



March 1, 2013

**TO:** Lise Peterson, Foreperson, FY 2012-13 Santa Cruz County Grand Jury

**FROM:** Fred Brousseau

**SUBJECT:** Responses to City of Watsonville's Rebuttal to Grand Jury's January 3, 2013 Report on Performance Audit of City of Watsonville

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We have reviewed the City of Watsonville's January 15, 2013 response to our January 3, 2013 report to the FY 2012-13 Santa Cruz County Grand Jury on our Performance Audit of the City of Watsonville. Overall, after reviewing the City's 118 page document, we continue to stand by all of the findings, conclusions and recommendations in our report. The City substantially agrees with the audit recommendations but takes issue with some of the information presented in the report.

We have the following comments on some of the key City responses:

**Section 1: Financial Condition, Reporting and Controls**

The City takes issue with some of the financial data presented in our report though overall agrees that the City's financial position is not good and has deteriorated over the five fiscal years ending June 30, 2011. Using information available from the City's own Comprehensive Annual Financial Reports, we stated that: end of year net assets had declined from start of year net assets for the last three fiscal years reviewed; that expenditures for all City activities except its enterprise departments outstripped revenues for the last two fiscal years; and, that the General Fund balance at year-end declined every year for the five fiscal years through FY 2010-11, ending in a balance of only 4 percent of expenditures in the final year. We also reported, again based on the City's Comprehensive Annual Financial Reports, that the City had a high level of indebtedness, with General Fund liabilities equal to 87 percent of General Fund assets at the end of FY 2010-11.

We stated that the City's financial decline does not appear to all be due to the national recession that was most evident in 2007-2009 based on a comparison of the City of Watsonville to the following seven cities throughout California of comparable size and characteristics.<sup>1</sup>

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<sup>1</sup> The one exception to the similarity of the comparison cities to the City of Watsonville was the inclusion of the City of Salinas, with a 2011 population of 152,992 compared to Watsonville's 2011 population of 51,586. The City of Salinas was added at the request of the City of Watsonville staff.

**Comparison Cities**

<b>City</b>	<b>2011 Population</b>
Cathedral City	52,381
Colton	52,940
Gilroy	49,482
Hanford	54,284
Porterville	55,023
Salinas <sup>1</sup>	152,994
Santa Cruz	54,284

By six key measures, the City of Watsonville was in a worse financial position than the median for the comparison cities.

**City of Watsonville vs. Seven Comparison Cities**

<b>Measure</b>	<b>FY 2010-11 Median</b>	<b>FY 2010-11 Watsonville</b>
General Fund (GF) Year-end Fund Balance	\$13,843,789	\$1,598,588
GF Year-end Cash Available	\$9,560,263	\$1,598,588
GF Cash Available as % Expenditures	42.8%	4.0%
GF Months Cash Available @ Year-end	2.3	.48
Ratio: GF Liabilities/Assets	10.7%	87.0%
GF Expenditures Per Capita	\$522	\$775

The City objected to these results primarily on two bases:

1. The comparison cities are not comparable.
2. The City of Watsonville had a one-time \$6.6 million expenditures in FY 2010-11 that makes their position look worse than in a normal year.

We do not agree that the cities are poor comparison cities. All of the cities except Salinas, which City of Watsonville management requested be included, are of comparable population, are on the fringes of, or outside, California's largest metropolitan areas and development in many of the cities has been replacing an agricultural base. Some, such as Santa Cruz and Gilroy, have much stronger economic

bases, while others such as Colton and Hanford, have less prosperous economies. Overall, we believe these cities represent a balanced cross-section of cities the size of Watsonville.

Regarding the City of Watsonville's one-time \$6.6 million expenditure in FY 2010-11, this was for a payment to CalPERS to pay off an obligation for retirement benefits for the City's sworn personnel. The payment was made using a loan from the City's pooled cash fund and represents a real, though one-time, expense in FY 2010-11. There is no reason to exclude it when assessing the City's financial position as it represents a real obligation incurred by the City for which its resources were used. It is particularly unwise to remove the expense when comparing to expenditures to other cities since all the data for all the cities came from each jurisdiction's audited Comprehensive Annual Financial Report (CAFR). Any of the other cities may also have had unusual one-time expenditures or revenues and, without reviewing the details of each city's situation, the comparison is only valid if each city's standardized financial reports is treated comparably since all jurisdictions classify their actual expenditures and revenues using the same methods.

Finally, while removing the \$6.6 million expenditure from the City's FY 2010-11 expenditures would improve the City's financial results somewhat for FY 2010-11, the City of Watsonville would still be in poor financial condition compared to the other cities and it would not change our overall conclusion or the five year trend shown in the report that the City's financial position worsened over the five year period ending June 30, 2011.

## **Section 2: Inter-fund Loans and Transfers**

The City contends that its cash position is not as bad as reported in the audit because much of their General Fund cash is transferred to other funds that have deficits for CAFR reporting purposes to comply with local government accounting practices. However, Watsonville's situation is not necessarily unique. The same accounting rules apply to all cities and the practice of making short-term loans from the general fund to other funds for CAFR purposes could well have been employed by one or more of the comparison cities as well and their reported general fund cash positions would thus also be affected by such transfers. Further, the short-term loans reported in the City of Watsonville's CAFR are noteworthy because they were needed to offset multiple years' worth of financial weaknesses in two of the receiving funds: the Parking Garage fund and the Airport fund, both of which had been incurring expenses in excess of their revenues for a number of years.

We reported a practice of making no-interest loans from the City's General Fund and other funds and concluded that this practice was harmful to the loaning fund and a poor business practice. The City contends that these no-interest loans were a policy choice by the City Council. The City is free to make such decisions but it still a poor business practice, particularly given the state of the City's General Fund. Further, no documents were produced by the City to show that the City Council was informed of the losses to the loaning funds that would be incurred when they made the decision to grant interest-free loans. For example, the \$4.4 million interest-free loan from the City's General Fund to the Redevelopment Agency to support downtown economic development resulted in a \$740,000 loss in

interest earnings to the General Fund. Similarly, the City's Impact Fee Funds provided a \$700,000 interest-free to the downtown redevelopment projects that resulted in an estimated loss of \$111,492 in interest earnings over the life of the loan. This loss was not reported to the City Council either.

### **Section 3: Budget and Expenditure Controls**

The City claims that its actual total General Fund expenditures did not exceed amounts approved by the City Council. Our comparison was to the City Council's originally approved budget at the beginning of FYs 2009-10 and 2010-11. The City contends that the City Manager made authorized intra-fund transfers during the year that allowed for changes to individual department budgets but kept total General Fund spending within the total appropriated by the City Council. We disagree.

The City Manager transferred nearly \$3 million in FY 2009-10 and \$1.3 million in FY 2010-11 from capital projects previously approved by the City Council for General Fund operations. Those transfers were not reported in either the operating or capital project budgets presented to the City Council. The last City Council expenditure approval for those funds was for capital projects that never occurred. Instead, the funds were transferred by the City Manager and used to cover General Fund operations without approval of this new use of the funds by the City Council. City policy calls for re-appropriation of capital project funds from year to year by the City Council for projects that span multiple years and for City Council approval of planned General Fund expenditures. Neither action occurred for these funds; therefore, we contend that final General Fund expenditures for those two years exceeded the General Fund expenditures authorized by the City Council.

### **Section 4: Capital Budget and Impact Fees**

The City claims its annual development impact fee reports are meeting all State requirements. We have reviewed the reports and we disagree. California Government Code Section 66006 requires that annual development impact fee reports contain the following information:

1. A brief description of the type of fee in the account or fund.
2. The amount of the fee.
3. The beginning and ending balance of the account or fund.
4. The amount of the fees collected and the interest earned.
5. An identification of each public improvement on which fees were expended and the amount of the expenditures on each improvement, including the total percentage of the cost of the public improvement that was funded with fees.
6. An identification of an approximate date by which the construction of the public improvement will commence if the local agency determines that sufficient funds have been collected to complete financing on an incomplete public improvement, as identified in paragraph (2) of subdivision (a) of Section 66001, and the public improvement remains incomplete.
7. A description of each interfund transfer or loan made from the account or fund, including the public improvement on which the transferred or loaned fees will be expended, and, in the case of an interfund

loan, the date on which the loan will be repaid, and the rate of interest that the account or fund will receive on the loan.

8. The amount of refunds made pursuant to subdivision (e) of Section 66001 and any allocations pursuant to subdivision (f) of Section 66001.

A review of the City's annual reports showed that they do not include items 2, 5, 6, 7 or 8.

### **Section 5: Procurement**

We continue to stand by our conclusions and reported variances with the City's procurement policies and procedures. Although the City disagrees with the number of contracts or purchase orders in compliance with its own policies and procedures, the fact that the City also found agreed with some of the non-compliant contracts or purchase orders we found illustrates our point that adherence to policies and procedures is inconsistent.

After receiving additional explanations and documentation from the City about certain of our sample purchase orders and contracts following their review of our draft report, we adjusted some of our findings accordingly and found instances in which the situation was better, or worse, than previously stated. For example, we found 15 instead of 11 purchase orders without sufficient documentation demonstrating that three sources of pricing were obtained as required or recommended in the City's policies and procedures. Although the City claimed that documentation existed, we were not provided additional documentation to disprove our findings regarding a number of contracts that had (1) only two vendors provided quotes through a formal bid, (2) only one or two quotes had with sufficient back up documentation from the vendors, and or (3) there was no written explanation for sole sourcing for some of the purchase orders.

In addition, we agree with the City and excluded public works contracts from our analysis of contracts requiring City Council approval. However, we still found and reported at least five non-public works contracts over \$50,000 that were not approved by the City Council, as required. The remaining five contracts that were over \$50,000 and not approved by the City Council were for professional services or obtained through a piggy back agreement. As we stated in the report, requirements for and the practice of approving professional service contracts are inconsistent. We agree that the two contracts obtained through piggy back agreements do not require approval by City Council.