



JOHN CHIANG
California State Controller

August 5, 2013

Bob Deis, City Manager
City of Stockton
425 El Dorado Street
Stockton, CA 95202-1997

Dear Mr. Deis:

I am responding to your July 11, 2013 letter to Steven Mar, Bureau Chief, Division of Audits, in which you express a number of concerns about the State Controller's Office (SCO) audits of the City of Stockton (attached).

While it is no secret that you have never supported an independent, outside review of Stockton's fiscal management practices, we had hoped that you would defer to the elected officials and taxpayer advocates who urged the SCO to step-in and provide answers to questions surrounding Stockton's fall into insolvency. While our findings of fiscal mismanagement are unflattering at times and our reform recommendations are tough medicine, they are not intended to "bayonet the wounded," but to provide a proud and resilient community with the tools it needs to recover from the fiscal and reputational distress from which it currently suffers.

The bane of any auditor is that we only have the authority to reveal, while it is left to the audited party to act. My hope is that you and/or your successor will do what is in Stockton's best interests and not dismiss our work out of wanton pride or political expediency. In case your current resistance is driven by misperceptions, as evidenced by the many incorrect statements and false accusations contained in your letter, I will address each, point-by-point. They include:

- *You imply that the SCO had 17 auditors operating full time for more than 15 months.*

Response: First, the majority of the work in the field was performed between (a) May and June 2012, when we audited the transfer of redevelopment assets, gas taxes, and crime statistic mandate claims; and (b) January through April 2013, when we audited Stockton's internal controls and its use of state and federal funds, along with follow-up on prior work. Second, the reference to the 17 auditors includes supervisors and managers who were never in the field for more than a few days. At most, only eight auditors devoted significant time to the four audits of the City and generally never more than four to six auditors were at City offices at any one time. Third, as the time line on pages 3-4 of the SCO Administrative and Internal Accounting Controls (AIAC) draft audit report details, for five months—from August through December 2012—almost no field work was performed, at the request of the City.

As you well know, out of professional courtesy, we honored virtually all of your repeated requests for delay to assuage your concern that this audit could draw City resources away from bankruptcy-related proceedings.

- *You state that a mid-audit retirement by one senior auditor contributed to delays and incorrect conclusions in the audit of federal funding sources.*

Response: The senior auditor in question never worked on the federal fund review and, therefore, could not have impacted either its timeliness or its conclusions.

- You expressed concern that the auditors never approached you regarding the results of our internal controls review.

Response: At the May 3, 2012 entrance conference, it was made clear to SCO auditors that all requests for information and all discussions about potential findings were to be coordinated with the Chief Financial Officer. This is a request that we honored throughout the course of the audit. The Deputy City Manager attended this meeting and did not request a special briefing for you. In addition, a representative of the City Manager's Office who attended the June 18, 2013, exit interview, at which all proposed findings and recommendations were presented, did not request a separate briefing for you. We cannot account for why the Chief Financial Officer or Deputy City Manager failed to keep you informed about the progress and proposed findings in the audits.

- *You assert that the Controller's April 2, 2012 letter notifying you that the SCO would be conducting a series of audits was released to the media before it was sent to you.*

Response: That is incorrect. Not only was the letter transmitted to you before it was publicly-released, but the Controller's Chief-of-Staff conferred with you several days earlier regarding the scope and objectives of the audit.

- *You expressed concern that the SCO did not adhere to your request at a March 28, 2012, meeting with the SCO Chief of Staff and other SCO staff that we delay our audits until after July 1, 2012, to avoid disruption of the AB 506 process.*

Response: At the March 28, 2012, meeting, it was made clear to you that it was highly likely that the SCO would be conducting an audit. It was also made clear that the SCO would approach the audit in a manner that would minimize the impact to the City's participation in the AB 506 proceedings. This commitment was demonstrated as follows (this information is clearly laid out in the April 2, 2012, letter and on pages 3-4 of the SCO AIAC draft report):

- The April 2, 2012, letter clearly states the SCO did not expect to begin the audits for another month and the report would not be issued until after the AB 506 process was completed.

- On April 26, 2012, you were notified in writing that we had scheduled an entrance conference on May 3, 2012. At the entrance conference, City management requested we postpone the audit of internal controls and state and federal programs until after July 2012 to allow them to continue to address the AB 506 process. The SCO agreed to that postponement and proceeded with the other audits—RDA Transfer of Assets review, Gas Tax audit and the audit of the Crime Statistics mandate.
- On July 31, 2012, the City requested, and the SCO granted, a 60-day extension to prepare materials related to the RDA Asset Transfer review. \
- In addition, based on discussions with the City, the SCO further delayed the audit of internal controls and state and federal programs until after the City had prepared its Comprehensive Annual Financial Report (CAFR) for 2010-2011.
- The City did not issue the CAFR until December 5, 2012 – nearly 18 months after the close of the fiscal year,
- After the issuance of the CAFR, the SCO on January 17, 2013, restarted the audit of internal controls and state and federal programs.

Therefore, the City had ample notice that an audit would be performed and the SCO made numerous accommodations to minimize the impact to City operations. In fact, this is the reason why the audits took as long as they did and makes your complaints about the length of time completely unfounded.

- *You dismiss the findings in the SCO audit of Gas Tax programs (including funding for Traffic Congestion Relief Funds and Proposition 1B funding) by asserting that a review of \$111 million of expenditures produced very little.*

Response: First, the total expenditures during the period reviewed were \$57.8 million. Second, the Gas Tax audits are required by state law to be performed by the SCO, regardless of the size of the program. Third, while the report identified some small unallowable expenditures, it also pointed out that the City's accounting practices of pooling Gas Tax funding with other funds threatened to impair such funding by using it to address general operating costs of the city. This is a major concern that must be addressed because it violates the provisions of California Streets and Highways (S&H) Code section 2101. This violation was sufficiently serious that the Gas Tax report includes an order by the Controller pursuant to S&H Code section 2118 to require the City to deposit future Gas Tax funding in a separate bank account.

- *You assert that the SCO only restarted the audits of internal control and state and federal funding because of the City's plan to contract with an independent certified public accounting (CPA) firm to do an internal control review.*

Response: This is incorrect. As noted above, the City was clearly informed that we planned to restart those audits once the CAFR was completed. As noted above, the CAFR was completed on December 5, 2012, and we restarted the audit on January 17, 2013. Also, while we knew

the City had issued a Request for Proposal to hire a CPA firm to perform a review of the City's internal controls, our audits covered more than just a review of internal controls.

- *You assert that we have ignored the challenges facing the City and failed to recognize recent accomplishments made to address these challenges. You also state that the Maze & Associates' CAFR for the 2010-11 fiscal year contained an unqualified opinion.*

Response: The scope of the SCO audits of internal controls and federal and state programs was for the period of July 1, 2010, to June 30, 2011. Given that the City could not provide us with a CAFR for any period beyond June, 30, 2011, our focus had to be on that period of time. However, we also indicated we would be looking at issues that occurred before and after this date related to findings during the period.

While you are correct that Maze & Associates issued an unqualified opinion in its review of the CAFR ending June 30, 2011, the report contained a 41-page Memorandum on Internal Control and Required Communications detailing numerous issues, many of which had not been addressed at the time the report was issued on December 5, 2012—nearly eighteen months after the close of the fiscal year. Additionally, the Single Audit report issued on March 26, 2013, contained numerous other findings and questioned costs.

- *You assert that late and non-financial reporting issues identified in the SCO report were the problems of the prior administration and that the current administration can produce accurate reports.*

Response: First, it should be noted that the SCO did not say that the City *could* not produce accurate reports. The finding clearly says that the City *had not* produced reports at all or on a timely basis. Second, on page 13 of the SCO AIAC draft audit report, we listed the following eight reports that had not been submitted and that were between two and 17 months overdue

- FY 2011-12 Annual Street Report
- FY 2011-12 CAFR
- FY 2011-12 Single Audit Report
- FY 2011-12 City Financial Transaction Report
- FY 2010-11 City Financial Transaction Report
- FY 2010-11 RDA Audited Financial Statements
- FY 2010-11 RDA Financial Transaction Report
- FY 2010-11 Housing Community Development Report

Currently, all eight have not yet been submitted.

- *You contend that the comment on page 5 of the SCO AIAC draft audit report regarding the effect of poor internal controls on decision making that has negatively affected the City's financial situation is "plain wrong and is irresponsible." As support, you provide an account of actions that you and the other City staff and the council have taken to "get the City's fiscal house in order." In addition, you express concern that the SCO did not discuss the proposed audit findings with you personally.*

Response: First, the findings in the SCO AIAC draft audit report provide a detailed account of the City's internal control weaknesses and specific examples of how these contributed to the City's financial situation. Second, as noted above, the scope of the SCO audit covered a period of time prior to the one you discuss. Finally, it was made clear at the entrance interview that all requests for information and all discussions about potential findings had to be coordinated through the Chief Financial Officer. Again, we cannot account for why the Chief Financial Officer failed to keep you informed.

- *You dismiss the findings in our review of internal controls (contained in Appendix 1 of the SCO draft report) as "checking a list of boxes."*

Response: Your conclusion is incorrect. The findings provided in Appendix 1 resulted from the following activities: 1) interviewing City staff to determine whether internal controls were in place, or not; 2) evaluating the formal written internal policies and procedures; 3) reviewing and assessing various prior reports issued by the Office of City Auditor on internal controls; and, 4) testing of internal control procedures to validate their effectiveness. Also, the findings in Appendix 1 are accompanied by comments that describe the basis for the conclusion that an internal control element is inadequate.

In summary, of the 79 internal control elements evaluated, we found that 48, or 60.8%, were not considered to be adequate. Your dismissive comments about the information provided to you in the AIAC report do not match with your assertion that the City is engaged in efforts to learn from the past and improve its operations going forward. The findings expose past problems and we recommend that you use them in your future efforts to improve the City's internal controls.

- *You indicate that the City Auditor's Office was not disbanded and that you decided to conduct a Risk Assessment and Internal Control audit with an outside vendor. You also contend that many of the old issues identified by the previous City Auditor had been addressed.*

Response: Our recommendation that the City Auditor's Office be re-established was based on our belief that a properly staffed and managed Internal Auditor's Office would be an extremely valuable tool for management. This conclusion seems supported by your comment that previous issues identified by the City Auditor had been, or are being, addressed by you and City staff.

- *Regarding the information provided under the heading of Observation in the SCO AIAC draft audit report, you indicate that our reference to stakeholders should include bond rating agencies, bond buyers and bond insurers.*

Response: The second-to-last paragraph under "Observation," states that stakeholders include the "City Council, City management, bond advisors and counsels, etc." However, it was the City Council that made decisions based on information that came from these other stakeholders and, ultimately, they should be held accountable for making decisions that contributed to the City's financial problems.

- *You indicate the SCO used an “inappropriate run-up of debt” as a rationalization for initiating the audits and again complain that SCO staff did not contact you regarding the information provided in the draft report under the heading of Observation.*

Response: First, it should be noted that in your June 5, 2012 presentation to the City Council, you stated that “Excessive Debt Burden” was one of the six factors that led to the City’s financial distress. While we don’t disagree with your assessment, we never used this term or the term “inappropriate run-up of debt” in the SCO AIAC draft audit report or in the April 2, 2012 notification letter. In addition, your presentation only indicates the impact of those six factors. Our evaluation of these same factors shows that there was sufficient information available to decision-makers and stakeholders that should have warranted a more cautious approach in dealing with them.

Second, as noted in the April 2, 2012 letter, the decision to initiate all of the audits was based on a number of factors, including your own statement that the City’s financial issues were the result of mismanagement. In addition, interested organizations and individuals requested that the SCO perform audits to identify the origins of the City’s fiscal distress.

Finally, regarding your concern about not contacting you, we have explained about the limits on contacts placed by the City on the SCO audit staff.

- *You express concern that the SCO did not “take into account the political pressure from the financial special interests that pursued their goals with vigor and success” that may have contributed to the City’s financial problems and believe that we have missed an opportunity to learn from the past.*

Response: As noted above, we stated in the SCO draft report that the former City Council and staff were influenced by various outside stakeholders while making critical decisions that led to the results you outlined in your June 5, 2012 report to the City Council. Our intent under “Observation” was to show that all stakeholders had access to information that should have warranted a more cautious approach to the decisions that were made relative to the six factors you identified that led to the City’s financial problems. We believe it is important to point out to current stakeholders that this same type of information can be available to them when making decisions going forward. We also point out that proper internal controls and timely financial reporting also can assist them in making decisions in the future and in avoiding the problems of the past. In other words, contrary to your statement, the information provided under the heading Observation provides an opportunity for stakeholders to learn from the past.

- *You conclude that the SCO audit is a “disappointment” and will take you “away from catching up on CAFRs, improving internal controls, etc” and “just inflames the situation and slows down Stockton’s recovery.”*

Response: There is no basis for this conclusion. By your own assertion, the SCO audits are only one of a number of audits, reviews, and evaluations conducted by your staff and contractors.

In conclusion, we hope that these detailed corrections of your misstatements and false accusations will cause you to revisit your dismissive attitude regarding our audit findings and recommendations. We fear that your current posturing may prevent you and the City from learning from its past mistakes and benefiting from recommendations aimed at steering the city away from repeating them.

This letter is in response to the issues you raised in your letter of July 11, 2013. The SCO will be using the information in the July 12, 2013 letter from Vanessa Burke, CFO, Administrative Services, to respond to specific issues in all the SCO draft reports.

If you have any questions regarding this matter, please contact me by phone at (916) 552-8080, or Jeffrey V. Brownfield, Chief, Division of Audits, by phone at (916) 324-1696.

Sincerely,
Original signed by:

George Lolas
Acting Chief Operating Officer

Attachment

cc: Vanessa Burke, CFO, Administrative Services, City of Stockton
Laurie Montes, Deputy City Manager, City of Stockton
Kurt Wilson, Deputy City Manager, City of Stockton
Elena Adair, Assistant Director, Administrative Services Department, City of Stockton
Anthony Silva, Mayor, City of Stockton
Paul Canepa, Vice Mayor, City of Stockton
Elbert H. Holman, Jr., Council Member, City of Stockton
Kathy Miller, Council Member, City of Stockton
Moses Zapien, Council Member, City of Stockton
Dyane Burgos, Council Member, City of Stockton
Michael Tubbs, Council Member, City of Stockton
Jeffrey V. Brownfield, CPA, Chief, Division of Audits, State Controller's Office
Steven Mar, Bureau Chief, Division of Audits, State Controller's Office



CITY OF STOCKTON

OFFICE OF THE CITY MANAGER

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July 11, 2013

Mr. Steven Mar, Chief
Local Government Audits Bureau
State Controller's Office, Division of Audits
Post Office Box 942850
Sacramento, CA 94250-5874

Dear Mr. Mar:

It appears to me the State Controller's Office is more interested in scoring political points than supporting good governance. Through your restating of old and well-documented problems (two years or older), much of which was shared by us, and taking things out of context, your office appears to be just another political operative that "bayonets the wounded" after the battle has been fought to repair a distressed city.

Your 17 auditors that visited the City over 15 months never approached me to get senior management's perspective and discover the facts that you opine on, such as Management Philosophy and Operating Style, Commitment of Excellence or Integrity and Ethical Values. Some of your findings in these areas are simply wrong. You never mention that your senior auditor retired mid-audit and that you had to re-examine old audit work due to poor documentation, which extended your audit timelines. I think this turnover contributed to incorrect conclusions in your audit of federal funding sources.

We are the ones that found the myriad of errors in accounting, the cumulative impacts of poor financial decisions and the need to restate previous financial statements. In fact, I shared all this with the State Controller on March 28, 2012. I told him and your staff that we uncovered a mess, which will require some heavy lifting, but we were on it. I made one simple request: that if you audit us, please wait until July 1, 2012 so we can support the hugely complex and demanding AB 506 process, two budget processes (with or without bankruptcy protection) and possibly a hugely complex Chapter 9 filing. We were also unwinding our RDAs. In response to the meeting, the SCO issued a letter soon thereafter but sent it to the media before I actually received it. The letter made various provocative statements, pretends like we never talked a couple days before and seriously complicated the AB 506 process. The SCO proceeded to overwhelm a distressed financial staff with a myriad of auditors while we were addressing all the time-



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sensitive issues listed above. And to what ends? You completed your audit of seven years of gas tax activity, a total of \$111 million and you found very little to question. Your staff then left.

I have been vocal with the City Council in open meetings and with department heads in closed meetings that I have been dissatisfied with the internal controls in the City. We have made huge progress in this area but have more work to do. Your audit does not reflect the current state of affairs, nor the progress we have made despite the handicap of being an insolvent city and managing the biggest city bankruptcy in the history of the country. The irony is, once we shared with you that we were contracting with a reputable CPA firm (Moss Adams) to conduct a comprehensive internal control audit, your staff hurried up and returned to conduct your own audit of internal controls. Why was the SCO in such a rush to conduct this "hit and run" piece and beat Moss Adams by a couple of months, on the very same topic? I think my first paragraph gives the answer.

The simple fact is we inherited a mess. The City cut 43 percent of its non-safety staff. Our first priority was avoiding an uncontrolled financial default, balancing a budget, developing a plan for recovery, continuing to provide city services and building the organizational capacity. In our spare time we responded to an unprecedented crime wave. As I see it, the challenge for a City Manager is that we take the organization as it is, good or bad, with resources or without, with competent people or without, with systems in place or without, with demands of the citizenry and from the City Council. We take these demands and begin to prioritize goals in the immediate, mid-term and long-term. In the perfect resource rich environment, we can implement all the best management practices, but in reality, we make less than optimum decisions that take into account the competing demands for the day, week, month or year. Your audit ignores the above facts of life.

We were fully aware that we needed to implement improvements to the internal controls. Your observations do not reflect the progress that we have made. In fact, your audit doesn't reveal any new information that we didn't already know, except in the area of indirect cost recovery.

The fact is, contrary to your report, the City can produce accurate financial information. It was previous administrations that could not produce accurate financial information. Our latest CAFR reflects an unqualified opinion and I don't recall any major audit adjustments. Most of the Management Letter involved issues that we uncovered after

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adding competent staff. We have contracted with a new CPA firm with the explicit plans to catch up on our CAFR's and state mandated reports.

Your statement on page 5 includes..... "The problem with internal controls resulted in a number of decisions that negatively affected the City's financial situation as described in the findings, and many have still not been addressed." This statement is plain wrong and is irresponsible.

You will be hard pressed to find a senior management team or City Council that does (or has done) the heavy lifting to get its fiscal house in order. The Council has been steadily implementing its strategic initiatives that comprehensively address the issues that contributed to its insolvency status. No one from the SCO has talked to me to find out what we are doing, or have done, to improve the internal control environment. The sheer number and magnitude of the issues make it a work in progress. I personally review all contracts and all agenda items. We have addressed a \$540 million OPEB unfunded liability by eliminating it. We conduct 10 and 20 year projections for financial planning. We fully cost out all new labor agreements for public discussion. We have made more radical change in such a short period of time than any governmental agency that I am aware of.....and your response is that we have a poor Management Philosophy and Operating Style via checking a list of boxes? Not only are you wrong, your report is inflammatory.

You speak to disbanding the City Auditor function, but this is simply not accurate. We have decided to experiment with contracting for the City Auditor function by conducting a massive Risk Assessment and Internal Control audit. This is partly a result of experiencing the same things with the previous City Auditor that you mention in your audit report.

Your statement about management was slow to take action when the City Auditor identified issues of significance. This is old information. When I arrived, I had staff close out a significant list of outstanding audit findings.

For some reason, you retrace information that my staff and I produced approximately 18 months ago (pages 21-24). It involved explaining how the City became insolvent. You suggest on page 24, the lack of internal controls and effective oversight is the more likely cause of the City's financial problems. You also explain that the stakeholders had information available to them that should have given pause in issuing loads of debt. If you wish to add stakeholders to this list, you should add bond rating agencies, bond buyers and bond insurers. These groups participated in their own way in the City's

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inappropriate run-up of debt. This statement seems to be an attempt to rationalize this rushed audit and its importance relative to Stockton's mess.

Unfortunately, like the rest of this audit, it fails to recognize the nuanced causes of Stockton's problems. Interesting enough, as one who has managed local government finances for 34 years, your staff never once attempted to meet with me about your observations or reciting my observations via pages 21-24.

In reaching your conclusions, you don't take into account the political pressures from financial special interests that pursued their goals with vigor and success. I believe the biggest factor in Stockton's problems was the apparent abdication of any fiduciary responsibility towards protecting the City's interests. I do concur with the observation that poor service management contributed to Stockton's problems. You also assume that previous City Managers did not share with the City Council the cumulative impact of their decisions and whether the Council chose to ignore it. In fact, your reward for taking on 15-20 years of mismanagement is to criticize what hasn't been done. This audit represents a missed opportunity for learning.

In summary, this audit is a disappointment. It produces very little new information. Instead, it just inflames the situation and slows down Stockton's recovery. We are working with a reputable CPA firm to assist in a more robust evaluation of our internal controls, but more importantly, crafting a triaged list of improvements that addresses the biggest concerns first. We will be revisiting some of the same issues that you brought up, thus yet again, taking us away from catching up on the CAFR's, improving internal controls, etc.

I have attached staff's detailed responses to your findings and recommendations.

Sincerely,



BOB DEIS
CITY MANAGER

Attachments

cc: John Chiang, State Controller
Jeffrey V. Brownfield, Chief, Division of Audits