San Joaquin County Grand Jury

Recovering from Stockton's Financial Sinkhole – Don't Fall Back In 2012-2013 Case No. 0112

Summary

The City of Stockton's financial situation has deteriorated over the past decade leading to the City's filing for bankruptcy protection under Chapter 9 of the Internal Revenue Code. The 2012-2013 San Joaquin County Grand Jury (Grand Jury) was concerned about the impact of the bankruptcy filing on the City's current and future services. However, the complexity of the bankruptcy action and the court filings led to the Grand Jury's decision to not look at the details of the bankruptcy itself, but rather to review the City's financial policies, procedures, and past actions that may have been material causes of the financial deterioration. This report reveals what happened in hopes of shedding light on identifiable problems with the City's past actions so that similar problems might be avoided in the future.

Among the issues evaluated were the City's internal financial procedures and capabilities; the role and competency of internal and external auditors; information provided by staff to the City Council; the City's administrative leadership's role in the financial problems; and, the capabilities and financial stewardship of the City's elected officials. During its investigation, the Grand Jury made a number of findings including evidence of inadequate information presented to the City Council by a former city manager; lack of project oversight; unilateral control and manipulation of projects by a former city manager without City Council knowledge or approval; poor accounting of the various transactions involving the Events Center; lack of reliable information between city staff and the City Council; and, a financial system that is inadequate for the accounting needed.

In view of these findings, the Grand Jury's recommendations reflect concerns that the City's financial operations need strengthening in personnel, procedures and equipment; that the audit activities, both internal and external, need better oversight by elected and appointed officials; that information on fiscal matters be given greater emphasis, clarity and attention; and, the elected City Council become better prepared to understand and address the complexity of local government finances in Stockton.

Glossary

Agenda Report	A report to the City Council usually prepared by city management providing an explanation of the requested action by the council members, including background information and the text of any resolution or ordinance proposed for adoption.
CAFR	Comprehensive Annual Financial Report; the annual report prepared by the City's external auditor and includes both financial information and general city fiscal and statistical information.
CFO	Chief Financial Officer; the individual responsible for the management and oversight of the City's financial operations.
City Auditor	The individual or firm appointed by the City Council to conduct internal audits of city operations and finances.
City Charter	The Charter of the City of Stockton which establishes the general framework for the government organization, authority, and operations.
City Council	Unless otherwise specified, includes the six elected council members and the mayor of the City of Stockton.
City Manager	The chief executive officer hired by the Stockton City Council to administer day-to-day operations of the City.
Council Member	Any one of the six elected members of the Stockton City Council; does not include the mayor.
CSAC	California State Association of Counties; an association comprised of and representing the interest of counties in California.
Current City Government	Unless otherwise specified refers to the mayors, city council members and city managers holding those positions between 2009 and the present.
Events Center	Includes the arena, ballpark, marina and other capital projects in downtown Stockton.
External Auditor	The firm hired by the City Council to conduct an annual audit of the City's financial records and procedures.
Fiscal Year/FY	Fiscal year; the Stockton government's financial year beginning on July 1 and ending the following June 30.

GASB	Governmental Accounting Standards Board; a federally established entity that establishes accounting standards for government.
GFOA	Government Finance Officers Association; a national organization of public finance officials.
KPI	Key performance Indicators; the quantifiable indicators used to measure performance to meet key operational goals.
LCC	League of California Cities; an association comprised of and representing the cities in California.
Material Weakness	The most critical of audit findings, these are deficiencies or combinations of deficiencies in the City's internal controls whereby there is a reasonable chance that a material misstatement of the financial statements will not be prevented or detected and corrected on a timely basis.
Mayor	The separately elected mayor of the City of Stockton pursuant to the City Charter with limited and defined authority under the City's Council/Manager form of government.
Prior City Government	Unless otherwise specified refers to the mayors, city council members an city managers holding those positions between 2000 and 2009.
Priority-Driven Budget Process	A method of preparing a budget by allocating available funds for service based on the importance of the service to meet long-term goals of the City
Significant Deficiency	An audit term referring to a shortcoming in a highly important control area, or a combination of problems, that could result in a misstatement of the financial statements that have consequences for the accuracy of the audit.

Background

The City of Stockton (City) is a Charter City operating under a Charter first adopted by the people of Stockton in 1888 and ratified by the State Legislature in 1889. As a Charter City Stockton is not restricted to the authorities granted to cities under California law. It may grant itself other authorities or undertake programs not specifically prevented by State law or the State Constitution. A charter city is subject, however, to general rules of operation that are required of all local governments in the State, such as an annual financial audit, public meeting procedures and public record requirements. The City Charter was amended in 2000 to allow the mayor to be elected by the citizens of Stockton; a change from the prior practice of the city council members selecting a mayor from within its membership.

The City Charter, Article XI, Section 1102, defines the scope of the powers and responsibilities of the Mayor, which include, but are not limited to:

Preside at Council meetings and vote as a member (without power of veto);
Review the City Council agenda and add items as necessary;
Direct officials appointed by the Council to provide information to the Council on matters requiring Council action;
Request budgetary and other information from officials appointed by the Council;
Recommend adjustments to the City Budget and propose modifications or curtailment of any city service; and
Make recommendations for appointments to Council committees, subject to approval by the other Council Members.

The operations of the City are managed under a Council/Manager form of government where the City Council is responsible for establishing the City's policies, adopting annual budgets and interacting with other governmental entities. The Council also appoints individuals to serve in specific positions in the City's government, including the city manager, city attorney, city auditor and city clerk. The city manager is the chief administrative officer. The City Charter, Article XII, Section 1201, defines the powers and duties of the City Manager. Among the powers outlined are:

Direct and supervise the administration of all departments, offices and agencies;
Prepare and submit the annual budget of the Council;
Make and execute contracts and authorize expenditures of less than $20,000;
Submit an annual report on the finances and administrative activities of the City, including an accurate and complete review of the fiscal status of the City; and
Faithfully execute all laws and provisions of the City Charter.

Issues

The Grand Jury initiated this investigation out of a concern for the potential long-term impact of the City of Stockton's financial situation and what may have been factors leading to the current financial position. While prior San Joaquin County grand juries have looked at the City's financial situation as it related to the City of Stockton's Community Development Department and the Redevelopment Agency, the current Grand Jury expanded its review to include the following general areas:

Information provided to the City Council by City staff
Effectiveness of the City Auditor
Effectiveness of the City's External Auditors
City Finance Department's Operations
City Budget
City Council Budget and Audit Committees
Financial Training for City Council members and City Mayor
City Council and City Manager Responsibilities and Oversight

Method of Investigation

The 2012-2013 Grand Jury performed the following:

Materials Reviewed

Prior Grand Jury reports

Management letters from the External Auditors from FY 2004-2005 through FY 2009-2010

2007 Taxable Pension Obligation Bonds' financial reports

October 31, 2003 staff report on *Stockton Event Center – Financial Summary*

August 26, 2008 staff report for *Agreement with the Government Finance Officers Association* for priority-driven budget process advisory services

September 11, 2008 GFOA report to Budget, Finance and Economic Development Council Committee on *Priority-Driven Budget Update*

September 19, 2008 draft Program list with PPG (Policy Priority Groups) Ranks

February 28, 2012 staff report to City Council regarding *Fiscal Condition Update for Fiscal years 2010-11, 2011-12 and 2012-13*

February 2012 report from *Management Partners* titled *City of Stockton Financial Condition Assessment*

Stockton City Council Resolutions No. 91-0017 and Resolution No.94-0607 pertaining to Council Committees

December 14, 2004 staff agenda report titled *Resolution: Authorize City Manager/Executive Director to Appropriate Funds from Designated Accounts of the Stockton Events Center Project and Revise the Guaranteed Maximum Price (GMP) for the Ballpark Stadium Component of the Project*

City Council Resolution No. 04-0836

City Council/Redevelopment Concurrent Meeting minutes for December 14, 2004

League of California Cities elected officials training programs offered in 2011 through 2013

California State Association of Counties elected officials training programs offered in 2011 through 2013

Survey results from Stockton City Council members and Mayor, and from San Joaquin County Board of Supervisors

Interviews Conducted

Current and former City consultants

Current and former City employees

Former members of the Stockton City Council

Discussion, Findings and Recommendations

1.0 Information Provided to the City Council

Timely, accurate, and easily understood information is crucial for elected council members and the public to review so they can understand the issues facing the city and to ensure prudent decisions are made. The 2005-2006 Grand Jury found that the then-City Manager repeatedly failed to provide information related to the Events Center to Council Members, which would have given an accurate picture of the true cost of the project. The current Grand Jury independently reviewed various documents and the sworn testimony of elected officials and city employees and reconfirmed that documentation was not presented to the City Council in a timely or clear manner. The Council agenda report for the December 14, 2004 meeting relating to the financing for the Events Center project was delivered after the balance of the agenda package reached the council. While there is no record of exactly when the report was delivered, the meeting minutes indicate two council members stated it was received the night before the meeting. That agenda item requested the budget for the Events Center project be increased from $113,512,640 to a new total of $115,384,299, an increase of $1,871,659. (The original estimate for the entire project was $67.1 million.) While this individual action increased the construction cost by less than 2%, the cumulative changes had increased the total cost by more than 70%. The action also authorized the then-city manager to approve change orders of up to 10 % ($11.5 million) of the total project cost without prior City Council approval. The city manager indicated that the cost increase was primarily due to increased costs in steel and concrete, but deflected an inquiry into why the City Council had not been asked to approve design changes which were already being implemented.

From direct testimony, the Grand Jury learned that the design changes were conceived and implemented by the then-city manager and mayor without the required City Council approval. While the exact amount of the cost increase associated with the design change was not determined by the Grand Jury, testimony verified that not only was it significant, but that it was also contrary to the recommendations of the sport facility experts hired by the City. In addition, the design changes led to an increase in the management fees the City paid to operate the facilities. At the December 14, 2004 meeting the city manager failed to disclose this fact to the Council and it was kept from

the public record. The Grand Jury notes that although the proposed agenda item at the December 14, 2004 meeting involved a major change in the Events Center project design and increase in cost, only one Council Member was recorded as asking questions of the city manager about the reasons for the changes and requesting additional supporting information.

The Grand Jury also learned from testimony that the former city manager would regularly delay providing council members with important background information related to other major financial decisions they were being requested to make. Budget documents were provided only a few days before Council discussions were held, requests for additional information were delayed until just before a vote was held, and independent analysis of bond documents was inadequate or not provided. Based on testimony and meeting minutes, when information was received, Council members who did ask questions about the fiscal impacts were at times ignored by the Mayor and/or removed from Council committees assigned to look at financial matters.

The former city manager proposed a number of transfers of funds between City accounts for the purpose of funding the Events Center project. Standard financial practice requires these inter-fund loans be accompanied with loan documents detailing such items as legal authority to make the loans, repayment requirements and interest charged. From documents and testimony the Grand Jury found that the loan documents were absent from agenda reports requesting the loan approvals and, of particular concern, there appeared to be no analysis of the impact on the City General Fund should the loan not be repaid. A similar finding about financial failures by management and council was reported by the 2005-2006 Grand Jury.

As a result of the limited information provided to the City Council and the failure by former management staff to respond to requests for information, witnesses testified that council members would often distrust the information presented to them by former city managers. While part of the problem may have been the result of the finance department's operating equipment, which is discussed later in this report, under testimony most witnesses perceived it was a result of the former city manager's manipulation of information.

Findings

F1.1 The agenda reports for the Events Center project for the December 14, 2004 council meeting, and other major projects were presented to Council Members with inadequate time to review the complex issues. The same finding was disclosed in the 2005-2006 Grand Jury report *City of Stockton Redevelopment*.

F1.2 Few Council Members asked questions of City staff about the City's financial condition or the financial impacts of major expenditures they were being asked to approve.

F1.3 The City Council's approval of loans between restricted funds without receiving any information or documents on the repayment requirements or impacts created an unclear picture of the actual fund balances in the various accounts.

Recommendations

R1.1 Information regarding major new and/or complex projects or programs that have an adverse impact on the City's financial condition be provided to the City Council members and public not less than 10 calendar days before the date of proposed Council actions to allow for a thorough review of materials and an opportunity for the Council Members and public to ask questions.

R1.2 The City Council hold a study session at least quarterly to receive and discuss complex financial issues to include, but not be limited to, the City's financial condition, long-term impacts of past, current and proposed financial obligations of the City, major capital outlays and employee contracts. An opportunity for all members of the City Council and the public to ask questions is to be incorporated into the study session.

R1.3 All proposals for the City Council to authorize inter-fund loans be accompanied with loan documents detailing obligations of the loan and any impacts on the City's General Fund.

2.0 Effectiveness of the City Auditor

The position of the City Auditor was created by a City Charter amendment in 1994 (Section 2.16). The position is appointed by, reports to, and serves at the pleasure of the City Council. Among the duties assigned to the City Auditor are:

Audit the books, accounts, money, and securities of departments and agencies of the City;
Select and manage the outside audit firm;
Determine the extent to which City department's assets are being accounted for;
Report results of audits to the City Council and City Manager; and
Perform such other auditing functions as may be assigned by the City Council.

All cities do not have an internal city auditor position. Some individuals with the title may be directly elected by the voters, appointed to the position, or serve in the internal auditor role as part of other duties. In 2006, the Government Finance Officers Association (GFOA) approved as a Best Practice the establishment of an internal Audit Function finding, stating that "…such a function can play an important role in helping management to maintain a comprehensive framework of internal controls." It also found that "Internal auditors can play a valuable role conducting performance audits, as well as special investigations and studies." The GFOA recommendation does not state a preference as to where the position is located in a city government structure, or who provides oversight, other than stating that interaction with the city's management staff is important.

In Stockton, only one person held the position of City Auditor from the time the position was created in 1994 until 2012. While the Grand Jury is not making a determination on this fact, it does question the possible lack of innovative thinking and broad expertise that a single person serving for such a period of time would offer to the City Council. Testimony from elected/ appointed city officials and consultants presented the view that the limited expertise in the City Auditor's Office may have prevented many detailed performance or financial audits of city departments/operations

from being conducted. The few audits recalled by former elected officials as being helpful were in the areas of library fee collections, overtime approvals and concession fees. Overall, there appeared to be little support for the City Auditor from either elected or appointed officials. In September 2008, the GFOA conducted a study as part of a Council-approved review of a priority performance budgeting process. The study included all elected and top management officials and was designed to determine their internal prioritization of all government programs. The ranking order went from zero (lowest) to 30 (highest). The City Auditor's performance auditing function was ranked an overall seven. The City Auditor's revenue auditing function was ranked an overall zero.

The Grand Jury further found that the City Auditor did not have the oversight or the independence described in the City Charter. While the City Council and its Council Audit Committee were charged with oversight responsibilities, there is little indication that either exercised that role. Testimony from prior elected officials, some of whom served on council audit committees, revealed they had little interaction with the City Auditor other than at presentations of the annual external audit. Few assignments were given to the City Auditor by the City Council as permitted under the Charter.

The City Council recently approved a City Manager recommendation that the City hire an outside firm to serve as City Auditor rather than hiring an individual for the position. The rationale given was that a firm would provide a broader scope and depth of expertise that the City could draw upon to study issues of concern to the City. Since this arrangement has just begun, the Grand Jury did not have an opportunity to review the arrangement or its effectiveness.

Findings

F2.1.1 While the City Auditor is accountable only to the City Council under the City Charter, city managers influenced the Auditor's day-to-day operations through recommendations on the City Auditor's budget, thus limiting the Auditor's direct interaction with department heads.

F2.1.2 The City Council showed little actual activity in fulfilling its obligations to oversee the City Auditor's office.

F2.2.1 The City Auditor was instructed by a former city mayor and former city manager not to review the City's overall finances. The City Auditor did not at that time or since, conduct independent reviews of revenue or expenditure projections used for project and program funding.

F2.2.2 Elected officials testified that the City Auditor was not assertive in conducting reviews and evaluations of city contracts, department programs, or the overall City financial condition, thus denying the City Council and public an independent review of financial implications of the city managers' recommendations.

F2.2.3 The City Auditor did not conduct, nor did the City Council direct, a separate review of compliance with construction contracts related to the Events Center or the assumptions on which financial decisions for the project were made.

F2.3 The recent practice of using a firm as the City Auditor gives the City Council more flexibility in directing what audits and studies are to be conducted since a wider field of expertise offered by the firm can be tapped to undertake the investigations.

Recommendations

R2.1 The City Council adopt a concise policy by December 31, 2013 identifying the City Council's oversight obligations of the City Auditor, whether an individual or a firm, and the review process of the Auditor's findings and reports.

R2.2 The City Council adopt a policy by November 30, 2013 clarifying the types of audits and reports the City Auditor is to perform and when the audits are to be conducted and under whose direction they are to be undertaken.

R2.3 For the next two years, the City contract with an outside firm with multiple areas of expertise to serve as City Auditor. The use of a firm (versus an individual) is to serve as City Auditor to be evaluated as a distinct action item annually as part of the budget review and adoption process.

3.0 Effectiveness of the City's External Auditors

The City Charter (Article XIX, Section 1911) requires the City to have an independent financial audit performed by an outside certified public accounting firm to test the City's financial processes and safeguards and to confirm the year-end fund balances in the various City accounts. This audit is also a requirement for many federal funding programs and in contracts with municipal bond buyers. The City of Stockton has a Comprehensive Annual Financial Report (CAFR) prepared which includes, in addition to the review of accounts and fund balances, a review with recommendations on the financial operations and other statistical information. The External Auditor is selected through a proposal and interview process that is headed by the City Auditor and approved by the City Council. The previous audit contract was managed by the City Auditor who oversaw the work schedule, billing submittals and reports prepared.

The former External Audit firm was first hired by the City for the FY 2000-2001 audit and provided services in that role through the FY 2009-2010 audit. In each of those years the External Audit firm prepared a *Report to Management* which is required to identify any deficiencies or weaknesses in the City's financial operations and accounts, and to make recommendations to correct or eliminate them. The External Audit firm also identifies problems in the operations of the finance or related departments that should be addressed by management but do not have a major impact on the financial accounting statements. These include items such as backup of computer tapes, reconciliation schedules and training and staffing. When a problem rises to a higher level it becomes a *significant deficiency.* These include matters such as lack of review of accounting entries or not reconciling bank account/s balances with internal account amounts in a timely manner. The most critical of audit findings are *material weaknesses* and include instances where

financial information has been omitted or recorded in a manner that significantly impacts the City's account balances.

As part of this investigation the Grand Jury reviewed the management letters in the CAFR reports for the fiscal years 2004-05 through 2009-10. While there were a number of minor recommendations made in each of these years, mostly related to the City's computer system and Finance Department employee training, no major problems were identified during the first four years reviewed. While the individual audit recommendations were not significant, the cumulative effect of the problems identified was an indication of a financial system that was not adequate for the City's increasingly complex fiscal situation.

For the Fiscal Year ending June 30, 2009, one *material weakness* was reported (omission of financial transactions involving the City's long-term liabilities); and one *significant deficiency* was reported (the understaffed finance department was unable to prepare proper financial statements). In the following year's audit report there was one *material weakness* finding (omission of financial transactions related to accounts receivable and revenues in the City's Library Fund); and two *significant deficiencies* were reported (a lack of timely cash reconciliations, and differences, in the amount of approximately $1.3 million, in the value of loan advances to property owners recorded by the third party administrator of the loan and the City's general ledger value of the loans).

As a comparison the final CAFR for the FY 2010-2011 audit, which was prepared by the City's new External Auditors, they reported 30 material findings of which 13 were identified as *material weaknesses*. This substantial increase in the number of major problems identified by the new External Auditors raises significant questions about the adequacy of the prior external auditor's examination of the City's financial statements and operations. Further, from testimony it was revealed that prior City management was aware of weaknesses in financial operations, yet did not appear to take proactive steps with the external auditors, or independently, to resolve the problems.

Another concern about these investigative findings is that it appears the City did not take appropriate steps to correct all of the problems that were identified. A number of the minor recommendations made by the former audit firm were repeated year after year. While mentioned in subsequent reports, they were not emphasized by the External Auditors to the Council Audit Committee.

Testimony from a number of City employees indicated that a complacency had developed between employees of the External Auditor and City Finance Department employees. The same auditors and employees worked on the audit review and report year after year. The City Auditor, charged with the management of the audit contract, provided very little oversight of the audit's preparation. Even with issues being raised about inter-fund loans and inaccurate fund transfers and account balances, the External Auditors did not raise any concerns to a *significant deficiency* level. In addition, the cumulative effect of years of failures in the City's accounting activity was not raised to a higher level of concern by the former External Auditors. Not until a new on-site

manager was assigned by the former audit firm, was the level of concern raised. This contributed to the delay in the preparation of the CAFR for the Fiscal year ending June 30, 2011 because of major problems in reconciling funds and accounts.

Findings

F3.1 The long-term nature of the contract with the former External Auditor firm may have been a major cause of complacency by both the auditors and City staff. The friendliness between the auditors and finance staff undermines the integrity and objectivity regarding the thoroughness of the audit process.

F3.2 The City Auditor did not manage the external audit process in an effective manner to determine if a full independent review of the accounting processes was being conducted.

F3.3 The final audit for the fiscal year ending June 30, 2011 indicated there had been major deficiencies and material errors in the prior financial accounting records and procedures, which the prior external audit firm failed to identify and emphasize in their reports.

F3.4 Concerns raised by the former External Auditors were repeated in subsequent Reports to Management indicating a lack of accountability before implementation of the City's action plan response by prior city management.

Recommendations

R3.1 The City Council adopt a policy no later than November 1, 2013 that stipulates all contracts for external audit services, including the preparation of the CAFR, be awarded for three year terms, with a maximum of two one- year extensions.

R3.2 Effective with the current external audit contract, the City require the audit firm to regularly rotate audit supervisors to provide fresh perspective on the City's financial accounts and operations, and to establish an arms-length professional relationship between the audits and City staff.

R3.3.1 No later than September 30, 2013 the City Council annually select a qualified individual or firm to provide an independent review of the external audit's Letter to Management and city management's response to include a report of findings to the City Council.

R3.3.2 Following the completion of the FY 2012-13 audit, the Chief Financial Officer and the City Manager provide the City Council with quarterly status reports describing actions that had been taken to address all recommendations, deficiencies and material weaknesses identified in the CAFR.

4.0 City Finance Department's Operations

The City's Finance Department is responsible for maintaining all of the City's funds and accounts in a manner consistent with law, regulations and accounting standards required by the Governmental Accounting Standards Board (GASB). The department manages cash flow, maintains accounts payable and receivable for all City departments, prepares payrolls, prepares billings for city services, makes purchases for the City's departments, prepares financial analysis and projections, prepares reports required by State and Federal laws and monitors expenditures versus budget appropriations. For FY 2005-2006 the department was authorized to have 56 employees to operate all of these financial functions.

The City of Stockton's financial system is very complex with over 200 funds and thousands of accounts. The size of the City and its full range of services require an expansive accounting system. Various State and Federal laws and regulations, and generally accepted accounting principles, require different sources of revenues to be placed into separate funds to accurately account for receipts and expenditures. They also require individual activities or programs to be recorded separately, resulting in the large number of accounts. Management of these complex operations requires trained and qualified staff and technology capable of handling the data.

Testimony has indicated that the City's financial accounting software and computer hardware are over 20 years old. The computer screens operate off a DOS screen, a technology that became obsolete about 20 years ago. The inability to manage and extract information makes it difficult to prepare timely financial reports in a format that is easily understood by elected officials and the public. Staff training was also noted as a concern by witnesses. There was a noted lack of individuals with advance training or specific accounting skills which would enable them to maintain accurate reconciliations, post accounts and properly account for the various inter-fund transfers being directed by the prior city management. In its Report to Management for the Fiscal year ending June 30, 2006, the former External Audit firm noted that the City's financial reporting requirements were becoming increasingly complex. The authors stated "…we noted that there appears to be a lack of adequate training of new staff accountants within the accounting unit." They also reported "The insufficient training of new accounting staff results in various inefficiencies." An additional impact on the finance staff was the reduction in the number of employees at the same time as other city department's faced staffing reductions. Compounding the staff reduction was a high turnover among Finance Department staff either through retirement or transfer to other departments, requiring new employees without the experience in the City's accounting procedures to take on responsibility and increasing workloads.

The cumulative impact of the conditions in the Finance Department was the lack of timely, accurate information being provided to the City Council and department managers. With reconciliations and fund balances being in question, and the number of internal transfers being implemented during the prior city government, the City was working with a distorted and inaccurate understanding of its financial condition.

Findings

F4.1.1 The Finance Department under the prior city government did not provide other City departments with timely or accurate information regarding financial status of expenditures versus budget appropriations.

F4.1.2 Using the cumbersome and outdated financial software, few detailed financial reports have been prepared for the City Council because of the difficulty in extracting and arranging data in a meaningful manner.

F4.2 Recommendations have been provided to the Stockton Civil Service Commission to upgrade selected staffing classifications and qualifications in the Finance Department; a CPA has recently been hired to augment the finance department's management. Additional classification reviews are needed to improve the overall qualifications and accounting capabilities of the department's employees.

F4.3 The complexity of City funds and accounts permitted prior city governments to move money among accounts without adequate tracking or knowledge of actual balances in the funds.

Recommendations

R4.1 No later than December 31, 2013, the City Council approve a study for an approach to replace or upgrade the finance operation's computer and software to current technology standards, and to develop a plan under the Direction of the City Manager and Chief Financial Officer to implement such a change.

R4.2.1 No later than December 30, 2013, the City's Chief Financial Officer conduct a comprehensive review of the education and experience requirements of all classifications within the Finance Department and submit recommendation to the Civil Services Commission for approval of the changes.

R4.2.2 No later than December 30, 2013, the City's Chief Financial Officer and City Manager prepare a training program with measurable outcomes for all Finance Department staff to improve their general finance and accounting skills and to provide for increased responsibility.

R 4.3 Prior to the Fiscal Year 2014-2015 budget preparation the Chief Financial Officer, with assistance from the City Auditor and External Auditors, review the City's Chart of Accounts and submit recommendations to the City Council on revisions to simplify the fund and account structure for more control and accountability.

5.0 City Budget

The City Council adopts an annual budget prepared by the City Manager to provide a policy statement of the City's priorities for its limited financial resources. The document also projects the

amount of revenues the City anticipates receiving during the fiscal year and appropriates funds for the various departments, capital improvements and other City financial obligations. A city manager during the prior city government moved the responsibility for preparation of the budget from the Finance Department and placed it in the City Manager's office. Prior to the current fiscal year, the current City Manager returned the budget function to the Finance Department.

Essential to the preparation of a reliable budget as a policy and operations document are accurate and comprehensive projections of the City's revenues and operating expenditures for the next and subsequent fiscal years.

Under the prior city government, comprehensive long-term projections of revenues and expenditures were not prepared by the Finance Department, but rather by the budget office in the City Manager's office. There was testimony from a number of witnesses that under the prior city government, the budget office and the finance department did not work together in verifying information while preparing the budget. Examples were given showing how the budget office under the City manager would manipulate information and costs for the sole purpose of presenting a balanced budget, knowing that the budget would be out of balance on adoption. These included arbitrarily reducing the costs for internal services charged to the departments to make the department's operating costs appear to be less than actual. Also, particular department overtime costs were budgeted at numbers that were known to be below what the actual costs would be during the fiscal year making overall expenditures appear to be less. Further, the complexity of the City's account structure allowed inter-fund loans to be included in the budget for approval without clearly indicating the implications of the loans to the City Council and public.

In 2008, the City Council approved a study to be conducted by the GFOA to review a procedure which bases budget appropriations on City Council's priorities and identified goals: A final study was not adopted by the City. To the Grand Jury's knowledge, the City had not undertaken a process of identifying long-term goals and priorities for appropriations, nor key performance indicators (KPI) to determine if those goals and priorities were being met by the departments.

The Grand Jury was also concerned about how well budget appropriations were managed by the department heads. A number of witnesses indicated that there were differences among department managers regarding their capabilities to stay within budget. Most were very effective and varied from appropriations only when extraordinary circumstances arose. A few took what appeared to be little interest in staying within budget, relying on their perceived political clout to cover any over expenditures that might occur, even when they could have easily controlled the cost. A hindrance for all department managers, as well as for the city manager in providing financial oversight, was the difficulty in obtaining timely and accurate information for their department's expenditure/appropriation comparison. The limitations of the Finance Department's financial software and computer hardware, previously discussed in this report, made it difficult to provide that fiscal management tool. Despite the limitations of the financial operations and the abilities of the department managers, the City Manager retained the fiscal oversight to keep expenditures within authorized appropriations.

The current City Manager has reorganized the budget function placing it back in the Finance Department where close coordination between the financial information and the budget estimates is more feasible. Testimony indicated more reliable and accurate budget assumptions will result from the inter-function communications.

Findings

F5.1.1 A director's management of his/her department's budget relies on timely and accurate information on expenditures versus budgeted amounts. Failure to have the information available to the directors reduces their ability to be financially accountable.

F5.1.2 A City Manager requires timely and accurate financial information to provide oversight and control of expenditures versus appropriations, which was not readily available in the past.

F 5.2 An identification of key performance indicators had not been clearly presented by the City Council to the public.

F 5.3 Past City Councils were not kept informed of the extent to which departments were or were not adhering to their budget appropriation limits, or about the City's overall financial health.

Recommendations

R 5.1 Department heads be held accountable by the City Manager to stay within Council's budget appropriations, with quarterly public reports prepared identifying and explaining all significant deviations.

R5.2 A public discussion and subsequent development of key performance indicators by the City Council with assistance from the City Manager, Chief Financial Officer and City Auditor, be completed prior to February 2014.

R5.3 Beginning with the Fiscal Year 2013-14 the City Manager and Chief Financial Officer provide the City Council a review of the budget expenditures at least quarterly, with a mid-year Council workshop to review the budget status in detail. When the key performance indicators have been established, they are to be included in the reviews. The requirement for these reports to be adopted as a City Council policy.

6.0 City Council Budget and Audit Committees

In 1981, the City Council passed Resolution No. 38,402 adopting Council Policy No. 100-4 which established procedures for the Mayor to make appointments to the Council Committees with the City Council's concurrence. The Policy was subsequently amended 14 times, most recently on February 2, 2010. The current Policy calls for five Council Standing Committees and four Special Committees with three members each serving two year terms. The five Standing Committees are:

- Budget/Finance/Economic Development Committee,
- Legislation/Environmental Committee,
- Community Improvement and Crime Prevention Committee,
- Water Committee, and,
- Audit Committee.

Of note to this report, the Audit Committee was established as a Standing Committee in 1994 with adoption of Resolution No. 94-0607; 13 years after the other council committee were first established.

The purpose of the Committees "... shall be to provide detailed analysis and study matters, including obtaining public input, which are referred to the Committee…" (Council Policy No. 100-4). All committees are required to hold open, noticed public meetings, unless the topic falls under State law allowing for a closed session meeting.

The Budget/Finance/Economic Development Committee (Budget Committee) is charged to "…review the City's fiscal policies and documents, review proposed amendments to City fees, develop new fiscal mechanisms needed, and develop and review policies and activities relating to the economic health of the community…" (Council Policy No. 100-4, Section IV(A)). This included the Committee's review and report on the proposed annual budget. The Audit Committee is charged with the responsibility to "… oversee all independent auditing services for the City provided by both the City Auditor and the City's commercial auditing firm…" (Council Policy No. 100-4, Section IV(E)).

Based on testimony received, mayors in the prior city government would make appointments to the Budget Committee based on who would not ask probing questions about major projects underway or their funding. When members of the Budget Committee asked questions about the financial information provided by City management, former mayors would suspend the Committee. By one testimony, the budget review function in 2009 was placed before the City Council as a whole because of the complexity and importance of the financial matters being presented by staff and to allow all council members to hear the information and ask questions at one time. Other testimony indicated the change was done for political purposes.

Findings

F6.1 Testimony from both elected and appointed City officials indicated the Audit Committee provided limited oversight of the City Auditor's function. Presentations on the annual financial audit were not detailed, and no witness recalled the Committee making inquiries into the External Auditor's results, findings or recommendations.

F6.2 Appointment to and removal from the Budget Committee by the prior city government had been based on political alliance rather than interest or knowledge of the City's fiscal activities, limiting the inquiries into the former management's activities.

Recommendations

R6.1.1 No later than November 1, 2013 the City Council amend Council Policy No. 100-4 to create a single Finance Committee to replace the current budget and audit committees, to allow the new Committee's involvement with the FY 2012-13 CAFR review and the FY 2014-15 budget adoption. The purpose of the new Standing Committee would be to review in detail and make comprehensive recommendations to the whole City Council on financial matters including, but not limited to, those related to the City's budget; internal and external auditor reports; proposed bonds or loans; any proposed fee or tax increases or modifications; and modifications to the City's account and/or budget structures. The Committee should meet no less than quarterly.
R6.1.2 Prior to December 1, 2013 the City Council review and amend as necessary the stated purpose of all Standing Committees established in Council Policy 100-4 and provide clear specifications of the committees' scope of activity, in particular minimum effective oversight responsibilities.

R 6.2 By November 1, 2013 the City Council amend Council Policy 100-4 to set defined staggered and rotating two-year terms on the Finance Committee in order to bring fresh perspective to the committee's deliberations and to provide an opportunity for more council members to serve.

7.0 Financial Training for City Council Members

Municipal finance can be very complicated and difficult to understand by individuals who lack specialized education or experience. The many nuances mandated by state and federal laws and regulations for accounting, budgeting and reporting financial operations can be daunting for a citizen facing the information for the first time. These include requirements for maintaining separate funds for each revenue source, including each grant; separate accounts of each activity performed by the city; and distinguishing between general funds which do not have restrictions on their use and restricted or revenue funds which can only be used for specific purposes. There are no national standards or recommendations related to what elected officials should know about municipal finance, but the Grand Jury wondered if the City's elected officials were concerned about their level of knowledge.

The Grand Jury requested information from all current members of the City Council regarding their individual training about municipal government finance, asking specifically if such training is necessary, and who should provide that training. Responses were received from four of the seven City Council members. The same information was also requested from members of the San Joaquin County Board of Supervisors to learn the perspective of other elected officials. It was also helpful that two of the five Supervisors had previously served on the Stockton City Council.

Information received from two of the four recently elected members of the Stockton City Council revealed that one member had taken several university continuing education courses related to municipal government finance and local government law prior to being elected to the City Council. The other respondent stated that prior to being elected he/she had not taken courses specifically focused on municipal finance, but had taken courses at a university that included business and

finance, and felt that this knowledge was helpful in preparation for dealing with financial issues. Since their election both respondents have attended the League of California Cities (LCC) New Council Member's Orientation as well as receiving general training from the City's management team. These two newly elected respondents agreed that individuals running for local government positions have the responsibility for being familiar with local finance, and that the responsibility for gaining that type of education rests with the elected members with the assistance of city staff. They further indicated that they would be seeking additional training as it becomes available.

The Grand Jury received information from two of the three incumbent members of the Stockton City Council, which revealed that while neither of them received training through university-type courses prior to running for election, they did receive training on municipal finance either through community-based experts, or through participation on other elected governmental bodies. Since their initial election, and similar to their recently elected colleagues, both have attended the LCC New Council Member's Orientation, as well as receiving assistance from the City's management team. One of the two incumbent respondents clearly stated the responsibility for being familiar with municipal finance rest with the one seeking elected office, and that it is further necessary that all elected members ensure through continuing education, that they are kept abreast of any changes in financial requirements. The other incumbent respondent felt that gaining knowledge relating to municipal finance was a joint responsibility of the elected official and the City management team. Responding to the question of who should provide training in municipal government finance issues to elected officials, one respondent answered "by persons knowledgeable in the subject area." The other respondent indicated his/her belief that the training should be provided by the *Good Government Committee* (a locally based program in partnership with the University of the Pacific which brings together local experts in the fields of Land Use, Water, Public Safety, Education, County/Regional Demographics, Economic Development, Municipal Finance, and Labor Relations).

All five members of the San Joaquin County Board of Supervisors, consisting of four incumbents and one newly elected member, responded to the Grand Jury's survey. Prior to their election to the Board, two of the five Supervisors had taken university-level courses covering business financing and economics, while the remainder gained their financial experience from serving with, or being on other elected governmental bodies. In addition, all respondents felt that it was the individual's responsibility to gain the appropriate education about government finance, as well as other subject matters, to assist in fulfilling their responsibilities to their constituents. Four of the five respondents have attended the *New Supervisor Training Program* provided through the California State Association of Counties (CSAC), which is offered as a primer for newly elected Supervisors. All respondents also relied on assistance from the Administrators throughout the County Departments, as well as educational conferences to assist them in continuing efforts to understanding the financial issues that come before them.

The LCC offers a two and one-half day academy for newly elected city mayors and council members. In 2011, the LCC offered a two-hour fifteen-minute program on city financial audits. In 2012 and 2013 a two and one-half-hour program titled "Financial Responsibilities, City Revenues

Workshop" was offered to inform new local officials about the varied aspects of local government finance. The 2011 LCC annual conference provided a number of sessions on municipal finance while the 2012 annual conference had no sessions related to general municipal finance. In general, the LCC, California's principal advocate for local elected officials, does not provide in-depth training programs in municipal finance or audits for local elected officials to be informed of the related laws, requirements and best practices.

As a comparison, from 2011 through early 2013, CSAC offered 12 courses related to local finance through its CSAC Institute for Excellence in County Government. Each course is five-and-one-half hours in length. Also, during each of the last two CSAC New Supervisors Institute Programs, two 75-minute presentations about county budgets were offered.

From testimony received, many of the City's elected officials relied on the city management staff to provide them with information about municipal finance. Most training opportunities focused on a particular action the Council was being requested to take, and at the time the action was to be taken. This included the bond issues for capital projects, inter-fund transfers or special assessments. There were no indications provided that any of the training was about municipal finance in general.

Findings

F7.1 The degree of training and knowledge about municipal finance varies among the current council members who responded to the Grand Jury's survey.

F7.2 The current City Manager and CFO provide training on financial matters as they relate to issues being presented to the city council.

F7.3 The lack of knowledge about municipal finance resulted in some council members not having the ability to ask questions or understand the financial information presented to them.

Recommendations

R7.1 The City Council submit a policy resolution for consideration during the LCC annual conference for the League to establish training programs for local elected officials to learn about the various aspects of municipal finance similar to the depth and content of the CSAC courses.

R7.2 The City Manager and CFO develop a workshop for elected officials on municipal finance operations, structure, responsibilities and oversight drawing upon best practices developed by other cities and professional organizations (with the assistance from local educational institutions). The workshop shall be available to all newly elected members of the City Council during the period between when election results are known and the members assume office.

R7.3 No later than January 2014 the City Manager and CFO present bi-monthly workshops to educate elected city officials about the various operations and responsibilities of Stockton's financial operations.

8.0 Council and Manager Responsibilities and Oversight

Under the City Charter the Mayor and Council, as a single body, have oversight responsibilities of the city manager. The better responsibilities and limitations of authority of each are understood, the better the public is served. In its investigation, the Grand Jury found that power was placed in one or two individuals, without effective checks and balances, resulting in some of the problems leading to Stockton's current financial situation. Without due diligence by all parties of city government and the public, those conditions could return exacerbating the City's current fiscal predicament and limiting its future potential.

The Grand Jury found, through testimony and review of documents, situations where elected and appointed leaders acted more for political advantages than for the benefit of the City. A prior city manager and mayor made major modifications of the design of the ballpark and arena without discussion by the entire City Council or public disclosure, and contrary to experts' advice, resulting in significant increased construction and operational costs. Testimony disclosed that both officials appeared to be on an ego trip. To avoid full disclosure, a prior city manager was given authority to negotiate contracts and approve construction change orders beyond the scope approved in the City Charter, and which resulted in actions that were not in the City's best interest. A former mayor would marginalize any council member questioning or opposing the mayor's desired programs, and sought to limit public discussion of important financial matters.

During the prior city government, many of the council members contributed to the veil of secrecy that was covering the city's operations. They would not question information or recommendations presented by prior city management, even when contradictory evidence was presented about the financial impacts of their actions. Review of Council meeting minutes during much of the Events Center project indicated approvals, questions and discussion was limited to a very few council members. Actions regarding movement of money between funds, granting of extraordinary authority to an individual, or approval of employee contracts with long-term fiscal impacts occurred with little detailed information or public discussion. Political expediency became more important than good governance, especially as elections drew near.

Findings

F 8.1 The behind the scenes actions and lack of complete and clear information from former city managers resulted in elected officials and the public having a false sense of confidence in the City's financial condition.

F 8.2 Failure of prior City Council Members to request information about or to question actions by city managers and mayors raises concerns of whether actions were taken for the City's benefit or for personal/political gain.

Recommendations

R8.1 The City Manager and his/her administrative staff provide detailed, timely, and accurate information supporting proposals with significant long-term financial implications for the City and that such documents be available to the public.

R8.2 Beginning immediately, ensure any proposals by the Council Members and the Mayor with long-term financial implications for the City be openly disclosed, explained and discussed for public review.

Conclusion

History has shown that when ego takes the place of responsibility, when personal agendas replace actions for the public good, or when silence replaces the community voice, the public is not well served. A Mayor and City Council that prefers to not ask questions or demand complete and accurate information from its management, or to remain uneducated about the intricacies of the city's financial structure and operations can be more easily swayed by staff recommendations that are not in the public's best interest. This observation is not new. It has been brought to the community's attention by past Grand Juries.

The 2012-2013 Grand Jury understands and appreciates the actions taken by recent council members and city managers to get Stockton out of its financial hole. It has not been easy and many parties to the problem have suffered grave personal loss. However, the Grand Jury also expresses its concern that without changes to how things were done in the past when reviewing and approving major actions with long-term fiscal impacts (and without improvements to the City's elected and appointed officials' ability to understand, operate and evaluate its financial health in an accurate and timely manner), this fiscal calamity could recur. The Grand Jury reminds the public that "*Those who ignore history are doomed to repeat it.*"

Disclaimer

Grand Jury reports are based on documentary evidence and the testimony of sworn or admonished witnesses, not on conjecture or opinion. However, the Grand Jury is precluded by law from disclosing such evidence except upon specific approval of the Presiding Judge of the Superior Court, or another judge appointed by the Presiding Judge (Penal Code Sections 911, 924.1(a) and 929). Similarly, the Grand Jury is precluded by law from disclosing the identity of witnesses except upon an order of the court for narrowly defined purposes (Penal Code Sections 924.2 and 929).

Response Requirements

California Penal Code sections 933 and 933.05 require that specific responses to all findings and recommendations contained in this report be submitted to the Presiding Judge of San Joaquin County Superior Court (within 90 days).

The City of Stockton is required to respond to each Finding and Recommendation contained in this Report.

Mail or hand-deliver a hard copy of the response to:

Honorable David P. Warner, Presiding Judge
San Joaquin County Superior Court
P. O. Box 201022
Stockton, CA 95201

Also, please email the response to Trisa Martinez, Staff Secretary to the Grand Jury at

grandjury@sjcourts.org.