



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Scott P. Johnson
Jennifer A. Maguire

SUBJECT: SEE BELOW

DATE: August 25, 2008

Approved

Deanna Jantua

Date

8/29/08

COUNCIL DISTRICT: City-Wide
SNI AREA: N/A

SUBJECT: RESPONSE TO CIVIL GRAND JURY REPORT RELATING TO THE CITY'S INTERNAL AUDIT REPORT REGARDING THE MANAGEMENT OF THE CITY'S TAX-EXEMPT BOND PROGRAM AND THE USE OF INTERFUND LOANS

RECOMMENDATION

Acceptance of the staff response to the Civil Grand Jury Report related to the City's Debt Management Program and use of interfund loans.

OUTCOME

An understanding of the rationale for the Administration's responses to findings and recommendation raised in the Civil Grand Jury Report and to provide assurance that implementation of the audit recommendations has been included in the appropriate departmental workplans for FY 2008-09.

BACKGROUND

On June 27, 2008, the Civil Grand Jury released a report entitled, "*San Jose Finance Department Practices Cost Taxpayers Money*". This report was released subsequent to the Santa Clara County Civil Grand Jury's ("Grand Jury") review of an audit report from the San Jose Office of the City Auditor ("Auditor"). The Report was entitled: "*An Audit of the Management of the City's Tax-Exempt Bond Program and Use of Interfund Loans to Provide Financing For Capital Bond Projects*", dated December 2007. (the "Auditor's Report")"

The Administration acknowledges that work conducted by the City Auditor and the Civil Grand Jury is important to the organization. The Administration welcomes the opportunity for independent and objective review of critical City programs such as the City's tax-exempt bond program and the use of interfund loans.

The Administration respectfully disagrees with the characterization of a number of issues discussed in the Auditor's Report. The Administration and the City Attorney's Office prepared detailed responses to the Auditor's Report for the Public Safety Finance & Strategic Support Committee's ("PSFSS" or "Committee") December 20, 2007 meeting. At that time, disagreement between the Administration and the Auditor's Office remained on four of the eleven recommendations. The Committee directed the Administration and the Auditor's Office to work through the issues and to report back to the Committee at its April 2008 meeting.

At the February 21, 2008 PSFSS meeting, the Committee extended the timeline to return to the Committee with a report on the audit recommendations from April to August 2008. This extension was given in order to prioritize the work efforts on mitigating the negative impact to the City from the disruption in the national municipal bond market. This disruption was due to the sub-prime mortgage crisis. The City began experiencing negative impacts on the variable rate bond program in February 2008, impacting approximately \$360 million in outstanding bonds in ten different bond series.

At the April 17, 2008 PSFSS meeting, the Auditor presented alternative language for the recommendations on which there had been disagreement at the December 2007 meeting. The alternative recommendations were the result of discussions with the Finance Department and the City Attorney's Office. The Committee approved the alternative recommendation language and the City Council subsequently accepted the Committee's report. The Auditor's report to the Committee specifically noted that the staff assigned to be working on the recommendations would be focusing on restructuring the City's variable rate debt portfolio until the end of the fiscal year. Approval of this alternative recommendation language negated the need for a follow-up report to the Committee in August 2008 and as noted in the Auditor's report, follow-up on the status of the recommendations will occur as part of the City Auditor's semi-annual report on the status of outstanding audit recommendations to the Committee

ANALYSIS

The California Penal Code Section 933c requires that a governing body of the public agency which has been subject to a Grand Jury final report shall respond within 90 days to the Presiding Judge of the Superior Court on the findings and recommendations pertaining to matters under control of the governing body. The same California Code, Section 933.05 contains guidelines for responses requiring the City to state one of the following in response to the Grand Jury findings:

- It agrees with the finding.
- It agrees partially with the finding and provides explanation.

- It disagrees wholly with the finding and provides explanation.

In addition, for each Grand Jury recommendation, the City is required to report one of the following actions:

- The recommendation has been implemented, with a summary regarding the implemented action.
- The recommendation has not yet been implemented, but will be implemented in the future with an implementation timeframe.
- The recommendation requires further analysis, with an explanation and the scope of the parameters of an analysis or study, and a timeframe for the matter to be prepared for discussion, which shall not exceed six months from the date of publication of the Grand Jury report.
- The recommendation will not be implemented because it is not warranted or is not reasonable, with an explanation.

GRAND JURY FINDINGS, RECOMMENDATIONS AND CITY'S RESPONSE

Civil Grand Jury Finding #1a

Finding #1a: The City Auditor found significant issues with the City Finance Department's management of the tax exempt bond program and interfund loan processes that have resulted in foregoing interest to the City and have potential to pose legal problems.

City Response to Finding #1a

The Administration acknowledges that work conducted by the City Auditor and the Civil Grand Jury is important to the organization. The Administration welcomes the opportunity for independent and objective review of critical City programs such as the City's tax-exempt bond program and the use of interfund loans.

However, as noted above in the Background section, the Administration respectfully disagreed with the characterization of a number of issues discussed in the Auditor's Report. At the time the Auditor's Report was discussed at the December 20, 2007 PSFSS Committee, disagreement between the Administration and the Auditor's Office remained on four of the eleven recommendations. As noted above, at the April 17, 2008 PSFSS Committee meeting, the Auditor presented alternative language for the recommendations on which there had been disagreement at the December meeting. The alternative recommendations were the result of discussions with the Finance Department and the City Attorney's Office. The Committee approved the alternative recommendation language and the City Council subsequently accepted the Committee's report. The Auditor's report to the Committee in April 2008 specifically noted that the staff assigned to be working on the recommendations would be focusing on restructuring the City's variable rate debt portfolio until the end of the fiscal year. Approval of this alternative

recommendation language negated the need for a follow-up report to the Committee in August 2008, and as noted in the Auditor's report, follow-up on the status of the recommendations will occur as part of the City Auditor's semi-annual report on the status of outstanding audit recommendations to the Committee.

Civil Grand Jury Finding #1b & Recommendation #1

Finding #1b: The City Auditor issued a report in December 2007 which listed all of the recommendations and required 60-day implementation. To date, there has been little action from the Finance Department regarding these recommendations.

Recommendation #1: The Finance Department should implement all Audit recommendations in the audit report immediately.

City Response to Finding #1b

The Administration has commenced work and is making progress on implementation of the audit recommendations as detailed in Exhibit A. While the implementation occurred on a schedule as originally anticipated in December 2008, the implementation timeline was discussed in conjunction with the alternative recommendations presented by the Auditor in April 2008. The City Council subsequently approved the alternative recommendations presented by the Auditor and both the Auditor's Office and the City Council acknowledged that implementation of the alternative recommendations would be delayed due to the need to restructure the City's variable rate debt portfolio, as outlined above in the Background section. Additionally, although status reports were provided to the Civil Grand Jury on the actions taken to date by the Administration on the Auditor's recommendations, the Civil Grand Jury Report does not acknowledge that the Administration has taken action on a number of the Auditor's recommendations.

City Response to Recommendation #1

Work has commenced on the implementation of the Audit Report recommendations. The Finance Department and Budget Office recently prepared audit recommendation follow-up reports for the City Auditor's Office as part of the Auditor's semi-annual report to the City Council. A summary of the status of the implementation of the audit recommendations is provided in Exhibit A to this report. Departmental workplans for FY 2008-09 include efforts to implement the Audit Recommendations. The Finance Department and Budget Office anticipate having a majority of the work completed or underway by June 30, 2009.

EVALUATION AND FOLLOW-UP

The status of the implementation of the audit recommendations will be included as part of the City Auditor's Semi-Annual Audit Recommendation Status Report which is prepared for the City Council and presented to the PSFSS Committee.

POLICY ALTERNATIVES

Not Applicable.

PUBLIC OUTREACH/INTEREST

- Criterion 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

Although the above criteria do not apply to this memorandum, the report will be posted to the City's Agenda Page for the September 16, 2008 Council meeting.

COORDINATION

This memorandum was prepared by the Finance Department in coordination with the City Manager's Office, Budget Office, City Attorney and City Auditor's Offices.

FISCAL/POLICY ALIGNMENT

Not applicable.

COST SUMMARY/IMPLICATIONS

Not applicable.

BUDGET REFERENCE

Not applicable.

HONORABLE MAYOR AND CITY COUNCIL

August 25, 2008

Subject: Debt Management Program - Grand Jury Response

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CEQA

Not a project.



SCOTT P. JOHNSON
Director, Finance



JENNIFER A. MAGUIRE
Director, Budget Office

For questions please contact Scott P. Johnson, Director of Finance, at (408) 535-7000.

Exhibit A

Response to Grand Jury Report on Debt Management Audit Status Report on Implementation of Audit Recommendations As of August 15, 2008

FINDING 1

The Finance Department's Administration of Tax-Exempt Bond Proceeds Resulted in the City's Cash Pool Financing an Average of \$40 million per Month to Capital Projects and Foregoing \$2.5 Million in Interest from 2005-2006 to 2006-2007.

Responses to Recommendations

Recommendation #1: Improve controls over the administration of the tax-exempt bond program and processes to mitigate negative cash balances in the City's Cash Pool caused by bond programs and adequately address other negative balances. (Priority 1)

The Finance Department continues to work with departments in submitting their reimbursement requests in a timely manner. To better monitor the status of negative cash balances related to bond-funded capital projects, Debt Management staff has developed a summary report which is reviewed monthly. Since June 30, 2007, when the total negative cash balance attributable to all bond-funded capital projects stood at \$70.7 million, the negative cash balance has been reduced to \$20.5 million, net of pending disbursements, as of June 30, 2008. During that same time period, the Debt Management Group has processed 146 reimbursement requests totaling over \$311.8 million

Recommendation #2: We recommend that the Finance Department work with the City Attorney's Office to evaluate what, if any, foregone interest to restricted funds may need to be repaid. (Priority 1)

The Administration's response remains unchanged and that each fund has received its appropriate share of actual interest earned, and each restricted fund, including interest revenue in that fund, has only been used for its restricted purpose. A formal audit follow-up response is expected to be prepared for the semi-annual period ending December 31, 2008.

Recommendation #3: We recommend that the Finance Department develop and implement procedures to ensure proper allocation of interest to restricted funds held within the City Cash Pool. (Priority 1 – may require additional staff resources)

The Finance Department is currently reviewing the City's interest allocation methodology and researching the methodology used by other public agencies. This review and research is being undertaken in order to ensure that the City has appropriate policies and procedures in place to account for and credit the various funds and accounts their prorated portion of the interest earnings in the City's Investment Pool. If, after the review and analysis is complete, a policy

change is made, such change will be reported through the City Auditor semi-annual audit update to Council Committee and the City Council.

Recommendation #4: Develop procedures applicable to all types of bond financings that incorporate appropriate timeframes for Project Managers and the Finance Department Debt Management Group review of the bond allocation process.

Work on this project has been delayed due to the unplanned work associated with the refundings of all of the City's outstanding variable rate lease revenue bonds and the Airport's auction rate securities due to the municipal market disruption as a result of the rating downgrade of several of the AAA rated bond insurers. This unplanned work was necessary in order to reduce the interest cost being paid by the City on approximately \$360 million in outstanding debt, representing about 7% of the City's outstanding debt portfolio. Based on this additional work load and the related shifting of priorities, staff anticipates commencement on this effort after calendar year end.

Recommendation #5: Implement a Compliance Check List and a Form of Bond Proceeds Allocation Certificate to ensure appropriate documentation and timeframe compliance for each bond issuance.

Work on this project has been delayed due to the unplanned work associated with the refundings of all of the City's outstanding variable rate lease revenue bonds and the Airport's auction rate securities due to the municipal market disruption as a result of the rating downgrade of several of the AAA rated bond insurers. This unplanned work was necessary in order to reduce the interest cost being paid by the City on approximately \$360 million in outstanding debt, representing about 7% of the City's outstanding debt portfolio. Based on this additional work load and the related shifting of priorities, staff anticipates commencement on this effort after calendar year end.

Recommendation #6: Develop written policies and procedures for Project Managers and other City staff to determine eligible and ineligible expenditures for each type of bond financing.

As noted in the response to Recommendation #4, the Finance Department will develop general written procedures and guidelines for the appropriate expenditure of tax-exempt bond proceeds, including development of appropriate timeframes for processing payments and reimbursements/disbursements of bond proceeds. These guidelines will include expenditure direction to assist bond project managers with reimbursement submissions. The revised guidelines will include expenditure direction to assist bond project managers with reimbursement submissions as stated in the response to recommendation #4 above. This work is commencing in FY 2008-09 given the unplanned work efforts in FY 2007-08 due to the disruptions in the municipal bond market.

Recommendation #7: We recommend that annual audits of Measures O and P be added to the external auditor's scope of work (Priority 1).

Audits of Measures O(2000) and P were included in an amendment to the agreement with Macias, Gini & Company, LLP for the inclusion of an audit of the financial statements of the Park Bond Projects Capital Project Fund and Branch Libraries Bond Projects Capital Project Fund ("Parks and Libraries Bond Funds") for the period of fiscal years 2001 – 02 through 2007-08.

FINDING 2

The City Relied On Sewer Connection Fee Funds To Bridge Unrelated Funding Gaps, Potentially Resulting In Non-Compliance With The City's Municipal Code And Possibly California State Government Code.

Responses to Recommendations

Recommendation #8: Evaluate and report on methods to remedy any potential past compliance issues associated with loans from restricted funds.

The Audit identified a past compliance issue with the payment of interest associated with a short-term loan for the Old City Hall Renovation. To address this issue, the Administration brought forward the \$65,000 interest payment as part of the 2006-2007 Annual Report. For the remaining outstanding loans, the 2008-2009 Adopted Operating and Capital Budgets included loan repayments for portions of all outstanding loans (2008-2009 Proposed Operating Budget: p. XI-34 – Fiber Optics Development Fund; p. XI-86 –Storm Sewer Operating Fund; and p. XI-74 – Public Works Program Support Fund. 2008-2009 Proposed Capital Budget: pgs. V-172 and V-190 – Water Utility Capital Fund Loan with full repayment programmed by 2013). A new Summary of Interfund Loans in Capital and Operating Funds (2008-2009 Proposed Operating Budget, p. III-8) was also developed that provides a description of each interfund loan, loan terms, the amount outstanding, and the 2008-2009 budgeted payments. The loan repayments will be made with the necessary interest component and consistent with the need for funds to be available for sewer capital projects.

Recommendation #9: Develop and implement a formal written policy on interfund loans and written procedures on how to manage and enforce such a policy.

Due to significant workload demands and staffing constraints, it is anticipated that the written policy on interfund loans and written procedures on how to manage and enforce such a policy will be presented later this year. The Administration plans to bring forward a recommended amendment to the City's Operating Budget and Capital Improvement Program Policy to incorporate the treatment of Interfund Loans as part of the 2007-2008 Annual Report that is scheduled to be released in late September 2008. While the formal policy has not yet been completed, the 2008-2009 Adopted Operating and Capital Budgets include payments for

portions of each outstanding loan. To address the loan documentation requirement for the Annual Budget, a Summary of Interfund Loans was incorporated into the 2008-2009 Proposed Operating Budget and provides a description of the loan, the terms of the loan, the receiving and lending funds, the estimated loan amount outstanding, and the amount of loan payments or repayments budgeted in 2008-2009.

Recommendation #10: Incorporate into the City's interfund loan policy controls to ensure short-term loans from restricted funds are not being used for on-going structural budget problems.

The Budget Policies incorporated into the 2008-2009 Proposed Operating Budget (p. V-2) includes the following revision bold/italicize/strikethrough):

A.2 Fiscal Integrity

The City will maintain the fiscal integrity of its operating, debt service, and capital improvement budgets, which provide services and maintain public facilities, streets, and utilities.

*Ongoing operating program costs will not exceed the amount of ongoing revenue to finance those costs. **Interfund loans will not be used as a funding mechanism to address ongoing gaps between revenues and costs. If a new program is added on an ongoing basis, an ongoing revenue source will be identified to fund the program costs.** ~~The ongoing revenue source will be identified along with new program costs.~~ Any available carryover balance will only be used to offset one-time costs.*

The Mayor's June Budget Message for 2008-2009 that was approved by the City Council incorporated a revision to City Council Policy 1-18 (Operating Budget and Capital Improvement Program Policy) to be consistent with this revised language.

Recommendation #11: Improve controls to ensure future transfers are in compliance with the City's Municipal Code.

The interfund loans included in the 2008-2009 Proposed Budget had been contained in prior budget documents. Any new loans proposed in the future will be coordinated with the City Attorney's Office to ensure compliance with the Municipal Code.