SAN JOSE FINANCE DEPARTMENT PRACTICES
COST TAXPAYERS MONEY

Introduction

The 2007-2008 Santa Clara County Civil Grand Jury (Grand Jury) reviewed an audit report from the San Jose Office of the City Auditor (Auditor) regarding the management of the City’s tax-exempt bond program and the use of interfund loans to provide financing for capital bond projects. The audit indicated that the City Finance Department’s process for reimbursing bond proceeds does not adequately protect the City’s Cash Pool and has resulted in lost interest to the City.

Background

In accordance with the City Charter, Article VIII, Section 806, the Director of Finance is charged with the responsibility for the conduct of all Finance Department functions.

The City’s Debt Management Policy states that the Finance Department is responsible for managing and coordinating all aspects related to the issuance and administration of the City’s debt. The Debt Management Policy sets forth five objectives for the Finance Department to follow: 1) minimize debt service and issuance costs, 2) maintain access to cost-effective borrowing, 3) achieve the highest practical credit rating, 4) ensure full financial disclosure and reporting, and 5) ensure compliance with applicable State and Federal laws.

The Finance Department’s Debt Management Group has the responsibility to ensure that the City is complying with its bond covenants, that reporting to third parties is timely and accurate, that the City’s bond funds are appropriately allocated, invested and disbursed, that its debt service payments are timely and accurate, that it has correctly calculated its estimated arbitrage rebate liabilities, that its investment agreements are properly collateralized, and that its liquidity and credit enhancement contracts are renewed in a timely manner. Debt Management staff is responsible for working closely with the bond trustees, Finance Department’s Treasury cash management staff, and Accounting Division staff to ensure that bond proceeds are invested properly, funds and accounts are properly established, cash flows are fully accounted for, and all bond covenants are complied with.
The method of interest allocation for the City’s Cash Pool dates back to 1988 when the Auditor issued a report entitled “An Audit Of The City’s Special Assessment District Formation and Financing Process” which found that eliminating negative cash balances in Special Assessment District funds would increase other City fund interest earnings.

Discussion

An audit was conducted by the City Auditor in 2007 of the City of San Jose’s Finance Department to evaluate the effectiveness of internal controls over the Finance Department’s administration of tax-exempt debt financing. The audit examined: 1) the extent that the City’s Cash Pool loses interest earnings by making the initial outlay for bond-funded capital expenses; 2) if the disbursement process for tax-exempt bond proceeds was efficient and had sufficient internal controls to satisfy regulatory requirements; 3) whether, in the case of voter-approved debt, ballot language authorizing the debt was adhered to, and 4) the appropriateness of utilizing loans from restricted funds to provide short- and long-term financing for capital projects and other City operations.

During the course of the audit, the auditor noted that the audit personnel were experiencing some difficulty in obtaining information from various City departments for the audit. As a result, the auditor obtained the outside professional services of a public finance specialist. The cost to the city for this professional service was $63,000.

The Grand Jury reviewed the status of the recommendations made by the Auditor in its December 2007 report to determine if compliance had taken place as required by the City Auditor’s report and the City of San Jose’s City Administration Manual.

Tax Exempt Funds

The City’s Debt Management Policy states, “the Finance Department shall be responsible for managing and coordinating all activities related to the issuance and administration of debt.” As such, the Finance Department must ensure the City’s compliance with the issuance of general obligation bonds.

The audit found that the Finance Department’s process for reimbursing bond proceeds does not adequately protect the City’s Cash Pool and may not be fully compliant with applicable laws and regulations.

When the City incurs expenses for bond-related projects, the City initially pays for the expenses with cash held in the City’s Cash Pool, rather than using the bond proceeds held with Bond Trustees. These payments cause an outflow of cash from the City’s Cash Pool, causing a negative fund balance. The negative balance lowers the amount of interest earned in the Cash Pool. As a result, it understates interest earned for the City’s General Fund. Interest income earned in the General Fund can be allocated to fund City expenses, and interest income earned in the Trustee Bond Fund can only be used for the bond project.
Guaranteed Annual Audits

In 2000, San Jose voters approved the issuance of over $439 million in General Obligation bonds for library and park capital projects with the requirement of “guaranteed annual audit(s)” of the Bond Funds. The audit revealed that the Finance Department has not ensured compliance with these bond requirements and instead has relied on the City’s Comprehensive Annual Financial Report (CAFR) statements as a substitute for an actual audit of Bond Funds. The audit report determined that the reliance on the City’s CAFR as an audit of bond funds is inconsistent with other projects that have complied with similar voter-approved requirements.

Interfund Loans

The City Charter places responsibility on the Finance Director to “receive or collect all monies or revenues due the City, maintain custody of all public funds and securities belonging to or under the control of the City, and deposit and invest funds in accordance with the applicable laws or ordinances.” The City’s Municipal Code authorizes the City to assess two separate connection fee charges for properties to connect to the Sanitary Sewer System. The Municipal Code places restrictions on the use of revenue derived from these fees. California Government Code Section 66013 also places restrictions on the use of revenue derived from municipal sewer and water connection fees.

The audit states:

Interfund loans of the Sewer Connection Fee funds may be permissible, but only if the interfund loan can reasonably be regarded as an investment meeting a prudent investment standard and only if the terms of the interfund loan, including particularly the timing of repayments, is consistent with the purposes of the restricted Sewer Connection Fee funds. Without sufficient controls, this practice of utilizing restricted Sewer Connection Fee funds for other unrelated purposes may not fully comply with certain provisions in the City’s Municipal Code and may also present compliance issues with the noted sections of the Government Code related to restrictions on Sewer Connection Fees.

The audit found that the Finance Department, the Budget Office and the City Attorney’s Office (Departments) coordinated and recommended to the City Council a practice of borrowing money from restricted Sewer Connection Fees to provide financing for a variety of unrelated program and capital projects without appropriate controls to ensure the loans constituted a proper and prudent use of restricted funds.

The audit found that: a) on at least eleven separate occasions, the City borrowed a total of nearly $40 million from Sewer Connection Fee funds with an additional $12.5 million “line of credit” to bridge funding shortfalls; years later, some of these loans remain outstanding; b) the Departments inconsistently implemented interfund requirements; and c) to help alleviate the City’s General Fund deficit the City transferred $10 million of Healthy Neighborhood Venture Fund (HNVF) money to the General Fund, which created chronic cash flow shortfalls in the HNVF that the City has chosen to address with yearly short-term interfund loans.
Response to Audit

The auditor surveyed ten large western cities and found that nine of these cities pay project expenses directly out of their bond fund rather than “front” cash through their city cash pool as is the practice in San Jose.

The audit report was issued in December 2007 with eleven recommendations and approved by the City Council in January 2008. The Audit Department agreed to work with the Finance Department and the City Attorney’s Office on alternative language to four of the recommendations. The alternative language for the recommendations was agreed to by the City Council’s Public Safety, Finance and Strategic Support Committee in April 2008.

A review of the status of these recommendations with the Audit Department and the Finance Department showed little progress in implementing the eleven recommendations even though they are classified as either priority one or two which require implementation scheduled within sixty days according to the City Administration Manual.

Conclusions

The results of the audit demonstrated that in the last two years the Finance Department extensively used the City’s Cash Pool to finance bond-related projects, thereby reducing the City’s Cash Pool balance by an average of $40 million per month. Because of this deficit, the City’s Cash Pool lost approximately $2.5 million in interest over the last two years alone.

The use of the Sewer Connection Fee Funds to bridge financing gaps is a questionable practice. The Finance Department needs to develop better controls for appropriately securing capital funding and for ensuring compliance with all applicable laws and regulations.

The Finance Department has not complied with the voter bond requirements to have annual audits for two measures that were approved by voters in 2000.
Findings and Recommendations

Findings were reviewed with the subject agency.

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 the potential to pose legal problems.

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.
Key References

Documents

California Government Code Section 66012-66014.

City of San Jose, City Auditor, to Grand Jury.  Email, March 18, 2008.

City of San Jose, Finance Department, to Grand Jury.  Email, May 27, 2008.

City of San Jose, Memorandum.  *Proposed Scope of Services with Macias Consulting to Address Debt Management Recommendations*, February 7, 2008.

City of San Jose, Memorandum.  *An Audit of the Management of the City’s Tax-Exempt Bond Program Use of Interfund Loans to Provide Financing for Capital Bond Projects*, April 7, 2008.


City of San Jose, Resolution No. 69822.  *A Resolution of the Council of the City of San Jose Ordering, On Its Own Motion, the Submission to the Electors of The City of San Jose, at the General Municipal Election to be Held on November 7, 2000, Two Measures Calling for the Issuance of General Obligation Bonds for the Acquisition, Construction and Completion of Certain Municipal Improvements in the City of San Jose*, August 10, 2000.

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<tr>
<th>Date</th>
<th>Interviewee</th>
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<tbody>
<tr>
<td>March 12, 2008</td>
<td>Deputy City Auditor, City of San Jose</td>
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<tr>
<td>April 7, 2008</td>
<td>Director, Finance Department, City of San Jose</td>
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<tr>
<td>April 8, 2007</td>
<td>Registrar of Voters, County of Santa Clara</td>
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<tr>
<td>April 9, 2008</td>
<td>City Auditor, City of San Jose</td>
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<tr>
<td>May 14, 2008</td>
<td>Director, Finance Department, City of San Jose</td>
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<tr>
<td>June 3, 2008</td>
<td>Director, Finance Department, City of San Jose</td>
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PASSED and ADOPTED by the Santa Clara County Civil Grand Jury on this 5th day of June, 2008.

Raymond A. Blockie, Jr.
Foreperson

Tim Cuneo
Foreperson pro tem

Kathryn C. Philp
Secretary