

City of Stockton

Stockton, California

Report on Internal Control Related Matters Identified in the Audit

For the Year Ended June 30, 2014

City of Stockton

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Honorable Mayor and Members of the City Council
of the City of Stockton
Stockton, California

In planning and performing our audit of the financial statements of the City of Stockton, California (the "City") as of and for the year ended June 30, 2014, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

The City's written responses included in this report have not been subjected to the audit procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This communication is intended solely for the information and use of management, audit committee, City Council, others within the organization, and agencies and pass-through entities requiring compliance with generally accepted government auditing standards, and is not intended to be and should not be used by anyone other than these specified parties.

Pun & McGeady LLP

Walnut Creek, California
January 6, 2015

City of Stockton
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Finding 2014-01 Financial Conditions

Criteria:

The City has engaged us to perform the audit of the City's financial statements. Our responsibility as auditors is to express opinions on the City's 2014 financial statements and to determine whether the financial statements are fairly presented, in all material respects, in accordance with accounting principles generally accepted in the United States of America. As part of our audit, we are required to consider conditions and events which indicate that there is a substantial doubt about the City's ability to continue as a going concern through June 30, 2015, its next fiscal year end.

Condition:

On May 26, 2010, the City Council declared a state of emergency based on fiscal circumstances and directed the City Manager to take appropriate and lawful measures to achieve a balanced budget for fiscal year 2010-11, which was accomplished. Unfortunately, the City's fiscal health continued to deteriorate in fiscal years 2010-11 and 2011-12 despite various cost cutting measures the City implemented. As a result, the fiscal emergency was continued on May 17, 2011 and February 28, 2012, along with Council authorization for the City Manager to enter into the measures specified in California Assembly Bill 506 (AB 506). By participating in the AB 506 process, the City hoped that discussions with creditors would yield concessions relating to the City's obligations. While progress was made with some creditors, sufficient progress was not made to avoid insolvency, thereby leading the City to file a petition for Chapter 9 Bankruptcy Protection on June 28, 2012.

Additionally, the City adopted a Pendency Plan on June 26, 2012, under which it is operating for fiscal year 2012-13. Payments of principal and interest for General Fund debt obligations, not required for the City to operate, have been suspended, pending the outcome of the bankruptcy process. The Bankruptcy Judge has appointed a mediator to work with the City and its largest creditors during the bankruptcy process toward a Plan of Adjustment.

The City was current on all debt payments for fiscal year 2010-11. On February 28, 2012, the Council approved suspending payment on three bonds, with payments due at various times prior to the end of the fiscal year 2011-12, to preserve General Fund cash and attempt to avoid insolvency. Accordingly, the City entered into default on the following debt obligations, beginning in fiscal year 2011-12:

- 2004 Series Lease Revenue Bonds of the Stockton Public Financing Authority (Parking and Capital Projects)
- 2007 Series A and B Variable Rate Demand Lease Revenue Bonds (City Admin Building)
- 2009 Series A Lease Revenue Refunding Bonds (Capital Improvement Bonds)

The City's bankruptcy filings and Pendency Plan notified debt creditors that the City would enter into default on the following debt and contractual obligations beginning in fiscal year 2012-13:

- 2003 Series A and Series B Certificates of Participation (Redevelopment Housing Program)
- 2007 Series A and B Pension Obligation Bonds
- California Department of Boating & Waterways (Stockton Downtown Marina)
- Howard – Jarvis Settlement
- Marina Towers

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
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Finding 2014-01 Financial Conditions (Continued)

In some cases, prior to bankruptcy, the creditors took possession and control of City assets backed by the debt obligations, including three downtown parking structures and 400 E. Main Street, the City Administration Building.

Cause:

The City had granted benefits to its employees without any plans to fund those commitments, debt incurred during the boom cycle that was back loaded accumulated over many years without a solid plan for maintaining solvency to pay that debt, and the long and deep impacts of the 2008 recession have had a severe adverse impact on the property and sales tax in the City which directly impacts revenue to the City. The City Council over the past few years has taken strong and bold steps to balance its budget and reduce costs by making several rounds of deep budget cuts including reduction in public safety and other personnel that ultimately compromised its service solvency. However, those efforts have been unsuccessful in balancing the City's budget resulting in a budget gap of over \$26.0 million in fiscal year 2012-2013 and \$22.0 million in fiscal year 2013-14. Absent the final and drastic measure of filing for chapter 9 bankruptcy protection the City would have been unable to balance its budget.

Effect:

In cases where there is substantial doubt about an entity's ability to continue to operate, there are two primary considerations that auditors are required to address. The first consideration is the disclosure of the issue in the audit opinion. This additional paragraph is considered as emphasis of a matter to inform the reader that there is substantial doubt about the entities ability to continue. The second consideration is the impact of the going concern on the financial statement data, including disclosures.

For the financial statements to be accurate, staff must be able to rely on arm's length agreements to accurately report and properly classify transactions and balances, and facts surrounding the going concern must be adequately disclosed in the financial statements. For that to occur, measurement and classification must be determinable.

Recommendation:

The City has hired consultants and legal experts to assist the City's new management team to work through the bankruptcy proceedings and develop other cost savings measures in order to enter a Plan of Adjustment that will return the City to financial health. City staff and management should continue to work as expeditiously as possible to return to financial solvency. This single issue remains the City's top priority.

Management View and Corrective Action Plan:

The City agrees with the findings and recommendation. Relative to the recommendation, the City as part of its chapter 9 bankruptcy protections is working with all of its significant creditors to return the City to solvency. The City has filed with the United States Bankruptcy Court its "Plan for the Adjustment of Debts" of the City of Stockton, California, dated October 10, 2013 (as amended) and its "Disclosure Statement" with respect to the "Plan for the Adjustment of Debts" ("the Plan").

The City's Plan includes the various agreements reached with employees, retirees, capital market creditors, and numerous other classes of creditors, implementing structural changes to the City's operations and finances that would

City of Stockton
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Finding 2014-01 Financial Conditions (Continued)

not have been possible outside of bankruptcy. On February 4, 2015, the Court entered its final order confirming the Plan. The Plan became effective on February 25, 2015. Payments required to be made by the City under the Plan to various creditors have been made and all of the documents implementing the Plan have been executed and delivered and are now effective. Stockton has been able to address over \$2 billion in long-term debt and obligations that had overburdened the General Fund and caused both fiscal and service insolvency for the City. With implementation of the plan agreements, the City is fiscally solvent and sustainable. The City has developed a Long-Range Financial Plan (LRFP) to inform and guide financial decisions for the duration of the agreements that comprise the Plan, some of which extend out to 2053. The Plan requires fiscal discipline because it is lean and does not allow for increases in employees or services, with the exception of police and the Marshall Plan on Crime. The LRFP is the basis of all the agreements made as part of the bankruptcy Plan. It will allow decision makers to examine the long-term impacts of policy decisions and budget assumptions to ensure future decisions are conservative and reasonable.

Since the filing of the Plan, one creditor filed an objection to the Confirmation of the Plan and an appeal to the Plan, if it is confirmed. Though the outcome of the appeal process remains uncertain, management is managing its operations and finances in alignment with the LRFP.

Finding 2014-02 Internal Controls

Criteria:

Management is responsible for designing, implementing, and maintaining appropriate internal control over financial reporting and compliance.

Internal control is defined as a process implemented and monitored by the City Council, management, and other personnel. The Internal Control System should be designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Reliability of financial reporting;
- Effectiveness and efficiency of operations; and
- Compliance with applicable laws and regulations.

The Internal Control Framework would include establishing or enhancing guidance in the following areas:

- *Control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.
- *Risk assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.
- *Control activities* are the policies and procedures that help ensure that management directives are carried out.
- *Information and communication* systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
- *Monitoring* is a process that assesses the quality of internal control performance over time.

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
For the Year Ended June 30, 2014

Finding 2014-02 Internal Controls (Continued)

Condition:

The City is in the process of upgrading its administrative and financial services by adding qualified personnel; hiring consultants with certain expertise; contracting with professional accountants to provide both internal and external auditing; and, making appropriate and informed decisions. As part of the upgrading process, the City has established a document titled “Auditing Findings Response Tracking Report” (the “Report”).

The Report displays findings identified by City management, State Gas Tax Audit, State Controller’s Office (SCO) Audits, prior external audit firm, County Grand Jury Report and the City’s Internal Auditor. The findings in the latest Report totaled 314 items as of December 2014 organized in the following areas:

	<u># of Findings</u>	<u>% of Total</u>
Internal Controls	85	27%
Compliance with Laws and Regulations	33	11%
Accounting and Financial Reporting	94	30%
City Policies	47	15%
Purchasing	18	6%
Internal Audit	7	2%
Others	30	10%
	<u>314</u>	<u>100%</u>

Cause:

The City does not have detailed policies and procedures for its accounting systems that emphasize the need for proper review and approval for certain transactions that are susceptible to fraud.

Effect:

The City must establish an effective system of internal controls that would provide reasonable assurance regarding achievement of the City’s objectives. An effective system of internal control reduces, to an acceptable level, the risk of not achieving the City’s objective and may relate to all three objectives presented above.

Recommendation:

We recommend the City work closely with the Internal Auditors to design, implement and maintain its system of internal controls using the Internal Control Framework as outline above.

Management View and Corrective Action Plan:

The City is in agreement with this finding and recommendation. The City Manager’s Office asked the City Auditor’s Office to conduct a more robust and improved risk assessment process. It was identified by new management as one of the City’s 37 Strategic Initiatives. The City has since contracted out the Internal Auditor role to Moss Adams LLP, a reputable CPA firm, to conduct a full risk assessment and several reviews of the City’s internal controls.

The internal auditors began an internal audit plan in November 2013. This internal audit plan is to take place over an 18-24 month period and will result in an evaluation and documentation of the City’s design of internal controls, make further recommendations to change internal controls, evaluate new or revised policies and procedures, and provide training for senior management, city council and staff on internal controls. That body of work has been prioritized based on those business cycles that are of highest risk to the City for material misstatement to financial reporting. The

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
For the Year Ended June 30, 2014

Finding 2014-02 Internal Controls (Continued)

result of the work will be implementation of new internal controls, new standards of operations, new policies, and subsequent testing to ensure they are working as planned and should remediate this finding. Administrative Services has categorized all findings and is prioritizing action items with the greatest effect on the City's internal control structure to mitigate those areas of highest risk.

Finding 2014-03 Accounting Manual

Criteria:

An Accounting Manual would aid the Administrative Services Department and the City in providing training for accounting personnel, communicating and providing a source of reference to approved policies, and maintaining consistency of recording financial transactions.

Condition:

During the performance of our audit for the year ended June 30, 2014, we noted that the City does not have an updated policies and procedures manual (Accounting Manual) which would define personnel roles and responsibilities, described appropriate procedures for recording significant transactions in finance and accounting systems, define and set procedures for management oversight and review, establish key internal controls, and ensure accounting and reporting requirements established by GAAP are followed.

Cause:

The City has been in a two year long process of restructuring its management team and a significant amount of time and effort was required of the new team in preparing the Chapter 9 filings and catching up on the long overdue audits. Therefore, City management has not had sufficient time to focus on the development of a comprehensive accounting manual and it has not taken the highest priority.

Effect:

Without the Accounting Manual, personnel responsible for the daily work and transactions do not have a clear understanding of their role and responsibilities or the accounting standards applicable to their function. In addition, the absence of standardized procedures has and will create inefficient and inconsistent processing of transactions. Absent clear guidance, delays in financial reporting occur as staffs are unaware of where to find the answers.

Recommendation:

We recommend that the City develop a comprehensive Accounting Manual that would set the guidelines for recording significant transactions in the general ledger. In addition, Management should consider developing an Accounting Manual which includes at a minimum:

- Descriptions of functions each position performs
- Specific duties and responsibilities (desk procedures)
- Minimum required qualifications or standards
- Council/Management approved policies relating to specific transactions
- Procedures for processing of specific financial activities
- Appropriate monitoring and review controls

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
For the Year Ended June 30, 2014

Finding 2014-03 Accounting Manual (Continued)

Management View and Corrective Action Plan:

The City agrees with the finding and recommendation. In addition, the City agrees that there hasn't been sufficient time or priority given to the development of this type of manual; though it wasn't due to the lack of understanding that one needs to be developed. Ensuring the accuracy of financial reporting took priority over development of the manual.

In some instances, manuals have started in draft form but have since been abandoned prior to their completion due to other pressing priorities such as the bankruptcy and getting its financial books and records cleaned up. With the largest burden on Finance for the bankruptcy filing which is now nearing completion, management and staff will be able to turn inward towards operational improvements, reviews of policies and procedures, and the establishment of better internal controls.

This recommendation will be considered in connection with the work being performed as a result of the Risk Assessment and Internal Control Review by Moss Adams. The outcome of that work will be improvements to the internal controls and revisions to policies and procedures which could be used for the development of a formal Comprehensive Accounting Manual.

Finding 2014-04 Accounting System

Criteria:

Reliable and updated financial systems are critical in producing accurate and timely financial statements.

Condition:

We evaluated the financial systems employed by the City in managing its overall fiscal operations, including processing of billings and payments, preparation of financial reports, budgets, and analysis of trends. These systems form the basis for all financial reporting that is critical to the decision making process, and ultimately, the basis for the financial stability of the City. We found that the systems employed by the City are outdated and are not adequate nor are appropriate for a City of this size and complexity. Specific deficiencies of the system employed include, but are not limited to:

1. Inability to automatically post activity from outsourced operations such as banking, loan servicer, parking, parking tickets, library and other auxiliary systems.
2. There is a sufficiently high volume of manually posted transactions to record daily financial activities due to the lack of integration. Manual entries are time consuming, subject to significant risk of error, and cause delays in monthly and year end close process.
3. Complex processes for the retrieval of data that is needed on a day-to-day basis. In addition, certain key reports used for budgeting and limited financial reporting contain unresolved errors in the data.
4. The library's accounting billing and AR system is not integrated into the City's GL. The City is only able to reconcile the two systems on an annual basis due to the time it consumes.

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
For the Year Ended June 30, 2014

Finding 2014-04 Accounting System (Continued)

The result of these overall system deficiencies is a significant degradation in efficiency of staff, who must utilize manual processes or other software products for the recording and reporting of routine financial activity, such as billings, personnel and payroll data, inventories, capital asset, depreciation, budgeting, etc.

Cause:

The City has a twenty plus year old outdated accounting system that needs to be updated.

Effect:

Accounting records and useful data cannot be easily accessed by management and others needed in analysis of current and historical financial conditions of the City. The lack of integration of the City's subledger can cause the general ledger to be misstated.

Recommendation:

The City is strongly urged to begin the process of review of other software applications that are specifically designed for municipal entities and have the full functionality needed for a City of this size and complexity. These other software applications should be evaluated in light of their general acceptance in cities of this nature and size, the level of internal user support required to operate the software, the training required for users and the cost.

Management View and Corrective Action Plan:

Management concurs that we need to replace our accounting system and review other software platforms and applications that can support the City based on its size and complexity. The City also agrees that it is problematic to retrieve data from the system in variety of formats due to limited system capabilities as a result of its age. This will continue to be an issue until the new financial system is acquired.

City management is well aware of the current system limitations and identified this in the Citywide Technology Strategic Plan as a high priority for replacement and in its mission critical spending in the LRFP. Recognizing this as a priority, the City Council appropriated in the 2014-15 Approved Budget mission critical funding of \$5.0 million for this project and established a separate Information Technology Department and the hiring of a Chief Technology Officer. Long-range project planning will be absolutely critical to this endeavor to include resource allocations of existing staff while emerging from bankruptcy. The City's CFO and new CIO are collaborating on the financial systems/business requirements and will be issuing an RFP for the needs analysis consultant as approved by City Council in 2014. This work will include identification of system needs city-wide, system demonstrations and recommendations for software applications that are appropriate and designed to support the City's needs.

With an outdated financial system, it is neither cost effective nor technologically and operationally feasible at this time to achieve full automation within the subsidiary systems or sub-ledgers for library services and loans receivable and parking tickets. The City's current financial system is unable to automatically post every single transaction carried on in the subsidiary ledgers or from other nonintegrated subsystems as it works in a batch environment which was common more than twenty years ago. However, the City's utility billing, accounts receivable and cash receipts modules are all subsidiary ledgers and are integrated with the City's general ledger through automated system interfaces and are a much larger share of our revenues.

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
For the Year Ended June 30, 2014

Finding 2014-04 Accounting System (Continued)

We agree reconciling the systems is difficult and time consuming; the use of systems with batch postings requires a manual effort no different than if we were operating twenty years ago. We agree more efficient operations could be achieved with a new system implementation. The interface of key data was also identified by Moss Adams in their Report on General Computer Controls dated June 2014.

Management also concurs that regular reconciliation is an industry standard and will continue to be pursued and implemented as an operational standard. Until a new system arrives and is operationalized, the City will continue to operate in a manual mode without needed modern business analytics processes or tools.

Following are the actions that will be taken by management:

- Issue an RFP for a financial system's business requirements development vendor to select a software application that are specifically designed for municipal entities and will support the City's needs.
- Work with the City's internal auditor to develop and implement monthly reconciliation policy, procedure, process, communication and standard practice within the City's key financial operation touch points over the next 24 months.
- Complete the rollout to City departments of the City's internally developed Financial Monitoring Tool (FMT), an Excel based revenue and expenditure drill down tool by the end of fiscal year 2014. To date, all departments have received training on the FMT.

Finding 2014-05 Debt Reserves

Criteria:

The City is required under the terms of their debt issuances to maintain certain levels of reserve cash for each debt issuance.

Condition:

The reserves maintained for the following debt issuances are below the required amount for the following debt issuances as for June 30, 2014.

Issuance	Reserve requirement	Reserve Balance	Deficiency
COP 1999 RDA 2003A	\$81,812	\$71,011	\$10,801
COP 1999 RDA 2003B	\$919,927	\$695,976	\$223,951
2009 CIP Bonds	\$2,945,462	\$831,395	\$2,114,067
Rev Bond Events Center – Arena Project 2004	\$3,883,479	\$3,427,272	\$456,207

Cause:

The City has declared bankruptcy and is having to use the amounts that are normally held in reserve to pay incoming trustee invoices.

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
For the Year Ended June 30, 2014

Finding 2014-05 Debt Reserves (Continued)

Effect:

The City is not in compliance with the requirements of the debt covenants for the debt issuances mentioned above.

Recommendation:

We recommend that the City needs to replenish its reserve balance in order to maintain the minimum requirements under its debt covenants and implement an ongoing monitoring process.

Management View and Corrective Action Plan:

The City agrees with this finding. The 2003 Series A&B COPs and 2004 Arena bonds are both backed by the City's General Fund. Under bankruptcy, the City maintains that the General Fund is unable to satisfy the requirement to refill the reserves. The external source of payment on both bonds, while the City has been in bankruptcy, has been the property tax increment funds that formerly flowed to the Redevelopment Agency and are now flowing to the Successor Agency.

The shortfall is the result of shortages in tax increment revenue which resulted in partial payment of debt service from the Reserve funds that has not been replenished. Additionally, the Trustee has been paying legal fees with these funds while the City has been in bankruptcy. The shortages have been placed on the Successor Agency ROPS and will be funded from tax increment as they become available or through the terms of settlements with bond insurers reached in bankruptcy, once the plan of adjustment is confirmed.

The 2009 Capital Improvement Bonds were previously paid for using public facility financing fees. However the City defaulted on these debt service payments as approved by its City Council on February 28, 2012. The sole bond holder, Franklin Funds, has pursued a claim in the City's chapter 9 bankruptcy proceedings including filing an objection to confirmation of the Plan and an appeal to the Plan, if confirmed. There has been no payment of debt service since September 1, 2012. Additionally the reserve has been funding the payment of legal fees incurred by the Trustee during this period. This bond is subject to the bankruptcy proceedings and there is no intent to cure the default or replenish the reserves at this time.

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
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Finding 2014-06 Allowance for Doubtful Accounts

Criteria:

Effective accounting systems require management to estimate an allowance for doubtful accounts. Once those amounts are deemed uncollectible and collections efforts are exhausted, those amounts should be written off as bad debt expense and removed from the accounting records.

Condition:

The City should remove all uncollectible accounts receivable amounts. The City has kept on its books for the past two fiscal years material amounts of uncollectible accounts receivable. Though the amounts have been reserved and are no longer showing as collectible, the subsidiary ledgers continue to be clogged with old data that ultimately won't be collected. This creates inefficiencies in city operations where sufficient difficulty already exists to extract system data. Compiling the receivable and aging information can take months for the revenue services division.

Cause:

The City does not actively reconcile or review outstanding accounts receivable for collectability.

Effect:

The City's records contain accounts receivables that are uncollectible and the chance of collection is so remote it should be removed from the records of the City.

Recommendation:

We recommend that the City take necessary action to bring the delinquent accounts to City Council for authorization to remove all uncollectible accounts receivable amounts from their records and create policies and procedures for the criteria for when an amount is determined to be uncollectible.

Management View and Corrective Action Plan:

Management partially agrees with this finding and recommendation. This information is not new and was reported to the City Council by the prior auditors and management during the fiscal year 2011 audit. Management disagrees that they have not been actively reconciling or reviewing outstanding accounts receivable for collectability. The write-off of aged receivables has been a very complex, high priority project. This project required the City perform an extensive reconciliation of the old accounts in multiple subsidiary ledgers to the general ledger. Due to increased collection efforts and stabilization in operations, there has not been a substantial increase in the aging of the outstanding receivables.

Also, a valid and good faith attempt to collect all possible accounts due to the bankruptcy filing was made before deeming an account uncollectible. Management felt it was not prudent to write-off amounts that could potentially be collected and converted to cash at a time when cash solvency was so critical to the City. Management also hired an outside collection agency to assist with these collection efforts.

City of Stockton
Report on Internal Control Related Matters Identified in the Audit (Continued)
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Finding 2014-06 Allowance for Doubtful Accounts (Continued)

Management does agree with the removal of all old uncollectable accounts receivable amounts from both centralized and decentralized accounts receivable systems and subsidiary systems that meet our policy criteria for write-offs. A project charter was initiated and substantial work and collaboration was performed with the departments to identify and approve all write offs for submission to the CFO, the City Manager and City Council. Responsible billing departments also received guidance on the requirements of the City Council Policy 700-3 *Uncollectible Accounts* in October 2013 and were requested to submit their write-off recommendations (with appropriate supporting documentation) in accordance with the Policy to the Administrative Services Department by November 15, 2013. This process has taken some time for training and evaluation. The identification of all write offs has now been completed and approved by the CFO and will be reported to the City Manager and City Council for final approval.