Fund expenditures have decreased by approximately \$4 – 5 million per year since FY 2008-09, many of the proposed reductions either have not been implemented or the estimated savings were not accurate. Details on the actual results of the proposed reductions should be presented to determine if further action is needed to effectuate the originally estimated savings.

The Mid-Year Budget Reports for FYs 2010-11 and 2011-12 both present City Manager-recommended amendments to the adopted budget. In both cases they are presented by fund, and not by department. Details are provided in the narrative that explains how the funds will be used, including the department that will receive the additional funding, but the summary table is not clear or consistent with presentation of the City's two year budget document. In addition, information presented to the City Council in budget documents is sometimes inaccurate. For example, in the FY 2009-10 approved budget, the accurate subtotal of \$808,036 for line item expenditures in the operations budget for the Police Department (Division 410) is greater than the \$774,436 subtotal printed in the department specific budget. Further, the total budget of \$9,015,596 for Division 410 in the General Fund summary matrix is greater than \$8,981,966 printed in the department specific budget, though the summary matrix is accurate.

#### **Disbursement Reports not an Effective Control**

In accordance with the Municipal Code, a report of disbursements of funds must be approved by the City Council at each City Council meeting. These reports are typically on the consent agenda, unless a Council member requests to remove the report off of the consent agenda for further discussion. The report itemizes every check issued since the last report and can be several pages long. The disbursements for each fund are not tied to any baseline budget or total contract or purchase order amount. As such, the reports can be cumbersome and do not serve as adequate reports for the City Council to control costs. Although City staff reports that this is not the original intention of the disbursement reports under the Municipal Code, staff agree that the City Council disbursement oversight process could be more effective.

The City should revise the Municipal Code and streamline the disbursements presented to the City Council for approval. Disbursements related to items already reviewed by the City Council, either through the approval of the annual budget or individual contract approval, should not be reviewed unless there is a significant variance between what was originally approved by the City Council and what is being disbursed to the vendor. Significant changes to be reviewed should include change orders for contracts and purchase orders that meet a specific threshold, such as a flat amount or percentage of the original contract or purchase order, or changes in the scope of a project or program. Additionally, significant expenditures for Open Purchase Orders, which are not usually approved by the City Council and are further discussed in Section 5, should be brought to the City Council for approval.

## Outdated Cost Allocation Plan

City departments such as the City Council, City Clerk, City Attorney, Finance, Information Systems and Purchasing departments provide services to multiple departments. The costs to provide these services are thus allocated Citywide. The City provided a cost allocation plan in which an analysis conducted in FY 2000-01 was used as the basis for the current fiscal year. According to the Finance Department, the City hired an outside firm to complete the cost allocation in FY 2000-01 based on each individual's duties, corresponding time allocation for each duty, and other analyses.

Although the cost allocation plan is based on FY 2008-09 total costs with an inflation rate applied to subsequent fiscal years, the allocation of costs across departments is still based on the allocation assumptions from FY 2000-01, or more than ten years ago. The City has undergone restructuring and reductions in staff since FY 2008-09 and the assumptions applied to allocate costs in FY 2000-01 may no longer be applicable. Departments that may be inappropriately overcharged for services received could be subsidizing other City departments.

Detailed cost allocation principles are contained in the Federal Office of Management and Budget (OMB) Rules and Regulations 2-CFR-Part 225 (formerly and commonly known as OMB Circular A-87). These principles are applied by local and state governments in determining how much of their indirect costs can be charged for federal grant programs. The principles in OMB Circular A-87 and guidelines published by the League of California Cities<sup>4</sup> suggest that cities cannot charge for services in excess of actual cost, plus overhead. While the OMB may require annual updates from some, but not all, jurisdictions, a good practice in local government jurisdictions is to update the plan annually.

Currently, the City of Watsonville's costs for services provided by the City Attorney, City Manager, City Council, Finance, Purchasing and Information Services are allocated to all City departments, including the City's utility departments. Appropriate allocations to each department are needed to ensure proper budgeting and cost accounting. An additional implication of proper cost allocations involves the City's utility departments. If the allocated costs to the utility departments are inappropriately high, then tax and rate payers could sue the City for violating Proposition 218, which restricts the use of fees and charges for services to the actual cost to provide services plus appropriate overhead.

The City should conduct another cost allocation study and plan given recently implemented changes in staffing and organization in response to the economic downturn, and reduce the potential risk of lawsuits by tax and rate payers for the inappropriate use of fees and charges for services. The Finance Department has reported that it plans to do so once funds become available. Further, the City should update the cost allocation plan annually, in alignment with best practices and the cost allocation principles in OMB Circular A-87.

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<sup>4</sup> *A Primer on California City Finance*, League of California Cities.

**Internal Service Funds**

The City of Watsonville has internal service funds for general liability insurance, workers' compensation, and employee health benefits. Analysis of financial and other documents demonstrated that the City (a) has insufficient revenue to meet current expenditure needs and (b) is not adequately planning for future costs through the use of actuarial reports and building up of reserve funds.

As shown in Exhibit 3.8 below, the Workers' Compensation and General Liability Fund generated negative revenues in FY 2008-09 and FY 2010-11, while the Health Benefits Fund had negative revenues in each of the last three fiscal years. Expenditures that consistently exceed revenues could be an indication that charges to departments for the Internal Service Funds are insufficient.

<b>Exhibit 3.8: Internal Service Fund Revenues and Expenditures, FY 2008-09 through FY 2010-11</b>						
	<b>Workers' Comp./Gen. Liability</b>			<b>Health Benefits</b>		
	<b>FY 2008-09</b>	<b>FY 2009-10</b>	<b>FY 2010-11</b>	<b>FY 2008-09</b>	<b>FY 2009-10</b>	<b>FY 2010-11</b>
Actual Revenues	\$1,866,210	\$1,944,310	\$2,020,140	\$5,526,067	\$4,937,471	\$5,714,893
Actual Expenditures	\$2,800,325	\$1,070,162	\$2,775,497	\$5,771,510	\$5,202,797	\$6,599,728
<b>Total Net Revenues</b>	<b>(\$934,115)</b>	<b>\$874,148</b>	<b>(\$755,357)</b>	<b>(\$245,443)</b>	<b>(\$265,326)</b>	<b>(\$884,835)</b>

Sources: City of Watsonville FY 2008-09 through FY 2010-11 CAFRs

In FY 2010-11, the Internal Service Fund had a cash shortfall of \$1,153,414 and required a short-term loan from the General Fund. According to the Finance Department, health insurance claims were more than anticipated during that fiscal year. Although the short-term loan from the General Fund may have been reversed in the books within the fiscal year, the Health Benefits Fund still has a liability equivalent to the short-term loan. The Finance Department reports that the City increased its health insurance rates in FY 2011-12 for both employees and the City.

Instances such as these could be avoided with proper City planning through the use of actuarial reports. The audit team requested actuarial reports for all Internal Service Funds, but received only a summary of Workers' Compensation claims since FY 1978-1979 and a one page report for health benefits showing benefit rates based on actuarial calculations. Several jurisdictions seek actuarial reports from actuarial firms that use city data to estimate the liability for the unpaid benefit/claims costs due to reported claims for which jurisdictions are currently paying *and* the unpaid benefit/claims costs for future claims expected to be reported. These are multi-page reports with multiple year trends and projections, which differ vastly from the documentation provided by City staff. The City should seek out actuarial reports and valuations that can more adequately determine expected costs, as opposed to its current methods, which



### 3. Budget and Expenditure Controls

have resulted in operating deficits for several fiscal years. While the City has increased health insurance rates, an actuarial report could help determine if the increase is adequate.

Finally, the City’s insurance charges should not only be sufficient to pay expected costs, but best practices suggest that the City’s revenue and assets should be sufficient to build a reserve of funds. Reserves established at expected cost are technically referred to as being set at a “50% confidence level”, which is a measure of statistical probability that reserves are sufficient to pay claims cost. Reserves may be established at any specific confidence level. A 50% confidence level means that there is a 50% chance that the actual claims cost can be paid with reserves and a 50% chance that the actual claims cost cannot be paid with reserves. An 80% confidence level means that there is an 80% chance that sufficient reserves will be available and a 20% chance that reserves will not be available to pay the actual cost of claims.

The California Code of Regulations requires that private sector self-insurance plans fund estimated liabilities at the 80% confidence level.<sup>5</sup> The purpose of this conservative requirement is to ensure that companies have set aside sufficient funds for their estimated claims liability in the event they go out of business or otherwise become incapable of funding their claims cost. However, because governments have taxing authority and are considered to be perpetual entities, public sector self-insurance funds are not subject to these same regulations.

Despite this distinction, many public jurisdictions follow more conservative private sector practices. However, the City of Watsonville does not attempt to fund its Internal Service Funds based on any funding probability. This is further demonstrated by the negative fund balances (when liabilities exceed assets) for the Internal Service Funds, shown in Exhibit 3.9 below.

<b>Exhibit 3.9: Internal Service Fund Assets and Liabilities, FY 2008-09 through FY 2010-11</b>						
	<b>Workers' Comp./Gen. Liability</b>			<b>Health Benefits</b>		
	<b>FY 2008-09</b>	<b>FY 2009-10</b>	<b>FY 2010-11</b>	<b>FY 2008-09</b>	<b>FY 2009-10</b>	<b>FY 2010-11</b>
Assets	\$1,647,756	\$861,539	\$814,911	\$650,538	\$231,738	(\$345,219)
Liabilities	\$5,990,703	\$4,407,044	\$4,145,347	\$1,477,946	\$1,155,707	\$1,838,475
<b>Fund Balance</b>	<b>(\$4,342,947)</b>	<b>(\$3,545,505)</b>	<b>(\$3,330,436)</b>	<b>(\$827,408)</b>	<b>(\$923,969)</b>	<b>(\$2,183,694)</b>

Sources: City of Watsonville FY 2008-09 through FY 2010-11 CAFRs

Based on actuarial studies, the City should charge sufficient insurance rates that can (a) increase the assets and fund balance for the Internal Service Funds and (b) build sufficient reserves for a 50% to 80% confidence level of funding, as practiced by many public jurisdictions. City staff agreed with such a policy, but noted that establishing such a reserve would require effort over multiple years.

<sup>5</sup> California Code of Regulations, Chapter 8, Subchapter 2, Article 13, §15475(d)(8).



### Comparison with Other Cities

A comparative analysis of Workers’ Compensation and General Liability Internal Service Funds demonstrates that the City of Watsonville’s insufficient (a) revenues, (b) fund balance (c) cash, and (d) assets are significantly worse than the median for four comparable cities—Colton, Gilroy, Hanford, and Santa Cruz.

<b>Exhibit 3.10: Comparison of Workers’ Compensation and General Liability Internal Services Funds, FY 2010-11</b>						
	<b>Colton</b>	<b>Gilroy</b>	<b>Hanford</b>	<b>Santa Cruz</b>	<b>MEDIAN</b>	<b>Watsonville</b>
Revenues	\$2,432,856	\$872,654	\$1,081,749	\$4,979,970	\$1,757,303	\$2,020,140
Expenditures	\$2,433,761	\$1,606,895	\$972,672	\$5,244,314	\$2,020,328	\$2,775,497
Net Revenues	(\$905)	(\$734,241)	\$109,077	(\$264,344)	(\$132,625)	(\$755,357)
Cash	\$558,391	\$1,020,388	\$3,785,699	\$9,670,423	\$2,403,044	\$250,000
Assets	\$607,971	\$1,020,388	\$3,785,699	\$14,381,814	\$2,403,044	\$814,911
Liabilities	\$2,370,129	\$2,117,832	\$134,031	\$9,323,373	\$2,243,981	\$4,145,347
Fund Balance	(\$1,762,158)	(\$1,097,444)	\$3,651,668	\$5,058,441	\$1,277,112	(\$3,330,436)

Sources: Cities of Colton, Gilroy, Hanford, Santa Cruz, and Watsonville FY 2010-11 CAFRs

As shown in Exhibit 3.10 above, Colton, Gilroy, Santa Cruz, and Watsonville had insufficient revenues in FY 2010-11, resulting in negative net revenues. However, the City of Watsonville had the largest deficit of all four cities. While negative net revenues can be offset by adequate fund balance reserves, Watsonville is one of three cities with negative fund balances as of FY 2010-11. Watsonville’s negative fund balance of \$3,330,436 is greater than the combined negative fund balances of Colton and Gilroy, or negative \$2,859,062. Additionally, Watsonville’s \$250,000 cash balance as of FY 2010-11 is approximately 10.4 percent of the median cash balance of \$2,403,044 for the four comparable cities. Finally, although Colton’s \$607,971 in assets is less than Watsonville’s assets of \$814,911 in FY 2010-11, Watsonville’s assets is still significantly lower than the median value of assets for all four comparable cities, or \$2,403,044.

These statistics further indicate that the City of Watsonville should plan accordingly for its insurance costs through the use of actuarial reports, and should charge sufficient insurance rates to meet expected costs and build up reserves for potential future costs.

### Cash Handling Procedures

Until the summer of 2012, the City did not have formal, written cash handling procedures in place in spite of the fact that tens of millions of dollars are collected each year Citywide by the utility departments and various General Fund departments such as the Parks and Community Services and Community Development departments. Though some departments have had informal procedures in place regarding cash handling, formal management-approved cash handling policies and procedures are a key element of an internal control system.

City management did prepare, approve and disseminate formal, written cash handling procedures for the Parks and Community Services Department and Citywide in August 2012, while this audit was in progress. City staff reports that more such written procedures will be prepared in the near future. This is an important step in improving the City's internal control system. It will be equally important to train staff on these policies and procedures and regularly conduct reviews or audits of City staff's adherence to the policies.

## **Conclusions**

The City of Watsonville's management tools and resources to control City expenditures could be improved. Although the annual approved budget is supposed to serve as a control on expenditures, for at least the last three fiscal years, most General Fund department expenditures have exceeded their approved budgets.

Though City policy calls for City Council approval to changes in any funds' budget that will result in that fund exceeding its originally approved amount, such approvals are not on record. Annual General Fund expenditures have exceeded annual revenues for the last three fiscal years and the City has been required to use depleting General Fund Balance, or reserve, when revenue is insufficient to meet its expenditures. The Finance Department's financial system has limitations such as not providing effective and timely reports to City managers for measuring budget variances. While the annual budget document and Mid-Year Budget Report both contain valuable details on the City's budget and financial state, they lack key summary and baseline information and timely revenue and expenditure data to facilitate decision making and public understanding of the City's financial course. Information provided to the City Council is either insufficient or too cumbersome to allow effective discussions and decision making toward controlling City expenditures.

The cost allocation plan for the City is outdated, which could result in inadequate reimbursements for services provided by City departments to other departments, or conversely, overcompensation for services provided.

The City's Internal Service Funds have insufficient revenue to meet current expenditure needs and the City is not adequately planning for future costs through the use of actuarial reports and building up of reserve funds.

The City did not have written cash handling procedures for the Parks and Community Services Department and Citywide until August 2012, while this audit was in progress. City staff reports that more such written procedures will be prepared in the near future, which is an important step in improving the City's internal control system.

## **Recommendations**

The City Council should direct the City Manager to:

- 3.1. Establish a mechanism to ensure adherence to City policies dictating levels of authority for making changes to the budget in the interest of controlling costs to the budget, to include the level of authority department directors have for shifting funds within their budget, the authority of the City Manager to make budget changes, and the criteria that would trigger further review and action by the City Council.
- 3.2. Conduct further review of expenditures in the Fire and Police Departments and assess and report on alternative cost saving plans and structures to reduce public safety expenditures comparable to similar sized and neighboring cities, including consideration of contracting with other firefighting agencies if more cost-effective to do so.
- 3.3. Revise the annual budget document and Mid-Year Financial Reports to include year-to-date actual revenues and expenditures, a distinction between management proposed and City Council adopted budgets, a clear summary of the fiscal results of past actions taken by the City Council to increase revenues or reduce/increase expenditures, and an explanation of the difference between actual amounts reported in the budget and the amounts reported in the City's Comprehensive Annual Financial Reports.
- 3.4. Revise the Municipal Code and streamline information provided in disbursement reports for City Council review to include only:
  - (a) New disbursements not tied to items previously reviewed by the City Council, such as approved budgets, expenditure plans and contracts;
  - (b) Disbursements representing significant changes to previously approved budgets, expenditure plans, contracts, and purchase orders, defined as a flat threshold amount determined by the City Council, a percentage threshold based on the previously approved amount, or changes in the scope of the project or program; and,
  - (c) Significant expenditures on Open Purchase Orders.
- 3.5. Conduct a new cost allocation study and develop a new plan to appropriately allocate City costs to departments, and update the plan annually.
- 3.6. Obtain actuarial reports for its Internal Service Funds that more adequately estimate expected costs.

- 3.7. Charge insurance rates that are sufficient for (a) meeting expected costs and (b) increasing the assets and fund balance for Internal Service Funds to build sufficient reserves for a 50% to 80% confidence level of funding, as practiced by many public jurisdictions.
- 3.8. Continue preparing and updating written policies and procedures in all areas of financial management and internal controls.

## **Costs and Benefits**

Additional staff time and resources will be needed to implement these recommendations, which are estimated to require .25 of a full-time equivalent (FTE) in the first year, and less staff time after that. However, clearly established policies and adequate management tools and reports to facilitate the control of City expenditures could result in City departments meeting budget targets. As a result, the City could reverse recent trends and begin to replenish General Fund reserves that have been depleted over the years to meet City expenditure needs.

## 4. Capital Budget and Impact Fees

- 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 capital improvement project budget consists of budgets for the subsequent five fiscal years for new equipment, buildings and structures, maintenance, computers and vehicles. The capital improvement project budget also presents projects and purchases approved in prior years that have not been completed or possibly have not yet commenced.
- 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, the document lacks key information needed to ensure adequate City Council oversight and control over City resources and for public understanding of these projects. Such information should include actual year-by-year project expenditures and timing relative to original and revised budgets and timelines and planned year-by-year expenditures and funding sources, if known. Currently, 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.
- 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-induced, as required by State law. 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. Future uses of the funds should be reviewed and approved by legal counsel.

The City of Watsonville's process for developing and approving its capital improvement project budget is specified in the Charter, which requires the City Manager to include a statement of pending capital projects and proposed new capital projects, showing the amounts to be raised by appropriation in the budget and the funding to be raised from other sources. The Charter also calls for the City Manager to include in the budget message a "program of proposed public

improvements for the ensuing five (5) year period prepared by the Planning Commission...”<sup>1</sup> The Planning Commission is required by the Charter to list and “classify all public improvements recommended by officers, departments, board of commissions of the City and... to recommend to the Council and the City Manager a coordinated program of proposed public improvements for the ensuing five year period, according to a logical order or priority.”<sup>2</sup>

The City’s budget documents include both the required list of projects and a statement in the City Manager’s message that the Planning Commission has certified that the projects are consistent with the General Plan. The budgets for recommended new projects are shown, along with the fund that will be paying for them and the project manager. The two year budget covering FYs 2011-12 and 2012-13 presents the “top 10 projects” recommended to the City Council by staff for those two years, with a total cost of \$15.35 million dollars, then a list of other projects comprising a “top six projects” list for the two subsequent fiscal years, FYs 2013-14 and 2015-16, with a total cost of \$15.35 million. The budget also contains a table showing approximately \$21.6 million in costs for all projects for the two year cycle, though the individual projects are not listed. The latter table presents capital project costs for the three years following the two year cycle. Details on individual projects for the two year cycle, including project titles, budget, fund and project manager, are presented on other schedules in the capital budget document. Specific funding sources are not listed.

The capital budget document presents a great deal of detail about individual projects but it does not provide a multi-year schedule to see what projects on the list are already underway or how long the new projects are expected to last, since many capital projects span multiple years. The same projects reappear on the Top 10 and Top 6 lists in successive budgets but it cannot be readily discerned if they were started in the prior budget cycle or not and, if so, how much of the project has been accomplished. The capital budget document should not only serve as a document to facilitate funding decisions but also as a project tracking tool.

As an example, the Corralitos Water Treatment Plant upgrade is presented on the Top 10 project list in the FY 2009-10 and FY 2010-11 budgets with a cost of \$12 million. It reappears on the Top 10 list in the FY 2011-12/2012-13 budget but the cost shown is now \$6 million. It is not clear from the document if this is a new related project, or the carryover from the old project. However, the project re-appropriation schedule in the budget document shows that \$11 million is being re-appropriated, so presumably \$1 million was spent on the project in the intervening years but one would have to cross reference two to three schedules to draw this conclusion.

The new Maintenance Shop project for the City Treatment Plant is listed as a Top 10 project in the FY 2009-10/2010-11 budget with a cost of \$1.5 million. In the subsequent FY 2011-12/2012-13 budget, the project is moved to potential project status on the Top 6 list for FYs 2013-14 through 2015-16, still with a \$1.5 million budget. However the re-appropriation schedule in that budget shows \$1,374,198 to be re-appropriated, indicating that \$125,802 was expended on the project. It is possible the project was started, then a decision was made to defer it for a few

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<sup>1</sup> Charter of the City of Watsonville, Section 1110.

<sup>2</sup> Charter Section 907(b).

years, possibly for good reason, but it is not possible to tell the status of the project from the budget document.

By presenting all projects on a multi-year schedule, with originally approved budgets, actual expenditures and planned expenditures, by year, the City Council and public would be able to determine exactly what new projects are being appropriated each year, what previously commenced projects are still underway and whether or not they are still on their original schedule and budget. The current document lists hundreds of projects in various stages of completion, including many approved projects that have never commenced but continue to be re-appropriated. Capital projects are complex and presenting all their details in a clear, easy-to-understand fashion is challenging. But the current document does not fully assist the City Council in fulfilling its role as oversight body and ensuring that capital project dollars are being spent effectively and efficiently.

At the time the budget document is prepared, funding for some projects has already been secured whereas funding for others has not. In the latter case, funding such as grants may not be secured until after the project is approved. It is not possible to determine from the capital budget the source of funding for a project or whether it has been secured or not. This information should be included for each project.

#### **Development Impact Fees**

One source of funding for the City's capital projects are development impact fees. Like many cities in California, the City of Watsonville has adopted development impact fees that are charged to developers to recover various City costs for public improvements that are needed due to new development. Fees are in place to recover City costs incurred for municipal facilities, parks, traffic signals and related items, fire department capital expenses and equipment, and other City infrastructure.

Development impact fees were first established in the City in 1983 based on a traffic analysis study that showed that new development in certain areas of the City would result in the need for new traffic signals and controls. It recommended that a portion of those costs be charged to land development projects in proportion to the size of the project (i.e., a fee for every square foot developed). During the subsequent 11 years, a number of traffic signal development impact fees were established by City ordinance to include other areas of the City. Several of the ordinances were also amended during that time to adjust the fees and make other changes.

Development impact fees currently in place, according to the City's 2011 annual impact fee report, are:

1. Affordable Housing Fee
2. Parks Development Fee
3. Fire Capital Improvement Fee
4. Public Facility Fee

5. City-wide Traffic Impact Fee
6. Impervious Area Impact Fee
7. Storm Drain Fee
8. Errington South Benefit Area Fee
9. Struve Bridge Fee
10. Errington/Clifford Area Fee
11. Watsonville Slough Area Fee
12. Airport Boulevard Fee
13. Pennsylvania Drive Fee
14. Crest View Area Fee
15. Green Valley Corridor Fee
16. East Highway 1 Fee

In FY 2010-11, the fees generated approximately \$2.3 million in revenue according to the City's Annual Impact Fee Report for that year. State law requires that municipal development impact fees be based on analyses known as nexus studies that identify the costs of public improvements that are tied to growth.<sup>3</sup> The fees can only recover those costs and cannot be used to support ongoing operations. Cities are required to do the following to establish development impact fees:

- Identify the purpose of the fee;
- Identify the improvements to be made with the fees collected;
- Determine a reasonable relationship between the fee's use and the type of development projects for which it is imposed; and,
- Determine a reasonable relationship between the fee and the cost of the public improvement.

Most of the City's development impact fees have not been codified in the Municipal Code though they have been in place for years and, if Watsonville is like most cities, are likely to remain in effect for the foreseeable future. Therefore, they should be included in the Code for easy public access. Upon request of the audit team, the City provided some of the early ordinances and reports that provided the basis of current fees. The documents reviewed do not provide sufficient detail to prove that current fees are appropriate for the City's costs that they are intended to recover. Further, the studies and ordinances for the most part do not set City standards for services that could serve as the basis of the fees. For example, the City's Fire Department reports that its response time goal is 4-6 minutes. A defensible fire impact fee

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<sup>3</sup> See California Government Code Sections 66000-66025.



could use that standard to ensure that funds are available from development fees that could pay for new fire stations and/or equipment needed to ensure the City's response time goal.

The existing development impact fees do not apply such service level standards such as those incorporated in the City's General Plan. In a number of cases, the fees are simply based on what other jurisdictions were charging at the time they were adopted.

A review of the expenditure of fee funds shows that they are spent on a variety of departmental needs, many of which do not appear to be growth-related public improvements or certainly not geared to maintaining a formalized service level standard. For example, fire impact fees have been appropriated in the FY 2011-12 capital budget to replace rescue equipment and fire hoses. Public Facility Impact fees have been used for roof repairs and door replacements at Fire Department facilities. These needs could possibly be explained by growth in the City but they also could be routine maintenance expenses.

State law calls for jurisdictions with development impact fees to prepare a public report on them each year containing, at minimum, the following information:

- Amount and description of each fee;
- Beginning and ending balance of each account or fund;
- Fee and interest revenue;
- Amount spent on each public improvement for which fee collected, including percentage of total project cost;
- Approximate date on which public improvement are to commence;
- Description of each inter-fund transfer or loan made including repayment date and rate of interest account or fund will receive; and,
- Dates by which incomplete public improvements will be completed or fees collected refunded, in instances where sufficient fees have been collected.

The City does prepare an annual report containing most of the elements shown above but it is missing the amounts spent on each public improvement funded with each fee's revenues, dates on which projects will commence, descriptions of any inter-fund transfers or loans, including repayment dates and interest, and dates by which incomplete projects will be finished. Details from the capital budget may or may not be reconcilable with the annual report.

The absence of these disclosures makes the annual report less useful as an oversight tool for the City Council and the public. It is not possible to tell what projects have been funded or how the monies have specifically been used from the contents of the report.

## **Conclusions**

Both the capital project budget and the development impact fee annual reports could be improved to provide the City Council and the public more clear information about how City funds are being spent. The nature of capital projects is complex and can be difficult to present in an accessible, clear fashion. But the City Council, as stewards of the City's resources, should

receive information in these important areas that enables them to understand, with reasonable effort, how City resources are being utilized to protect and enhance the City's physical assets and to accommodate growth while maintaining desired service levels.

## **Recommendations**

The City Council should direct the City Manager to:

- 4.1 Modify the capital budget document to include multi-year presentations of all capital projects including:
  - a. Funds already spent on previously approved projects and date of project commencement;
  - b. Funds budgeted in the current and future years on previously approved projects;
  - c. Identification of changes in previously approved project budgets;
  - d. Funds proposed for current and future years on projects for which approval is requested;
  - e. Funding sources and an indication of whether or not funding has been obtained yet;
  - f. Brief explanations of any changes in project timing.
- 4.2 Review the bases of all development impact fees and report back to the City Council on whether or not the fees are in compliance with State Mitigation Fee Act requirements including the bases of the fees and the projects for which they have been used.
- 4.3 Establish service level standards to serve as the basis of each development impact fee such as acres of park per resident, fire department response time, etc.
- 4.4 Prepare annual impact fee reports that are fully compliant with all reporting requirements in State law.

## **Costs and Benefits**

Better information and disclosure on the City's capital projects and use of development impact fees will better enable the City Council and public to better assess the efficacy and benefits of the allocation of funding for maintaining and improving the City's physical assets. An estimated .1 full-time equivalent position will be needed to initially implement the recommendations, with a lesser amount of staff time needed after that to maintain the new reports and information.

## 5. Procurement

- Adherence to City of Watsonville policies and procedures for procurement is inconsistent. For instance, a review of purchase order files demonstrated that 14 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. Six of these 14 purchase orders were for professional services. Existing policies and procedures for the procurement of professional services through competitive bidding are vague and conflicting.
- 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.
- 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 cost 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.
- 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. Additionally, adequate controls are not in place over procurements off Open Purchase Orders in excess of their maximum amounts. Payments to the top ten Open Purchase Orders with payments above authorized annual limits ranged from 104 to 1,377 percent more than their annual limit. Aggregate purchases off Open Purchase Orders resulted in payments to 19 vendors in excess of the \$50,000 threshold for City Council approval of competitively bid purchase orders. However, these expenditures were not subject to City Council approval.

## Procurement Policies and Procedures

Like all cities in California, the City of Watsonville’s procurement process is governed first by State law and then by local ordinances and policies and procedures. State law requires that every city adopt policies and procedures, including bidding regulations, by ordinance covering the purchase of supplies and equipment<sup>1</sup>. State law also establishes dollar thresholds for bidding regulations for “public projects” (improvements to or construction of public facilities) for cities that agree to adhere to uniform construction cost accounting procedures, which the City of Watsonville has done.

Local ordinances and procedures for the City of Watsonville are promulgated in the Municipal Code<sup>2</sup>, Administrative Rules and Regulations<sup>3</sup>, City of Watsonville Intranet<sup>4</sup>, and California Public Contract Code Section 22030-22045, which require competitive bidding for the procurement of supplies, equipment, and non-personal contractual services and awards bids to vendors that offer the lowest cost to the City. However, the Municipal Code states that the following are exceptions to these requirements:

- An emergency requiring that an order be placed with the nearest available source of supply;
- A commodity can be obtained from only one vendor; or,
- The amount involved is less than the amount established by Council resolution for informal bidding.

Individual departments are responsible for obtaining and providing documentation of competitive prices for the supplies, services, and equipment they wish to procure, unless exempt for the reasons above. The departments then submit “Requests for Checks” or purchase order requisitions, along with any required documentation and approval from authorized department staff, to the Purchasing Division of the Finance Department to allow disbursements of funds for the requested goods or services.

When the City’s written procurement policies and procedures were requested at the beginning of the audit, the City of Watsonville provided only its Administrative Rules and Regulations. The policies on procurement in the Administrative Rules and Regulations were last updated in July of 2000. However, dollar threshold amounts for procurement, which are not included in the Municipal Code, were updated in January of 2011. These policies, including a few City Council resolutions regarding procurement, were not provided to the audit team until after a draft audit report was submitted to the City. In addition, many of these policies are not included in the Administrative Rules and Regulations. However, the City reports that staff is informed of

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<sup>1</sup> California Government Code 54202.

<sup>2</sup> “Chapter 5: Purchasing Procedure,” and “Chapter 14: Public Works Bid Requirements,” City of Watsonville Municipal Code.

<sup>3</sup> “Chapter VII: Purchasing,” City of Watsonville Administrative Rules & Regulations.

<sup>4</sup> City of Watsonville Intranet: “Purchasing Overview”.

changes in procurement policies through e-mails and the Intranet. The City of Watsonville should update its Administrative Rules and Regulations to reflect all City Council resolutions and changes in procurement policies so that existing and new staff may reference a single document with up to date procurement information.

Exhibit 5.1 below describes the (a) procurement dollar amount thresholds listed in the City’s procurement policies and procedures that require or are exempt from competitive bid procedures, (b) documentation required to determine the least expensive price to the City, and (c) level of final approval or authorization for the purchase order based on procurement.

<b>Exhibit 5.1: Procurement Thresholds, Documentation, and Approval</b>			
<b>Amount</b>	<b>Procurement Process</b>	<b>Quote and Bidding Requirements</b>	<b>Highest Level of Authorized Approval</b>
<i>Non-Public Works:</i>			
\$0.01 - \$9,999	Purchase Requisition only	3 verbal quotes recommended	Department <sup>5</sup>
\$10,000 - \$14,999	Purchase Requisition only	3 written quotes required	Department
\$15,000 - \$49,999	Informal “QuickBid” <sup>6</sup>	Minimum 3 bids	City Manager
\$50,000+	Formal Bid	Not specified	City Council
<i>Public Works:</i>			
\$0.01 - \$45,000	Purchase Requisition only	3 quotes suggested	Department
\$45,001 - \$175,000	Informal “QuickBid” <sup>6</sup>	Minimum 3 bids	City Manager
\$175,001+	Formal Bid	Not specified	City Council

Sources: City of Watsonville Intranet, “Chapter 14: Public Works Bid Requirements,” City of Watsonville Municipal Code and California Public Contract Code Section 22030-22045

As shown in the exhibit above, the City requires at least three different sources of pricing for procurements greater than \$10,000 for non-Public Works purchase orders and \$45,001 for Public Works purchase orders, allowing the City to determine and select the least expensive price in an open and competitive market.

**Adherence to City Policies is Inconsistent**

Although written procurement policies and procedures appear to encourage competitive pricing through quotes or bids and also include internal controls, a review of a sample of active purchase orders with encumbered funds in FY 2011-12 revealed that adherence to these policies is inconsistent.

<sup>5</sup> Each department submits to the Purchasing Division a list of authorized personnel to sign off on requests for checks and purchase order requisitions. The management levels of authorized staff vary across departments, from Department Heads to Administrative Analysts.

<sup>6</sup> The primary distinction between Informal and Formal Bids is the requirement for Council approval of (a) the call for bids and (b) bid award.

In FY 2011-12, the City had 136 active purchase orders with encumbered funds with 96 vendors. Of the 96 vendors, 22, or 22.9 percent, had multiple purchase orders with the City. The total value of the active purchase orders with encumbered funds was \$17,596,184.

From the list of purchase orders with encumbered funds, the audit team selected a judgmental sample of 20 purchase orders, representing various funds and departments, costs, and type of procurement (i.e. equipment, supplies, services, and public works projects). The audit team then conducted a review of the transaction files for the sample of purchase orders to review the following documents: Request for Checks, Purchase Order Requisitions, purchase orders, pricing quotes, invitations to bid, bid proposals, bidder scoring criteria and staff recommendations, contracts, resolutions for City Council approval, invoices, and copies of disbursed checks. Exhibit 5.2 below provides a breakdown of the types of purchase orders selected in the sample file review and observed inconsistencies in the implementation of procurement policies. These characteristics and inconsistencies are further discussed below.

<b>Exhibit 5.2: Purchase Order Sample Characteristics</b>					
<b>Amount</b>	<b># in Sample</b>	<b>Quote, Bidding and Approval Requirements</b>	<b># with less than 3 Quotes or Bids</b>	<b># Without Bid Documents</b>	<b># Without Required Council Approval</b>
<b>Non public works:</b>					
\$0.01 - \$9,999	2	3 verbal quotes recommended; department approves	2	N/A	N/A
\$10,000 - \$14,999	1	3 written quotes required; department approves	1	N/A	N/A
\$15,000 - \$49,999	7	Minimum 3 bids; City Manager approves	1	4	N/A
\$50,000+	5	Number of bids not specified; City Council approves	0	5	1
<i>Subtotal: non-public works</i>	15		4	9	1
<b>Public works:</b>					
\$0.01 - \$45,000	2	3 quotes suggested; department approves	1	N/A	N/A
\$45,001 - \$175,000	1	Minimum 3 bids; City Manager approves	1	0	N/A
\$175,001+	2	Number of bids not specified; City Council approves	0	0	0
<i>Subtotal: public works</i>	5		2	0	
<b>Total</b>	<b>20</b>		<b>6</b>	<b>9</b>	<b>1</b>

Source: City of Watsonville Purchase Order Files

## Lack of Competitive Pricing and Bidding

As shown in Exhibit 5.2, City departments do not always obtain three sources of pricing, either through quotes or bids, when policies encourage or require them to do so. Nine out of the sample of twenty files reviewed did not contain documentation proving that required bidding had occurred.

### Informal Process: Three or more Bids Required

Of the eight procurement files reviewed where three or more bids were required<sup>7</sup> only four contained documentation demonstrating that an informal bid process (two files) or exception (two files) had taken place. The other four did not have documentation showing if and how many vendors had been solicited by City staff, if the City had received at least three bids and/or if they were sole source solicitations that qualified as exempt from the requirement for three bids.

Of the four files with documentation, two explicitly stated that the vendor was selected through a sole source process. However, the justification for using the sole source method was not stated in one of these two procurement files, though such information is required in the City's written procurement policies and procedures<sup>8</sup>. The remaining two purchase order files contained documents detailing the competitive bidding process. It should be noted, however, that the two purchase order files with bid documents only had records of two bidders each while the policies and procedures require a minimum of three bids, when possible. The Finance Department stated that only two vendors made the product requested for one of these purchase orders and both submitted quotes. However, there was no documentation in the files of the other purchase order with bid documents indicating how many vendors had been solicited by City staff.

### Formal Bidding Process

Five<sup>9</sup> of the seven purchase order files reviewed for which formal bidding was required<sup>10</sup> did not have bid documents demonstrating that formal bid procedures occurred, as required by City policy. For example, a purchase order for radio equipment, estimated to cost approximately \$70,000, had three written quotes from vendors as opposed to formal Invitation

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<sup>7</sup> Regular purchase orders valued at between \$15,000 and \$49,000 or public works bids valued at between \$45,001 and \$175,000.

<sup>8</sup> The Finance Department reports that there is only one vendor that sells the products requested in the sole source purchase orders. However, only one of the purchase orders had documentation of this included in the files when the audit team conducted its review.

<sup>9</sup> The Finance Department reports that a request for a proposal for one of these five purchase orders was sent to three qualified consultants, but the City received only two responses. However, documentation of this solicitation was not in the transaction files during the audit review.

<sup>10</sup> Five regular purchase orders valued at \$50,000 or more and two public works projects with a value of \$175,001 or more. .

to Bid documents, formal vendor bid documents, records of published notices, and other formal bidding documents required by City policies and procedures.

### **Smaller Purchase Orders**

Of the two files reviewed with a purchase value of less than \$9,999, one contained only one written quote, though three verbal quotes are recommended. The City later reported that the original purchase order was cancelled because the department was able to find another vendor that offered a lower price for the requested supplies. Obtaining multiple sources of pricing prior to submitting a request for funds can save staff time and resources, as well as ensure cost savings for the City.

### **Professional Services**

Five of the nine purchase order files reviewed that lacked documentation demonstrating that competitive bidding had taken place were for professional services. The City's policies and procedures for procuring professional services are vague and conflicting. For example, the Administrative Rules and Regulations state that either formal or informal bidding procedures are required for all "service, material, and equipment" procurements over \$15,000, without exempting professional services. Bidding procedures in the Municipal Code are required for "supplies, equipment, and non-personal contract services" but do not include any explicit provisions for personal or professional service contract bidding. The only reference to professional services in the City's written Administrative Rules and Regulations is that "professional services are to be judged on quality, not solely on price." This statement, consistent with State law, does not preclude professional services from participating in competitive bidding; it only acknowledges that the criteria for selection could result in not selecting the lowest price.

Though professional services contracts are not required by State law or local ordinance to be competitively bid, doing so is a best practice and could result in cost savings for the City. Of the City's active purchase orders with encumbrances in FY 2011-12, those identified as being for expert and consultation services, legal services, or other contract services had a total value of \$4,506,154. Assuming a conservative cost savings of five percent to account for the price benefits of competition, requiring competitive bidding for most professional services could result in an estimated savings of \$225,308. The City should revise its policies and procedures to encourage competitive bidding for professional services.

### **Inconsistent City Council Approval Process**

One of the seven sample purchase order files reviewed that required formal bidding and City Council approval<sup>11</sup> did not have documentation on file that they received approval from the City Council, though such approval is required under City policies and procedures. This conclusion is

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<sup>11</sup> Regular purchase orders valued at \$50,000 or more or \$175,001 or more for public work projects.



based on a review of the purchase order files, review of City Council agenda items from FYs 2011-12 and 2010-11, and subsequent follow up with the Finance Department.

To test City compliance with City Council approval requirements, the audit team analyzed all FY 2011-12 active purchase orders with encumbrances and concluded that 21 of those, with an aggregate value of \$7,590,053, should have been approved by City Council. However, according to the Finance Department, only 11 of the 21 new contracts, with an aggregate value of \$6,103,983, were approved by the City Council. Documentation of City Council approval of the remaining ten contracts, with an average value of \$148,607, was not found in City Council records. Three of the ten purchase orders that did not have City Council approval in FY 2011-12 were for professional services. However, as previously stated, policies and procedures for procuring professional services are vague and conflicting, including if and when they should be approved by City Council. Further, at least two purchase orders for professional services with values greater than \$50,000 have been approved by City Council.

In addition, there were three purchase orders with a value greater than \$50,000 that went through the informal bid process and were not approved by City Council, even though these purchase orders met the criteria for formal bid procedures and approval by City Council. One purchase order for \$321,100, which was awarded on a sole source basis, was never approved by the City Council.

In contrast to the lack of approvals for purchase orders with a value greater than \$50,000, five of the twenty sample purchase orders reviewed were approved by the City Council, even though the purchase orders were less than \$50,000 each. Two of these purchase orders were for the use of grant funds, and a City Council resolution was required by the grantors.

All purchase orders and proposed contracts with a value greater than \$50,000 for regular purchase orders or \$175,001 or more for public work projects should be presented to the City Council for approval in order to adhere to the City's procurement policies. Documentation of such approval should be included in the purchase order file for review by the City's Purchasing Officer and interested third parties such as auditors. Consistent implementation of this policy would ensure City Council oversight of high-cost purchase orders and reduce risk exposure for contract favoritism and potential fraud.

In addition, the City's policies and procedures should include specific examples of when the City Council should approve purchase orders that are less than \$50,000, such as when it is required by a funding entity, to ensure efficient and appropriate use of City Council time.

### **Insufficient Controls over Change Orders**

According to the FY 2011-12 purchase order encumbrance report, there were at least 24 change orders on 19 purchase orders in FY 2011-12. The final authorized total value of these 19 purchase orders was \$6,654,722. Unfortunately, due to the way previous fiscal years' purchase

order amounts and change orders are recorded, the audit team could not determine the total or average value of change orders.

The City's Administrative Rules and Regulations do not discuss the process of approving change orders. However, according to a City Council resolution approved in 1996:

- Changes in contract values of less than 15 percent may be approved by Department Heads;
- Changes in contract value of between 15 and 25 percent may be approved by the Department Head, after conference with the City Manager and Administrative Services Director, who jointly approve said change orders in writing; and,
- Changes in contract value greater than 25 percent must be approved by City Council.

These policies do not provide sufficient mechanisms to control cost increases that arise from change orders. The percentage increases resulting from change orders in contracts reviewed exceed the common practice of allowing 10-15 percent contingency reserves for change orders without City Council approval. A 25 percent threshold for City Council approval on high value purchase orders could expose the City to the risk of fraud. For example, a vendor could fraudulently provide the lowest priced bid, knowing that they could increase the cost of services, supplies, or equipment with little to no scrutiny from the City, particularly if department staff is also in agreement with the valid, or fraudulent, increased costs.

In the sample file review, 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. Though technically compliant with City policies, the change order amount is more than twice the \$175,001 threshold for City Council approval of new public works purchase orders. In addition, the new purchase order amount of \$2,262,591 is greater than the amount bid by four other competing vendors. As a financial control, the City Council should have reviewed and approved the change order to ensure that it truly represented an unforeseen change in the scope of services, as opposed to an increase due to fraudulent underbidding or unnecessary or inappropriate project costs.

The City's procurement policies and procedures should be revised, and included in the Administrative Rules and Regulations, to require departments to seek City Council approval of change orders if the change order amount (a) results in a total purchase order amount greater than \$50,000, including the sum of previous change orders, or (b) exceeds a ten percent increase based on the original purchase order amount.

### **Inadequate Policies and Procedures for Open Purchase Orders**

In addition to departments requesting purchase orders for their specific departmental supplies, equipment, and service needs, the City also maintains Open Purchase Orders prepared by the

Purchasing Division. According to the Administrative Rules and Regulations, Open Purchase Orders are “appropriate for small, repetitive purchases negotiated with a vendor,” or as Finance Department staff reports, when multiple departments utilize the same vendor. Open Purchase Orders may be used, for example, by a City crew working in the field and needing to buy some unforeseen parts for their job that day.

According to a report provided by the Purchasing Division, there were 159 vendors with Open Purchase Orders in FY 2011-12, with an aggregate maximum allowed dollar value of \$3,366,482<sup>12</sup>. Purchases were made off 136 of these Open Purchase Orders, with a value totaling \$3,081,502 in that fiscal year.

In contrast to the policies and procedures for purchase orders for specific departmental supplies and services, the Administrative Rules and Regulations do not elaborate how vendors with Open Purchase Orders are selected, require contracts to obtain negotiated price discounts, or specify adequate controls over increasing expenditures throughout the year.

The City has credit card accounts with five of these vendors. Procedures for the use of the credit cards are similar to those for requesting payment for any other vendor with a purchase order in that only approved staff have access to the cards and must sign off and submit receipts to the Purchasing Division for payment of the monthly statement.

#### **Open Purchase Order Vendor Selection and Contracts**

Finance Department staff reported that the majority of Open Purchase Orders have not been competitively bid in recent years and that the City does not have contracts with these vendors. Staff also report that most of the vendors have had Open Purchase Orders for over 20 years and it is not clear how they were originally selected.

In a review of a judgmental sample of twenty Open Purchase Orders, documentation demonstrating that the vendors were competitively selected and had contracts with the City was provided for only four, or 20 percent, of the twenty reviewed. These four contracts were not all current and none included the current cost for specific services and goods. For instance, one contract had prices for an expired term, but the new, negotiated prices for the current term were not included in the files. Additionally, another contract with an expired term did not include any prices whatsoever.

Without clear policies and procedures for vendor selection for Open Purchase Orders, the City may not fully achieve the benefits of competitive bidding and there is risk exposure for favoritism in contracting and potential fraud. A competitively bid contract for items purchased at a high volume from multiple departments should include consistent contract discounts and stable prices from month to month or year to year. A review of invoices from an office supply store with an Open Purchase Order that was not competitively bid and did not have a contract

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<sup>12</sup> This aggregate amount is based on the assumption that the City can incur expenditures up to the limit for each credit card each month, as long as the City pays the full balance of the credit card with each statement.

revealed that discounts and net prices for the same product varied month-to-month. Although no fraud was identified in this audit, a vendor could potentially inflate prices charged to the City and share the price differential with colluding City staff members abusing the Open Purchase Order system, if there is no competition with other vendors or a signed contract.

### Open Purchase Order Cost Controls

Similar to other purchase orders, each Open Purchase Order includes an estimated amount that can be spent on it, as needed, representing estimated expenditures within a year as opposed to total maximum expenditures for the term of a contract. According to Finance Department staff, the annual Open Purchase Order maximum amounts are determined based on past usage or requests from City staff.

In FY 2011-12, the authorized annual amount for 154 Open Purchase Orders (the 159 total Open Purchase Orders less four that are based on credit card purchases) was \$2,702,882<sup>13</sup>. However, the City incurred \$3,015,083 in expenditures, which is \$312,201, or 11.6 percent, more than authorized. Expenditures for most of the Open Purchase Orders were less than their annual limits, saving the City from any additional increases above the authorized amounts. However, these cost savings were offset by other Open Purchase Orders that had significant expenditures over their annual limit. Exhibit 5.3 lists the top ten vendors with expenditures significantly in excess of their annual limits in FY 2011-12.

<b>Exhibit 5.3: Top Ten Open Purchase Orders with Over Expenditures, FY 2011-12</b>				
<b>Vendor</b>	<b>Annual Limit</b>	<b>Actual FY 2011-12 Expenditures</b>	<b>Amount of Over Expenditures</b>	<b>Percent Variance</b>
Calcon Systems, Inc.	\$20,000	\$208,596	\$188,596	943%
Golden State Flow Measurement	\$40,000	\$208,650	\$168,650	422%
Bud's Electric Service, Inc.	\$49,500	\$166,051	\$116,551	235%
Polydyne, Inc.	\$60,000	\$171,753	\$111,753	186%
Pacific Truck Parts	\$10,000	\$110,722	\$100,722	1,007%
Evergreen Oil Inc.	\$40,000	\$123,410	\$83,410	209%
Groeniger & Company	\$6,000	\$88,602	\$82,602	1,377%
A-1 Janitorial	\$20,000	\$74,190	\$54,190	271%
Large's Metal Fabrication, Inc.	\$50,000	\$101,943	\$51,943	104%
Mid Valley Supply	\$20,000	\$71,288	\$51,288	256%
<b>Total</b>	<b>\$315,500</b>	<b>\$1,325,205</b>	<b>\$1,009,705</b>	<b>320%</b>

Sources: City of Watsonville 2012 Open Purchase Order Vendor List and FY 2011-12 Transaction Reports

<sup>13</sup> Credit card expenditures were excluded from this analysis because the "purchase order amount" is the credit card limit for balances at any given time. The amount does not represent an annual limit or estimate of expenditures. For example, a credit card with a \$5,000 limit could incur up to \$60,000 in expenditures within a year, as long as the balance on the credit card is paid in full with each monthly statement.

As shown in Exhibit 5.3 above, the top ten Open Purchase Orders with expenditures in excess of their annual limits incurred additional costs that were 104 percent to 1,377 percent more than their annual limits. This indicates that (a) the annual limits do not accurately reflect department needs for services and supplies and (b) there are insufficient internal controls in the Purchasing Division to identify and prevent significant expenditures with a single vendor. For example, a single transaction of \$40,735 for Golden State Flow Measurement already exceeded the annual limit for that Open Purchase Order. Similarly, a single transaction of \$21,194 for Calcon Systems, Inc. also exceeded its annual limit. Additionally, \$62,488 in expenditures had already been incurred for Calcon Systems, Inc. in the month prior to the \$21,194 transaction. If transactions with these vendors had been processed as regular purchase orders, they would all have been subject to competitive bidding requirements.

The lack of internal cost controls for Open Purchase Orders drastically contrasts and is inconsistent with the controls included in approving expenditures for other purchase orders. All of the top ten Open Purchase Orders had expenditures exceeding \$50,000, the threshold amount for non-public works contracts to be subject to formal bidding requirements and approved by the City Council. Additionally, a single transaction for Calcon Systems, Inc. exceeded the \$50,000 threshold. However, there are no contracts for a majority of the Open Purchase Orders and expenditures exceeding annual limits are never reviewed by City Council. Transactions for Open Purchase Orders are included in the monthly disbursement reports provided to the City Council, but the information provided is insufficient for Council members to identify that expenditures have exceeded annual limits.

The Finance Department recognized that there are problems with the procedures for Open Purchase Orders and stated they would consider increasing the annual limits to reflect actual expenditure patterns or change some Open Purchase Orders with high expenditures into purchase orders that follow the same purchase order procedures discussed previously in this report.

However, the City of Watsonville should still revise its Administrative Rules and Regulations to include clear policies and procedures for Open Purchase Orders that are consistent with the requirements for all other purchase orders. These policies should include: a) a requirement for competitive bidding for Open Purchase Orders, unless explicit exemption criteria are met; b) the execution of a contract that clearly states i) the term of the Open Purchase Order, ii) an annual or contract term limit for expenditures, prices, and discounts, and iii) a mechanism to approve changes in prices and discounts; as well as c) internal controls for identifying and approving significant expenditures. Open Purchase Orders that have an annual or contract term limit greater than \$50,000 should be approved by the City Council, in addition to expenditures that exceed the annual or contract term limit and meet the same criteria discussed above for change orders requiring City Council review.

The Purchasing Division should also implement additional monitoring and reporting to facilitate cost control throughout the year. Because multiple departments may utilize the same Open Purchase Order, the Purchasing Division has a unique perspective and can identify significant

expenditures for a particular Open Purchase Order. Monthly reports should be provided to management to identify Open Purchase Orders with expenditures that exceed estimated average monthly expenditures based on the contract annual limit. The Purchasing Division could then determine if a change order request for City Council approval is necessary, or if it should require departments to limit expenditures for the remainder of the year.

Additional staff may be required to facilitate competitive bidding and contract execution for existing Open Purchase Orders. However, estimated costs savings from the benefits of competitive bidding and implementing more cost controls could offset staff costs. A conservative estimate of a five percent reduction in payment to Open Purchase Order vendors would result in \$154,075 in cost savings, based on the \$3,081,502 in expenditures for Open Purchase Orders in FY 2011-12.

Finally, all City staff involved with purchase orders, from the various departments to the Purchasing Division, should be trained on the revised Administrative Rules and Regulations to ensure proper implementation.

## **Conclusions**

A review of the City's policies and procedures along with a review of the files and transactions for 20 purchase orders in FY 2011-12 revealed that adherence to the policies and procedures is inconsistent. Specifically, three quarters of the sampled purchase orders did not obtain three competitive prices through quotes or bids, though the policies encourage or require such, depending on the purchase order amount. Lack of evidence of competitive bidding for professional services was prevalent, while policies on competitive bidding for professional services are vague and conflicting. The City Council does not always approve agreements that are greater than \$50,000 for non-public works purchase orders, though it is required under the City's policies and procedures. Further, policies for change orders approved through a City Council resolution are not included in the Administrative Rules and Regulations and are insufficient for curbing escalating and possibly unnecessary costs through multiple contract change orders.

Written policies and procedures for Open Purchase Orders do not exist. In the absence of such policies, a majority of the 159 FY 2011-12 Open Purchase Orders have not been competitively bid in over 20 years and most do not have contracts with the City to ensure consistent prices and negotiated discounts for goods and services purchased at high volumes by City departments. Finally, adequate controls over increasing Open Purchase Order expenditures do not exist. As a result, some Open Purchase Orders incurred single transactions that were greater than their annual limit, and some had expenditures exceeding the \$50,000 threshold for City Council approval of competitively bid purchase orders. However, such Open Purchase Orders were not brought to the City Council for approval.

## Recommendations

The City Council should direct the City Manager to:

- 5.1 Revise the City's written Administrative Rules and Regulations to include the following:
  - (a) Requirement for competitive bidding for all professional service contracts above a designated amount such as \$15,000 without requiring that contracts be awarded to the lowest responsible bidder (qualified contractor or vendor that meets bid specifications at the lowest cost), but rather, the most qualified if the lowest responsible and most qualified bidder are not the same;
  - (b) Require executed contracts for all Open Purchase Orders that include: a) contract term; b) annual or contract term limit for expenditures, prices, and discounts; c) mechanisms to approve changes in prices and discounts; and, d) City Council approval for all Open Purchase Orders estimated to exceed \$50,000;
  - (c) Clear procedures for approving change orders to all purchase orders, including Open Purchase Orders, such as requiring City Council approval for change orders that (i) result in a total purchase order greater than \$50,000 (or \$175,001 for public works), including the sum of previous change orders, or (ii) exceed a ten percent increase over the original purchase order amount;
  - (d) Monitoring and reporting procedures for Open Purchase Order expenditures, such as monthly reports by the Purchasing Division, that could result in requesting change orders for approval by City Council, or halting ongoing expenditures for the remainder of the year; and,
  - (e) Examples of when the City Council should approve purchase orders that are \$50,000 or less.
- 5.2 Train all City staff involved in purchase orders on the revised Administrative Rules and Regulations to ensure proper and consistent implementation of policies and procedures, including City Council approval of all purchase orders greater than \$50,000.
- 5.3 Provide annual reports to the City Council summarizing purchase order and contract activity for the past year, including original contracts and amounts, number and value of change orders, and number and value of purchases from Open Purchase Orders.

## Costs and Benefits

Implementation of all recommendations should be accomplished using existing resources. It is estimated that implementation would require approximately .5 of a full-time equivalent (FTE) position for the first year, and less staff time after that. Competitive bidding of purchase orders, including for professional services and Open Purchase Orders, could (a) result in lower prices for the City, including consistent discounts for the purchase of commodities in high volume, and (b) reduce risk exposure to contract favoritism and potential fraud. Improved controls over change orders for all purchase orders and expenditures for Open Purchase Orders could also result in cost savings. Conservative estimates of cost savings for competitive bidding and improved controls include \$225,308, or five percent of professional service contracts in FY 2011-12, and \$154,075, or five percent of FY 2011-12 expenditures for Open Purchase Orders. If additional staff is required to implement these recommendations, then the estimated cost savings would offset the costs of these staff.