



Office of the City Auditor

**Report to the City Council
City of San José**

**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**

**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 2005-06 To 2006-07**

**The City Relied On Restricted Sewer
Connection Fee Funds To Bridge Unrelated
Funding Gaps Without Sufficient Controls,
Potentially Resulting In Non-Compliance
With The City's Municipal Code And
Possibly California Government Code**

**Report 07-06
December 2007**

December 13, 2007

Honorable Mayor and Members
of the City Council
200 East Santa Clara Street
San Jose, CA 95113

Transmitted herewith is the report *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*. This report is in accordance with City Charter Section 805. An Executive Summary is presented on the blue pages in the front of this report. The City Administration's response is shown on the yellow pages, and the City Attorney's response on the pink pages. Comments on these responses by the City Auditor and the City Auditor's Public Finance Specialist follow on the green pages before the appendices.

I will present this report to the *Public Safety, Finance & Strategic Support Committee* at its December 20, 2007 meeting. If you need any additional information, please let me know. The City Auditor's Office staff members who participated in the preparation of this report are Lynda Flores Brouchoud, Jorge Oseguera, and Jazmin LeBlanc.

Respectfully submitted,



Steven Hendrickson
Interim City Auditor

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Table of Contents

Executive Summary	i
Introduction	1
Background	1
Organizational Structure	2
Debt Management Program Responsibilities.....	3
Bond Fund Allocation And Disbursement Process.....	3
Laws And Regulations	4
Audit Objective, Scope, And Methodology.....	5
Major Accomplishments Related To This Program	8
Finding I	
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 2005-06 To 2006-07	9
The Finance Department Has No Controls To Prevent Lost Interest Caused By Negative Fund Balances In The City’s Cash Pool	11
The Finance Department Needs To Improve Controls To Ensure Bond Proceeds Are Spent And Accounted For In Compliance With Applicable IRS Regulations	25
The Finance Department Needs To Ensure Voter-Approved Bond Requirements For Audits Of Certain General Obligation Bonds Are Fulfilled.....	33
CONCLUSION	35
RECOMMENDATIONS	36
Finding II	
The City Relied On Restricted Sewer Connection Fee Funds To Bridge Unrelated Funding Gaps Without Sufficient Controls, Potentially Resulting In Non-Compliance With The City’s Municipal Code And Possibly California Government Code	39
The City’s Current Process For Obtaining Interfund Loans From Sewer Connection Fee Funds May Not Comply With The City’s Municipal Code And Other Related Laws And Regulations.....	41
On At Least Eleven Separate Occasions, The City Borrowed A Total Of Nearly \$40 Million From Restricted 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	44
The Departments Inconsistently Implemented Interfund Loan Terms	45

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 HNMF Fund That The City Has Chosen To Address With Annual Short-Term Interfund Loans	49
CONCLUSION	54
RECOMMENDATIONS	55
Administration’s Response	57
City Attorney’s Response	73
City Auditor And The City Auditor’s Public Finance Specialist’s Comments On The Responses From The City Attorney’s Office And City Administration	87
Appendix A	
Post Issuance Compliance Checklist	A-1
Appendix B	
Form Of Bond Proceeds Allocation Certificate	B-1
Appendix C	
Foley & Lardner LLP Memorandum	C-1
Appendix D	
Definition Of Priority 1, 2, And 3 Audit Recommendations	D-1

Table of Exhibits

Exhibit 1	
Finance Department Debt Management Organizational Chart.....	2
Exhibit 2	
The Finance Department’s Spending And Processing Of Expenditures From Tax-Exempt Bond Funds And The Impact On The City’s Cash Pool Balance.....	13
Exhibit 3	
Comparison Of Tax-Exempt Bond Holding Practices Among Ten Large Western Cities	15
Exhibit 4	
Growth Of Negative Balances In The City’s Cash Pool Attributed To Bond Projects.....	16
Exhibit 5	
Example To Illustrate Rate Of Return Calculation And Interest Allocation Process	18
Exhibit 6	
Example Of Understating Of The Annualized Interest Rate And Monthly Factor In The City’s Cash Pool.....	19
Exhibit 7	
Breakdown Of \$2.5 Million Lost Interest In The City’s Cash Pool	21
Exhibit 8	
Summary Of Loans And Line Of Credit From Sewer Connection Fee Funds To Unrelated Projects.....	45
Exhibit 9	
Reduction In Programmatic Funding After Transferring \$10 Million From The HNVF Fund To The City’s General Fund (As Shown In Adopted Budget Numbers)	50
Exhibit 10	
Process Illustrating The \$10 Million HNVF Transfer To The General Fund To Balance The General Fund Deficit And The Resulting Need For Annual Short-Term Loans From The Sewage Treatment Plant Connection Fee Fund.....	53

Executive Summary

In accordance with the City Auditor's 2006-07 Audit Workplan, we have audited the Finance Department's Debt Management Group regarding its administration and financial management of the City of San José's tax-exempt bond program and use of interfund loans to provide financing for capital bond projects. This is the first audit report in a series of audits designed to evaluate the Finance Department's debt management, investment, and bond issuance processes. We conducted this audit in accordance with Generally Accepted Government Auditing Standards (GAGAS) and limited our work to those areas specified in the Scope, Methodology, and Objective section of this report.

Finding I

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 2005-06 To 2006-07

According to the 2006 Comprehensive Annual Debt Report (CADR), the Finance Department's Debt Management Group has responsibility to:

...ensure that the City is complying with its bond covenants, that reporting to third parties is done timely and accurately, that its [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 variable rates are set at market levels, that its investment agreements are properly collateralized, and that its liquidity and credit enhancement contracts are renewed in a timely manner.

Debt Management staff work very closely with other City departments as well as with the City Attorney's Office and the Budget Office to coordinate the investment and disbursement of bond funds to assure expenditures are in compliance with IRS Regulations and the California State Constitution. Debt Management staff also work closely with the bond trustees and the 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.¹

The City Attorney's Office, in conjunction with outside bond counsel, provides advice on regulatory and legal requirements associated with tax-exempt bond issuance and continuing compliance. They also coordinate and provide advice on the financing methods used in the tax-exempt bond program. It is important to have strong internal controls over the above-noted activities because they are important factors in contributing to the City's bond rating and maintaining tax-exempt status, which ultimately impacts the interest rate the City pays to borrow funds for capital projects. These internal controls are also important to ensure the City maintains compliance with regulatory requirements, such as State Constitution Sections XIII C and D (Proposition 218), which limit the use of enterprise funds for financing methods, and voter-approved bond measure obligations.

We found that the Finance Department's process for reimbursing bond proceeds does not adequately protect the City's Cash Pool. Furthermore, the Finance Department may not be fully compliant with applicable laws and regulations. In our opinion, the Finance Department needs to improve controls over the administration of the tax-exempt bond program. Our conclusions are based upon the following:

- The Finance Department has no controls to prevent lost interest caused by negative fund balances in the City's Cash Pool;

¹ It should be noted that the Redevelopment Agency handles its own debt issuance and administration. The Debt Management Group assists with the Airport's debt issuance but the Airport approves the invoices and use of bond proceeds, and provides copies of the disbursements to the Debt Management Group.

- *The Finance Department's process relies on the City's Cash Pool to front bond-related expenses even when bond proceeds are available;*
- *The Finance Department's process resulted in negative balances and lost interest in the City's Cash Pool;*
- *The City's restricted funds held within the City's Cash Pool are not receiving their entitled amount of interest earnings due to the deficiencies we found, which appears to be noncompliant with State and Federal laws;*

The Finance Department needs to improve controls to ensure bond proceeds are spent and accounted for in compliance with applicable IRS regulations;

- *The Finance Department's lack of appropriate controls resulted in accounting and allocation delays;*
- *The Finance Department lacks written procedures to guide Project Managers in identifying eligible bond expenses; and*
- The Finance Department needs to ensure voter-approved bond requirements for audits of certain general obligation bonds are fulfilled.

As a result, over 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. Due to this deficit, we estimate the City's Cash Pool lost approximately \$2.5 million in interest over the last two years alone. The Finance Department has been aware of this impact but has not addressed the issue because interest is earned in the trustee-held accounts rather than in the City's Cash Pool. We should note, however, that this explanation ignores the repercussions of lost interest to the City's enterprise funds and potential violations of Proposition 218, Federal, and other regulations that govern restricted funds. Furthermore, unlike the interest earned in the City's Cash Pool, interest earned in bond fund accounts can only be used for qualifying capital projects.

In addition to our concerns about negative balances, the administrative deficiencies we noted may create further liabilities to the City from potential violations of IRS Treasury Regulations for tax-exempt bonds.

RECOMMENDATIONS

We recommend that the Finance Department:

- 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. The Finance Department could hold tax-exempt bond proceeds within the City’s Cash Pool, or have the trustee directly pay expenses. (Priority 1)**
- Recommendation #2** **Work with the City Attorney’s Office to obtain the services of an independent consultant to evaluate and report on methods to address any potential past compliance issues with Federal and State law arising from the negative cash balances and lost interest in restricted funds. (Priority 1)**
- Recommendation #3** **Develop and implement procedures to prevent potential interest diversion of restricted funds held in the City Cash Pool. (Priority 1)**
- 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. (Priority 1)**
- 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. (Priority 2)**
- Recommendation #6** **Work with the City Attorney’s Office to develop written policies and procedures for Project Managers and other City staff to determine eligible and ineligible expenditures for each type of bond financing. (Priority 1)**

We recommend that the Finance Department:

- Recommendation #7** **Work with the City Attorney’s Office to ensure that all voter-approved bond language is fully complied with, including issuing annual audits for Measures O and P. (Priority 1)**

Finding II **The City Relied On Restricted Sewer Connection Fee Funds To Bridge Unrelated Funding Gaps Without Sufficient Controls, Potentially Resulting In Non-Compliance With The City’s Municipal Code And Possibly California Government Code**

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 principles of sound treasury management and in accordance with the applicable laws or ordinances.” The City’s Municipal Code authorizes the City to assess two separate connection fee charges (referred hereafter as Sewer Connection Fee funds) for properties to connect to the Sanitary Sewer System. The Municipal Code also 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. These two sources of regulations state that connection fee funds and charges cannot be used for any other purposes, thereby restricting their use. It is important for the Finance Department and City Attorney’s Office to appropriately evaluate these regulations in contemplating the use of restricted sources of funding to provide financing for capital bond projects and other budget gaps.

According to our public finance specialist, 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 Government Code related to restrictions on Sewer Connection Fees. We 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 Fee funds 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 the restricted funds.

Specifically, our audit found that:

- On at least eleven separate occasions, the City borrowed a total of nearly \$40 million from restricted 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;
- The Departments inconsistently implemented interfund loan terms; and
- 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 HNMF Fund that the City has chosen to address with yearly short-term interfund loans.

The number and nature of these transactions raises concerns that the Departments may be condoning the use of these restricted sources of funds as a financing method without properly documenting or administering the terms of such loans. We also noted that the loans were not easily traceable because they were not centrally tracked, were not consistently listed in Budget Office documents, and did not have consistently documentation.

In our opinion, using restricted Sewer Connection Fee funds to bridge financing gaps without appropriate controls is a questionable practice and we believe the Finance Department and City Attorney's Office need to develop better controls for appropriately securing capital funding and for ensuring that restricted sources of funding are used in compliance with all applicable laws and regulations. We also recommend that the

City Administration improve its tracking and documentation to ensure the loan terms are consistent, appropriate, and implemented.

RECOMMENDATIONS

We recommend that the City Manager's Office:

- Recommendation #8** **Work with the City Attorney's Office to evaluate and report on methods to remedy any potential past compliance issues associated with the loans from restricted funds. (Priority 1)**
- Recommendation #9** **Develop and implement a formal written policy on interfund loans, including the establishment of a prudent investor standard, and written procedures on how to manage and enforce such a policy. (Priority 1)**
- 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. (Priority 1)**
- Recommendation #11** **Improve controls to ensure future transfers are in compliance with the City's Municipal Code. (Priority 2)**

Introduction

In accordance with the City Auditor's 2006-07 Audit Workplan, we have audited the Finance Department's Debt Management Group regarding its administration and financial management of the City of San José's tax-exempt bond program and use of interfund loans to provide financing for capital bond projects. This is the first audit report in a series of audits designed to evaluate the Finance Department's debt management, investment, and bond issuance processes. We conducted this audit in accordance with Generally Accepted Government Auditing Standards (GAGAS) and limited our work to those areas specified in the Scope, Methodology, and Objective section of this report.

The City Auditor's Office thanks the Finance Department and other departmental staff who gave their time, information, insight, and cooperation during the audit process.

Background

In accordance with the City Charter, Article VIII, Section 806, the Director of Finance is charged with responsibility for the conduct of all Finance Department functions. The City's Debt Management Policy, adopted by the City Council, states that the Finance Department is responsible for the City's debt administration activities, particularly investment of bond proceeds, compliance with bond covenants, continuing disclosure, and arbitrage compliance, which shall be centralized within the Finance Department. The Debt Management Group is housed in the Treasury Division within the City of San José's Department of Finance and is the group responsible for implementing the City's Debt Management Policy.

The City's Debt Management Policy also 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 six 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 and timely repayment of debt, 5) maintain full and complete financial disclosure and reporting, and 6) ensure compliance with applicable State and Federal laws.

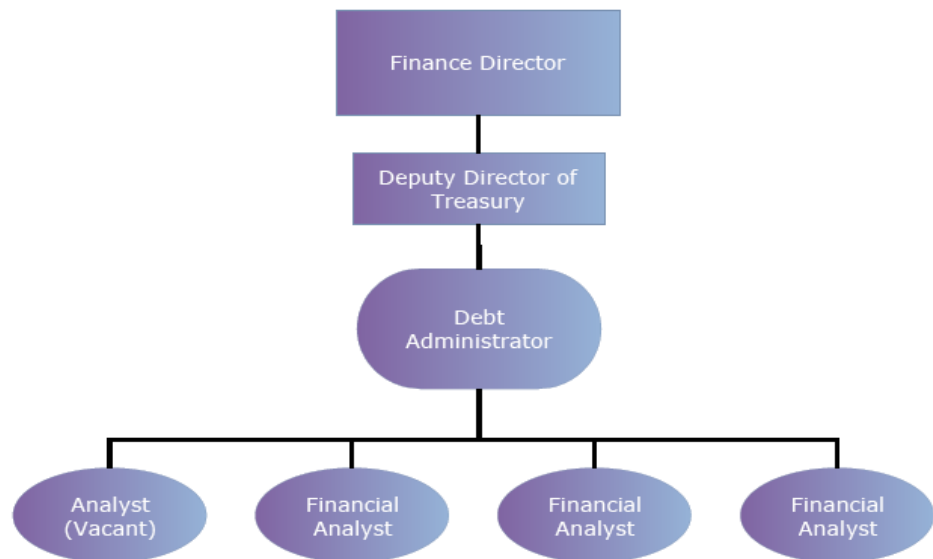
It should be noted that the Redevelopment Agency (RDA) handles its own debt issuance and administration, although the Debt Management Group and the Housing Department staff have primary responsibility for the issuance and administration of the RDA housing set-aside tax allocation bonds.

As of April 2007, the City had over \$515 million in bond proceeds held in fund balances by the City's trustees. According to the Finance Department, of the \$515 million in bond proceeds, \$409 million are available for disbursement.

Organizational Structure

The Finance Director and the Deputy Director of the Treasury Division oversee the Debt Management Program, as shown in the following organizational chart.

Exhibit 1 Finance Department Debt Management Organizational Chart



According to the Finance Department, the Debt Management Group has experienced significant turnover and vacancies since 2001. However, the Debt Management Group was fully or nearly fully staffed from September 2002 to March 2006 with the same core group of employees and relatively little turnover. Since March of 2006, the Debt Management Group has experienced turnover. For example, two of the current financial analysts began work in September 2006 and a third financial analyst began work in April 2007. The vacant analyst position

is under recruitment. According to the Finance Department, the vacancies are due to staff turnover within the Debt Management Group and reassigning Debt Management Group staff to other vacant positions within the Treasury Division.

Debt Management Program Responsibilities

According to the 2006 Comprehensive Annual Debt Report (CADR), the Finance Department's Debt Management Group has responsibility to:

...ensure that the City is complying with its bond covenants, that reporting to third parties is done timely and accurately, that its [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 variable rates are set at market levels, that its investment agreements are properly collateralized, and that its liquidity and credit enhancement contracts are renewed in a timely manner.

Debt Management staff work very closely with other City departments as well as with the City Attorney's Office and the Budget Office to coordinate the investment and disbursement of bond funds to assure expenditures are in compliance with IRS Regulations and the California State Constitution. Debt Management staff also work closely with the bond trustees and the 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.

Bond Fund Allocation And Disbursement Process

The City's process for disbursing bond proceeds is outlined in the 2006 CADR as follows:

Most of the City's bond-financed project funds are held by trustees, who disburse the construction or improvement funds only after Debt Management has reviewed a disbursement request from the City department managing the project.

Disbursement requests are reviewed and approved by department heads or their deputies before they are submitted to Debt Management. Debt Management staff then reviews, reconciles and qualifies the bond-financed project expenditures before submitting disbursement requests to the trustees. When there is an ambiguity, the City Attorney's Office assists in determining the eligibility of expenditure items.

Laws And Regulations

The Finance Department's Debt Management Group must ensure that accounting and allocation of debt proceeds comply with a number of laws and regulations. Major laws and policies with which the Debt Management Group must comply are issued by groups including:

- The Internal Revenue Code (IRC) and Internal Revenue Service (IRS). The IRS regulates the Federal income tax requirements relating to investment and use of tax-exempt bond proceeds. The IRS may audit the City to determine compliance with the requirements of sections 103 and 141 through 150 of the IRC, which include requirements relating to the allocation and accounting of bond proceeds, use of bond-financed property and restrictions on investment return. A bond may lose its tax-exempt status for Federal income tax purposes if the bond issue does not comply with the applicable IRC requirements. Possible consequences of noncompliance could include the payment of a closing agreement amount by the City to the IRS in settlement of a compliance dispute or exposure to claims of owners of bonds that are not treated as tax-exempt obligations by the IRS.
- The Federal securities law regulations and the United States Securities and Exchange Commission (SEC). The SEC regulates disclosure of information relating to securities offerings, such as bonds issued by the City, under the requirements of Federal securities laws. The City has potential exposure to monetary liability and to cease and desist orders relating to any material misrepresentations made to the public in connection with securities offerings. Among other things, the SEC has promulgated Rule 15c2-12, under which the City has entered into undertakings with various municipal

securities dealers to provide additional material information to the public markets after the issuance of bonds.

- The California State Constitution and general laws of the State. These regulations impose a number of restrictions and requirements on the issuance of debt by the City and the use and investment of funds and accounts of the City.
- The San Jose City Charter and Municipal Code. Under the State Constitution, the City is generally empowered to adopt rules relating to its “municipal affairs.” Under this authority, the City Charter and Municipal Code impose a number of restrictions and requirements on amending City ordinances and code, the issuance of debt and the use and investment of funds and accounts held by the City.

**Audit Objective,
Scope, And
Methodology**

The objective of our audit was to evaluate the effectiveness of internal controls over the Finance Department’s administration of tax-exempt debt financings. More specifically, we determined: 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. We issued a preliminary draft report on August 9, 2007 and updated the information in the report through October 1, 2007.

We evaluated the Finance Department’s procedures, tracking, and approvals for utilizing the governmental tax-exempt bond proceeds with respect to General Obligation and Lease Revenue bonds, with an emphasis on the last two fiscal years, 2005-06 and 2006-07. The Finance Department’s Debt Management Group relied on an Excel worksheet to track debt disbursements and we evaluated this mechanism. The scope of our analysis did not include bonds for the Airport, Redevelopment Agency, Housing Department, or reimbursement of State grants. Our scope also did not include private-use bonds or activities such as the Tuers-Capitol Golf Course or the Logitech Ice Center. We also did not evaluate

the City's Capital Improvement Program (CIP) database. Due to the scope impairments, we did not test specific expenditures for their eligibility to be used as tax-exempt bond expenditures.

Our methodology utilized interviews of Finance Department, City Attorney and Budget Office staff, project managers, and other staff members involved in the process of utilizing tax-exempt bond funds and allocating interest to the City's Cash Pool. We conducted file reviews of the Finance Department's disbursement requests from 2005 and 2006. We also reviewed legal and other bond documents on file in the Finance Department associated with the projects we sampled. We reviewed trustee statements for bond proceeds. We reviewed transactions in the City's Financial Management System and the City's budget documents. We reviewed the constitutional, statutory, and regulatory requirements relevant to the tax-exempt bond programs, including the requirements of the City Charter and Municipal Code, Internal Revenue Code and IRS Treasury Regulations Sections 1.148-6 and 1.150-2, California Government Code Section 66013 restrictions on connection fees, and California State Constitution Sections XIII C and D restrictions on property-related fees (Proposition 218). We interviewed staff from other jurisdictions involved in overseeing their cities' bond programs.

We also obtained the professional services of Michael Bailey, a public finance specialist from Foley & Lardner LLP to evaluate significant risks of non-compliance with the above-noted regulations. Mr. Bailey is a partner with Foley & Lardner LLP where his practice focuses on the taxation of financing transactions, with a particular emphasis on tax-exempt financing and structured finance. He served as Counsel to the Assistant Chief Counsel at the IRS prior to his current position, was one of the principal authors of major Federal income tax regulations concerning tax-exempt bonds, including the arbitrage regulations and the private activity bond regulations, and reviewed or authored most other administrative guidance issued by the IRS on tax-exempt bonds from 1990 through 1997, including published rulings, private letter rulings, and technical advice memoranda. He also played a key role in developing the IRS compliance program for tax-exempt bonds. He received his J.D. degree from the University of Chicago Law School and received his bachelor's degree from Stanford University.

*External Impairment
To The Audit Scope*

According to GAGAS, the general standard related to independence states, in part:

*In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, should be free both in fact and appearance from personal, external, and organizational impairments to independence.
(Section 3.03)*

*Factors external to the audit organization may restrict the work or interfere with auditors' ability to form independent and objective opinions and conclusions. External impairments to independence occur when auditors are deterred from acting objectively and exercising professional skepticism by pressures, actual or perceived, from management and employees of the audited entity or oversight organizations.
(Section 3.19)*

*In using the work of a specialist, auditors need to consider the specialist as a member of the audit team and, accordingly, assess the specialist's ability to perform the work and report results impartially. [...] If the specialist has an impairment to independence, auditors should not use the work of that specialist.
(Section 3.06)*

It became apparent in early March 2007 that the City Attorney's Office was limiting our access to pertinent information. Our office attempted to remedy this problem by speaking directly with the City Attorney in early March regarding access to bond counsel; however, we continued to experience the same issues. More specifically, the City Attorney's Office and bond counsel did not completely answer questions we posed to them, provided contradictory responses to our various questions, and in May, the City's bond counsel declined to provide further information to use in the audit. At that point, we concluded that we could not rely on the limited information provided by bond counsel and the City Attorney's Office and we therefore initiated an effort to procure the services of a public finance specialist. While this impairment limited our audit scope, we were ultimately able to satisfy our overall audit objectives by contracting with a public finance specialist.

**Major
Accomplishments
Related To This
Program**

In the Administration's response to this audit report, on page 57, the Director of Finance informs us of accomplishments related to this program.

Finding I

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 2005-06 To 2006-07

According to the 2006 Comprehensive Annual Debt Report (CADR), the Finance Department's Debt Management Group has responsibility to:

...ensure that the City is complying with its bond covenants, that reporting to third parties is done timely and accurately, that its [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 variable rates are set at market levels, that its investment agreements are properly collateralized, and that its liquidity and credit enhancement contracts are renewed in a timely manner.

Debt Management staff work very closely with other City departments as well as with the City Attorney's Office and the Budget Office to coordinate the investment and disbursement of bond funds to assure expenditures are in compliance with IRS Regulations and the California State Constitution. Debt Management staff also work closely with the bond trustees and the 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.¹

¹ It should be noted that the Redevelopment Agency handles its own debt issuance and administration. The Debt Management Group assists with the Airport's debt issuance but the Airport approves the invoices and use of bond proceeds, and provides copies of the disbursements to the Debt Management Group.

The City Attorney's Office, in conjunction with outside bond counsel, provides advice on regulatory and legal requirements associated with tax-exempt bond issuance and continuing compliance. They also coordinate and provide advice on the financing methods used in the tax-exempt bond program. It is important to have strong internal controls over the above-noted activities because they are important factors in contributing to the City's bond rating and maintaining tax-exempt status, which ultimately impacts the interest rate the City pays to borrow funds for capital projects. These internal controls are also important to ensure the City maintains compliance with regulatory requirements, such as State Constitution Sections XIII C and D (Proposition 218), which limit the use of enterprise funds for financing methods, and voter-approved bond measure obligations.

We found that the Finance Department's process for reimbursing bond proceeds does not adequately protect the City's Cash Pool. Furthermore, the Finance Department may not be fully compliant with applicable laws and regulations. In our opinion, the Finance Department needs to improve controls over the administration of the tax-exempt bond program. Our conclusions are based upon the following:

- The Finance Department has no controls to prevent lost interest caused by negative fund balances in the City's Cash Pool;
 - *The Finance Department's process relies on the City's Cash Pool to front bond-related expenses even when bond proceeds are available;*
 - *The Finance Department's process resulted in negative balances and lost interest in the City's Cash Pool;*
 - *The City's restricted funds held within the City's Cash Pool are not receiving their entitled amount of interest earnings due to the deficiencies we found, which appears to be noncompliant with State and Federal laws;*
- The Finance Department needs to improve controls to ensure bond proceeds are spent and accounted for in compliance with applicable IRS regulations;

- *The Finance Department’s lack of appropriate controls resulted in accounting and allocation delays;*
- *The Finance Department lacks written procedures to guide Project Managers in identifying eligible bond expenses; and*
- The Finance Department needs to ensure voter-approved bond requirements for audits of certain general obligation bonds are fulfilled.

As a result, over 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. Due to this deficit, we estimate the City’s Cash Pool lost approximately \$2.5 million in interest over the last two years alone. The Finance Department has been aware of this impact but has not addressed the issue because interest is earned in the trustee-held accounts rather than in the City’s Cash Pool. We should note, however, that this explanation ignores the repercussions of lost interest to the City’s enterprise funds and potential violations of Proposition 218, Federal, and other regulations that govern restricted funds. Furthermore, unlike the interest earned in the City’s Cash Pool, interest earned in bond fund accounts can only be used for qualifying capital projects.

In addition to our concerns about negative balances, the administrative deficiencies we noted may create further liabilities to the City from potential violations of IRS Treasury Regulations for tax-exempt bonds.

The Finance Department Has No Controls To Prevent Lost Interest Caused By Negative Fund Balances In The City’s Cash Pool

According to the City’s Charter, the Finance Director is obligated to 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 principles of sound treasury management and applicable laws and ordinances. We found that the Finance Department’s current process for accounting and allocating tax-exempt bond proceeds lacks sufficient

controls to ensure compliance with applicable laws, results in interest losses to the City's Cash Pool,² and does not sufficiently protect the City's Cash Pool Balance.

The Finance Department's Process Relies On The City's Cash Pool To Front Bond-Related Expenses Even When Bond Proceeds Are Available

The Finance Department's bond fund allocation and disbursement process, commonly termed the "reimbursement process,"³ is outlined in the 2006 CADR:

Most of the City's bond-financed project funds are held by trustees, who disburse the construction or improvement funds only after Debt Management has reviewed a disbursement request from the City department managing the project.

Disbursement requests are reviewed and approved by department heads or their deputies before they are submitted to Debt Management. Debt Management staff then reviews, reconciles and qualifies the bond-financed project expenditures before submitting disbursement requests to the trustees. When there is an ambiguity, the City Attorney's Office assists in determining the eligibility of expenditure items.

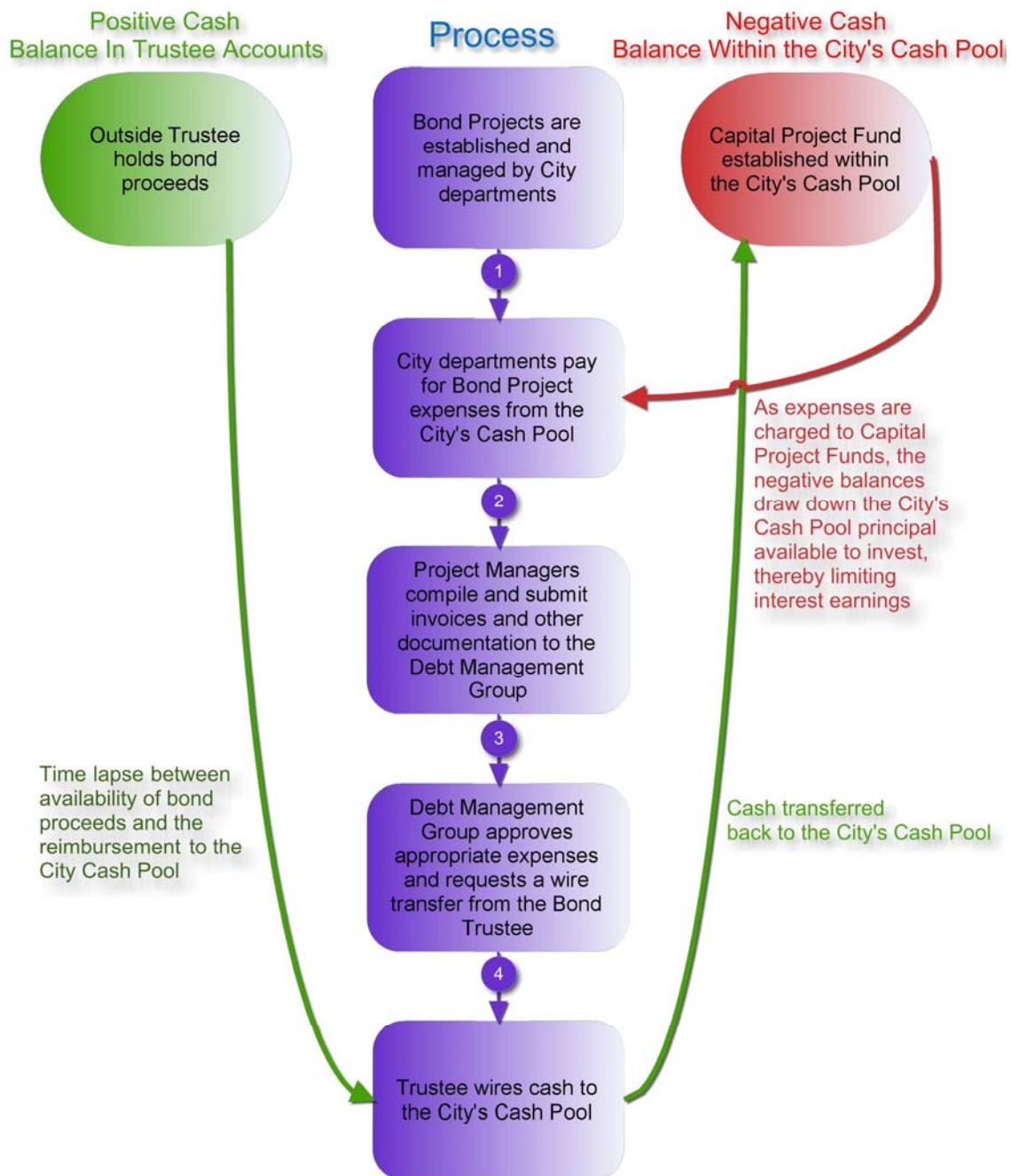
As of April 2007, the City had over \$515 million in bond proceeds held in fund balances by the City's trustees. According to the Finance Department, of the \$515 million in bond proceeds, \$409 million were available for disbursement. While \$409 million in bond proceeds were in the trustee accounts and available for disbursement, the City's Cash Pool was fronting over \$42 million in costs for the bond projects.

The City's method for processing and spending these tax-exempt bond funds is shown in the following exhibit.

² According to the City's Investment Reports, the City's Cash Pool consists of most City funds including: the General Fund, Special Revenue Funds, Capital Projects, Parking, Municipal Water, Waste Water, Airport, Redevelopment Agency, Debt Service, and Other.

³ Finance and other departments often refer to the allocation and disbursement process for bond proceeds as a "reimbursement" process, which is different than the IRS' definition of "reimbursement" referring to reimbursement bonds.

Exhibit 2 The Finance Department’s Spending And Processing Of Expenditures From Tax-Exempt Bond Funds And The Impact On The City’s Cash Pool Balance



As shown in the above exhibit, when the City incurs expenses for bond-related projects, the City initially pays for them with cash held in the City's Cash Pool, rather than using the bond proceeds held with trustees. These payments cause an outflow of cash from the City's Cash Pool, which appears in the City's financial management system as a negative fund balance for each bond project. As bond projects incur expenses, bond project managers within City departments track project costs and submit the expenses in bundles, along with a memo requesting a specific dollar amount, to the Finance Department's Debt Management Group for approval to obtain disbursement from the bond proceeds. An analyst in the Debt Management Group reviews each request for completeness, followed by the Debt Administrator. After this review, the Finance Deputy Director approves the request by signing it and sends notification to the trustee bank, allowing release of the bond funds.

Although the use of a trustee or fiscal agent to hold proceeds to pay for bond-related expenses is not unusual, we found that the City's process for using the City's Cash Pool to front bond-related project expenses is not typical of larger cities. We surveyed ten large western cities (seven of these cities are located in California and subject to the same State laws) and found that nine of these cities pay project expenses directly out of their bond funds, regardless of whether bond proceeds are held with a trustee or held within their Cities' cash pools, thus minimizing impacts to their respective city cash pools. San Francisco was the only city to front cash through its city cash pool, but it did so only on a limited basis. When this city uses their city pool for bond related expenses, their process requires reimbursement of the city pool funds on a quarterly basis. Most notably, none of the ten cities have a system such as ours, wherein most of the tax-exempt bond funds are held with a trustee and the City's Cash Pool fronts the project expenses, as can be seen in the table below.

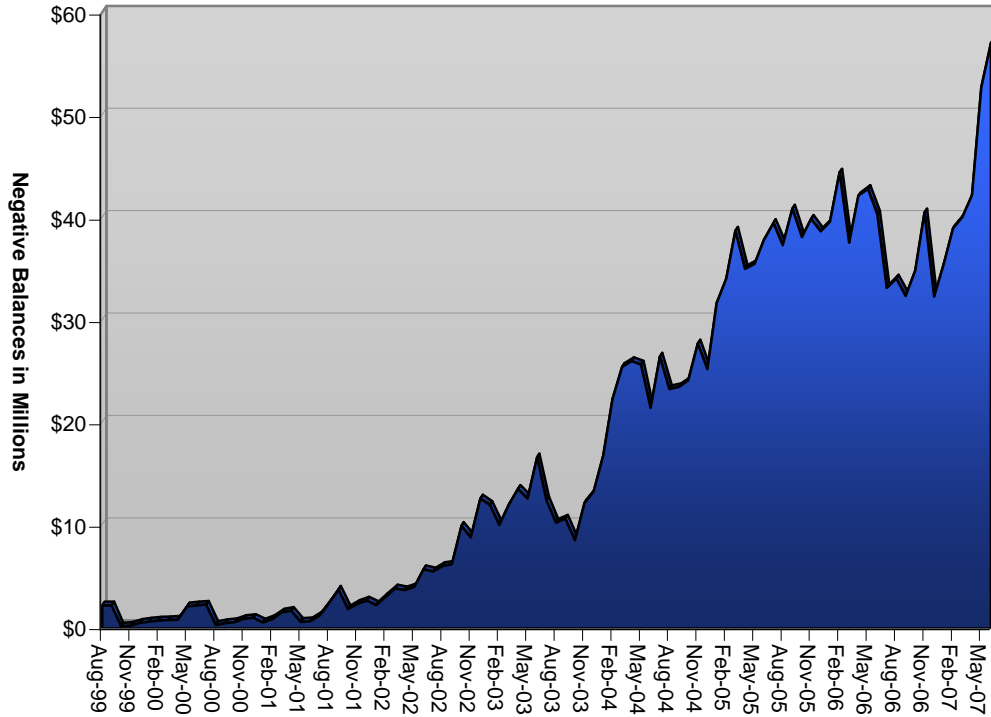
**Exhibit 3 Comparison Of Tax-Exempt Bond Holding Practices
Among Ten Large Western Cities**

Proceeds Normally Held With Trustee/Fiscal Agent		Proceeds Normally Held Directly With City Pool
Payments Made Directly From Bond Proceeds	City Pool Fronts Cash	
Oakland Anaheim San Diego	San Francisco (sometimes) San José	Portland Phoenix Los Angeles Long Beach Seattle Sacramento San Francisco (sometimes)

The Finance Department's Process Resulted In Negative Balances And Lost Interest In The City's Cash Pool

The Finance Department's administration of the tax-exempt bond program should have sufficient controls in place to ensure that the City is efficiently and effectively utilizing all funds. Despite having over \$400 million in available bond proceeds as of April 2007, we found that the Finance Department's lack of controls to address the negative funds impacted the City's Cash Pool balances and interest. This process, coupled with the large dollar value of bond-related capital expenditures, reduced the City's Cash Pool by an average of \$40 million per month during 2005-06 and 2006-07. The negative fund balances have been an on-going problem. However, the impact on the City's Cash Pool has heightened as the City increased its bond-related capital expenditures through the voters' approval of library and park facilities with Measures O & P in 2000, and Measure O in 2002, which resulted in over \$450 million in General Obligation bond issuances from 2002-2006. The following chart shows the growth of these negative balances in the City's Cash Pool.

Exhibit 4 Growth Of Negative Balances In The City’s Cash Pool Attributed To Bond Projects



As a result of the negative fund balances attributed to bond projects, the City’s Cash Pool has lost approximately \$2.5 million in interest over the last two years alone. Therefore, the City is not efficiently or effectively utilizing all funds.

We should note that our estimate of the lost interest may be understated because our audit scope did not include an analysis of the debt management process for Redevelopment, Housing, and other funds that may have also had negative fund balances impacting the City’s Cash Pool during the last two years. For example, in April 2006, the negative fund balance attributed to the bond projects was \$40 million, but the total amount of negative funds within the City’s Cash Pool was \$62 million.⁴

⁴ In April 2006, the \$22 million difference included approximately \$2 million in other bond projects that we did not evaluate as well as Federal reimbursement-based grant funds, and a group of other City funds, which from time to time are negative for a variety of reasons.

The City's Restricted Funds Held Within The City's Cash Pool Are Not Receiving Their Entitled Amount Of Interest Earnings Due To The Deficiencies We Found, Which Appears To Be Noncompliant With State And Federal Laws

One of the main objectives of the City's Debt Management Policy is to "ensure compliance with applicable State and Federal laws." As such, the Finance Department's process should have sufficient internal controls to achieve this objective. We found that the \$2.5 million in lost interest negatively impacts the restricted funds held with the City's Cash Pool, which appears to be noncompliant with State, Federal, and Municipal laws that govern restricted funds. Specifically, the Finance Department's procedures for allocating interest are outdated and their current methodology does not take into account the negative balances in distributing interest earnings in the City's Cash Pool. Therefore, instead of isolating lost interest to unrestricted funds, the burden of lost interest is shared amongst all funds in the City's Cash Pool. Furthermore, the Finance Department's current methodology for allocating interest understates the City's Cash Pool rate of return.

Each month, the Finance Department distributes interest earned to each fund in the City's Cash Pool on a proportional basis. To allocate the interest, the Finance Department first determines the average monthly fund balances for every fund within the City's Cash Pool. However, because the City's Cash Pool contains some funds that have negative balances, the Finance Department removes the negative fund balances and only sums the funds that have a positive balance to determine the total funds held in the City's Cash Pool. It also runs a report to determine the total amount of interest earned within the City's Cash Pool. The ratio between the total interest and total *positive* funds determines the "monthly factor" or monthly interest rate.⁵ The Finance Department then distributes interest proportionately using the monthly factor determined above. This methodology is incorrect because the sum of positive balances does not accurately reflect the total amount of cash actually invested in a given month. The actual amount of cash invested would be the net of both positive and negative fund balances in the City's Cash Pool. The current methodology conceals lost interest associated with maintaining a large amount of negative fund balances because the City's Cash Pool rate of return or "monthly factor" is understated. As a result, it understates interest earned for restricted funds.

⁵ We should note that the City's Cash Pool rate of return reported to the departments does not match the City's Cash Pool interest rate disclosed in the City's monthly and quarterly investment reports. Because this issue exceeds the scope of this audit, we plan to include this in our audit of the City's Investment Program.

In order to clarify the interest earnings calculation the Finance Department uses, we have created a simple example to show the calculation for determining actual interest earnings on the amount invested (e.g. rate of return). We then compare this calculation of actual interest to the methodology the Finance Department currently uses to determine its rate of return for the City's Cash Pool.

Exhibit 5 Example To Illustrate Rate Of Return Calculation And Interest Allocation Process

Simple Example To Illustrate Rate Of Return Calculation	
Assume you have \$1,000. During the year, you place your \$1,000 in a savings account.	\$ 1,000
At the end of the year, you earn \$40 in interest.	\$ 40
By simply dividing the interest earned by the amount invested, you could determine that, for the year, you earned 4% on your investment.	4%

Example To Illustrate The Cost Of Lending Out Monies (Similar to Maintaining Negative Fund Balances) That Would Otherwise Be Available For Investment	
Now assume that once again you have \$1,000 to invest.	\$ 1,000
However, this time, you decide to lend \$200 at the beginning of the year.	\$ (200)
Because you lent \$200, you are only able to invest \$800.	\$ 800
For the purposes of this example, assume that at the end of the year, you are still able to earn \$40 as in the example above.	\$ 40
By simply dividing the interest earned by the amount invested, you can determine that, for the year, you earned a 5% rate of return.	5%
It would be reasonable for a person to then also recognize the cost of having lent out \$200 at the beginning of the year. If you had invested the money that you lent in the same way that you invested the \$800, it also would have earned a 5% rate of return, meaning you would have earned \$10 in additional interest. The \$10 in lost interest is the cost of lending this money.	\$ (10)

Example To Illustrate The Cost Of Allowing Negative Fund Balances (Similar To Lending Out Monies) In The City's Cash Pool And How It Impacts The City's Allocation Method	
Using this example, we can illustrate how pooled investment funds are impacted by negative funds. When some funds in the pool hold negative balances, the pool as a whole is able to invest less and, therefore, earn less interest. When determining the interest rate earned for the pool as a whole, one should determine the rate of return based on the actual amount of money invested and the total amount of interest earned.	
Assume the City has \$1,000 to invest in the City's Cash Pool (total positive funds).	\$ 1,000
However, due to fronting bond project expenses, the City is carrying a \$200 negative fund balance in a capital project fund.	\$ (200)
Because the City fronted \$200, the City would only be able to invest \$800.	\$ 800
Once again, assume that, at the end of the year, you are still able to earn \$40 as in the example above.	\$ 40
Using the rate of return calculation shown above, one would determine that the \$800 investment yielded a 5% rate of return.	5%
However, the City would calculate its rate of return based on earning \$40 of interest on \$1000 instead of on \$800 as shown above. This has the effect of reducing the rate of return from 5% to 4%.	4%
Consequently, the City underreports its actual rate of return, which obscures the impact of negative balances in the City's Cash Pool.	

The following exhibit is an actual example from April 2006 of the impact of carrying negative balances in the City’s Cash Pool and the interest allocation process. It also shows the impact to one particular City fund in that month, the City’s General Fund.

Exhibit 6 Example Of Understating Of The Annualized Interest Rate And Monthly Factor In The City’s Cash Pool

April 2006	
General Fund (Fund 001) Balance	\$ 196,412,247.39
Total Positive Cash Pool Balance	\$ 1,193,707,114
Total Negative Cash Pool Balance	\$ (62,922,019)
Net Cash Pool Balance (Amount Invested)	\$ 1,130,785,095
Total Interest Earned	\$ 3,236,196

	Current	Correct	Understatement
Monthly Factor Calculation	<u>Total Interest Earned</u> Total Positive Cash Pool Balance	<u>Total Interest Earned</u> Net Cash Pool Balance	
Monthly Factor (Interest Rate)	0.002711047	0.002861902	-0.000150855
Annualized Rate	3.25%	3.43%	-0.18%
Interest Allocated to General Fund	\$ 532,482.89	\$ 562,112.66	\$ (29,629.77)

The above exhibit shows that in April 2006, the negative fund balances, coupled with the Finance Department’s interest allocation methodology, resulted in an understatement of the City’s Cash Pool interest. Additionally, it highlights the impact on particular funds, in this case the General Fund, which actually earned \$29,630 more in interest than was allocated by the City. This example also highlights the fact that the burden of the \$2.5 million in lost interest from 2005-06 and 2006-07 is shared proportionately amongst all of the funds that make up the City’s Cash Pool. The Finance Department’s interest allocation formula for distributing interest within the City’s Cash Pool does not take into consideration the negative balances in bond funds and thus, all other funds in the City’s Cash Pool are losing a portion of their interest earnings as a result of having negative balances in the City’s Cash Pool. Finance Department officials have explained that this outcome is simply one of the costs associated with being in an investment pool. Finance Department officials have also stated that this outcome has not been viewed as a problem.

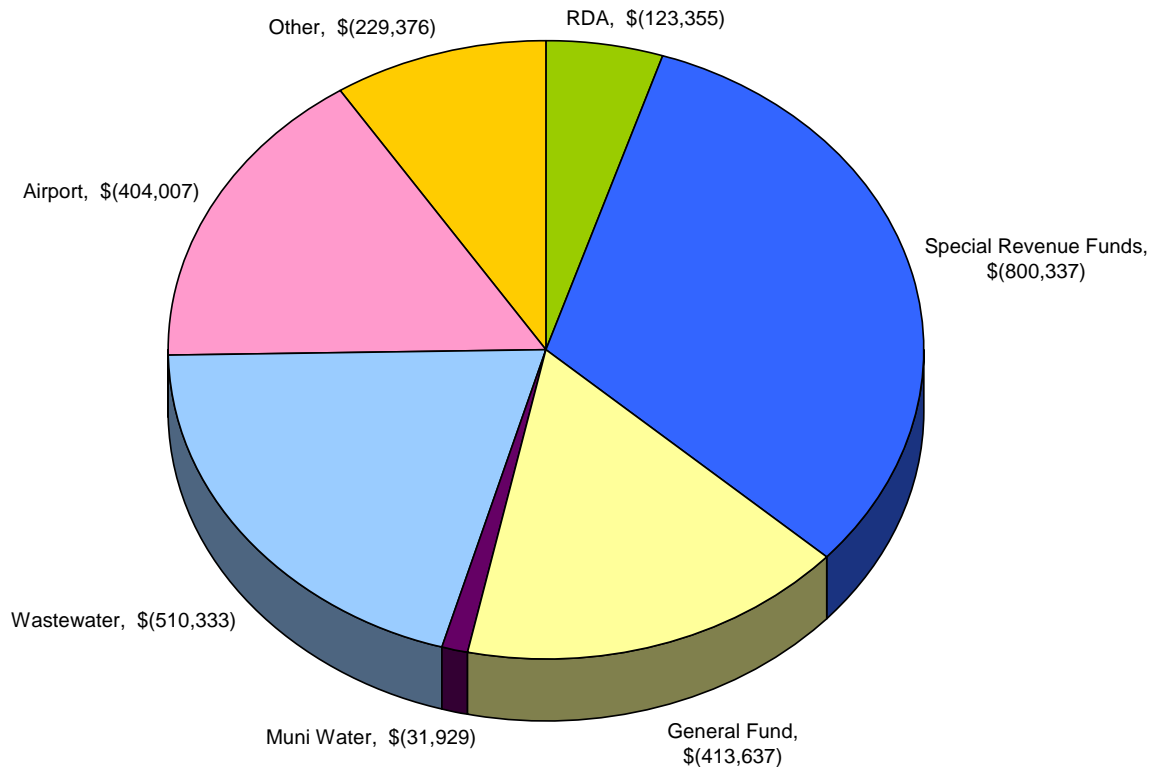
The economic effect of this allocation methodology (which in substance results in lost interest to certain funds) may not fully comply with requirements of the Municipal Code, the Government Code, and Proposition 218, which place restrictions on the use of certain funds, including funds derived from water and sewer connections and property-related charges. One example of this type of restriction is embodied in Government Code Section 66013, which imposes requirements on sewer and water connection fees and charges. It states, “Any interest income earned from the investment of moneys in the capital facilities fund shall be deposited in that fund.” Since restricted funds did not receive all of their entitled interest, it appears that the City may be out of compliance with the laws and regulations that cover such funds.

There may also be additional restrictions on other enterprise funds, such as Federal Aviation Administration (FAA) requirements for Airport funds. For example, the Airport and Airways Improvement Act of 1982, as amended and codified in Title 49, United States Code, Chapter 471, restricts all airport sponsors receiving Federal assistance to use airport revenues for capital or operating costs of the airport only. Any other use of airport revenue is considered revenue diversion. In situations of revenue diversion, the FAA may seek recovery of the lost revenue, with interest. To the extent that other sources of revenue have similar restrictions, the City may be liable for interest lost to these programs as well.

We should note that our office recommended changing the interest allocation procedure for the City’s Cash Pool as far back as 1988 when our office issued an audit report entitled, “An Audit Of The City’s Special Assessment District Formation And Financing Process.” Specifically, we found that eliminating negative cash balances in Special Assessment District funds would increase other City fund interest earnings. Furthermore, we found that the Finance Department needed to improve its accounting and administrative procedures for Special Assessment District funds because their negative cash balances reduced the interest earnings distributed to the other funds in the City’s Cash Pool.

The following exhibit shows how the \$2.5 million in lost interest is broken down by major fund types. The breakdown is based on the City’s Cash Pool compositions provided in the Finance Department’s Investment Reports from 2005-06 and 2006-07.

Exhibit 7 Breakdown Of \$2.5 Million Lost Interest In The City’s Cash Pool⁶



As shown in the above exhibit, the City’s General Fund lost approximately \$413,637 (16 percent) of the \$2.5 million interest allocation because it made up approximately 16 percent of the City’s Cash Pool. The remainder of the lost interest impacted all other fund types, including the Wastewater, Muni

⁶ As of April 2007, the City’s Cash Pool portfolio was valued at over \$1.1 billion and consisted of the following fund types: Unrestricted General Fund, Special Revenue Funds, Redevelopment, Parking, Capital Projects, Muni Water, Airport, Wastewater, Debt Service, and Other.

Water, Redevelopment Agency, Airport, and Special Revenue Funds. The Special Revenue Funds include the Anti-Tobacco Master Settlement Agreement Revenue Fund, the Integrated Waste Management Fund, the Low and Moderate Income Housing Fund, the Storm Sewer Operating Fund, and the Transient Occupancy Tax Fund. A number of these Special Revenue Funds, in addition to the Wastewater Funds and Muni Water funds, may be subject to the State limitations we noted above, as well as to the Municipal Code limitations.

The Finance Department has been aware of the negative fund balances' impact on interest earnings in the City's Cash Pool but has not considered the impact problematic. When the City began expending large amounts of cash in the City's Cash Pool on General Obligation bond projects, according to the Budget Director, the Budget Office brought their concerns about the interest losses to the Finance Department's attention but, to date, no action has been taken to address this concern. The Finance Director has stated that the Finance Department's current interest allocation method has been a longstanding practice; however, we noted that the Finance Department's procedures for allocating interest include outdated information. Additionally, the Debt Administrator was aware that the reimbursement process for bond projects does cause the City to lose interest earnings in the City's Cash Pool, but he did not believe the City was negatively impacted by this method because the bond proceeds earn interest in the trustee accounts, thereby offsetting losses to the City's Cash Pool.

However, our audit found that this reasoning does not take into account that all funds in the City's Cash Pool are negatively impacted. We should note that the Finance Department's explanation also ignores the potential repercussions of violating Federal and California State Law caused by inadvertently diverting interest earnings owed to restricted sources of revenue. Further, unlike the interest earned in the City's Cash Pool, interest earned in the bond funds can only be credited to the capital projects and the Finance Department does not track this interest. Lastly, interest earned in the City's Cash Pool is not limited to a particular rate; however, interest earned by bond proceeds is limited by the arbitrage rate⁷.

⁷ State and local bond proceeds are subject to Federal arbitrage restrictions. Because bonds are tax-exempt, issuers are able to borrow at a low rate and invest at higher rates in the taxable market. Arbitrage rules attempt to discourage issuers from borrowing more than necessary to avoid taking advantage of "arbitrage" investment opportunities.

Other investment pools have adopted procedures to mitigate the impact on negative funds in their pools. Two examples are the Short Term Investment Pool (STIP) for the University of California Berkeley and the San Diego County Treasurer's Pooled Money Fund. The University of California Berkeley's policy is as follows:

To offset the loss of income produced by STIP-earning funds with cash balance deficits, units will now be assessed a charge. These negative STIP charges will be transferred to departments concurrently with any positive STIP income received through the positive balances of other funds. The negative STIP charge highlights the necessity of avoiding overdrafts in STIP-generating funds.

The San Diego County Treasurer's Pooled Money Fund Investment Policy states similar procedures:

In the event there is a negative balance in a participant's fund at any time, it shall reduce the average daily balance for the fund. If at quarter-end there is a negative average daily balance in a participant's fund, that fund will be charged the higher of the apportionment rate for the quarter or the overnight Repo rate the Pool invests in [...] the treasurer shall be able to find that all proposed deposits/withdrawals will not adversely affect the interest of the other depositors in the County Treasury Pool.

Given the high dollar value of current tax-exempt debt balances and planned future bond issuances, it is imperative for the Finance Department to improve internal controls over the tax-exempt bond program. Otherwise, as the City continues to issue additional debt, the deficit balance related to the bond projects may continue to grow. As of April 2007, the City had over \$500 million in outstanding debt proceeds held within trustee accounts. In June 2007, the Finance Department reported issuing an additional \$90 million in General Obligation bonds and in August 2007, issued another \$725 million in tax-exempt bonds for the Airport. Based on the interest lost in the last two fiscal years noted above, by improving controls on negative balances the City's Cash Pool could save over \$1 million per year in interest earnings. Additionally, according to our public finance specialist, the

City's Cash Pool may actually be eligible to recover some portion of the lost interest because under IRS regulations, bond proceeds are considered "spent" on the day the eligible expenses are incurred and therefore, those funds are no longer considered to be bond proceeds and any interest earned on those funds in trustee accounts would be unrestricted from a Federal tax perspective.

In our opinion, the Finance Department needs to significantly improve controls over its administration and processing of the tax-exempt bond funds.

We recommend that the Finance Department:

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. The Finance Department could hold tax-exempt bond proceeds within the City's Cash Pool, or have the trustee directly pay expenses. (Priority 1)

Recommendation #2

Work with the City Attorney's Office to obtain the services of an independent consultant to evaluate and report on methods to address any potential past compliance issues with Federal and State law arising from the negative cash balances and lost interest in restricted funds. (Priority 1)

Recommendation #3

Develop and implement procedures to prevent potential interest diversion of restricted funds held in the City's Cash Pool. (Priority 1)

The Finance Department Needs To Improve Controls To Ensure Bond Proceeds Are Spent And Accounted For In Compliance With Applicable IRS Regulations

The Finance Department's Debt Management Group must ensure that accounting and allocation of debt proceeds comply with a number of laws and regulations, including Federal Internal Revenue Service regulations for tax-exempt bonds and State law. For example, IRS Treasury Regulations Sections 1.148 and 1.150 provide bond issuers with rules for allocating and spending tax-exempt bond proceeds. We found that the Finance Department lacks the appropriate controls to ensure that bond disbursements are done in a timely manner. Furthermore, the Finance Department does not have formal controls in place to ensure consistent understanding of the laws and regulations that determine eligibility of bond expenditures.

The Finance Department's Lack Of Appropriate Controls Resulted In Accounting And Allocation Delays

The manner in which the City spends and allocates its \$500 million in bond proceeds is important for the program's compliance, efficiency, and effectiveness. The City must track, spend, and allocate its tax-exempt bond proceeds in accordance with IRS Treasury Regulations and bond covenants. This helps to ensure the City's bonds maintain their tax-exempt status and that appropriate disclosures are made to public investors. The Debt Management Group reviews and approves the bond-financed project expenditures before allocating the bond proceeds held in the trustee accounts. However, we found that the Finance Department lacked internal controls to ensure that all bond proceeds are allocated in a timely and efficient manner. This lack of controls was shown in both the timelag between Project Managers submitting capital project expenses to the Debt Management Group, and in the Debt Management Group delaying the submittal of disbursement requests to the trustees holding the bond proceeds. Overall, the Debt Management Group did not have an appropriate mechanism to track the time lapses between the dates the bonds were issued and the dates the funds were accounted for, which is an important measure to ensure the City remains in compliance with the IRS time limitations.

IRS Treasury Regulation Section 1.148-6(d)(1)(iii) requires the City to "account for the allocation of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project, if any, that is financed by the issue is placed in service. This allocation must be made in any event by the date 60 days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier." The Finance Department does not have an appropriate mechanism to ensure compliance

with this requirement. In addition, we noted that the bond covenants incorporated time limitations that are consistent with the IRS regulations, however, these time limitations are not set forth in any of the Debt Management Group's operational controls.

We reviewed seventeen expenditure requests the Debt Management Group processed during specific timeframes in 2005 and 2006.⁸ These 17 requests consisted of over \$19 million of the total \$134 million (14%) processed during the time periods we examined. Our review of each of these requests revealed significant time lapses. In our review, we found that Project Managers waited in some cases, over 18 months to submit project expenditures to the Debt Management Group. We noted that the Debt Management Group had no procedure or other controls such as written timeframes or checklists to provide Project Managers incentives to submit the disbursement requests in a timely manner and to ensure the City maintains compliance with the regulatory time limitations.

In addition, we found instances in which the Debt Management Group significantly delayed the submittal of disbursement requests Project Managers had submitted. For example, during our audit fieldwork in February 2007, we found that the Finance Department had not approved the allocation of \$1.8 million in bond funds for the City Hall Civic Center that had initially been paid out of the City's General Fund and had been outstanding for years. Specifically, between 1998 and 2003, the Civic Center Project spent about \$1.8 million from the City's General Fund to pay for expenditures. On February 2, 2004, in order to reimburse the General Fund with the bond proceeds for the project, Public Works staff submitted documentation to the Finance Department's Debt Management Group for about \$1.7 million of these expenditures. On February 17, 2004 (15 days later), an analyst in the Debt Management Group signed off that "all of the supporting documentation [is] present [and] all of the reimbursement request amounts agree." However, the Debt Administrator did not approve the request and therefore did not allocate the bond proceeds to be used because, according to him, the Debt Management Group needed to include additional documentation to support the use of bond proceeds. Rather

⁸ We noted that the Debt Management Program's turnover began in March 2006. Therefore, we included disbursement requests processed prior to the turnover and after the addition of new staff to ensure adequate coverage in our sample.

than requesting use of the bond proceeds for the documented expenditures, the Debt Management Group decided to wait until it had supporting documentation for each expenditure.

Over the last three years the Debt Management Group held up submitting the \$1.8 million request due to seven missing and easily accessible documents consisting of copies of City contracts and purchase orders. According to the Debt Administrator, the Debt Management Group was busy during the ensuing three years and was not able to secure the missing seven documents. The Finance Department Deputy Director stated that staff turnover had been an issue, but we noted that the Debt Management Group had not experienced staff turnover issues until nearly two years after the Public Works Department had submitted the request. We also found that the Finance Department had not processed the request even after the 2005-2006 Capital Budget directed the Administration to reimburse the General Fund for prior year expenditures associated with the Civic Center Project. In September 2005, the Finance Department transferred \$1.5 million from the Civic Center Project Fund 425, but this was simply an accounting entry and not an actual transfer of funds to the City's General Fund from the trustee that holds the bond proceeds. The General Fund's cash balance remained unchanged, continuing to have \$1.8 million outstanding.

Because the Finance Department failed to process the request in a timely manner, we estimated that the City's General Fund lost approximately \$88,000 in unrestricted interest earnings since Public Works submitted its disbursement request file to the Debt Management Group on February 2, 2004. Further, we should note that since 1998, the General Fund lost an estimated \$501,000 (including the \$88,000 noted above) in unrestricted interest earnings related to the \$1.8 million in expenditures.⁹ According to the City Attorney's Office and bond counsel, bond proceeds cannot be used to pay interest to the General Fund or any fund within the City. According to our public finance specialist, the General Fund may actually be eligible to recover the lost interest because under IRS regulations, the bond proceeds could be considered "spent" on the day the eligible expenses were incurred and therefore, these funds were

⁹ This foregone interest is in addition to the interest lost from the negative balances we found in the City's Cash Pool and noted earlier in this audit report.

no longer considered to be bond proceeds. Therefore, the General Fund could potentially recover lost interest from outstanding reimbursements.

Nonetheless, in our opinion, the three-year delay in processing the bond proceed disbursement to the City's General Fund demonstrated an ineffective process. Generally Accepted Government Auditing Standards (GAGAS) required us to issue an Interim Audit Report to alert officials of matters needing immediate attention in order to take corrective action. On March 1, 2007, we issued a preliminary draft Interim Audit Report that detailed the above concerns. Because of our efforts to bring this issue to light, the Finance Department finally initiated the transfer of funds from an outside trustee to the General Fund on March 8, 2007. At that time, the City Auditor decided to incorporate the draft Interim Audit Report findings into this final audit report because the Finance Department had taken corrective actions after we brought the item to its attention. In addition, we noted that the Finance Department as of yet had not accumulated all of the supporting documentation the staff initially told us they needed to fully approve and allocate the bond expenditures for this request.

Finally, we understand there may be other bond projects with long outstanding bond allocations that may pose compliance issues with regulatory timeframes. For example, during our audit fieldwork, the Hayes Mansion/Edenvale Garden Park project showed a negative fund balance of nearly \$1.9 million that had yet to receive bond proceeds from the trustee, and some of these expenditures appeared to date back to fiscal year 2002-03. Some of the delay appears to be caused by confusion in allowing capital redistribution charges from Public Works staff. In January 2003, the Project Manager sent an email to the Debt Management Group stating, "My question is what to do? It appears that DPW [Department of Public Works] is awaiting for some kind of official statement in writing from Finance and/or the City Attorney's Office as to whether cap redistribution is allowed or not on bond projects. As [another Project Manager] indicates below, he seems to have heard inconsistency with regard to some projects allowing cap redistribution and others not allowing it. I think this issue is way beyond my ability to deal with... Can any of you help me on this?" Fourteen months later, in March 2004, it appears this issue was not yet resolved when the Project Manager submitted a request to the Debt Management Group to reimburse the City Cash Pool with the bond funds held in the trustee account. In

this request, the Project Manager stated, “As far as I know- all those payments I requested were bumped back (by Finance) because of cap. distribution charges.¹⁰ This was never resolved, so I didn’t process any other payment/reim. requests.” The charges the Project Manager gathered pertained primarily to the park portion of the project, such as landscaping, and amounted to nearly \$1 million.

The Project Manager’s documentation to the Debt Management Group contained supporting documentation and emails the Project Manager had gathered. The Debt Administrator gathered additional information and has been using the negative fund balance shown in the City’s Financial Management System to identify additional project costs. Similarly to the above-noted Civic Center disbursement, rather than process the portion of the disbursement request that had documentation, the Debt Management Group decided to wait and held up the entire request.

After the issuance of our draft audit report on August 9, 2007, the Debt Management Group revisited this outstanding disbursement request and plans to reimburse the City’s Cash Pool with the bond proceeds currently held in the trustee account.¹¹ To the extent that the Hayes Mansion/Edenvale Garden expenditures may no longer be reimbursable due to regulatory time limitations, the City may no longer be able to use the tax-exempt bond proceeds for this project. Therefore, these bond proceeds may no longer be eligible for use on the Hayes Mansion/Edenvale Garden Park project and the Finance Department may have to go through the increased administrative burden to allocate the unused bond proceeds to other qualifying projects or expenses. Furthermore, holding the bond proceeds for extended periods of time may increase the City’s susceptibility to possible arbitrage rebate payments to the IRS.

The Finance Department developed an Excel worksheet to track the length of time between receipt of a department’s request for bond funds and the Debt Management Group’s processing of the request. However, this mechanism only tracks the time to process the request after the departments send them to the

¹⁰ Capital Redistribution Charges are a type of overhead charge for City staff time.

¹¹ On October 12, 2007, the Finance Department submitted a disbursement request for \$952,989.81 to the Trustee to reimburse a portion of the \$1.9 million outstanding for the Hayes Mansion project. However, we note that this may not comply with the IRS time limitation noted in this report.

Finance Department, and does not incorporate the regulatory time limitations, nor does it track time lag starting from when the City Cash Pool incurs the expenses. Furthermore, we found that this worksheet was incomplete and unreliable. When we examined the tracking of the two unprocessed requests for the Civic Center Project and Hayes Mansion Project we found that the Debt Management Group did not include these items in the worksheet's calculation for the processing time. We also noted that the worksheet had missing fields indicating this control tracking mechanism is weak.

In our opinion, these two examples of long outstanding bond allocations, coupled with the lack of controls to prevent these situations, indicate increased vulnerability in this area. Accordingly, we recommend that the Finance Department implement an After-Issuance Compliance Checklist for each bond issuance to track the important documents and timeframes needed for compliance. The GFOA and National Association of Bond Lawyers recommend incorporating a post issuance compliance checklist which includes controls to ensure compliance with pertinent regulatory requirements, including the IRS time limitation we noted above (See Appendix A). We also recommend that the Finance Department implement a Form of Bond Proceeds Allocation Certificate into its process to ensure all requirements contained in the bond covenants and other pertinent regulations are completed and documented (See Appendix B).

We recommend that the Finance Department:

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. (Priority 1)

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. (Priority 2)

*The Finance
Department Lacks
Written Procedures
To Guide Project
Managers In
Identifying Eligible
Bond Expenses*

According to the City's CADR, the Finance Department's Debt Management Group is responsible for qualifying the bond-financed project expenditures and, when there is ambiguity, the City Attorney's Office assists in determining the eligibility of expenditures. It is important that the Finance Department's Debt Management Group effectively identify all expenditures eligible for the use of bond expenditures, without unnecessarily burdening the City's General Fund. However, we found that the Finance Department did not have formal controls in place and cannot sufficiently ensure all of the expenses associated with bond projects are appropriately charged to the project, and not to the City's General Fund or City Cash Pool.

Between 2001-2003, the City Attorney's Office circulated two memos and various emails to department Project Managers to use as a guide in determining appropriate expenses for projects involving General Obligation bonds. These memos and emails are the only documented guidance we could identify for the City's tax-exempt bond program. The Finance Department and City Attorney's Office did not have any other written procedures related to appropriate expenses for other types of tax-exempt bond financings, such as lease revenue and commercial paper issuances. Furthermore, the Finance Department does not have written procedures or manuals for the overall process to provide internal controls within their department in processing the project expenses, or to provide internal controls within other City departments responsible for processing bond-related project expenses. It also does not have consistent training programs to train City department personnel involved in the bond-funded capital projects. Project Managers have told us that, for the most part, they learn the process through informal meetings, emails, and interdepartmental sharing of information. As a result, we noted inconsistencies and misunderstandings during the course of our fieldwork. For example, as mentioned previously, our review of the documentation revealed that the Finance Department lacked formal controls in communicating eligible bond expenditures to Project Managers. One Project Manager stated, "We have yet to receive anything in writing from Finance and/or the Attorney's Office saying that Capital Redistribution is not allowed to be charged to Bond Funds. Everytime I attend a meeting, I hear a different response. Sometimes it's allowed, sometimes it's not."

We also noted that several City departments are involved in processing bond-related expenses including the Library, Police and Fire, Public Works, and Parks, Recreation, and Neighborhood Services departments. Without formally documented procedures and training to ensure consistency among the various departments, we found that each project manager had designed their own system and process for tracking and submitting bond-related expenses.

For example, one Project Manager tracked expenses for a capital project that were charged in the City's Cash Pool, but were determined to be "ineligible" for bond funds. Other project managers did not track these ineligible expenses, but had designated a fund to absorb the costs. The Finance Department's Debt Management Group also indicated that they do not track expenditures determined by the City to be ineligible expenses. According to Federal tax law de minimis rules, in certain cases, a portion of bond funds can be used on ineligible or "non-qualifying" expenses at the end of each project. However, if the Finance Department does not track these expenses, and project managers do not have sufficient training or procedures on these rules, then the City may be losing opportunities to fund these charges with tax-exempt bond proceeds, rather than tapping into the City's General Fund or City Cash Pool. The lack of procedures can also have the opposite effect of permitting inappropriate expenditures; however, because the City has not adequately defined allowable expenses, we were unable to evaluate the appropriateness of specific expenditures.

We recommend that the Finance Department:

Recommendation #6

Work with the City Attorney's Office to develop written policies and procedures for Project Managers and other City staff to determine eligible and ineligible expenditures for each type of bond financing. (Priority 1)

The Finance Department Needs To Ensure Voter-Approved Bond Requirements For Audits Of Certain General Obligation Bonds Are Fulfilled

The City’s Debt Management Policy states that, “The Finance Department shall be responsible for managing and coordinating all activities related to the issuance and administration of debt.” As such, it is important for the Finance Department to ensure the City’s compliance with any voter-approved requirements associated with the issuance of General Obligation bonds. 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, however, the Finance Department has not ensured compliance with these bond requirements and instead relied on the City’s general Comprehensive Annual Financial Report (CAFR) statements as a substitute for an actual audit of the bond funds. This reliance on the City’s CAFR as an audit of the bond funds is inconsistent with other projects that have complied with similar voter-approved requirements. Because voter-approved measure language results in contractual obligations, not fulfilling these obligations is problematic.

Measure O’s language is as follows:

To improve San Jose’s neighborhood libraries and expand literacy and learning opportunities for children, families and seniors by: expanding and improving aging branch libraries to reduce noise, add parking, and add space for more books and computers; and building new libraries in neighborhoods throughout the City, shall the City issue \$211,790,000 in bonds, at the best rates possible, with guaranteed annual audits, a citizen’s oversight committee, and no money for library administrators’ salaries? (emphasis added)

Measure P’s language is as follows:

To improve San Jose’s neighborhood parks’ safety and expand recreation opportunities for children, families and seniors, by: installing lighting, reconstructing deteriorating playgrounds and restrooms; preserving open space; constructing trails; constructing new recreational sports facilities; improving Community and Senior Centers; and constructing improvements to regional parks, like Happy Hollow shall the City issue \$228,030,000 in bonds, at the best rates possible, with

guaranteed annual audits, a citizen's oversight committee, and no money for parks administrators' salaries? (emphasis added)

We noticed that the City appears to be in non-compliance with the measures' obligations for "guaranteed annual audit(s)" as the City does not issue annual audits outside of the City's general CAFR for these bond funds. The audit contract with the City's independent auditor does not have any specific requirements to audit these bond programs and only includes these funds to the extent that all City funds are included in the CAFR's financial sections. The independent auditor may issue separate audits of funds at the City's discretion. To date, the City has not required a separate audit of the bond funds from Measures O and P.

We noted that another voter-approved obligation with similar language issue agreed-upon-procedures statements and/or independent audits to meet their guaranteed annual audit requirements. For example, Proposition BB, approved in 1997, authorized the Los Angeles Unified School District (LAUSD) to spend \$2.4 billion:

To improve health and safety conditions in 800 neighborhood schools and improve classroom instruction, by replacing deteriorating roofing, heating, plumbing, electrical systems; providing earthquake reinforcements, asbestos removal, increased campus security; reducing class size, upgrading science labs, wiring for computer technology and air conditioning; with guaranteed annual audits and no money for administrators' salaries, shall the Los Angeles Unified School District issue \$2.4 billion in bonds, at the legal interest rate for repairs/construction? (emphasis added)

The guaranteed annual audit language in the above proposition is identical to the language used in the City's Measures O and P. To satisfy its requirement for guaranteed annual audits, LAUSD issues independent financial audits and agreed-upon procedures reports each year that focus exclusively on Proposition BB and other school bond measures. We should note that to comply with their ballot language, LAUSD began issuing independent audits of Proposition BB in 1999. These

audits began prior to the enactment of Proposition 39, a statewide proposition requiring all school bond projects to issue annual financial and performance audits of bond projects.

LAUSD’s annual audits of the bond funds include a statement of expenditures for each school bond measure, a procedure to review charges to verify that no bond funds were spent on “administrator salaries”, and a test of sample invoices to verify compliance with procedures.

As previously noted, our City does not issue independent audits each year focusing exclusively on Measures O and P nor does it issue independent agreed-upon procedures reports for these measures. The only consideration of the bond funds provided in the City’s audited financial statements is the same reporting standard provided to all City funds – there is no special consideration of the bond funds included in Measures O and P. In our opinion, this level of detail does not satisfy the City’s obligation to issue guaranteed annual audits for these measures and therefore, puts the City at risk of non-compliance with its obligation to treat these measures as contracts.

We recommend that the Finance Department:

Recommendation #7

Work together with the City Attorney’s Office to ensure that all voter-approved bond language is fully complied with, including issuing annual audits for Measures O and P. (Priority 1)

CONCLUSION

As a result of the processes we identified, over 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. Due to this deficit, we estimate the City’s Cash Pool lost approximately \$2.5 million in interest over the last two years alone. The Finance Department was aware of the negative fund balances and has not considered the impact problematic. By not addressing the impact of the negative fund balances, the Finance Department has not taken into account the repercussions of lost interest to the enterprise funds and potential violations of State and other regulations that govern restricted funds. Furthermore, unlike the interest

earned in the City's Cash Pool, interest earned on bond proceeds can only be credited to qualifying capital projects and the Finance Department does not track this interest.

The administrative deficiencies we noted may create additional liability for the City in that the City may not be fully complying with Federal IRS Treasury Regulations, State Constitution and Government Code regulations, and City Charter and Municipal Code restrictions.

RECOMMENDATIONS

We recommend that the Finance Department:

- 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. The Finance Department could hold tax-exempt bond proceeds within the City's Cash Pool, or have the trustee directly pay expenses. (Priority 1)**
- Recommendation #2** **Work with the City Attorney's Office to obtain the services of an independent consultant to evaluate and report on methods to address any potential past compliance issues with Federal and State law arising from the negative cash balances and lost interest in restricted funds. (Priority 1)**
- Recommendation #3** **Develop and implement procedures to prevent potential interest diversion of restricted funds held in the City Cash Pool. (Priority 1)**
- 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. (Priority 1)**
- 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. (Priority 2)**

We recommend that the Finance Department:

- Recommendation #6** **Work with the City Attorney’s Office to develop written policies and procedures for Project Managers and other City staff to determine eligible and ineligible expenditures for each type of bond financing. (Priority 1)**
- Recommendation #7** **Work with the City Attorney’s Office to ensure that all voter-approved bond language is fully complied with, including issuing annual audits for Measures O and P. (Priority 1)**

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Finding II

The City Relied On Restricted Sewer Connection Fee Funds To Bridge Unrelated Funding Gaps Without Sufficient Controls, Potentially Resulting In Non-Compliance With The City’s Municipal Code And Possibly California Government Code

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 principles of sound treasury management and in accordance with the applicable laws or ordinances.” The City’s Municipal Code authorizes the City to assess two separate connection fee charges (referred hereafter as Sewer Connection Fee funds) for properties to connect to the Sanitary Sewer System. The Municipal Code also 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. These two sources of regulations state that connection fee funds and charges cannot be used for any other purposes, thereby restricting their use. It is important for the Finance Department and City Attorney’s Office to appropriately evaluate these regulations in contemplating the use of restricted sources of funding to provide financing for capital bond projects and other budget gaps.

According to our public finance specialist, 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 Government Code related to restrictions on Sewer Connection Fees. We 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 Fee funds 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 the restricted funds.

Specifically, our audit found that:

- On at least eleven separate occasions, the City borrowed a total of nearly \$40 million from restricted 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;
- The Departments inconsistently implemented interfund loan terms; and
- 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 HNMF Fund that the City has chosen to address with yearly short-term interfund loans.

The number and nature of these transactions raises concerns that the Departments may be condoning the use of these restricted sources of funds as a financing method without properly documenting or administering the terms of such loans. We also noted that the loans were not easily traceable because they were not centrally tracked, were not consistently listed in Budget Office documents, and did not have consistently documentation.

In our opinion, using restricted Sewer Connection Fee funds to bridge financing gaps without appropriate controls is a questionable practice and we believe the Finance Department and City Attorney’s Office need to develop better controls for appropriately securing capital funding and for ensuring that restricted sources of funding are used in compliance with all applicable laws and regulations. We also recommend that the City Administration improve its tracking and documentation to ensure the loan terms are consistent, appropriate, and implemented.

The City’s Current Process For Obtaining Interfund Loans From Sewer Connection Fee Funds May Not Comply With The City’s Municipal Code And Other Related Laws And Regulations

Section 603 of the San Jose City Charter specifically provides that “no section of any ordinance or of any code shall be amended unless the whole section to be amended is set forth as amended.” Therefore, it appears that the City may not amend any ordinance or code by passing subsequent contrary ordinances without first expressly modifying the specific ordinance or code. The above-mentioned City Charter requirement is important because of the explicit limitations the City’s Municipal Code places on the use of funds from the City’s Sanitary Sewer System. The City’s Municipal Code provides authority and places restrictions on the City to charge fees for connecting to the City’s Sanitary Sewer System. Title 15, Section 15.16.560 of the City’s Municipal Code states the following for the Sanitary Sewer Connection Fee fund (Fund 540):

“All sanitary sewer connection fees collected pursuant to the provisions of this part shall be placed into a special fund which is hereby created and established for such purpose, and which shall be known as the “sanitary sewer connection fee fund.” Such revenues so placed and deposited in such fund may be used for the construction and reconstruction of the sanitary sewer system of the city of San Jose and for the acquisition of land for such system, and for no other purpose or purposes.” [emphasis added]

Title 15, Section 15.16.790 of the City’s Municipal Code has similar provisions for the Sewage Treatment Plant Connection Fee fund (Fund 539) stating:

“All sewage treatment plant connection fees collected pursuant to the provisions of this part and Part 4 shall be placed into a special fund which is created and established for such purpose, and which shall be known as the “sewage treatment plant connection fee fund.” Such revenues so placed and deposited in such fund may be used only for the acquisition, construction, reconstruction and enlargement of the sewage treatment plant, to repay principal and interest on any bonds which have been issued or which may hereafter be issued for the acquisition, construction, reconstruction and enlargement of the sewage treatment plant, and to repay federal or state loans or advances which have or may hereafter be made to the

*city for the acquisition, construction, reconstruction and enlargement of the sewage treatment plant.”
[emphasis added]*

These restrictions are in compliance with Government Code Section 66013 which regulates local agencies in their assessment of water and sewer connection fees and charges. Section 66013 states:

A local agency receiving payment of a charge as specified in paragraph (3) of subdivision (b) shall deposit it in a separate capital facilities fund with other charges received, and account for the charges in a manner to avoid any commingling with other moneys of the local agency, except for investments, and shall expend those charges solely for the purposes for which the charges were collected. Any interest income earned from the investment of moneys in the capital facilities fund shall be deposited in that fund.

We should also note that according to Government Code Section 66013, cities cannot charge more for connection fees than is needed to cover the cost of providing the services, without the popular approval of a two-thirds vote on the issue. Although the City plans to use revenues collected in the connection fee funds in the near term for permitted capital projects, the fact that the City has willingly lent nearly \$40 million to unrelated projects over the past seventeen years may create the perception that Sewer Connection Fee revenue was excessive. We also noted that the Environmental Services Department currently plans to hire a consultant to study the connection fee structures and rates to determine whether the fees should be increased and/or restructured.

Three of these loans are long-term and date back as early as 1990. If these long-term loans are actually a type of debt financing, the City also appears to be non-compliant with its own Debt Management Policy, which outlines the purposes for which debt may be issued and the processes that must be followed when issuing debt. These processes require the Finance Department to analyze the City’s debt capacity with each new debt issuance and to utilize the services of independent financial advisors and bond counsel. In our opinion, the Finance Department should have sufficient internal controls to ensure compliance with the City’s Debt Management Policy.

Finally, this practice may create liability issues for the City's compliance with California State Constitution Section XIII C and D, (also known as Proposition 218), which places restrictions on cities charging fees for property-related services, such as water and sewer. Although connection fee revenue may be exempt from Proposition 218 restrictions, we noted that one of the interfund loans was repaid with revenue from the Water Utility Capital Fund (Fund 500). This fund receives most of its revenue from the Water Utility Fund 515 (Fund 515), which receives its funds from water sales. During the course of our audit work, the City of San Jose was named as a defendant in a claim regarding transfers the City made from the Water Utility Fund (Fund 515) to its General Fund. Based on this recent claim and our audit findings, we are concerned that the City's practice of using restricted funds as loans to unrelated capital projects may make the City vulnerable to further litigation.

We should note that in September, the City Attorney's Office provided our office with five memorandums in which the City Attorney's Office advised City Administration officials on how to structure interfund loans originating from restricted Sewer Connection Fee revenues. The City Attorney's Office has labeled 4 of the 5 memos they provided on interfund loans as confidential attorney/client information.¹² One of the memos they provided is a public document that advised the City Administration to include controls to structure the loan as a "true" loan, use a reasonable rate of return, identify a specific source of repayment, and include a provision to require the borrowing fund to repay the lending fund on demand. This advice is generally consistent with the memos labeled as attorney/client privileged. However, we found that the Departments coordinated and recommended to the City Council, a practice of borrowing money from restricted revenues in the Sewer Connection Fee funds (Fund 539 and Fund 540), to finance capital projects and budget gaps, without consistently including these controls. As a result, the City may

¹² The memos labeled as attorney/client privilege were directed to officials within the City Administration. As the client recipient of these memos, we sought and received permission from the City Administration to use and refer to the information contained in these documents. However, the City Attorney's Office subsequently informed us that the City Administration did not have authority to release the attorney/client privilege. GAGAS Sections 8.35 thru Section 8.37 on *Reporting Privileged and Confidential Information* requires government auditors to state the nature of the information omitted and the requirement that makes the omission necessary. Given that the City Attorney's Office has asserted the City Administration cannot waive the attorney/client privilege on memos directed to the City Administration, we are only stating the nature of the omitted information so that we can remain in compliance with GAGAS.

have improperly used restricted revenue for projects that are unrelated to the purpose for which the fees and charges were created.

We should also note the City Attorney's Office advice contained in the memorandums is generally consistent with the advice we received from our public finance specialist. According to our public finance specialist, interfund loans of the 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. (See Appendix C for the complete analysis).

On At Least Eleven Separate Occasions, The City Borrowed A Total Of Nearly \$40 Million From Restricted 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

The exhibit below outlines the loans issued from the two Sewer Connection Fee funds (Fund 539 and Fund 540) to unrelated programs and capital projects. Specifically, the Finance Department, Budget Office, and City Attorney's Office coordinated and recommended the use of restricted Sewer Connection Fee funds to provide bridge financing for renovating the old City Hall, constructing the new Civic Center, constructing libraries, and for bridge financing of the City's Healthy Neighborhood Venture Fund programs. The Sewer Connection Fee funds were also used to provide long-term financing for the construction of the City's Fiber-Optic Network, the City's Storm Sewer Extension Program, and North Coyote Valley's Municipal Water System. These long-term loans have been outstanding since 1990, 1996, and 2000, respectively. In addition, the City's 2007-08 Proposed Operating Budget shows a \$3 million loan from Fund 540 to the Healthy Neighborhood Venture Fund program. The number and nature of these transactions raises concerns that the departments may be condoning the use of these restricted sources of funds as a financing method without properly documenting or administering the terms of such loans.

Exhibit 8 Summary Of Loans And Line Of Credit From Sewer Connection Fee Funds To Unrelated Projects

Receiving Fund	Lending Fund	Amt. of Loan	Description	Issue Date	Repaid Date/Amt. Outstanding	Actual Interest
1	446	539 \$	9,640,000 Long Term Loan to Finance Storm Sewer Extension Program	10/19/1990	\$458,451	\$ -
2	007	539 \$	5,152,000 Long Term Loan to Finance Fiber Optic Conduit Network	6/30/1996	\$2,253,918	\$ -
3	500	539 \$	5,100,000 Long Term Loan to Finance Coyote Valley Water Project	11/14/2000	\$4,227,764	\$ 1,227,764
4	485	539 \$	2,400,000 Bridge Financing for Old City Hall Renovation*	5/7/2003	3/19/2004	\$ -
5	426	550** \$	2,500,000 Bridge Financing for Healthy Neighborhoods Venture Fund	3/16/2005	5/16/2005	\$ 4,169
6	426	539 \$	1,000,000 Bridge Financing for Healthy Neighborhoods Venture Fund	3/24/2006	4/20/2006	\$ 2,211
7	426	539 \$	1,500,000 Bridge Financing for Healthy Neighborhoods Venture Fund	2/2/2007	4/17/2007	\$ 9,434
8	001	540 \$	2,000,000 Bridge Financing for Civic Center Project	11/30/1998	6/30/2000	\$ 163,126
9	425	540 \$	2,200,000 Bridge Financing for Civic Center Project	6/28/2001	6/27/2003	\$ 149,799
10	433	540 \$	1,500,000 Bridge Financing for Civic Center Project	6/28/2001	6/27/2003	\$ 102,136
11	472	540 \$	6,450,000 Bridge Financing for Library Bond Project	6/30/2004	7/14/2004	\$ 5,026
		Subtotal	\$ 39,442,000			
	425	539 \$	12,500,000 Bridge Financing for Civic Center Project (Line of Credit)	10/1/2002	2/11/2003	Not Drawn Upon
		Grand Total	\$ 51,942,000		Grand Total	\$ 1,663,666

*After issuance of our August 9, 2007 draft audit, the Budget Office included a \$65,000 interest payment on this loan in the City's Annual Report. City Council approved this transfer on October 16, 2007.

**Fund 550 is a memorandum fund to Fund 539.

The City's Finance Department and Budget Office do not centrally track these loans and, as a result, we could not ensure we identified all internal loans. We gathered the above information from Budget Office documentation, the Finance Department's Comprehensive Annual Financial Report (CAFR,) the City's Financial Management System, the City's Mid-Year Reports, the City's Proposed and Adopted Operating Budgets, and the City's Annual Reports.

The Departments Inconsistently Implemented Interfund Loan Terms

As discussed in Appendix C of this report, proper documentation and implementation of the loan terms are important factors to ensure the appropriateness of interfund loans and to demonstrate a prudent investor standard. However, we found inconsistent documentation and implementation of the loan terms. For example, although a memo documented the first loan from Fund 539 to Fund 426 for the HNVP programs, the departments could not provide any loan documents for the second and third loans from Fund 539 to Fund 426. They also could not provide loan documents for the Storm Sewer Extension Program that has been outstanding since 1990.

Furthermore, as shown in Exhibit 8 above, interest payments varied from loan to loan. For example, the loan document for the Fiber Optic Network Fund 007 (Loan #2), required Fund 007 to pay interest to Fund 539 at the City's Cash Pool rate. However, Fund 539 did not receive interest payments for the Old City Hall Renovation loan (Loan #4) and the Fiber Optic

Network Loan (Loan #2) even though the Fiber Optic Network loan (Loan #2) has been outstanding since 1996 and the Old City Hall Renovation (Loan #4) was repaid in 2004.¹³ The Storm Sewer Extension Program loan (Loan #1) has been outstanding since 1990 and no interest has been accrued. To the extent any connection fee funds lost interest revenue as a result of the loans, the City may be liable to reimburse the funds for any loss. This is especially a concern for the loans that did not pay interest and remain outstanding.

We also noted that the repayment source for two of these loans (Loans #2 and #3) was questionable due to the lack of a sufficient revenue stream for the projects. In 1996, prior to the enactment of Government Code Section 66013, a memorandum from the City Attorney's Office recommended formalizing a loan in the amount of \$5,152,000 from the Sewage Treatment Plant Connection Fee Fund to the Fiber Optics fund.

According to the memorandum, the term of the loan shall not exceed fifteen years and also states, "In the event that a shortfall arises in the Sewage Treatment Plant Connection Fee Fund, the loan shall become immediately due and payable." We noted that, of the loans identified in Exhibit 8, only the Fiber Optic Network loan (Loan #2) had a provision to repay the lending fund on demand. This provision appears to try to mitigate the risk inherent in loaning money without a guaranteed revenue stream. Even with this provision, this loan remains outstanding due to the lack of revenue stream.

The Coyote Valley Water Project also has a long outstanding loan (Loan #3) dating back to 2000, due to that project's lack of a revenue stream. According to budget documents, this loan was obtained to develop the water utility system "to serve projected demands in North Coyote Valley." At the time of the loan, the source of repayment was not known and the loan document only noted that "the repayment of the loan is dependent on the future development of this area. The uncertainty of the development in the area has prevented ... showing the specifics of a loan repayment schedule." The City's 2002-06 CIP mentions the loan and states, "City funding for water facilities in the primarily industrial North Coyote Valley Service Area will be provided in accordance with the Master Development Agreement. A loan from the Sewage

¹³ As noted in Exhibit 8, the City recently paid interest on the Old City Hall Renovation loan (Loan #4).

Treatment Plant Connection Fee Fund of \$5.1 million will provide funding for the North Coyote Valley Water System project.”

Beginning in 2004-05, the Water Utility Capital Fund (Fund 500) began to repay the Sewage Treatment Plant Connection Fee Fund (Fund 539) for a portion of the original \$5.1 million loan. The City’s budget documents planned annual payments of \$700,000 until 2013 to repay the loan amount and interest. However, Fund 500 receives revenue from water service connection fees (subject to Government Code Section 66013) and water rate fees (subject to Proposition 218). Therefore, water service connection fees and water rate revenue are likely to have been used to repay a portion of the Coyote Valley Water project loan, which may not be compliant with Government Code 66013 and Proposition 218. Proposition 218 may restrict the use of property-related fees, such as water rate revenue, for future development and states, “No fee or charge may be imposed for a service, unless that service is actually used by, or immediately available to, the owner of the property in question. Fees or charges based on potential or future use of a service are not permitted.” We should also note that the City’s 2007-08 Adopted Capital Budget states that in 2007-08, the City increased water rates approximately 7.3 percent (7.3%) “to pass through increased wholesale water and other ancillary costs to residents... which will assist in maintaining the Water Utility System Capital Program” in Fund 500, the same source of revenue used to repay the Coyote Valley Water Project (Loan #3).

In our opinion, the City Manager’s Office, which has oversight of the Finance Department and Budget Office, should collaborate with the City Attorney’s Office to evaluate and report on methods to remedy any potential past compliance issues associated with these loans. Furthermore, the City Manager’s Office needs to develop adequate controls to prevent the deficiencies noted herein from occurring and to ensure future financings of capital projects are in compliance with the City’s Charter, the City’s Municipal Code, and any relevant laws and regulations that are applicable.

As such, our consultant recommends, and we agree, that the City should adopt a formal policy and procedure for making interfund loans. Specifically, the policy should direct that no interfund loan will be made unless (1) the Finance Director makes a specific finding that the interfund loan meets the

prudent investor standard, (2) the Finance Director makes a specific finding that the interfund loan is consistent with the purposes of the fund from which the loan is made, and (3) the interfund loan is formally documented in a manner consistent with a standard form approved by the City Attorney.

In determining whether an interfund loan meets the prudent investor standard, the Finance Director should make the following findings: (1) the security for repayment for the interfund loan provides for reasonable certainty regarding repayment, and is not speculative, (2) there is a reasonable expectation that all payments of principal and interest will be repaid when due, (3) the interest rate established for the interfund loan is a market rate for a loan with comparable security and repayment terms, and (4) the City Attorney has provided assurances that the interfund loan is enforceable.

In determining whether the interfund loan is consistent with the purposes of the fund from which the loan is made, the Finance Director should determine a schedule of the reasonably expected expenditures from the fund. The Finance Director should specifically determine that the repayment terms of the interfund loan will be consistent with such reasonably expected expenditures needs.

Finally, these procedures should include a control that requires the repayment of any outstanding loans prior to the implementation of any connection fee increases.

We recommend that the City Manager's Office:

Recommendation #8

Work with the City Attorney's Office to evaluate and report on methods to remedy any potential past compliance issues associated with the loans from restricted funds. (Priority 1)

Recommendation #9

Develop and implement a formal written policy on interfund loans, including the establishment of a prudent investor standard, and written procedures on how to manage and enforce such a policy. (Priority 1)

**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 Fund That
The City Has
Chosen To Address
With Annual Short-
Term Interfund
Loans**

In 2003-04, the City faced its largest projected General Fund deficit to-date, and had to develop a strategy to balance the City’s budget. We found that in the face of this deficit, the City made a one-time transfer of \$10 million from the Anti-Tobacco Master Settlement Agreement Revenue Fund (also known as the Healthy Neighborhood Venture Fund (HNVF) to the City’s General Fund. As a result of this transfer, the HNVF Fund became depleted and each year thereafter, had to rely on annual short-term loans from the Sewer Connection Fee funds to meet programmatic funding demands. To date, these actual and proposed loans total \$8 million.

In general, the City allocates each year’s tobacco settlement revenue, plus prior carryovers, for programmatic uses. After the \$10 million transfer to the General Fund in 2003-04, the HNVF ending fund balance decreased from its previous year’s balance of \$17.1 million to \$5.2 million in 2003-04. It appears that as a result of the transfer to alleviate the budget deficit, the HNVF Committee decided to use the HNVF Fund’s Interest Earnings Reserve, stating, “The Interest Earnings Reserve must be made available for additional funds in order to help alleviate the City’s current budget challenges and at the same time continue to support community based organizations in providing needed services for our community.” By using the Interest Earnings Reserve, the City could continue its anticipated funding levels for 2003-04. However, by the following year, in 2004-05, the City decreased its HNVF programmatic budget on anti-tobacco activities, senior services, and education and health activities by nearly \$3 million. The Budget Office asserts that some of this decrease may have been attributed to their anticipation that tobacco settlement revenue would decline in 2004-05. The HNVF Fund’s adopted budget amounts reflect the amount of money allocated for programmatic uses in each year. The following exhibit shows the adopted budget amounts for the tobacco settlement revenue and amounts allocated for programmatic uses.

Exhibit 9 Reduction In Programmatic Funding After Transferring \$10 Million From The HNVF Fund To The City’s General Fund (As Shown In Adopted Budget Numbers)

	FY 2001-2002	FY 2002-2003	FY 2003-2004	FY 2004-2005	FY 2005-2006	FY 2006-2007	FY2007-2008
Projected Tobacco Settlement Revenue	\$ 10,725,000	\$ 10,725,000	\$ 10,725,000	\$ 9,984,293	\$ 9,052,791	\$ 9,334,000	\$ 9,645,508
Funds Allocated For Programmatic Use	\$ 11,378,293	\$ 11,737,202	\$ 12,632,906	\$ 9,653,486	\$ 8,777,789	\$ 8,541,365	\$ 8,591,944

\$10 million transfer to the General Fund (points to FY 2003-2004)
First year that short term loans were needed (points to FY 2004-2005)
\$3 million decrease in programmatic funding from previous fiscal year (points to FY 2004-2005)

The City’s Anti-Tobacco programs began in 2000 when the City received its first funding through a tobacco settlement, which anticipated a total of \$250 million in City funding over 25 years. Using community involvement, the City Council approved an allocation plan, timeline, criteria, and funding priorities for the tobacco settlement funds, referred to as the Healthy Neighborhood Venture Fund Program. The City Council stipulated that any allocation of HNVF Program funds should be decided through a competitive process. Specifically, the City Council directed that approximately 25 percent of the funds be allocated for existing or new Tobacco-Free Community/Health programs, approximately 50 percent for Education/Health programs, and the remaining approximately 25 percent for Senior Services/Health programs. The City Council incorporated these requirements in the City’s Municipal Code, Section 4.80.1830, as follows:

Moneys in the anti-tobacco master settlement agreement revenue fund may be expended only for the following purposes:

- A. *Anti-tobacco programs. Twenty-five percent of the settlement proceeds collected in any fiscal year shall be expended for existing or new anti-tobacco programs, including but not limited to licensing of tobacco sales, law enforcement, code enforcement, anti-tobacco public education or marketing, anti-smoking and smoking cessation programming, and healthcare programs.*

- B. Education. Fifty percent of the settlement proceeds collected in any fiscal year shall be expended for new education programs or expansion of existing education programs, including, but not limited to, art and music education, homework centers, mentoring, school safety, gang prevention/intervention centers, and healthcare programs.*
- C. Seniors. Twenty-five percent of the settlement proceeds collected in any fiscal year shall be expended for healthcare programs or new senior programs or the expansion of existing senior programs, which may include an element of anti-tobacco programming, and for senior discount programs for city provided services.*
- 1. City funded senior programs may include, but are not limited to: nutrition programs, senior adult day care, elder abuse protective services programs and senior housing programs.*
 - 2. City senior discount programs may include discounts for sewer, garbage, transit, recreation, and other services or programs either provided by the city or sponsored by the city for its residents.*
 - 3. For the purposes of this section, the term discount shall mean the reduction of a fee or charge in any amount, up to and including a 100% reduction. [emphasis added]*

In March 2003, the City Manager's 2003-04 Budget Request identified a \$72.6 million shortfall and noted that "...the General Fund shortfall for 2003-04 projected in this document is the largest in the City's history." The Mayor's March 2003 Budget message states:

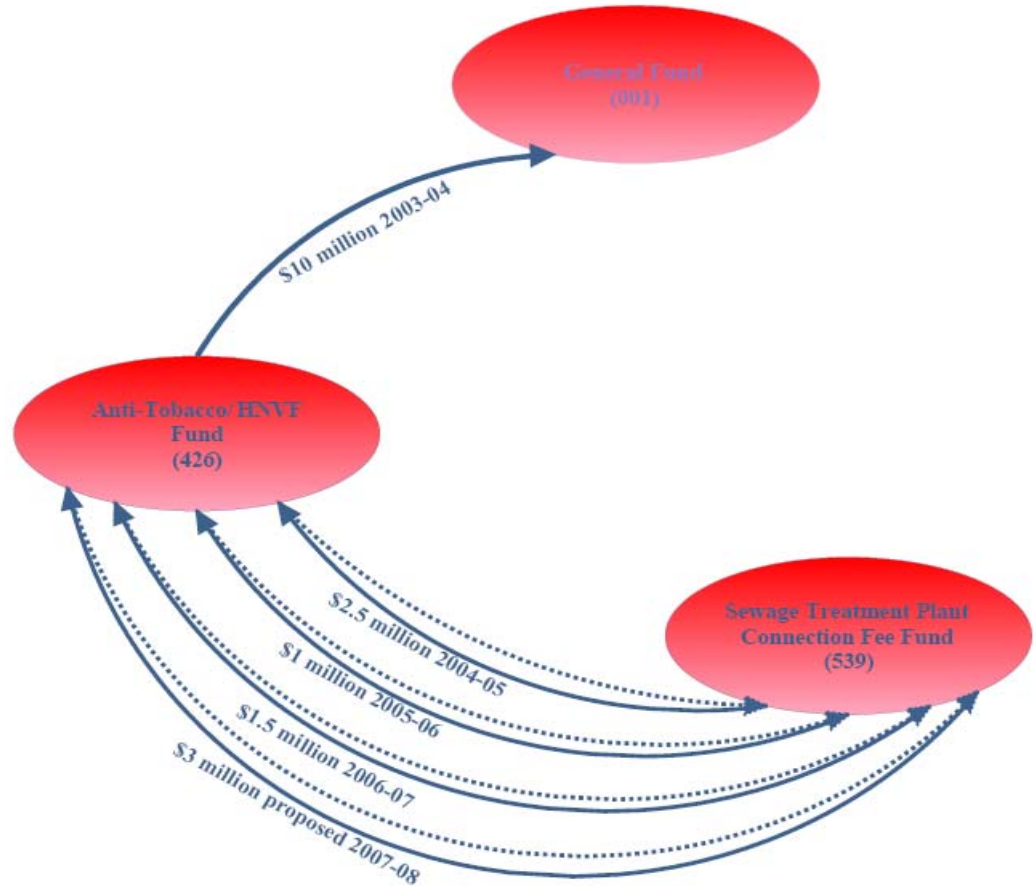
Move the majority of the funds in the Healthy Neighborhood Venture Fund ending fund balance and, to the extent possible, a majority of the uncommitted future HNMF funds into the General Fund to support the City's current education, health, anti-tobacco, and senior activities. However, we must preserve funding for multi-year commitments/contracts such as the Children's Health Initiative.

According to the City's 2003-04 Adopted Operating Budget:

As recommended in the Mayor's March Budget Message, the City Council approved the transfer of \$10.0 million to the General Fund to assist the City in minimizing the impact of the economic downturn on City services.

However, contrary to the City's Municipal Code requirements to expend HNVF Fund monies only for the specific purposes noted above, and the Mayor's Budget message's direction to transfer *to the extent possible* the majority of the uncommitted future HNVF funds, the City subsequently transferred \$10 million from the HNVF Fund to the City's General Fund. This transfer was made to balance the General Fund deficit and did not document that the transfer would be made to expend the funds on permitted uses as specified in the City's Municipal Code. Furthermore, the transfer was made without analyzing the effect of transferring \$10 million from a fund that previously had a \$17 million ending fund balance. As a result of this transfer, it appears that the HNVF Fund has no longer been able to meet its yearly funding commitments and has begun an annual process of taking out short-term loans from the City's Sewage Treatment Plant Connection Fee Fund in order to meet its funding commitments. The City has continued to loan money from the Sewage Treatment Plant Connection Fee Funds to HNVF for each of the last three years, totaling \$5 million, and plans to lend another \$3 million during this fiscal year, for a grand total of \$8 million in short-term loans.

Exhibit 10 Process Illustrating The \$10 Million HNVF Transfer To The General Fund To Balance The General Fund Deficit And The Resulting Need For Annual Short-Term Loans From The Sewage Treatment Plant Connection Fee Fund



Prior to transferring the \$10 million from the HNVF Fund to the City’s General Fund, in our opinion, the City Manager’s Office should have performed an analysis to determine the impact on the HNVF program. In May 2004, the Parks, Recreation and Neighborhood Services Department conducted a cash flow analysis of the HNVF Fund and found that they did not have sufficient cash on hand to continue funding the community programs. However, they did not perform this analysis until one year after the transfer, when the HNVF Fund had already realized the impact.

Also, we believe the City Attorney’s Office should have implemented controls to ensure this transfer complies with the Municipal Code provisions for the use of the HNVF revenue.

According to the City Attorney’s Office, “Because ordinances are inherently revocable, the legislative body always retains the power to amend or repeal its own ordinances by adopting other, contrary ordinances at a later date, even if such later ordinances do not mention the earlier ones.” However, Section 603 of the City Charter specifically provides that “no section of any ordinance or of any code shall be amended unless the whole section to be amended is set forth as amended.” Therefore, since the City’s Municipal Code, Section 4.80.1830 was not specifically set forth to be amended, it appears that the transfer of funds may have been performed without proper authorization.

In our opinion, the City Manager’s Office needs to improve controls to ensure short-term loans from restricted funds are not being used for on-going structural budget problems. We also recommend that future transfers be evaluated for compliance with the City’s Municipal Code.

We recommend that the City Manager’s Office:

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. (Priority 1)

Recommendation #11

Improve controls to ensure future transfers are in compliance with the City’s Municipal Code. (Priority 2)

CONCLUSION

In our opinion, using restricted Sewer Connection Fee funds to bridge financing gaps is a questionable practice and we believe the Finance Department and City Attorney’s Office need to develop better controls for appropriately securing capital funding and for ensuring that restricted sources of funding are used in compliance with all applicable laws and regulations. We also recommend that the City Administration improve its tracking and documentation to ensure the loan terms are consistent, appropriate, and implemented.

RECOMMENDATIONS

We recommend that the City Manager's Office:

- Recommendation #8** Work with the City Attorney's Office to evaluate and report on methods to remedy any potential past compliance issues associated with the loans from restricted funds. (Priority 1)
- Recommendation #9** Develop and implement a formal written policy on interfund loans, including the establishment of a prudent investor standard, and written procedures on how to manage and enforce such a policy. (Priority 1)
- 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. (Priority 1)
- Recommendation #11** Improve controls to ensure future transfers are in compliance with the City's Municipal Code. (Priority 2)

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DEC 11 2007

CITY AUDITOR

Memorandum

TO: Steven Hendrickson
Interim City Auditor

FROM: Scott P. Johnson

**SUBJECT: RESPONSE TO THE AUDIT OF THE
MANAGEMENT OF THE CITY'S
TAX EXEMPT BOND PROGRAM AND
USE OF INTERFUND LOANS TO
PROVIDE FINANCING FOR CAPITAL
PROJECTS**

DATE: December 10, 2007

Approved

Date

12/10/07

The Administration has reviewed the “*Audit of the Management of the City’s Tax-Exempt Bond Program and Use of Interfund Loans to Provide Financing for Capital Projects*” (the Audit) and is in general agreement with several of the recommendations identified in the report. However, the Administration has a different professional opinion on some of the recommendations. In addition, the Administration disagrees with the characterization of a number of the issues discussed under each of the Audit’s two findings.

In order to provide additional context and the Administration’s position on these issues, this memorandum includes a Background section which provides a context in which the City has operated during the “Decade of Investment”. During this period of significant expansion of the City’s capital program, the general economy has been challenged with in initial recession and, of recent years, a slow recovery. Therefore, it is important that we also recognize the general conditions of limited, declining resources to administer the capital program and related bond administration. At the same time, under these challenging times, the City generated jobs as an economic development strategy and delivered significant community facilities that were highly desirable by the residents of San Jose.

Following the Background section is an Analysis section which provides comments on the Administration’s response, as well as specific discussions on the findings, and responses to the recommendations.

BACKGROUND

In analyzing the performance of the City’s tax-exempt bond program, it is important to understand the breadth of the City’s Debt Management program as well as the City’s economic

environment in recent years. As with many other programs within the City, business decisions and tradeoffs are made every day based on changing priorities and available resources. A significant focus of the Audit is on the administration of the City's General Obligation (GO) bond programs for parks, libraries and public safety facilities. The residents of the City of San Jose overwhelmingly supported \$598.82 million in three separate GO Bond initiatives to enhance the quality of life in the City. As of June 30, 2007, the City's GO Bond program has delivered 108 library, park, community center and public safety projects funded with general obligation bonds. These completed projects undertaken during the City's "Decade of Investment" have generated thousands of jobs while providing economic opportunity for local businesses, through a period of significant economic challenges at the local and national level. Even under these difficult economic challenges, the City has successfully delivered these projects to the community resulting in significant enhancements to San Jose's educational, recreational, cultural, and public safety facilities. Funding for these projects was provided by the voter approved general obligation bonds totaling over \$547 million issued to date.

In addition to the general obligation bond programs noted above, there are other major debt issuance and debt administration activities that have contributed significantly to the City's "Decade of Investment." Since June 2001, when the first series of general obligation bonds were issued, the Finance Department's, Debt Management staff has managed the issuance of 74 series of bonds totaling over \$3.6 billion for community projects that include Airport enhancements and renovations, the recycled water system, special assessment and community facilities districts, affordable housing projects, and City facilities including City Hall and employee parking garage, and the Central Service Yard.

During the same time period since June 2001, the Finance Department's Debt Management staff has also been administering a steadily growing debt portfolio. As of June 2001, the City's debt portfolio consisted of 81 series of bonds totaling almost \$2.5 billion. By September 2007, the City's debt portfolio had grown to 117 series of bonds totaling over \$5.3 billion, more than doubling the size of the portfolio of outstanding bonds in which the Debt Management staff must monitor, manage and report on a regular basis. During this period, the Finance Debt Management staff processed 876 disbursement requests totaling over \$912 million, reviewed and processed monthly and semi-annual debt service invoices for all of the City's bond series, reviewed and processed approximately 700 vendor invoices, actively reinvested bond proceeds for over 50 project and reserve funds, and met federal Security and Exchange Commission (SEC), Internal Revenue Service (IRS) and other contractual and compliance reporting requirements. This work is being accomplished by a five-person work group, which has experienced reduced staffing levels due to vacancies and staff reassignments during the last two fiscal years. For almost all of this two-year period, the Debt Management work group has consisted of no more than three staff.

During this period of increased capital investment activity, the City has weathered one of the worst economic downturns in recent history. Shortly after voter approval of Measures O & P in November 2000, the San Jose area experienced a major downturn in economic activity that

resulted in significant budget cuts. Over a six-year period, General Fund budget deficits totaling over \$300 million were solved through a variety of budget balancing strategies that included the elimination of 460 positions, which resulted in City-wide service reductions including negative impacts to the City's administrative support functions.

Despite these staffing challenges and the City's generally unfavorable economic environment, the City successfully delivered the capital facilities described above and, at the same time, under these difficult economic conditions maintained its outstanding credit ratings (Aa1/AA+/AA+), the highest of any large city in California, obtained a rating upgrade for the San Jose-Santa Clara Clean Water Financing Authority, and received commendations from rating agencies for the City's strong financial management. The City's strong ratings will save taxpayers an estimated \$7.1 million in property taxes over the life of the GO bonds that have been issued to date. The City was also recognized with the Bond Buyer "Deal of the Year Award" in 2005 for its innovative Series 2005 Housing Set-Aside Tax Allocation Bonds which provided financing or re-financing for 1,821 affordable units. This national recognition of staff's innovation and creativity by working with the State to provide additional capacity for the City and Redevelopment Agency's affordable housing funding which is now a statewide model that can be replicated by other issuers to enhance their bonding capacity for affordable housing projects.

Throughout the Decade of Investment, San Jose's financial statements and budgets have continued to receive the highest honors from the Government Finance Officers Association (GFOA). Additionally, the City's senior Finance and debt management staff have been recognized as leading professionals in municipal debt, regularly serving as panelists for professional seminars and training sessions for their peers, publishing articles in professional publications, and serving in leadership roles in professional organizations such as the GFOA and the California Society of Municipal Finance Officers (CSMFO).

ANALYSIS

The following section provides comments on each of the findings to clarify the Administration's position as well as responses to each of the recommendations.

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

Comments on Finding

City expenditures, including capital project expenditures, are generally paid from the City's Cash Pool. Capital projects that are funded through the issuance of the City issuing debt are reimbursed by the City's trustee, who holds and invests the bond proceeds on the City's behalf.

Pool and interest will be earned in the trustee-held bond funds rather than in the City's Cash Pool.

There are two City practices that need to be understood to evaluate Audit Finding 1 and the resulting recommendations. The first practice relates to the City's bond proceeds disbursement process and the second practice relates to the City's interest rate allocation methodology. These practices are the product of business decisions that the City has made over time to best manage both the City's Investment Portfolio and the Debt Management Program. These two practices are addressed below.

Bond Proceeds Disbursement Process

The City Council's Adopted Debt Management Policy has the purpose of guiding the City in pursuing several equally important objectives, one of which is to ensure compliance with applicable State and Federal laws. Oversight and ensuring compliance with various Federal and State regulations with respect to the use of bond proceeds is a very important part of the compliance objective in the policy.

The City's current bond proceeds disbursement process balances multiple objectives. These objectives include:

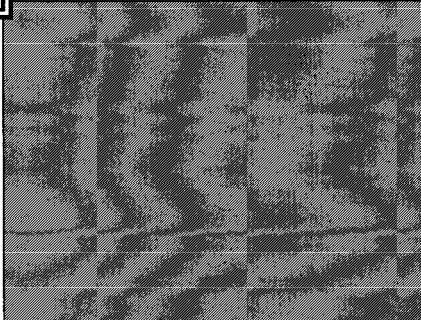
- Ensure bond proceeds are allocated only to eligible expenditures in accordance with relevant laws and ballot language (if voter-approved).
- Create records of the City's investment and expenditure of bond proceeds that satisfy IRS requirements for documentation and record retention.
- Establish and maintain a clear accounting vehicle to support annual arbitrage rebate calculations¹.
- Invest bond proceeds in compliance with bond documents and the City's Investment Policy while minimizing negative arbitrage.
- Minimize impact on other City funds.
- Minimize City staffing requirements.
- Pay contractors, consultants, and vendors accurately and on time.

Table I below provides a matrix of three alternative methods of investing and disbursing bond proceeds (trustee holds bond proceeds/City disburses bond proceeds (City's current practice); trustee holds and disburses bond proceeds; or City holds and disburses bond proceeds). Along

¹ Arbitrage – with respect to municipal bonds, "arbitrage" is the profit made from investing the proceeds of tax-exempt bonds in higher yielding securities. IRS requirements on tax-exempt bonds generally require a payment to the US Treasury for arbitrage or profit made by an issuer on the proceeds of a tax-exempt bond issue. Any amounts due must be paid every five years to the US Treasury. Best practices recommend calculating any payment due annually, with funds set-aside for future payments.

with each alternative, a summary is provided on how the objectives of the bond disbursement process are achieved. As the matrix illustrates, the City’s current process, where the trustee holds the bond proceeds and the City is subsequently reimbursed after the expenditures have been made, best meets the City’s objectives.

**TABLE I
BOND FUND DISBURSEMENT METHODOLOGY MATRIX**

	City Disburses Bond Proceeds	Trustee Disburses Bond Proceeds
Trustee Holds Bond Proceeds Executes Investment Trades	Review before funds disbursed Strong control Few disbursements Simple cash flow record Initial payments out of City pool City pool earnings reduced Standard City AP process Trustee executes trades Minimal staffing impact	Review after funds disbursed Weak control Many disbursements Complex cash flow record Outside standard trustee scope Payments made from bond funds Minimal impact to City pool Exception to City AP process Increased staffing requirement
City Holds Bond Proceeds Executes Investment Trades	Review after funds disbursed Weak control Many disbursements Complex cash flow record Payments made from bond funds Minimal impact to City pool City staff execute trades Increased staffing requirement	

Over the past several years the City Council has approved debt financing for a series of capital projects ranging from park improvements to public safety projects. The scope and size of these improvements, along with the capital projects in the Five Year Capital Improvement Program has resulted in what has been characterized as the City’s “Decade of Investment”. The City Council has tasked the Administration to deliver these projects in a timely manner. The Administration has followed this direction and is proud of the number and type of projects that have been put into public service for the San Jose community. This level of activity, however, has presented unique challenges to the City from an administrative standpoint.

The City pays for capital project costs as they are incurred. The costs are initially funded through the City’s cash pool through the accounts payable process. After which, as expeditiously as possible, the capital project manager prepares and submits requests for

reimbursements from trustee-held bond funds to the Finance Department. These requests are reviewed by the Debt Management staff to ensure compliance with the bond documents and then submitted to the bond fund trustees for reimbursement. Inherent in this process is a lag period that gives rise to a negative capital project fund balance in the fund's relative balance in the City's Cash Pool. There are several reasons for the lag period and the Administration recognizes the need to mitigate such delays.

As the Audit notes, bond funds (for capital projects) must be "...appropriately allocated, invested and disbursed..." To ensure compliance with these strict requirements, the City maintains a rigorous reimbursement process. That is, all expenditures are carefully reviewed for appropriateness, amount, authorization, etc. Once this process is complete, then a reimbursement request can be submitted to the trustee for reimbursement. This process, however, takes time and in some cases the lag time is greater than desired. Additional resources committed to the reimbursement process would certainly reduce the lag time but, in the City's budget environment, additional resources have not been a reality (this would require more staff throughout the organization not just in Finance).

Interest Rate Allocation Methodology

The second issue raised by the Audit is the impact of reimbursement lag times on the City's Cash Pool. As noted earlier, the number and complexity of debt funded capital projects can cause a lag period from the time costs are incurred and reimbursement is received from the bond trustees. This lag period can cause capital project funds to incur a negative cash balance in the City's Cash Pool. The Audit indicates that the City's treatment of negative balances causes the Cash Pool to lose interest income thereby negatively impacting all other funds that participate in the City's Cash Pool. In effect, the City does not charge interest to those funds that carry negative fund balances.

The City of San Jose has a long standing practice of not charging interest on negative balances in the City's Cash Pool. This practice is contained in the City's Accounting Policies Manual and dates from 1986 as amended in 1992. The procedures followed are consistent with the policy. The practice was founded on practicality and the policy has served the City well for many years. For the majority of time this practice has been in place, the impact of negative balances has not been significant.

As indicated in Exhibit 4 of the Audit, the negative balances have increased in recent years as a result of expenditure of funds related to projects in the GO capital programs. In order to ensure that all bond expenditures are appropriate, the bond proceeds are held and invested by a trustee rather than the Cash Pool and reimbursements are made after the expenditures have been verified. This practice has helped ensure the integrity of the bond program, but has resulted in larger negative cash balances in the City's Cash Pool. As noted in the Administration's response to Recommendation #1 below, the Finance Department has been working with bond program project departments to improve the reimbursement process by minimizing the lag period to mitigate negative cash balances in the City's Cash Pool.

The Audit asserts that because certain funds were allowed to accumulate negative balances, the City's investment pool could have earned more interest, and by excluding negative balances in the interest allocation process, interest allocations were diminished to other funds; therefore concluding that the City may be in non-compliance with State and Federal laws. As a practical matter, the amount of interest earned by the pool depends on a variety of factors, including available investment instruments and maturities, projected cash demands and other portfolio holdings. Accordingly, estimating a theoretical rate of return, as the Audit proposes, and then applying that as a test of compliance is not appropriate.

When funds are placed in the Investment Pool, both benefits and obligations are incurred. The benefits include guaranteed liquidity, access to professional management, access to financial markets and other benefits; similarly, obligations to the cash pool are incurred which include paying the cost of running the Cash Pool from investment earnings. The Administration, in consultation with the City Attorney's Office, believes that as long as all actual earnings are allocated to participating funds according to policy the Cash Pool is in compliance with Federal and State law.

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. The Finance Department could hold tax-exempt bond proceeds within the City's Cash Pool, or have the trustee directly pay expenses.

The Administration agrees that improvements to the processes for the administration of the bond program can be made. Finance has been working with bond program project departments to improve the reimbursement process by minimizing the lag period to mitigate negative cash balances in the City's Cash Pool and will evaluate holding bond proceeds within the City's Treasury pooled accounts. These efforts have proven to be successful resulting in reducing the negative balances and streamlining the reimbursement process. For example, as reported in the Finance Department's October 2007 Monthly Investment Report, the City received approximately \$26 million in reimbursements in the first week of September from bond funds held by trustees. Additionally \$17.6 million was reimbursed in November and another \$8.1 million for the month of December (as of December 7, 2007).

The City has used the trustee payment method (New City Hall Project) in the past when it was deemed the best method for the administration of bond proceeds and project management. The City Hall project was a unique situation since all invoices were accounted for and processed through one City staff person, as opposed to the typical capital project in which payment processing occurs through a multitude of city departments and staff.

Recommendation #2: Obtain the services of an independent consultant to evaluate and report on methods to address any potential past compliance issues with Federal and California State Law arising from the negative cash balances and lost interest in restricted funds.

The Administration has consulted with the City Attorney's Office and does not believe there are any compliance issues with federal or state law from past negative cash balances. 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.

Recommendation #3: Develop and implement procedures to prevent potential interest diversion of restricted funds held in the City Cash Pool.

The Administration has reviewed the "Distribution and Recording of Investment Earnings" procedures and conferred with the City Attorney's Office, and does not believe interest diversion has occurred in the past or will occur in the future.

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.

Finance and the City Attorney's Office have provided guidance to the bond project managers and will continue to do so. Finance has continually worked together with the bond project managers since the bond projects began. Finance is currently in the process of working on expanding and improving processing guidelines which will include timeframes for bond project managers processing payments and reimbursements.

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.

Finance Department will work with the City Attorney's Office, bond counsel, and financial advisors to develop appropriate check lists and certifications in our prospective bond issues. We will examine the feasibility and cost of including this work in future bond counsel and financial advisor agreements.

It should be noted that the Post Issuance Compliance Checklist attached as an Appendix to the Audit was released by the National Association of Bond Lawyers (NABL) and the GFOA after the period of the audit. It is intended to be a guide for bond counsel in discussing with issuers compliance matters for bond issuers or as a guide for preparing a written checklist for the issuer.

Additionally, the Deputy Director of Finance, Treasury is a member of the GFOA Debt Committee and is currently serving as Vice-Chair of the committee. She was intimately involved in the development of the checklist with NABL and GFOA members and a party to the

development of the checklist. The overall intent of the checklist was to provide bond counsel a method of communicating to issuers their long-term responsibilities related to the bond issue and to provide issuers with a document which will withstand the inevitable change in staffing during the term of the bonds. The GFOA members who worked on the check list were particularly concerned with the membership who were infrequent issuers and in many cases unsophisticated in their knowledge of debt management responsibilities. The checklist is a tool which provides issuers and bond counsel a way to have a conversation regarding ongoing obligations prior to bond sale and closing. While the checklist is an excellent tool for all issuers of municipal bonds, the primary audience was not the issuer who has a dedicated debt management staff.

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.

Recommendation #7: Ensure that all voter approved bond language is fully complied with, including issuing annual audits for Measures O and P.

The City's annual audit includes an audit of the Measure O and Measure P general obligation bond project funds. The Administration believes that the City's annual audit meets the audit requirements specified in Measures O and P. The Public Safety Bond Measure (Measure O 2002) did not include any audit language, yet is still audited as part of the City's annual audit process. Bond related transactions are included in the scope of the City's annual audit and if the external auditor notes any findings related to bond programs, they are resolved or reported on in the external auditor's Management Report to the City Council. To date there have been no findings reported related to bond expenditures.

The Administration has submitted annual reports on the Library Bonds (Measure O) and the Parks and Recreation Bonds (Measure P) to the respective Bond Oversight Committees each year since the approval of these bond measures. These reports include a discussion of project financing, expenditures, and the status of the various projects. These annual reports also clearly identify the audit requirement and discuss compliance with the requirement through the annual audit of the City's funds performed by an independent accounting firm. Annual Reports on the Bond Funds are then submitted from the Oversight Committees to the City Council for acceptance. The Administration also meets regularly with the Bond Oversight Committees to provide status reports on the projects funded by the Bond Funds.

Since the City Auditor has the responsibility, per the City Charter, to “conduct or cause” the City’s audits, should Council wish to require separate audits for Measure O & P bond funds, these services could be contracted with the City’s current independent external auditor, Macias, Gini & O’Connell (MG&O), as additional audit services under the existing agreement between MG&O and the City. Upon consultation with MG&O, separate audits, depending on transaction volumes, are projected to cost between \$15,000 and \$20,000 annually for each bond fund. In addition, MG&O may require audit work on the prior fiscal years in which there was financial activity, increasing the cost accordingly. The Administration believes that these additional audits would provide little increase in the external auditor’s assurance level. Thus staff does not recommend spending \$30,000 to \$40,000 annually for separate audits of the Measure O & P bond funds. However, this option is available if the Council so directs.

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.

Comments on Finding

There are two areas the Administration would like to address related to Finding 2. These include the appropriateness of interfund loans and the transfer of \$10 million from the Healthy Neighborhoods Venture Fund (HNVF) to the General Fund as a budget balancing action in 2003-2004.

Interfund Loans

The Administration disagrees with the implication in Finding 2 that interfund loans are improper. The City has used interfund loans as a legal and effective financing method to bridge funding gaps, a practice that is used by many governmental entities, including the State of California. By definition, all loans are “bridges” that allow the borrowing fund to meet cash shortfalls due to timing issues. Because the lending fund is being repaid with interest at the rate earned by the City’s investment pool these loans are not improper.

There are several advantages to interfund loans. Generally, interfund loans carry an interest rate equal to the entity’s pooled investment rate. This practice ensures that the lending fund does not suffer an economic penalty for making the loan. Since an entity’s pooled rate is usually less than an “outside borrowing” interest rate, the borrowing fund incurs a savings. Other advantages to interfund loans includes the avoidance of “costs of issuance”, a quicker turnaround time to process the loan, and access to funds in amounts and for terms/periods of time that would not be practical for the issuance of bonds or commercial paper due to their short term nature.

As reported in the Audit, the 11 interfund loans that were approved over the 17-year period between 1990 and 2007 included five short-term loans that were repaid within a year, three loans

that were repaid within one to two years, and three long-term loans. For the three outstanding long-term loans, the Administration has made payments on each of these loans and will continue to recommend budget actions to achieve full repayment with interest, as has been the City's standard practice. Of the eight loans that were repaid, interest was calculated (using the City's pooled investment rate) as a component in the repayment for seven of the loans. There was one short-term loan for the Old City Hall Renovation that was repaid in less than a year without the necessary interest. Once the Administration was made aware of this administrative oversight as part of this Audit, the Administration brought forward the \$65,000 interest payment as part of the 2006-2007 Annual Report.

All of the City's interfund loans were approved by the City Council and were budgeted. Any loans that remained outstanding at the end of a fiscal year were documented in the City's Comprehensive Annual Financial Report (CAFR). These interfund loans account for only a small fraction of the City's total budgets (the 2007-2008 Adopted Budget alone totaled \$3.7 billion) and represent one of several funding mechanisms utilized by the City in its management of over 100 City funds. In the limited instances that they are used, these loans are an effective tool to continue progress on various projects.

While the City has maintained strong financial management on an overall basis, the Administration acknowledges that improvements are necessary in the documentation of interfund loans to ensure consistency in the implementation and presentation of these loans. The response to Audit Recommendation #9 outlines the Administration's plan to address this issue.

The Audit specifically questions the use of the restricted Sanitary Sewer and Sewage Treatment Plant Connection Fee Funds for interfund loans. The Administration agrees with the Audit's general statement that restricted funds should be used for the purpose intended. Further, staff agrees that if funds were removed from one fund to another and expended for an unrelated purpose, then such action would be in violation of municipal and State codes. However, interfund loans (one fund makes a loan to another fund and is repaid with interest), which are the subject of this Finding; specifically avoid the improper expenditure of funds. The loans are not considered an expenditure for an unrelated purpose, if the funds earn the same amount of interest as if these funds had remained in the City's cash pool and are repaid. As such, the Administration believes these loans are legal and appropriate, and disagrees with the Audit's contention that they are in anyway "questionable".

The Audit also discusses the fact that the Connection Fee Funds were used to provide loans of almost \$30 million over the last 11 years and that this may create the perception that connection fee revenue was excessive. Given this potential misperception, it is important to provide additional information on the use of these funds. As discussed in the Audit, the Sanitary Sewer Connection Fee Fund (Fund 540) is used for the construction, reconstruction, and acquisition of land for the City's sewer system and the Sewage Treatment Connection Fee Fund (Fund 539) is used to pay for the acquisition, construction, reconstruction and enlargement of the sewage treatment plant or debt service on bonds or federal/State loans used for the acquisition, construction, reconstruction and enlargement of the sewage treatment plant. Although labeled as

connection fees, these fees are in fact capacity charges, which allow the City to accumulate the revenue over a number of years before making an expenditure for a needed improvement. Given that these funds are used for capital improvements, the Administration believes it is not at all unusual or inappropriate for funds to accumulate to support these large projects. For instance, these funds, along with other funding sources, have supported the \$88 million Water Pollution Control Plant Reliability Improvements project and the \$33 million Edenvale Sanitary Sewer Supplement project in recent years. It should be noted that neither of these connection fees has been increased for approximately 20 years. However, given the significant infrastructure needs, the Administration is in the process of analyzing these fees to determine if adjustments are necessary.

Healthy Neighborhoods Venture Fund (HNVF) Transfer

The Audit also questions the transfer of \$10 million from the Healthy Neighborhoods Venture Fund (HNVF) to the General Fund, which was done as a budget balancing strategy to close the \$81 million General Fund budget deficit in 2003-2004. The Administration firmly believes that the transfer of \$10 million was entirely consistent with City Council direction. As background, the organization was faced with very difficult choices to resolve this large deficit, particularly after addressing a \$46 million General Fund deficit in 2002-2003. The use of \$10 million from the unallocated fund balance in the HNVF was weighed against the many other direct service reductions and potential employee layoffs that would have otherwise been necessary. This would have undoubtedly impacted General Fund programs that would have been eligible for HNVF funding. The transfer of the \$10 million in ending fund balance was compliant with the Mayor's March 2003 Budget message statement to "*move the majority of the funds in the Healthy Neighborhood Venture Fund ending fund balance and, to the extent possible, a majority of the uncommitted future HNVF funds into the General Fund to support the City's current education, health, anti-tobacco, and senior activities*". In the 2003-2004 Proposed Budget, the Administration made it clear that the \$10 million transfer was its interpretation of the City Council direction. This action and its compliance with Council direction were validated by Council adoption of the 2003-2004 Operating Budget.

As is recognized in the report of the City Auditor's Consultant, "there is a reasonable position that the transfer was authorized provided that there is a reasonable basis to establish a relationship between the transfer and the permitted expenditures." If the basis for the \$10 million transfer was that the HNVF Fund was providing to the General Fund moneys sufficient to make expenditures within the listed categories, we believe that there is a reasonable position that the transfer was authorized provided that there is a reasonable basis to establish a relationship between the transfer and the permitted expenditures." Given the magnitude of General Fund expenditures for HNVF funded programs including anti-tobacco, healthcare, education and senior programs, the Administration believes such a reasonable basis clearly exists.

The Administration acknowledges, however, that the City's Municipal Code needs to be updated to be consistent with City Council direction regarding the HNVF. The HNVF is supported by

tobacco settlement funds that were originally unrestricted in nature. The City Council established the use of these funds and has the authority to update this use at any time. The Administration will work with the City Attorney's Office to bring forward this update before the end of the fiscal year, which will also include the direction approved by the City Council in November 2001 that changed the HNVF funding allocation percentages to "guidelines" rather than requirements.

The Administration would also like to clarify that given the projected funding from the tobacco settlement, it is anticipated that sufficient funding will continue to be available to fund HNVF programs. The annual funding received in that Fund fully covers the annual costs incurred by the Fund. The \$10 million transfer of ending fund balance from the HNVF to the General Fund resulted solely in a cash flow problem because the tobacco settlement funds are received once a year in April while HNVF payments are made throughout the year. This necessitated short-term loans to address the cash flow issue. As shown in Exhibit 8 of the Audit, the duration of these short-term loans have ranged from less than one month to 2 ½ months, with annual interest payments of \$2,200 to \$9,400. The loans, which are budgeted each year and displayed in the Adopted Source and Use Statements, have been fully repaid with interest in a timely manner each year, resulting in no financial harm to Sewage Treatment Plant Connection Fee Fund (Fund 539).

The \$10 million transfer to the General Fund did eliminate the majority of one-time funds for the HNVF program. After 2003-2004, the budgeted expenditures in any given year have remained within the revenue stream for that year, which is a sustainable strategy to fund these programs. In the extremely challenging 2002-2003 and 2003-2004 fiscal years, the City Council approved additional HNVF programs by using one-time HNVF funds that included portions of the Unrestricted Ending Fund Balance (2002-2003) and the Interest Reserve (2003-2004). With the depletion of these one-time sources in 2003-2004 through the \$10 million transfer to the General Fund and the use of the Interest Reserve, this approach of funding HNVF projects above the ongoing revenue stream could no longer continue.

Responses to Recommendations

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

As discussed above and in the Audit, the short-term loan for the Old City Hall Renovation was repaid in less than a year without the necessary interest. The Administration brought forward the \$65,000 interest payment as part of the 2006-2007 Annual Report. This payment has been processed by the Finance Department.

For the three outstanding loans, the Administration will ensure that payments are made with the necessary interest component and that all future documentation for these loans is consistent with policies and procedures discussed under Recommendation #9 below. The Administration will recommend specific loan repayment terms for the Coyote Valley Water and Storm Sewer loans

in the FY 2008-09 budgets that are 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.

The Administration agrees with this recommendation and will develop a formal written policy on interfund loans for Council consideration and written administrative procedures on how to manage these loans. The policy will be presented for Council consideration before the end of the current fiscal year. If the Policy is approved, the administrative procedures will be incorporated into the City's Administrative Manual by July 2008. The following components will be addressed in the recommended Council Policy and administrative procedures:

- ***Loan Eligibility Requirements:*** Loans must have an identified repayment source and date; include an interest component that equals the investment earnings the fund would have received had the loan not occurred; and be immediately due and payable if needed by the fund that provided the loan.
- ***Loan Documentation Requirements:*** Loan amount, term, and repayment source will be identified anytime a loan is recommended. Payments made on outstanding loans will continue to be reflected in the Adopted Budget and Annual Report. A summary of all outstanding loans will also continue to be included in the CAFR. The CAFR will also consistently include, the loan term, rate of interest, and the interest amount due in its calculation of the total liability associated with a loan.

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 Administration believes that this recommendation may have been developed to address the HNMF loan transactions. If that is the case, the Administration does not believe that the HNMF has a structural budget problem. As discussed previously, the annual revenue in the HNMF is sufficient to cover the annual costs.

However, the Administration does agree and has complied with the policy direction to match ongoing costs with ongoing revenues. Section A.2 (Operating Budget – Fiscal Integrity) of the City's current Budget Policies addresses this issue:

“The city will maintain the fiscal integrity of its operating, debt service, and capital improvement budget, 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. 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.”

Steven Hendrickson

Subject: Audit Response – Tax-Exempt Bond Program and Use of Interfund Loans

December 10, 2007

Page 15

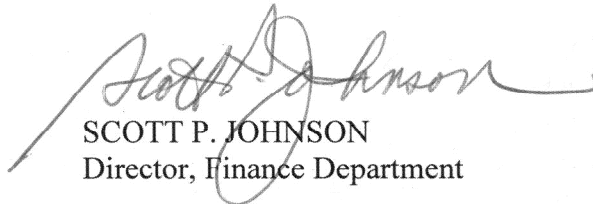
The Administration will implement Recommendation 10 by recommending as part of the 2008-09 budget process that Section A.2 of the City's Budget Policies be broadened to include language that interfund loans should not be used to address ongoing budgetary shortfalls. The Administration believes that the City's Budget Policies are the appropriate vehicle to address budget balancing principles.

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

The Administration agrees with this recommendation and will work with the City Attorney's Office to improve controls to ensure that future transfers and interfund loans are in compliance with the Municipal Code. As part of the Annual Budget process, the Administration will provide documentation on proposed transfers and interfund loans for review by the City Attorney's Office. Any Municipal Code changes will be identified as part of the budget process.

COORDINATION

This report has been prepared by the Finance Department in coordination with the City Manager's Office, City Manager's Budget Office, Environmental Services Department and the City Attorney's Office.


SCOTT P. JOHNSON
Director, Finance Department

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DEC 06 2007

CITY AUDITOR

Memorandum

TO: Steven Hendrickson
Interim City Auditor

FROM: Richard Doyle
City Attorney

SUBJECT: Response of the City Attorney's
Office to the Audit of the
Management of the City's Tax-
Exempt Bond Program and Use
of Interfund Loans to Provide
Financing for Capital Projects

DATE: December 6, 2007

This Office's response to the "Audit of the Management of the City's Tax-Exempt Bond Program and Use of Interfund Loans to Provide Financing For Capital Bond Projects" (the "Audit") includes two components: (1) our response to the allegations made in the Audit regarding this Office; and (2) a discussion of the legal issues raised in the Audit's findings.

The Auditor's Office asserts that this Office impaired the conduct of the Audit. As more fully discussed below, this Office vigorously disagrees. We attempted to resolve the matters discussed in our response through several meetings with the Auditor's Office. We did not reach consensus with the Auditor's Office on the points addressed in our response.

The Audit discusses legal issues concerning special funds, restrictions on the expenditure of tax exempt bonds, ballot language requirements and the processing of interfund loans. In a number of instances, our response differs with the conclusions reached by the Audit.

Our response also includes as Appendix 1 the response of Jones Hall, the bond counsel firm who assisted with the Audit without charge. The Jones Hall response addresses the impairment issue as well as the firm's disagreement with the Audit's legal analysis of IRS regulations discussed in Finding No. 1. The Auditor's Office is aware that Jones Hall has a different viewpoint regarding the IRS regulation discussed in connection with the Edenvale Garden Park reimbursement, although that point is not referenced in the Audit.

Impairment of Audit

The Audit states that beginning in February, 2007, this Office "limited [the Auditor's Office] access to pertinent information and bond officials" and that in early March, the Auditor's Office attempted to remedy this problem by speaking directly with the City Attorney. The Audit also states "[the Auditor's Office] attempted to remedy this problem by speaking directly with the City Attorney in early March regarding access to bond counsel; however, we continued to experience the same issues. Ultimately, in May, the City's bond counsel declined to provide further information to use in the audit. At this point, we concluded that

we could not rely on the limited information provided by bond counsel and the City Attorney's Office...."

Contrary to the Audit, in February, 2007, following a late January meeting with the Auditor's Office, this Office provided general information regarding tax exempt bonds. We also arranged a conference call with Steve Melikian of Jones Hall, a member of the City Attorney's Office and members of the Auditor's Office. The conference call occurred in early March and lasted approximately 60 to 90 minutes. During the conference call, no limits were placed on the questions that could be posed by the Auditor's Office. Following the conference call, the former City Auditor and another former member of the Auditor's Office met with the City Attorney to request direct access to Jones Hall. The City Attorney agreed that the Auditor's Office should directly contact Jones Hall.

Subsequently, the Auditor's Office posed several questions in an email directly to Jones Hall. Jones Hall reviewed the responses with a member of the City Attorney's Office. No substantive changes resulted from this Office's review. Jones Hall then emailed the responses to the City Attorney, which the City Attorney provided to the Auditor's Office and to the Finance Department. Because the Auditor's Office had follow-up questions, the City Attorney's Office arranged a conference call with Steve Melikian and his partner, David Walton. That follow-up call occurred in mid-April and took approximately 90 minutes. A member of the City Attorney's Office and members of the Auditor's Office participated on the call. No restrictions were placed on the questions that could be asked by the Auditor's Office.

Following the April conference call, the Auditor's Office posed additional questions to Jones Hall, which Jones Hall addressed. Then in early May, the Auditor's Office forwarded their notes of the April conference call to Jones Hall to review and approve. On May 10, Steve Melikian responded by email to the Auditor's Office. The full text of his message is set forth below:

We have reviewed the notes of the April 16, 2006 conference call during which David Walton and I addressed various questions that were posed by the Auditor's Office related to tax-exempt bonds, particularly in the area of reimbursements of expenditures incurred both prior to, and following, the issuance of bonds. We have also addressed the written questions from the Auditor's Office on the topics discussed during the course of our call.

As David Walton pointed out during our call, this is a complex area and the IRS regulations do not (and cannot) address every situation. Accordingly, tax attorneys often will need to review various regulations and other legal authority in order to provide advice on a particular question. It is for this reason we cannot "approve" the notes of the meeting. As the notes of the April 16 call are in summary form, we would need to significantly edit and expand upon the notes so that readers of the notes would not draw incorrect conclusions. Further, we believe that we have addressed the areas of concern in our written responses.

We understand that the Auditor's Office will issue a draft report for review and comment before it is finalized. We will work with the City Attorney's office to provide our comments to the draft report.

During March, 2007, the Auditor's Office had issued two preliminary draft audit reports. The matter addressed in the preliminary draft audit reports concerned processing of reimbursement requests. Other issues included in this Audit, such as the matters addressed in Finding No. 2, were not addressed in these preliminary reports.

This Office arranged a meeting with the Auditor's Office staff, Steve Melikian, and the Finance Department to occur on April 26, in order to discuss the second preliminary draft (which had replaced an earlier draft preliminary report). When the Auditor's Office determined to not issue the preliminary report, the Auditor's Office canceled the meeting. The City Attorney's Office requested that the meeting still take place as it had been difficult to arrange a meeting of all the interested parties. We had scheduled the meeting because we believed that it would be useful for all involved in the Audit to understand the legal advice provided by Jones Hall, to understand the issues that the Auditor wished to address in the audit and to address any remaining questions that the Auditor's Office had. The former Auditor declined to participate and the meeting did not occur.

Following Steve Melikian's May 10 email regarding the review of the notes, the Auditor's Office did not inform this Office that they believed they were being impaired. It would have been beneficial if the concerns of the Auditor's Office had been communicated at an earlier point in time as we would have had the opportunity to discuss the issues in dispute. This Office did not learn that the Auditor's Office had concluded that this Office had impaired the conduct of this Audit until the Auditor's Office issued a preliminary draft of this Audit in early August. It was also at this time that we learned that the Audit addressed many more legal issues (including interfund loans), than those that had been posed to Jones Hall and to this Office during the period between February and May, 2007.

In light of the work done both by this Office and Jones Hall with respect to the Auditor's Office questions and our efforts to cooperate with the Auditor's Office, this Office did not in any way impair the conduct of this Audit.

Allocation of Interest

The Auditor's Office asserts that the City's interest allocation methodology may present potential violations of State and Federal law based on their view that the special funds participating in the City's investment pool have "lost" interest to which they were entitled. The Audit specifically points to Proposition 218 with respect to property-related fees, to the City Municipal Code and to Government Code Section 66013 with respect to sewer connection fees and Federal statutes governing airport revenues.

The Administration's response explains that there are costs and benefits associated with participating in the City's investment pool. The benefit of pooled investments, such as fund liquidity to meet expenses and a reduced cost of investment management, comes with the

consequence that participating funds are not assessed a charge during those periods when the other funds within the pool advance funds.

We found no case law directly on point to assist us in advising the Administration and the Auditor's Office on whether the City's interest allocation methodology violates the cited authorities. Generally speaking, the restricted funds, including any interest earnings, must be used for the purpose for which the funds were charged or imposed. However, these authorities do not require that a particular interest rate be earned.

In the case of the City's investment pool, it is our understanding that the actual interest earned by the pool was appropriately credited to each participating fund and that no principal was lost. Accordingly, each participating fund within the pool remains "whole" consistent with the legal authorities cited by the Auditor's Office.

Recommendation No. 2 in the Audit recommends that an independent consultant be retained in order to evaluate and report on any potential past compliance issues arising from the City's interest allocation methodology. We view the retention of a consultant and preparation of this type of report as unnecessary. We instead recommend that this Office work with the Finance Department in its implementation of the Audit's other recommendations regarding the investment pool.

Independent Audits

The Audit concludes that the language in Measures O and P specifying "guaranteed annual audits" requires the City to have independent audits of the expenditures of the Measure O and P bond funds. This conclusion is based on the practice of the Los Angeles Unified School District ("LAUSD"). According to the Audit, LAUSD included the "guaranteed annual audit" language in a 1997 bond measure for \$2.4 billion and has caused independent audits of the bond funds issued pursuant to the 1997 measure.

The City's practice has been to rely on its Comprehensive Annual Financial Report ("CAFR") in order to satisfy the "guaranteed annual audit" requirement in Measures O and P. Neither the City Council memoranda nor the minutes of the City Council discussion regarding the placement of Measure O and P on the November, 2000 ballot address what the "guaranteed annual audit" language was intended to mean. However, these measures should be interpreted in light of the Charter's audit requirements. As Charter Section 1215 requires the conduct of an independent annual financial audit (which is satisfied by the CAFR), it is reasonable to conclude the Charter's audit requirement was in fact the "guarantee" of the annual audit and that no separate audit of these bond funds would be performed.

This interpretation of these measures does not preclude the City Council, if it so chooses, to cause separate audits of the Measure O and Measure P bond funds.

Legality of Interfund Loans

The Audit addresses eleven interfund loans made from the Sewer Connection Fee Funds over a seventeen year period of which three remain outstanding. All of the loans were approved by the City Council and were documented through appropriation ordinances and City Council memoranda¹. As we have previously advised the City Council, and the Audit acknowledges, interfund loans are not illegal. The Administration acknowledges in its Audit response there have been some inconsistencies in documenting the terms of these loans and a few reporting issues that require correction. While we agree with the Administration that these inconsistencies and reporting issues need to be corrected, it is our opinion that the loans identified in the Audit met legal requirements.²

We agree with the Administration's recommendation that the City Council adopt an interfund loan policy that addresses issues such as loan documentation, maximum loan term and the appropriate rate of interest for such loans. Such a policy would be consistent with our prior legal advice regarding loans from the Sewer Connection Fee Funds. As we have previously advised the City Council, we believe that the correct standard for assuring the legal validity of interfund loans is that: (1) each loan earn interest at the rate the loaned funds would have earned had the funds been retained in the lending fund (e.g. the pool rate); and (2) if the loan term extends beyond one year, the loan must be "payable on demand."

We believe this standard closely aligns with the explicit requirements of both the Municipal Code and the Government Code. Further, we believe that "long term" loans can meet this standard, so long as they have a defined term and are "payable on demand." As noted in the Administration's response, the documentation for two of the outstanding long term loans will need to be revised in order to explicitly reflect a loan term and reference the payable on demand feature.

The Audit questions the source of repayment for the Fiber Optics loan and the Coyote Valley Water Project loan. We disagree with the Audit on this point. The General Fund, an unrestricted fund, is the source of repayment of the Fiber Optics loan. As noted in the Audit, this loan is payable on demand in the event that projects funded through the Sewer Connection fees require funding.

¹ We also point out the interfund loans reviewed in the Audit differ from the transaction at issue in the *Stark* case cited by the Auditor's consultant. In *Stark*, criminal charges were brought against a county budget director arising from his transfer of moneys from one fund to another without an appropriation action being taken by the Board of Supervisors. This scenario clearly differs from the interfund loans addressed in the Audit which were approved by the City Council.

² We also advise that if the City Council adopts an interfund loan policy as recommended by the Administration, and the Administration wants to continue to recommend using the Sewer Connection Fee Funds for such future loans, we would recommend as a best practice that the City Council also adopt an ordinance clarifying that loans from the Sewer Connection Fee Funds do not constitute a prohibited use of these funds, so long as the loans are consistent with the City Council interfund loan policy.

With respect to the Coyote Valley Water Project, as the Audit notes, the source of repayment is the Water Utility Capital Fund, which receives most of its funding from water sale revenues. The Audit suggests that use of the Water Utility Capital Fund presents a potential violation of Proposition 218 (Article XIID of the California Constitution), which the Audit characterizes as restricting the use of water rate revenue for "future development." This Office disagrees with this characterization of the Proposition 218 expenditure restriction, as Proposition 218 specifically allows fees or charges to be used for service that is "immediately available" to the property served. Putting aside the issue of whether Proposition 218 even applies to the Municipal Water System sales revenue, we note that using revenue from water sales in Coyote Valley, including the revenues from the potable and recycled water sales to the Metcalf Energy Center, to pay for the capital costs of improvements that provide water service in Coyote Valley is clearly allowed under Proposition 218. This Office will work with the Administration to address any legal issues regarding the repayment source for the Coyote Valley Water Project loan when the Administration brings forward its recommendation for a specific term for this loan.

Audit Recommendations Regarding Interfund Loans

The Audit recommendations with respect to the interfund loans are that: (1) the City Manager's Office work with the City Attorney's Office "to evaluate and report on methods to remedy any potential past compliance issues with the loans from the restricted funds; and that (2) the City Manager's Office develop and implement a formal written policy on interfund loans, including the establishment of a prudent investor standard, and written procedures on how to manage and enforce such a policy."

With respect to methods to "remedy any potential past compliance issues," we believe that our submission of this memoranda and our review of the Administration's response to the Audit fulfills the Audit recommendation for an evaluation and report. Specifically, we concur with the Administration that the following actions have, or will remedy any potential past compliance issues: repayment of \$65,000 in interest on the Old City Hall renovation loan; approval in the FY 2008-09 budget of loan terms for the Coyote Valley Water and Storm Sewer loans; and improved reporting on outstanding loans in the CAFR.

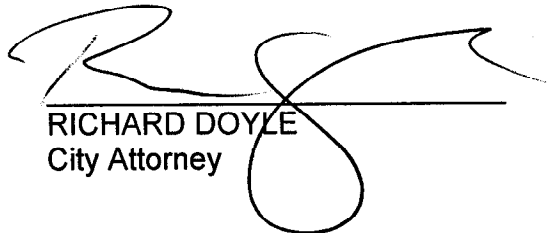
Regarding the interfund loan policy, as addressed above, we concur with the Administration's recommendations. The Audit recommends that a "prudent investor standard" be employed. It is our opinion that the elements of the Administration's recommended policy address the legal concerns that (1) the lending fund is compensated with interest at the rate it would have otherwise earned and (2) that monies in the lending fund be available for the purpose for they were charged should the need arise. In our view, in the event that the Administration were to recommend a loan be made consistent with the term of the interfund loan policy, the legal requirements for the loan would be met.

Accordingly, we disagree with the Audit's recommendation that the Director of Finance be required to make the findings noted in the Audit. We also note that the Audit suggests that the City Attorney's Office provide "assurances that the interfund loan is enforceable." Consistent with the City's standard practice, we instead recommend that the Administration coordinate with this Office in advance of bringing forward an interfund loan for City Council

approval so that we can review the loan terms for consistency with the legal requirements.³ Since the City is the only party involved in these loans, "enforceability" as used in transactions involving different parties is not relevant. Rather, the issue is whether the interfund loan meets the legal elements discussed above.

Legality of HNMF Transfer

We agree with the Auditor's consultant that the stated purpose of the Healthy Neighborhood Venture Fund ("HNMF") are quite broad, and if the transfers were made in order to provide money for expenditure by the General Fund within the listed categories, a court would be likely to hold that the transfer complied with the Municipal Code. We also note that a court would be likely to defer to the City on interpretation of the Municipal Code, as reflected in the appropriation ordinance approving the transfer. In other words, a court would be likely to uphold the City Council's judgment that, in light of the budget shortfall, the purposes behind the HNMF could best be met by transferring the funds to the General Fund. We do agree with the Administration, however, that it would be appropriate to update the Municipal Code to be consistent with City Council direction regarding the HNMF. We will work with the Administration to bring forward this update.



RICHARD DOYLE
City Attorney

³ If the City Council adopts an interfund loan policy as recommended by the Administration, and the Administration wants to recommend using restricted funds other than the sewer connection fee for such loans, we will review the applicable Municipal Code provisions at that time and advise on whether to recommend as a best practice that the City Council also adopt an ordinance amending the Municipal Code to clarify that loans from the restricted fund do not constitute a prohibited use of funds, so long as the loans are consistent with the City Council interfund loan policy.

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APPENDIX 1

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December 5, 2007

Richard Doyle
City Attorney of the City of San José
200 East Santa Clara Street
San José, CA 95113

Re: Final Draft Report – 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

Dear Mr. Doyle:

Thank you for providing a copy of the referenced final draft audit (the “Audit”) prepared by the Office of the City Auditor of the City of San José. I have had the opportunity to review the Audit, and would like to comment on certain findings made therein.

First, we disagree with the Audit’s comments about our availability and our willingness to provide the Auditor’s Office with requested information. Notwithstanding the comments on page 5 and 6 of the Audit to the effect that we “declined to provide further information” and provided “only limited information”, we in fact did make ourselves available to the Auditor’s Office to discuss issues addressed in the Audit. I participated in a conference call with the Auditor’s Office on March 5, 2007, David Walton¹ (Jones Hall’s tax partner) and I participated in a conference call with the Auditor’s Office on April 16, and David and I participated on a conference call with the Auditor’s Office and Michael Bailey, a consultant to the Auditor’s Office,

¹ David has served as Counsel to the Assistant Chief Counsel (Technical) - Financial Institutions and Products at the Internal Revenue Service and functioned as the highest level municipal finance expert in the Office of Chief Counsel, and as Attorney-Advisor in the Office of Tax Policy at the United States Department of Treasury where he functioned as the only Tax Policy attorney with expertise in municipal finance. He also served for 3 years as a member of the Board of Directors of the National Association of Bond Lawyers (NABL), chair of NABL’s annual tax seminar, chair of NABL’s Committee on Arbitrage and Rebate, as a member of the Steering Committee for NABL’s Bond Attorneys Workshop, and as a member of the American Bar Association Section on Taxation, Tax-Exempt Finance Subcommittee.

on October 23. We also answered follow-up questions asked by the Auditor's Office after both the March and April conference calls. We did not, however, agree to comment on notes of the April 16 conference call prepared by the Auditor's Office that were sent to us on May 2, 2007. We responded by e-mail on May 10 that "we would need to significantly edit and expand upon the notes so that readers of the notes would not draw incorrect conclusions." We also noted that we believed that we had addressed the questions raised in the notes in our prior written responses.² After sending this e-mail to the Auditor's Office on May 10, neither David nor I had any contact with the Auditor's Office until our conference call on October 23.

Second, we believe the Audit's discussion regarding potential tax issues relating to the delayed reimbursement of City's Cash Pool in connection with \$1.9 million of expenditures for the Hayes Mansion/Edenvale Garden Park project (pages 23 and 24 of the Audit) is misguided. In particular, we do not agree with the implication contained in the last paragraph on page 23 of the Audit that "Hayes Mansion/Edenvale Garden expenditures may no longer be reimbursable due to regulatory time limitations." This particular issue was the subject of the October 23 conference call with the Auditor's Office and Mr. Bailey. We clearly stated on that call that we believed the reimbursement, as of 2007 (not retroactively to prior years) was allowable under federal tax law and the relevant regulations. Further, we never heard Mr. Bailey state that he disagreed with our position. While he did propose a different interpretation of the applicable regulations, when pressed by David as to whether he disagreed with David's interpretation, he did not state that he believed our interpretation of federal tax law and the relevant regulations to be incorrect. David also pointed out that Mr. Bailey's position that there could be no reimbursement after 5 years would prohibit the universal practice of month end reimbursements by the trustee from bond proceeds in a project fund for project expenses paid with other issuer cash during the month. Mr. Bailey acknowledged that this was an odd result, and provided no reasonable response to David's observation.

Third, we are puzzled by the suggestion on page 22 of the Audit that the City's General Fund could potentially recover lost interest from outstanding reimbursements. The Audit states that

[a]ccording to the City Attorney's Office and Bond Counsel, bond proceeds cannot be used to pay interest to the General Fund or any fund within the City. According to our public finance consultant, the General fund may actually be eligible to recover the lost interest earning because under IRS regulations, the bond proceeds could be considered "spent" on the day the eligible expenses were incurred and therefore, these funds were no longer considered to be bond proceeds.³

This statement does not make any sense and is inconsistent with the tax positions taken by the Auditor's Office and Mr. Bailey with respect to the Hayes Mansion/Edenvale Garden Park

² David was reluctant to comment on these notes because they contained a very general summary of a small portion of the tax rules, and he has always resisted commenting on these types of summaries as they can be very misleading not only for what they discuss but, more importantly, for what they do not discuss.

³ This statement was not in the prior draft of the Audit so we were unable to discuss it with the Auditor's Office and Mr. Bailey on our October 23 conference call.

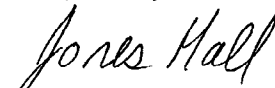
Park reimbursement. It is our understanding that the Auditor's Office, based on Mr. Bailey's advice, is taking the position that, for any date more than 5 years after the date of issue of the bonds, the City may not make any reimbursement for any expenditures with proceeds of the bonds. In other words, project expenses paid in 2001 from the General Fund cannot be reimbursed in 2007 with proceeds of bonds issued in 2001 because more than 5 years has passed since the date of issue of the bonds. However, in the statement cited above, the Auditor's Office is now saying that the "bond proceeds could be considered 'spent' on the day the eligible expenses were incurred". This sounds like the Auditor's Office is promoting a policy of retroactive reallocation of proceeds of the bonds after 5 years.

We believe that this interpretation is ill-advised and could be subject to challenge by the IRS because the City would have no paper trail documenting the allocation of the bonds to the project expenditures as of the "deemed expenditure date". Our advice to the City remains that there should be no retroactive reallocation of the uses of General Fund moneys and bond proceeds after the 5-year period. However, we do advise that in 2007 (post 5-year period), the City may reimburse unreimbursed expenditures paid by the General Fund in 2001 by treating the bond proceeds as spent in 2007 as reimbursement to the General Fund. Because both bond proceeds and General Fund moneys were available in 2001 to pay the project expenditures in question, we believe that a reimbursement of the project expenditures is permitted. We believe that this is a conservative approach which should protect the City in the event of an audit. This methodology is consistent with the actual flow and use of the bond proceeds and does not involve retroactive "deemed" reallocations.

Finally, we would like to note that the federal tax law issues relating to tax exempt bonds are extremely technical and do not cover every circumstance that can arise with respect to a tax exempt bond issue. Tax lawyers use their knowledge of the regulations and related rulings, and their understanding of the policy behind those regulations and rulings, to apply the regulations and rulings to the facts and circumstances of a particular situation. The City's Finance Department and the City Attorney's Office frequently contact us to discuss issues regarding the expenditure and investment of bond proceeds. Occasionally, they ask questions for which the regulations and rulings do not provide direct guidance. In such circumstances, we outline different approaches aimed at protecting the tax exempt status of the bonds.

Thank you this opportunity to review and respond to the Audit. Please feel free to contact David or me if you have any questions.

Respectfully submitted,



A Professional Law Corporation

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**OFFICE OF THE CITY AUDITOR'S
COMMENTS ON THE RESPONSES FROM THE
CITY ATTORNEY'S OFFICE AND
CITY ADMINISTRATION**

The following comments are presented to expand upon, clarify, and correct statements in the responses from the City Attorney's Office and the City Administration to audit #07-06 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."*

Auditor's Comments to the City Administration's Response:

1. The City Administration's response on page 5, Table I Bond Fund Disbursement Methodology Matrix, presents their understanding of advantages and disadvantages with respect to three alternatives for holding and disbursing bond proceeds.

City Auditor's response:

We disagree with some of the assumptions contained within the City Administration's matrix. The City Administration asserts that the current methodology of holding bond proceeds with the trustee while having the City Cash Pool "front" bond expenses best meets the objectives of the bond disbursement process. However, the Administration's matrix does not consider the consequence of negative fund balances caused by this process and its associated impact of lost interest to restricted funds contained within the City Cash Pool. In our opinion, and to be in compliance with applicable regulations, the bond disbursement process should not negatively impact restricted funds held within the City Cash Pool.

The Administration's matrix also assumes that there will be no review of the bond expenditures prior to disbursement with either of the other two alternatives and their response states, "In order to ensure that all bond expenditures are appropriate, the bond proceeds are held and invested by a trustee rather than the Cash Pool and reimbursements are made after the expenditures have been verified." Regardless of the method of disbursement, or placement of the proceeds (whether the proceeds are held with a trustee or in the City's Cash Pool), the expenditures should be reviewed prior to disbursement. For example, when the City had the trustee pay for expenses directly from the trustee account for the Civic Center, the Finance Department still reviewed the disbursement request prior to the trustee's disbursement of bond proceeds.

Finally, the Administration's matrix assumes differences in the number of disbursements for each alternative. However, the matrix does not disclose the additional cost and staff time associated with the City's current process, which requires the submission of individual invoices to the City's Accounting Division

for payment out of the City's Cash Pool, prior to requesting disbursement from the trustee. As noted in our audit report, no other large western city we surveyed has chosen a process such as ours. Regardless of the methodology selected, our audit recommends the implementation of controls to improve the efficiency of the bond disbursement process and to ensure restricted funds are not negatively impacted by the bond disbursement process.

2. The City Administration's response on page 7 describes the lost interest caused by the negative fund balances in the City Cash Pool as a "theoretical rate of return."

City Auditor's response:

Characterizing the impact of the negative balances as a "theoretical rate of return" is inaccurate because the lost interest resulting from the negative balances is an *actual* loss to the City Cash Pool. This label of a "theoretical rate of return" is inconsistent with the City Administration's matrix on page 5. The Administration's matrix acknowledges that the "City pool earnings [are] reduced" with the City's current process of making initial payments from the City Cash Pool.

3. The City Administration's response to Recommendation #2 on page 8 states that "The Administration has consulted with the City Attorney's Office and does not believe there are any compliance issue with federal or state law from past negative cash balances. Each fund has received its appropriate share of actual interest earned, and each restricted fund, including interest revenue in that fund, had only been used for its restricted purpose."

City Auditor's response:

In Recommendation #2, we recommend that the Finance Department "work with the City Attorney's Office to obtain the services of an independent consultant to evaluate and report on methods to address any potential past compliance issues with Federal and State law arising from the negative cash balances and lost interest in restricted funds." We recommend using an independent consultant because the City Attorney's Office and the Finance Department have disagreed with the audit findings concerning the impact of the negative fund balances on the actual interest earnings credited to the restricted funds held within the City's Cash Pool. As noted in our audit report, other entities have recognized this effect and implemented controls to mitigate the impact of negative balances on all funds held within the pool, including restricted funds. In our opinion, the risk of not adequately evaluating the City's compliance with the noted regulations pertaining to restricted funds is significant, and we believe an independent consultant with expertise in these areas could provide the objective perspective necessary to adequately address the concerns raised in our audit.

4. The City Administration's response to Recommendation #3 states, "The Administration has reviewed the 'Distribution and Recording of Investment Earnings' procedures and conferred with the City Attorney's Office, and does not believe interest diversion has occurred in the past or will occur in the future."

City Auditor's response:

As noted in our audit report, the procedure referenced in the Administration's response is outdated and their current methodology does not take into account the negative balances in distributing interest earnings in the City Cash Pool. Specifically, the procedure noted in the Administration's response was last reviewed 15 years ago, references systems no longer used, and does not adequately address the weaknesses we disclose in our audit report. Therefore, we believe Recommendation #3 is appropriate.

5. The City Administration's response on page 9 states: "*The City's annual audit includes an audit of the Measure O and Measure P general obligation bond project funds... Bond related transactions are included in the scope of the City's annual audit and if the external auditor notes any findings related to bond programs, they are resolved or reported on in the external auditor's Management Report to the City Council. To date there have been no findings reported related to bond expenditures.*"

City Auditor's response:

We respectfully disagree with the Administration's viewpoint on this matter. The primary objective of the City's Comprehensive Annual Financial Report (CAFR) is to render an opinion on the presentation of the City's basic financial statements, in conformity with generally accepted accounting principles. Furthermore, we reviewed the City's contract with the external auditor responsible for the financial audits and noted that the scope of services does not mention an audit of bond related transactions for Measures O and P (2000). The City's CAFR does include basic financial statement information on the bond funds, as it does for all other City funds, such as the fund balance at year-end. However, we note that the CAFR's evaluation of the bond fund is not an audit of the use of bond proceeds and could not provide assurances as to the appropriateness of the bond expenditures. For example, Measures O and P require that no bond funds be used on administrators' salaries, and the CAFR does not audit this requirement or appropriateness of any other uses of the proceeds. The Finance Department is responsible for ensuring compliance for all debt-related activities and bond issuances. As such, the Finance Department should ensure compliance with the bond measure requirements for guaranteed annual audits and work with the City Attorney's Office to ensure in the future, that any voter-approved bond measure requirements are implemented.

6. The City Administration's response on page 11 regarding interfund loans states: *"The loans are not considered an expenditure for an unrelated purpose, if the funds earn the same amount of interest as if these funds had remained in the City's cash pool and are repaid. As such, the Administration believes these loans are legal and appropriate, and disagrees with the Audit's contention that they are in anyway "questionable."*

City Auditor's response:

As stated in our audit report, without proper documentation and execution of loan terms, an interfund loan from a restricted fund could be challenged as an improper use of funds. Our audit report notes several weaknesses in these areas. For example, two of the three outstanding long-term loans have not paid any interest to the lending fund and these loans have been outstanding since 1990 and 1996. The departments could not provide loan documents for the loan outstanding since 1990. Although a memo documented the first loan from fund 539 to Fund 426 for the HNVP programs, the departments could not provide any loan documents for the second and third loans from Fund 539 to Fund 426.

Auditor's Comments to the City Attorney's Response:

The City Attorney's response has several inaccurate points. Instead of addressing each inaccuracy, we have chosen to highlight below the most important items requiring clarification. We also shared the City Attorney's response, and its Appendix 1 containing a letter from bond counsel, with our public finance specialist. Our public finance specialist responded to certain legal points and we attached his responses on pages 95 through 103.

1. The City Attorney's response, page 4 on "Allocation of Interest" states: *"Accordingly, each participating fund within the pool remains 'whole' consistent with the legal authorities cited by the Auditor's Office."*

City Auditor's response:

This is not an accurate statement and ignores the audit report's Finding 1 which points out that the City's Cash Pool has foregone an estimated \$2.5 million in interest as a result of the negative balances associated with the bond projects. As we have explained in our audit report, the participating funds have not remained "whole" because bond projects have "borrowed" principal from the City's Cash Pool without compensating those funds held within the City's Cash Pool for the interest they have lost as a result of having their funds "borrowed." Therefore, funds held within the City's Cash Pool have not remained "whole."

2. The City Attorney's response, page 5, states that: *"The Audit questions the source of repayment for the Fiber Optics loan... we disagree with the Audit on this point."*

The General Fund, an unrestricted fund, is the source of repayment of the Fiber Optics loan."

City Auditor's response:

As discussed in the audit report, identifying a secure source of repayment is one of the factors used to determine whether an interfund loan qualifies as a prudent investment of the restricted Sewer Connection Fee funds. We agree that the General Fund has become the source of repayment for the Fiber Optics loan, but the General Fund was not the original or intended source of repayment when the loan was approved in 1996. When the loan was established, the City determined that projected lease payments for use of the fiber optics system would repay the loan principal and the General Fund would pay interest. However, these leases did not come to fruition and this loan remains outstanding since 1996 with no interest accrued or paid. Beginning in 2005-2006, the City determined that revenue from lease payments could not be anticipated and began to repay the loan principal from the General Fund.

3. The City Attorney's response, page 5, states that: *"The Audit questions the source of repayment for ...the Coyote Valley Water Project loan... we disagree with the Audit on this point. [...] the audit suggests that use of the Water Utility Capital Fund[as a source of repayment] presents a potential violation of Proposition 218 (Article XIID of the California Constitution), which the Audit characterizes as restricting the use of water rate revenue for 'future development.' This Office disagrees with this characterization of the Proposition 218 expenditure restriction, as Proposition 218 specifically allows fees or charges to be used for service that is 'immediately available' to the property served."*

City Auditor's response:

As we state in the audit report, according to City documents, the Coyote Valley Water loan, which is repaid in part from water sale revenues, was obtained to "serve projected demands in North Coyote Valley" and that "the repayment of the loan is dependant on the future development of this area." Contrary to the City Attorney's response, the loan was obtained for projected demands, not immediate service. Therefore, use of water sale revenues to pay off loans for projected demands could be inconsistent with the requirements placed on funds restricted by Proposition 218 which states, "Fees or charges based on potential or future use of a service are not permitted."

4. The City Attorney's response incorrectly states that the City's Administration (i.e. the City Manager's Office) has recommended the development of an interfund loan policy (page 5) and controls to ensure future transfers are in compliance with the City's Municipal Code requirements (page 7). For clarification purposes, these recommendations are from the independent City Auditor's Office and are

contained in the audit report as Recommendations #9 and #11.

5. The City Attorney's response details some of the meetings and communications between the City Attorney's Office, bond counsel, and the City Auditor's Office. It also states that the City Attorney's Office never placed limitations on our questions and was never informed of the audit scope impairment until early August 2007.

City Auditor's response:

We agree that our Office had a number of meetings and communications with the City Attorney's Office and bond counsel. However, it is the substance of the information provided throughout these communications, or lack thereof in some instances, that led to the disclosure of an impairment to the audit scope. Further, the Auditor's Office did express concern over an impairment prior to issuing a draft audit report in early August 2007. The Auditor's Office carefully examined the information that led to disclosing an impairment to the audit scope, and even consulted and confirmed with the General Accountability Office on the appropriateness of disclosing such an impairment. Following are the additional details leading to the impairment.

Early on in the audit process, in March 2007, the City Auditor had a meeting with the City Attorney to discuss significant concerns about the information and access we were receiving from the City Attorney's Office and bond counsel. Over the course of about 4 months, from late January through May, the City Auditor's Office made numerous attempts to obtain complete and accurate information from the City Attorney's Office and bond counsel to use in our audit. Despite these numerous attempts, and the City Auditor's discussion with the City Attorney, the information we received was not forthcoming, complete, or accurate in all cases and therefore, could not be relied upon as an objective and complete source of information to use in our audit.

In May 2007, we asked the bond counsel to verify the accuracy of information we received through an interview with them and the City Attorney's Office. We provided detailed interview notes restating the information they had communicated to us. The bond counsel declined to verify the notes, expressed concerns about incorrect conclusions, and concluded that they would wait for our audit report to comment on, rather than clarify the information for us to use in the audit.

We communicated our concerns of an impairment to the City Auditor and the Mayor's Office. Both of these officials supported us in moving forward to secure the work of an outside public finance specialist. We then began the process of obtaining the services of an independent public finance specialist so that we could obtain the information necessary to complete the audit. We were eventually able to secure an independent public finance specialist to use for our audit and we

relied on this source of information to draw our conclusions. Throughout the process of obtaining this specialist, we communicated with the City Attorney's Office and explained our reasons for securing these services and even communicated our concerns of an "impairment" to two different employees within the City Attorney's Office in June and July 2007.

6. The City Attorney's response, page 3, states: *"This Office arranged a meeting with the Auditor's Office staff, Steve Melikian, and the Finance Department to occur on April 26, in order to discuss the second preliminary draft (which had replaced an earlier draft preliminary report). When the Auditor's Office determined to not issue the preliminary report, the Auditor's Office canceled the meeting."*

City Auditor's Response:

The meeting referenced in the City Attorney's response was scheduled as an Exit Conference to discuss the draft Interim Report we issued in March 2007 (as discussed in this audit report). However, prior to this meeting, the Finance Department took corrective action to address the urgent item necessitating the Interim Report and therefore, the City Auditor decided to not issue the Interim Report and instead incorporate the findings into the overall Debt Management audit report. As a result, the Exit Conference on the draft Interim Report scheduled for April 26 was cancelled.

The City Attorney's response further states that: *"The City Attorney's Office requested that the meeting still take place as it had been difficult to arrange a meeting of all interested parties. We had scheduled the meeting because we believed that it would be useful for all involved in the Audit to understand the legal advice provided by Jones Hall, to understand the issues that the Auditor wished to address in the audit and to address any remaining questions that the Auditor's Office had. The former Auditor declined to participate and the meeting did not occur."*

City Auditor's response:

We disagree with the City Attorney's response that the Auditor declined to participate in a meeting to understand the legal advice provided by Jones Hall. This is an inaccurate portrayal of the meeting and is inconsistent with our documentation which indicates that the City Attorney wanted to meet with us to discuss the scope of our audit, even though the audit scope was already established. In an email on April 24, 2007 the City Attorney's Office indicated they would "like to meet in order to discuss the scope of the audit." The City Attorney's Office did not mention that they wanted to meet to discuss bond counsel's legal advice. The City Auditor responded in email stating, "Rick [City Attorney] has never met with me to discuss the scope of an audit. Why would he want to do so now?" The City Attorney's Office then replied that they were

cancelling the meeting.

7. The City Attorney's response, page 3 states: *"It was also at this time [early August] that we learned that the Audit addressed many more legal issues (including interfund loans), than those that had been posed to Jones Hall and to this Office during the period between February and May, 2007."*

City Auditor's response:

We documented discussions with the City Attorney's Office relating to the interfund loans dating back to early March and questions concerning State and Federal laws beginning with our initial meeting in January and continuing throughout May 2007. These interactions are documented in interviews and emails.

MEMORANDUM

CLIENT-MATTER NUMBER
090184-0101

TO: Office of the City Auditor
City of San Jose, California

FROM: Michael G. Bailey

DATE: December 11, 2007

RE: Response of the City Attorney's Office to the Audit of the Management of the City's Tax-Exempt Bond Program and Use of Interfund Loans to Provide Financing for Capital Projects

We have represented the City Auditor of the City of San Jose (the "City") in connection with certain matters related to the audit referenced above, including matters related to certain interfund loans made by the City. The Office of the City Auditor has requested that we provide further explanation of our views in response to the "Response of the City Attorney's Office", dated December 6, 2007 related to the audit (the "City Attorney Response").

In our engagement, the City Auditor has asked our views regarding the best interpretation of the requirements of the laws of the State of California, the City Charter and the City Municipal Code that apply to certain of the City's interfund loans. The City Auditor also asked that we suggest best practices for procedures for the City to use in making interfund loans. We would like to emphasize that we have suggested particular best practices as a possible approach, but fully acknowledge that any of a number of different possible approaches could be reasonable to comply with underlying legal requirements. In that light, we fully acknowledge that the finances and debt program of the City are highly complex, that adoption of procedures for making interfund loans properly should take into account practical considerations of cost and administrability, and that the responsible City officials are of course in the best position to weigh the costs and benefits of various acceptable approaches.

In our recommended best practices, we suggested that the City Attorney should provide assurances that each interfund loan is enforceable. The City Attorney Response states that the City Attorney rather should review each interfund loan for "consistency with legal requirements." We wish to clarify that, by using the word "enforceable", we meant to only to recommend that each interfund loan should be reviewed to provide assurance that the City has

legal authority both to make the interfund loan from the lending fund, and to repay the interfund loan from the borrowing fund.

In our recommended best practices, we suggested that the interest rate established on each interfund loan should be a market rate for a loan with comparable security and repayment terms. The City Attorney response states that the interest rate on each interfund loan should be established such that the lending fund is compensated at the rate it would have otherwise earned. We continue to believe that most correct approach is to take into account the terms and nature of the specific interfund loan in determining the appropriate interest rate, but we also acknowledge that it is proper to give weight to considerations of practical administrability in establishing procedures, and that a number of different procedures could be reasonable.

The City Attorney Response appears to indicate that at least some interfund loans should be viewed as effectively made or guaranteed by the City's General Fund, even though the specific terms of the interfund loan may provide that only a particular special fund is the payor. If that is the case, there would be less difference in the nature of various interfund loans, and less reason to consider the terms of nature of the specific interfund loan in determining the appropriate interest rate.

The City Auditor requested that we outline the possible consequences of improper interfund loans under the general laws of the State of California. In that light, we made reference to the *Stark* case in our prior memorandum. We wish to clarify that we fully concur with the statements made in the City Attorney Response that the interfund loans reviewed in the audit differ from the transaction at issue in the *Stark* case. We wish to emphasize that we have reviewed no facts whatsoever that would lead us to conclude that the interfund loans made by the City are similar to those made in the *Stark* case. We are of the view, however, that a discussion of general laws of the State of California concerning interfund loans should properly include reference to such a prominent case.

We appreciate the opportunity to clarify our views on these matters.

MEMORANDUM

CLIENT-MATTER NUMBER
090184-0101

TO: Office of the City Auditor
City of San Jose, California

FROM: Michael G. Bailey

DATE: December 11, 2007

RE: Response of the City Attorney's Office to the Audit of the Management of the City's Tax-Exempt Bond Program and Use of Interfund Loans to Provide Financing for Capital Projects – Response to Bond Counsel Letter

We have represented the City Auditor of the City of San Jose (the “City”) in connection with certain matters related to the audit referenced above, including matters related to the City’s tax-exempt bond program. The Office of the City Auditor has requested that we provide further explanation of our views in response to the letter by Jones Hall, A Professional Corporation, the City’s Bond Counsel, dated December 5, 2007 related to the audit (the “December 5 Bond Counsel Letter”).

We agree with the statement made by Jones Hall that the federal tax law issues relating to tax-exempt bonds are extremely technical and do not cover every circumstance that can arise with respect to a tax-exempt bond issue. The December 5 Bond Counsel Letter largely concerns the interpretation of a particular provision contained in the so-called tax-exempt bond “allocation and accounting” regulations. The particular provision in question, which is set forth in Section 1.148-6(d)(1) of the Income Tax Regulations, and which is incorporated by reference in Section 1.141-6(a) of the Income Tax Regulations, sets forth requirements for the timing of when an issuer of tax-exempt bonds must determine how the bond proceeds are treated as spent for federal income tax purposes. Accordingly this provision has particular practical importance and implications for the City’s tax-exempt bond compliance policies and procedures.

We of course acknowledge that Jones Hall is a highly reputable and experienced bond counsel law firm. As is set forth in this memorandum, however, we believe that the interpretation of the tax-exempt bond allocation and accounting rules set forth in the December 5 Bond Counsel Letter is not correct. Among other things, we believe that the attorneys responsible for tax-exempt bond matters in the Internal Revenue Service Office of Chief Counsel

would not concur with the interpretation set forth in the December 5 Bond Counsel Letter. We note that the City may have the opportunity to informally discuss this question with the responsible Internal Revenue Service attorneys by contacting them at (202) 622-3980. Although Internal Revenue Service attorneys are plainly not infallible in their interpretation of the Income Tax Regulations, we suggest that it may be prudent for the City to consider the informal interpretation of the responsible Internal Revenue Service attorneys in establishing a tax-exempt bond compliance program.

We emphasize that the federal income tax requirements discussed in this memorandum govern only how tax-exempt bond proceeds are treated as spent for federal income tax purposes, and do not govern how the bond proceeds are treated as spent for other purposes, such as state or local law requirements.

The “arbitrage” rules set forth in section 148 of the Internal Revenue Code (the “Code”) set forth a number of restrictions on the investment of tax-exempt bond proceeds. Regulations setting forth allocation and accounting rules for these arbitrage restrictions are set forth in Section 1.148-6 of the Income Tax Regulations. Section 1.148-6(d) of the Income Tax Regulations in particular sets forth rules for “allocation of gross proceeds to expenditures” and Section 1.148-6(d)(1) of the Income Tax Regulations generally provides as follows:

- (i) *General rule.*—Reasonable accounting methods from different sources to expenditures for the same governmental purpose include any of the following methods if reasonably applied: a specific tracing method; a gross proceeds spent first method; a first-in, first-out method; or a ratable allocation method.
- (ii) *General limitation.*—An allocation of gross proceeds of an issue must involve a current outlay of cash for a governmental purpose of the issue. A *current outlay of cash* means an outlay reasonably expected to occur not later than 5 banking days after the date as of which the allocation of gross proceeds to the expenditure is made.
- (iii) *Timing.*—An issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project, if any, that is financed by the issue is placed in service. This allocation must be made in any event by the date 60 days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier. This paragraph (d)(1)(iii) applies to bonds issued on or after May 16, 1997.

Section 1.148-6(a) of the Income Tax Regulations also sets forth the following general rules for allocation and accounting methods:

- (1) *Reasonable accounting methods required.*—An issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments and expenditures of an issue.
- (2) *Bona fide deviations from accounting methods.*—An accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item. Bona fide governmental purposes include special state law restrictions imposed on specific funds or actions to avoid grant forfeitures.
- (3) *Absence of allocation and accounting methods.*—If an issuer fails to maintain books and records sufficient to establish the accounting method for an issue and the allocation of the proceeds of that issue, the rules of this section are applied using the specific tracing method. This paragraph (a)(3) applies to bonds issued on or after May 16, 1997.

The foregoing regulations technically apply only to the tax-exempt bond arbitrage rules (that is, rules relating to restrictions on investments). Section 141 of the Code contains rules (the so-called “private activity bond” rules) that in addition place restrictions on the private business use of tax-exempt bond-financed property and bond proceeds. The regulations interpreting these private business use restrictions contain allocation and accounting rules that expressly incorporate by reference the arbitrage rules for allocation of bond proceeds to expenditures set forth in Section 1.148-6(d) of the Income Tax Regulations. Section 1.141-6(a) of the Income Tax Regulations provides as follows:

For purposes of [all of the private activity bond regulations], the provisions of Treas. Reg. §1.148-6(d) apply for purposes of allocating bond proceeds to expenditures. Thus, allocations generally may be made using any reasonable, consistently applied accounting method, and allocations under section 141 [which concerns restrictions on private business use] and section 148 [which concerns restrictions on investments] must be consistent with each other.

Although not expressly included in the cross-reference, we believe that it is reasonable to conclude that the general allocation and accounting rules set forth in Section 1.148-6(a) also apply for purposes of the private activity bond restrictions.

The timing requirements described above were adopted in final Income Tax Regulations published on January 16, 1997. The preamble to those final Income Tax Regulations describes the requirements as follows:

The final regulations continue the approach of the proposed regulations [that proceeds must be allocated to expenditures consistently for private activity bond purposes and arbitrage purposes]. Final regulations are also adopted under Code section 148 clarifying that allocations of proceeds to expenditures must be made by a definite time (in no event later than the date that rebate is, or would be, due).

62 FR 2279 (January 16, 1997).

Purposes of the timing restrictions. We believe that the purpose of the timing restrictions on determining how bond proceeds are spent were in general intended to provide for reasonable administrability of the arbitrage restrictions and the private activity bond restrictions, both from the point of view of the Internal Revenue Service and from the point of view of issuers of tax-exempt bonds. The provision was in part occasioned by tax-exempt bond issues that were examined by the Internal Revenue Service in enforcement actions where the issuers or borrowers sought to redetermine how tax-exempt bond proceeds were spent long after the date of issuance. See, e.g., TAM 9723012. The Internal Revenue Service Office of Chief Counsel took the view that the tax-exempt bond rules generally depend on a consideration of how bond proceeds are spent and invested, and that these rules would not be administrable by the Internal Revenue Service unless definitive determinations of how bond proceeds are spent are made reasonably contemporaneously with when the projects financed by a bond issue are placed in service.

On the other hand, the final Income Tax Regulations also effectively acknowledge that application of the Federal income tax restrictions may be complex for issuers, and provide issuers a reasonable, but limited, period of time to determine how tax-exempt bond proceeds are spent. Accordingly, in our view the timing restrictions set forth in the Income Tax Regulations in effect represent a compromise that takes into account the needs of the IRS to administer rules and the needs of issuers to have some reasonable degree of administrative flexibility to determine and review how bond proceeds are spent and to correct mistakes.

Interpretation of the rules for allocating bond proceeds to expenditures. In light of this background, we believe that the rules for allocating bond proceeds to expenditures are properly applied in the following manner.

First, if bond proceeds are to be treated as spent on a project, the issuer must determine (“account for”, in the terminology of the Income Tax Regulations) how the bond proceeds are spent on that purpose no later than 18 months after the project is placed in service. This timing restriction applies regardless of whether the issuer desires to allocate the bond proceeds for the first time or desires to change an earlier allocation.

If such a restriction did not apply to “unspent proceeds”, an issuer would be able to allocate bond proceeds to expenditures a very long period after financed projects are placed in service (perhaps as much as 20 or 30 years). We believe that the Internal Revenue Service would not accept such an interpretation of the regulations, in part because it could make

administration of the Federal income tax requirements for tax-exempt bonds difficult or impossible.

The maximum time periods for determining how bond proceeds are initially spent (5 years and 60 days after the date of issuance or, if earlier, 60 days after the retirement of all of the bonds of an issue) correspond to the dates that “rebate” is first required to be paid to the Internal Revenue Service. The “rebate” requirement of section 148(f) of the Code generally requires that investment profits made from investing tax-exempt bond proceeds must be paid to the Internal Revenue Service, unless an exception applies. In most cases, this timing restriction is less important than the 18-month requirement, because bond proceeds are usually spent before 5 years after the date of issuance or the date on which the bonds are retired. We do not interpret this timing restriction as prohibiting an issuer to spend bond proceeds after the date that is 5 years after the date of issuance, but rather that the expenditures that are taken into account in determining whether “rebate” is owed to the Internal Revenue Service must be determined by the first date rebate would be required to be paid to the Internal Revenue Service.

Second, bond proceeds are required to be spent on the same date for arbitrage and rebate purposes. An issuer is permitted to account for bond proceeds in a manner such that the bond proceeds are treated as spent on a prior date, provided that the timing restrictions for determining how bond proceeds are spent are met.

An example may illustrate this point. Suppose the City issues tax-exempt bonds on February 8, 2001 for a construction project. The City then actually pays amounts to a third-party contractor on February 8, 2002 for the project. On February 8, 2003 the project is placed in service. In such a case, the City could take an action to “account for” the allocation of bond proceeds to that project until August 8, 2004 (assuming the bonds had not been retired by that date). If the City makes such an allocation in 2004, the bond proceeds could be treated as spent on February 8, 2002 (the date it actually made payments to the third party) for both arbitrage and private use purposes. If the City fails to take action to account for the allocation of the bond proceeds to expenditures by 60 days after February 8, 2006, however, the City generally would lose its ability to allocate bond proceeds to those particular expenditures for federal income tax purposes. This treatment is contemplated by the reference in the Income Tax Regulations to the requirement that a corresponding “current outlay of cash” must occur not later than 5 business days after the date “as of which” the allocation of bond proceeds is made. In other words, the Income Tax Regulations follow economic substance in this regard by generally permitting bond proceeds to be treated as spent on the date on which the issuer makes actual payments to third parties, not the date a tax accounting entry is made, provided that the tax accounting entry is made on a reasonably timely basis.

The audit report makes the point that this aspect of the tax-exempt bond allocation and accounting regulations (that is, permitting bond proceeds to be treated as spent on the date a payment is made by the City to a third party, even if that date is prior to the date the City “accounts for” the spending of bond proceeds) could help to mitigate possible interest allocation problems raised by the City’s current disbursement procedures.

Third, if an issuer makes no special tax allocations, the Internal Revenue Service would likely determine how bond proceeds are spent by simply “tracing the dollars” of disbursements of bond proceeds. Thus, if the City makes a mistake in the actual disbursement and use of bond proceeds in such a case, it will be bound by allocation to that use, even if that disbursement is mistaken.

Interpretive questions. Although we believe the basic framework of the requirements for allocation and accounting of tax-exempt bond proceeds is as described above, there is very little Internal Revenue Service interpretation of the applicable regulatory provisions, and application of the requirements to particular situations may raise difficult interpretive questions.

For example, one difficult interpretive question that may arise is whether a specific direction to use, or not to use, bond proceeds for a particular purpose is an “allocation method” that will be respected under the allocation and accounting requirements. The regulations literally provide only that an “accounting” that establishes how the bond proceeds are spent be made prior to the time periods specified. For example, a provision in the tax certificate executed on the closing date that bond proceeds will be applied to pay only the first costs incurred for a particular project might suffice as an acceptable “accounting method” established on a timely basis, even though the provision is not labeled as an “accounting method”.

Another difficult interpretive question that sometimes arises is how a “project” is defined for purposes of the 18-month rule. For example, it is possible that functionally related projects may be treated as parts of a single “project” for purposes of the 18-month restriction in certain cases.

Need for “project completion tax review” procedures (completion certificate). Although the tax-exempt bond allocation and accounting rules set forth in the Income Tax Regulations sometimes raise difficult interpretive questions, as is discussed above, the most important practical point is straightforward: these rules in effect establish a tax compliance deadline for each bond issue for a new project. In that light, we recommend that the City should consider the adoption of a more formalized “project completion tax review” or “bond proceeds spending review” procedure for its new money tax-exempt bond issues. Such a project completion tax review should be initiated and completed before the expiration of the 18-month time limit referenced above. Among other benefits, such a project completion tax review procedure may benefit the City by enabling it:

- To correct any mistakes made in disbursing, or failing to disburse, bond proceeds.
- To simply compliance by avoiding situations in which same bond proceeds are treated spent on different projects for federal income tax and state law purposes.
- To save money by maximizing opportunities to qualify for spending exceptions from the “rebate” requirement.

- To establish a better record of how bond proceeds have actually been spent to use as a basis for future tax compliance and future refinancings.
- To mitigate possible interest allocation problems.
- To establish the amounts of any City cash contributions (other than tax-exempt bond proceeds) to pay the costs of the same project that is financed to provide more flexibility for future private business use of the financed project.

We appreciate the opportunity to further clarify our views on this matter.

APPENDIX A



POST ISSUANCE COMPLIANCE CHECKLIST

The National Association of Bond Lawyers (“NABL”) and the Government Finance Officers Association (“GFOA”) have jointly developed the following checklist to assist bond counsel in discussing with issuers and conduit borrowers, as applicable, post issuance compliance matters. The checklist is divided into three parts: tax, securities and State law matters. The checklist can serve as a framework for discussion at an appropriate time during the transaction or as a written document prepared by bond counsel and furnished to the issuer or conduit borrower after completion of the financing. Bond counsel may need to explain various items on the checklist to provide the issuer with a more complete understanding of the noted concept. The checklist can be amended or supplemented as needed to address the particular financing issue. Issuers and conduit borrowers are encouraged to contact bond counsel at any time they may have questions or concerns pertaining to tax, securities or State law issues.

In the “document reference” column, where applicable, the financing document pertaining to the referenced point should be named. This will assist others on the finance team – present and future – to be able to locate the original notation. The “responsibility” column should list the various offices/desks within the government or legal or other professional that have been engaged for the purpose of that section who is/are responsible for maintaining the noted task. This list covers a broad spectrum of financing purposes of which only some will apply to your financing. Instances where each line will be completed are unlikely. However, you are encouraged to review the entire document and complete the lines that are applicable to your financing.

The checklist is intended to help issuers and/or borrowers throughout the entire lifetime of the financing to identify matters that need to be analyzed by the issuer and perhaps by counsel. Issuers are encouraged to retain and distribute the checklist to all “responsible” parties and others who may find it useful during the lifetime of a financing. **Keeping the checklist throughout the lifetime of the financing is important. Thus, issuers are encouraged to keep the document with the transcript.**

The completion and distribution of this checklist does not presume a contractual obligation on parties to complete these tasks.



National Association of Bond Lawyers

POST ISSUANCE COMPLIANCE CHECKLIST

TRANSACTION PARTIES		
Overall Responsible Office for Debt Management Activities	_____	
Bond Counsel	_____	
Trustee	_____	
Paying Agent	_____	
Rebate Specialist	_____	
Other:	_____	
Other:	_____	
Other:	_____	
A. TAX LAW REQUIREMENTS	Document Reference	Responsibility
1. General Matters.		
(a) Proof of filing Form 8038, 8038-G or 8038-GC. Copies of Form 8038, etc., to State authorities as required by State procedures.		
(b) "Significant modification" to bond documents results in reissuance under Treas. Reg. § 1.1001-3. Proof of filing new Form 8038, etc., plus final rebate calculation on pre-modification bonds.		
2. Use of Proceeds: Governmental Bonds or Qualified 501(c)(3) Bonds.		
(a) No private business use arrangement with private entity (includes federal government) beyond permitted <i>de minimis</i> amount unless cured by remedial action under Treas. Reg. § 1.141-12.		
(i) Sale of facilities.		
(ii) Lease.		
(iii) Nonqualified management contract. Rev. Proc. 97-13.		
(iv) Nonqualified research contract. Rev. Proc. 97-14.		
(v) "Special legal entitlement."		

APPENDIX A

(b) Additional requirements for qualified 501(c)(3) bonds.		
(i) No unrelated business activity income in facility beyond permitted <i>de minimis</i> amount.		
(ii) No activities jeopardizing 501(c)(3) exemption of 501(c)(3) borrower.		
(c) Remedial action may consist generally of redemption or defeasance of bonds (with notice of defeasance to IRS). Where disposition is a cash sale, remedial action may be an alternative qualifying use of proceeds. If bonds are 501(c)(3) bonds, alternative use must have “TEFRA” hearing and elected official approval prior to sale of original facilities. Proof of filing new Form 8038, etc.		
3. Private Activity Bonds. IRC §142.		
(a) Exempt facilities—in general.		
(i) Continuing use of exempt facilities in accord with basis of tax exemption.		
(ii) Use excess proceeds for redemption or defeasance (with notice of defeasance to IRS) within 90 days of determination that proceeds will not be spent, or date financed facility is placed in service. Treas. Reg. § 1.142-2(c).		
(b) Residential rental project bonds.		
(i) Meet low-income requirements for qualified project period. IRC §142(d).		
(ii) Proof of filing annual reports of compliance by project operator on Form 8703.		
(c) Qualified mortgage bonds.		
(i) Good faith compliance efforts for mortgage eligibility. IRC §143(a)(2).		
(ii) Spend proceeds or redeem bonds within 42 months of issuance; use mortgage prepayments after first 10 years to redeem bonds at next semiannual debt service date after receipt.		

APPENDIX A

<p>(iii) Proof of filing annual reports of mortgagor income due 8/15. Treas. Reg. § 1.103A-2(k)(2)(ii).</p>		
<p>(d) Small issue manufacturing bonds using \$10,000,000 (\$20,000,000 for 2007) capital expenditure limit: monitor capital expenditures during three years after issuance for compliance with limit. IRC §144(a).</p>		
<p>(e) Acquisition of existing facilities: make qualifying rehabilitation within 24 months unless covered by exceptions. IRC §147(d).</p>		
<p>4. Arbitrage.</p>		
<p>(a) Rebate. IRC §148(f).</p>		
<p>(i) First installment of arbitrage rebate due on fifth anniversary of bond issuance plus 60 days.</p>		
<p>(ii) Succeeding installments every five years.</p>		
<p>(iii) Final installment 60 days after retirement of last bonds of issue.</p>		
<p>(iv) Monitor expenditures prior to semi-annual target dates for six-month, 18-month, or 24-month spending exception.</p>		
<p>(b) Monitor expenditures generally against date of issuance expectations for three-year or five-year temporary periods or five-year hedge bond rules.</p>		
<p>(c) For advance refunding escrows, confirm that any scheduled purchases of 0% Securities of State and Local Government Series are made on scheduled date.</p>		
<p>5. Special Rules for Pool Bonds.</p>		
<p>(a) Redeem bonds at one-year and three-year expenditure target dates. Pay 95% of costs of issuance within 180 days. IRC §149(f), as amended 2006.</p>		
<p>(b) 501(c)(3) pools: redeem bonds at one-year expenditure target date. IRC §147(b)(4).</p>		
<p>6. Record Retention.</p>		

APPENDIX A

<p>(a) Maintain general records relating to issue for life of issue plus any refunding plus three years.</p>		
<p>(b) Maintain special records required by safe harbor for investment contracts or defeasance escrows. Treas. Reg. § 1.148-5.</p>		
<p>(c) Maintain record of identification on issuer’s books and records of “qualified hedge” contract. Treas. Reg. § 1.148-4(h)(2)(viii) and § 1.148-11A(i)(3).</p>		
<p>(d) Maintain record of election not to take depreciation on leased property that must be treated as owned by a governmental unit. Treas. Reg. § 1.103(n)-2T Q/A7.</p>		
<p>(e) Maintain record of agreements and assignments between governmental units that affect volume cap allocations under IRC §146. Treas. Reg. § 1.103(n)-3T Q/A8, 13 & 14.</p>		
<p>(f) Maintain record of election to utilize the \$10,000,000 small issue bond limit on the books and records of the issuer. Treas. Reg. § 1.103-10(b)(2)(vi).</p>		
<p>7. Allocations of Bond Proceeds to Expenditures.</p> <p>Make any allocations of bond proceeds to expenditures needed under Treas. Reg. § 1.148-6(d) and § 1.141-6(a) by 18 months after the later of the date the expenditure was made or the date the project was placed in service, but not later than the earlier of five years after the bonds were issued or 60 days after the issue is retired.</p>		
<p>B. DISCLOSURE REQUIREMENTS</p>		
<p>1. SEC Rule 15c2-12 Requirements.</p>		
<p>(a) Determine applicability of continuing disclosure undertaking (“CDU”).</p>		
<p>(b) Identification of “obligated person” for purposes of Rule 15c2-12.</p> <p>Governmental Bonds: Issuer. Private Activity Bonds: Issuer or Borrower.</p>		
<p>(c) Name of Dissemination Agent, if applicable.</p>		
<p>(d) Periodically determine that required CDU filings have been prepared, sent to and received by NRMSIR’s.</p>		

APPENDIX A

(e) Information required to be provided to NRMSIR and SID:		
(i) Annual Reports.		
(1) Quantitative financial information and operating data disclosed in official statement.		
(2) Audited financial statements.		
(ii) Other information.		
(1) Change of fiscal year.		
(2) Other information specified in CDU.		
(f) Material Event Disclosure. Notification by obligated person to SID and each NRMSIR, in timely manner, of any following events with respect to bonds, if event is material within the meaning of the federal securities laws:		
(i) Principal and interest payment delinquencies.		
(ii) Non-payment related defaults.		
(iii) Unscheduled draws on debt service reserves reflecting financial difficulties.		
(iv) Unscheduled draws on credit enhancements reflecting financial difficulties.		
(v) Substitution of credit or liquidity providers, or their failure to perform.		
(vi) Adverse tax opinions or events affecting the tax-exempt status of the bonds.		
(vii) Modifications to rights of holders of the bonds.		
(viii) Bond calls.		
(ix) Defeasances.		
(x) Release, substitution or sale of property securing repayment of the bonds.		

APPENDIX A

(xi) Rating changes.		
(g) Failure of the obligated person to timely file financial information (including audited financial statements) and operating data with SID and either each NRMSIR or MSRB.		
<p>2. Notification to Underwriters of Bonds.</p> <p>Determination of whether bond purchase agreement requires issuer of the bonds to notify underwriters for a specified period of time of any fact of event that might cause the official statement to contain any untrue statement of material fact or omit to state a material fact necessary to make the statements made therein, in light of the circumstances in which they were made, not misleading.</p>		
<p>3. Information Required to be Filed with Other Entities.</p>		
(a) Trustee.		
(b) Rating Agency(ies).		
(c) Bond Insurer.		
(d) Credit Enhancer.		
Examples:		
(i) Financial records.		
(1) Annual.		
(2) Quarterly.		
(ii) Budgets.		
(iii) Issuance of additional bonds.		
(iv) Events of default.		
(v) Notices of redemption.		
(vi) Amendments to bond documents.		
<p>4. Local Disclosure.</p> <p>State and/or local requirements.</p>		

APPENDIX A

C. MISCELLANEOUS STATE LAW AND DOCUMENT REQUIREMENTS		
1. Security.		
(a) Proof of filing UCC statements with appropriate authorities as required by State procedures.		
(i) Initial UCC financing statements filed with appropriate authorities. UCC 9-515(a).		
(ii) Continuation statements filed by fifth anniversary. UCC 9-515(d).		
(iii) Transfer by government or governmental unit not requiring a UCC statement. UCC 9-102(a)(45) (UCC exception adopted in certain jurisdictions).		
(iv) Public finance transaction in connection with debt securities (all or portion of securities have initial stated maturity of 20 years; obligated party is State or State governmental unit) qualifies for 30-year filing. UCC 9-515(b)		
(v) Other local requirements or exceptions.		
(b) Proof of filing recorded mortgages, deeds of trust with appropriate authorities and proof of delivery of originals to trustee or custodian.		
2. Insurance.		
(a) Proof of receipt of final title policy and proof of delivery to trustee or custodian.		
(b) Monitor compliance with property and casualty insurance requirements.		
3. Financial Covenants.		
Monitor compliance with rate covenant or other covenants not included in B(3) above.		
4. Transfer of Property.		
(a) Restrictions on transfer of cash.		
(b) Restrictions on releases of property.		
(c) Restrictions on granting liens or encumbering property.		

APPENDIX A

<p>5. Investments.</p> <p>Compliance with permitted investments.</p>		
<p>6. Derivatives.</p> <p>Entering into and ongoing compliance of derivatives contracts is complex and a universe in and of itself. GFOA has created a Derivatives Checklist and a Recommended Practice on the Use of Debt-Related Derivatives Products and the Development of a Derivatives Policy to assist issuers with understanding these products. These documents can be found at: http://gfoa.org/services/rp/debt.shtml.</p>		

APPENDIX B

FORM OF BOND PROCEEDS ALLOCATION CERTIFICATE

Bond Issue: [Formal Name of Bond Issue] (the “Bonds”)

This Bond Proceeds Allocation Certificate sets forth the allocation of proceeds of the Bonds to expenditures and projects. The Issuer will maintain this Bond Proceeds Allocation Certificate in its books and records for the Bonds to establish compliance with federal tax requirements applicable to the Bonds.

This Bond Proceeds Allocation Certificate makes allocations of only “new money” proceeds of the Bonds and any unspent net proceeds of any bonds that were refunded by the Bonds. The allocation of proceeds of refunded bonds is otherwise set forth in the certificates for the respective refunded bond issue. This Bond Proceeds Allocation Certificate does, however, set forth certain summary information for the entire issue of the Bonds.

I. *Summary Information Relating to the Bonds*

Issue Date	[Date of Issuance]
New Money Sale Proceeds	#[New Money Sale Proceeds]
New Money Investment Earnings	#[Actual New Money Investment Earnings]
New Money Proceeds	#[New Money Sale Proceeds plus Actual New Money Investment Earnings]
Total Bond Issue Sale Proceeds	#[Total Bond Issue Sale Proceeds]
Total Bond Issue Proceeds	#[Total Bond Issue Proceeds]
Weighted Average Bond Maturity	[Weighted Average Maturity] years
Applicable Private Use Limit	[Percentage Limit]%

II. *Allocation of Bond Proceeds to Expenditures*

The Issuer hereby allocates the proceeds of the Bonds to the expenditures set forth in Schedule 1 to this Certificate. In connection with this allocation, the Issuer represents as follows:

1. The Issuer will consistently treat these expenditures as the expenditures financed with the Bonds for private use, arbitrage and rebate purposes.
2. The weighted average reasonably expected economic life of the property financed with these expenditures is [Final Reasonably Expected Weighted Economic Life] years. 120% of the actual reasonably expected economic life of all of the property

APPENDIX B

financed with the Bonds ([120% of Final Weighted Reasonably Expected Economic Life] years) is greater than the weighted average maturity of the Bonds, as shown above.

3. Each asset of the financed property is owned, and is reasonably expected to be owned for the lesser of the remaining term of the Bonds or the remaining economic life of the asset by the Issuer.

4. The private use of the financed property is reasonably expected to be not more than [Reasonably Expected Private Use Percentage]%, [determined on an annual basis].

5. In each case, the allocation of Bond Proceeds to an expenditure has been made, or is now being made in this Certificate, within 18 months of the placed in service date of the project of which it is a part.

III. *Allocation of Bond Proceeds to Projects*

The Issuer hereby allocates the proceeds of the Bonds to the projects set forth in Schedule 2 to this Certificate (the “Financed Projects”), which Financed Projects have also been, or are reasonably expected to be, financed in part with other sources of funding, which may include proceeds of other tax-exempt bonds and equity of the Issuer. In connection with this allocation, the Issuer represents and elects as follows:

1. Each Financed Project consists only of one or more identified facilities or capital projects that are functionally related or integrated and are located on the same site or on reasonably proximate adjacent sites and that have been or are reasonably expected to be placed in service within the same 12-month period.

2. The Bond Proceeds and other sources of funding set forth on Schedule 2 have been, or are reasonably expected to be, expended pursuant to the same plan of financing.

3. Amounts set forth as Issuer “equity” consist only of proceeds of taxable obligations and cash spent on the Financed Project, and does not include equity interests in real property or tangible personal property. In addition, “equity” does not include amounts spent on subsequent improvements or replacements.

APPENDIX B

**SCHEDULE 1 TO BOND PROCEEDS ALLOCATION CERTIFICATE
ALLOCATION TO EXPENDITURES**

[Attach spreadsheet schedule showing amount, date, location,
and related purpose of expenditures]

APPENDIX B

SCHEDULE 2 TO BOND PROCEEDS ALLOCATION CERTIFICATE

ALLOCATION TO FINANCED PROJECTS

This Schedule 2 provides information regarding projects financed in part with Bond Proceeds and in part with equity of the Issuer, and does not necessarily list all expenditures made with Bond Proceeds.

[INSERT A SEPARATE TABLE FOR EACH FINANCED PROJECT]

Description of Project	
Commencement Date	
[Reasonably Expected] [Final] Placed in Service Date	
[Reasonably Expected] [Final] Total Project Costs	
Bond Proceeds Expenditures	
[Reasonably Expected] [Final] Equity Contribution	
[Reasonably Expected] [Final] Expenditures Financed with Other Tax-Exempt Bonds	

APPENDIX B

FORM OF PROJECT COMPLETION FUNDING ALLOCATION CERTIFICATE

This Project Completion Allocation Certificate sets forth the allocation of proceeds of the tax-exempt bond issues and equity to the project described in herein. The Issuer will maintain this Bond Proceeds Allocation Certificate in its books and records for the tax-bonds described in this Certificate to establish compliance with federal tax requirements applicable to those tax-exempt bonds. The allocations in this Certificate are consistent with the allocations made in Bond Proceeds Allocation Certificates for the tax-exempt bond issues described in this Certificate, and provide final information based on actual project expenditures.

Description of Project:

Commencement Date of Project:

Placed in Service Date of Project:

Total Project Costs:

Sources of Funding:

<i>Source of Funding</i>	<i>Expenditures</i>	<i>Percentage of Total Project Costs</i>
Equity		
[Tax-Exempt Bond Issue 1]		
[Tax-Exempt Bond Issue 2]		
[Tax-Exempt Bond Issue 3]		

MEMORANDUM

CLIENT-MATTER NUMBER
090184-0101

TO: Office of the City Auditor
City of San Jose

FROM: Michael G. Bailey

DATE: October 25, 2007

RE: Use of Sewer Connection Fee Funds to Make Interfund Loans and Transfer of Anti-Tobacco Funds to the General Fund

We have represented the City Auditor of the City of San Jose (“City”) in connection with a review of the use of sewer connection fees to make interfund loans, the use of the Anti-Tobacco Fund to make an interfund transfer to the General Fund and certain other matters relating to a performance review of bond issuance practices of the City. The City Auditor has requested our opinion on whether such interfund loans and interfund transfer are permitted under the Charter and Municipal Code of the City and the laws of the State of California.

Conclusions

(1) *Interfund Loans.* Although there is no authority expressly on point, there is a reasonable position an interfund loan from Sewer Connection Fee Funds 539 and 540 is (and has in the past been) authorized under applicable law, 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 sewer connection fee funds. Whether any particular interfund loan meets the prudent investment standard depends upon the facts and circumstances of that interfund loan. Relevant factors include the following: (a) source of and security for repayment of the interfund loan; (b) the reasonable expectations regarding repayment on the date the interfund loan is made; (c) the interest rate of the interfund loan; (d) the term of the interfund loan; and (e) the formality taken in documenting the terms of the interfund loan. Whether any particular interfund loan is consistent with the purposes of the sewer connection fee funds depends on whether, at the time the interfund loan is made, the timing of required repayments is consistent with the reasonably expected expenditures from the fund for the purposes of the fund. Under these standards, the

APPENDIX C

authority to make some of the interfund loans that have been made from Funds 539 and 540 is questionable.

Transfer from the HNVF Fund to the General Fund. The adoption of the City's 2003-04 Operating Budget cannot be properly regarded as an amendment to the specific restrictions on the HNVF Fund imposed by the Municipal Code. If the basis for the transfer was that the adoption of the operating budget in substance amended that provision of the Municipal Code, we do not believe that the transfer was properly authorized.

On the other hand, if the basis for the transfer was that the HNVF Fund was providing to the General Fund moneys sufficient to make expenditures within the permitted categories, we believe that there is a reasonable position that the transfer was properly authorized, provided that a reasonable basis to establish a relationship between the transfer and the permitted expenditures is demonstrated.

Facts

Interfund loans. We are advised by you that, as is further described in the Audit Report, Exhibit 8, the City has made loans from Sewer Connection Fee Funds 539 and 540 to unrelated programs and capital projects. Specifically, restricted Sewer Connection Fee funds have been used to provide bridge financing for renovating the old City Hall, constructing the new Civic Center, constructing libraries, and for bridge financing of the City's Anti-Tobacco/Healthy Neighborhood Venture Fund programs. The Sewer Connection Fee Funds have also been used to provide long-term financing for the construction of the City's Fiber Optic Network and for North Coyote Valley's Municipal Water System. In addition, the City is planning to issue another \$3 million loan from Fund 539 to the Anti-Tobacco/Healthy Neighborhood Venture Fund program in this fiscal year, according to the City Budget Office's 2007-2008 Proposed Operating Budget. Certain of these long-term loans have been outstanding since 1996 and 2000, respectively.

Pursuant to a Cost Sharing Agreement between the City and the West Valley Sanitation District of Santa Clara County (the "Sanitation District") for Construction, Operation and Maintenance of Joint Use Sanitary Sewers dated June 25, 2002 (the "Sanitary Sewer Joint Use Agreement"), the City and the Sanitary District share the cost for maintenance, installation, construction and rehabilitation of sewers jointly used by the City and the Sanitary District. Section VII.B of the Sanitary Sewer Joint Use Agreement expressly provides that nothing in that agreement shall deprive either party of the right to impose and collect fees or charges for the privilege of connecting any property in its legal jurisdiction to its own sewer system or for sewer services.

Interfund transfer. We are advised by you that the City's anti-tobacco programs began in 2000 when the City received its first funding under a tobacco settlement, under which the City was anticipated to receive \$250 million over 25 years. The City Council approved an allocation plan, timeline, criteria, and funding priorities for the tobacco settlement funds, referred to as the Healthy Neighborhood Venture Fund ("HNVF") Program. Specifically, the City Council directed that 25% of funds be spent on new or existing tobacco-free community health

APPENDIX C

programs, 50% be spent on education programs, and 25% be spent on senior services programs. These requirements are set forth the City's Municipal Code.

In March 2003, the City Manager's 2003-04 Budget Request identified a \$72.6 million shortfall. According to the City's 2003-04 Adopted Operating Budget: "As recommended in the Mayor's March Budget Message, the City Council approved the transfer of \$10.0 million to the General Fund to assist the City in minimizing the impact of the economic downturn on City services." The City subsequently transferred \$10 million from the HNVF Fund to the General Fund.

Applicable Law and Authority

Article 11, section 5(a) of the Constitution of the State of California (the "State") generally provides that "[i]t shall be competent in any city charter to provide that the city governed thereunder may make or enforce all ordinances and regulations in respect to municipal affairs, subject only to restrictions and limitations provided in their several charters and in respect to other matters they shall be subject to general laws."

A California court has held that the "acquisition, construction, improvement, extension, maintenance, operation and financing of a sewer system are 'municipal affairs' concerning which a chartered city is not subject to general law, except as its charter may provide." *See, e.g., Cramer v. City of San Diego*, 164 Cal. App.2d 168, 330 P.2d 235 (1958).

Section 200 of the Charter of the City generally provides that the City has the power to make and enforce all laws and regulations in respect of municipal affairs, subject only to such restrictions and limitations as may be provided in the Charter or in the Constitution of the State. Section 806 of the Charter of the City generally provides that the functions of the Finance Department of the City and the powers and duties of the Finance Director of the City shall include to "receive and collect all revenues due to the City; to maintain custody of all public funds and securities belonging to or under control of the City, and deposit and invest funds in accordance with principles of sound treasury management and in accordance with the applicable laws or ordinances."

Section 1211 of the Charter generally provides that all monies paid into the City Treasury shall be credited to and kept in separate funds in accordance with the provision of the Charter or ordinance. Section 1211 also generally provides that all funds and receipts that are not required by the Charter, State law or ordinances to be placed in special funds shall be credited to the General Fund of the City.

Interfund loans. The Charter does not otherwise address the authority to make interfund loans.

The City's Municipal Code provides authority and places restrictions on the City to charge fees for the provision of services such as water, sewer connection, storm water and other fees and charges. Title 15, Section 15.16.560 of the City's Municipal Code restricts the use of the Sanitary Sewer Connection Fee Fund (Fund 540) in the following manner:

APPENDIX C

All sanitary sewer connection fees collected pursuant to the provisions of this part shall be placed into a special fund which is hereby created and established for such purpose, and which shall be known as the “sanitary sewer connection fee fund.” Such revenues so placed and deposited in such fund may be used for the construction and reconstruction of the sanitary sewer system of the city of San Jose and for the acquisition of land for such system, and for no other purpose or purposes.

Title 15, Section 15.16.790 of the City’s Municipal Code restricts the use of the Sewage Treatment Plant Connection Fee Fund (Fund 539) in a similar manner:

All sewage treatment plant connection fees collected pursuant to the provisions of this part and Part 4 shall be placed into a special fund which is created and established for such purpose, and which shall be known as the “sewage treatment plant connection fee fund.” Such revenues so placed and deposited in such fund may be used only for the acquisition, construction, reconstruction and enlargement of the sewage treatment plant, to repay principal and interest on any bonds which have been issued or which may hereafter be issued for the acquisition, construction, reconstruction or enlargement of the sewage treatment plant, and to repay federal or state loans or advances which have or may be hereafter made to the city for the acquisition, construction, reconstruction and enlargement of the sewage treatment plant.

Title 2, section 2.04.2020 of the City’s Municipal Code provides that the Finance Director shall “[a]dminister and supervise the investment of city funds in accordance with the city’s investment policies as may be adopted or amended by the city council from time to time.”

Section 66013(c) of the California Government Code sets forth restrictions on sewer connection funds that are similar to the City’s Municipal Code restrictions:

A local agency receiving payment of a [capacity charge] shall deposit it in a separate capital facilities fund with other charges received, and account for the charges in a manner to avoid any commingling with other moneys of the local agency, except for investments, and shall expend those charges solely for the purposes for which the charges were collected. Any interest income earned from investment of moneys in the capital facilities fund shall be deposited in that fund.

Section 66013(b)(3) of the California Government Code provides that the term “capacity charge” means “a charge for facilities in existence at the time a charge is imposed or charges for new facilities to be constructed in the future that are of benefit to the person or property being charged.”

APPENDIX C

Section 66013(d) generally provides that, for a capacity charge fund established under section 66013(c), the local agency shall make certain available to the public each fiscal year. Section 66013(d)(5) specifically requires information regarding interfund transfers:

A description of each interfund transfer or loan made from the capital facilities fund. The information provided, in the case of an interfund transfer, shall identify the public improvements on which the transferred moneys are, or will be, expended. The information, in the case of an interfund loan, shall include the date on which the loan will be repaid, and the rate of interest that the fund will receive on the loan.

Article XIID of the Constitution of the State specifies various restrictions and requirements for assessments, fees, and charges that local governments impose on real property or on persons as an incident to property ownership. The California Supreme Court has held that a charge that a local water districts imposed as a condition to making a new connection to the water system, and that the district used to finance capital improvements to the water system, is not subject to the restrictions of Article XIID. *Richmond v. Shasta Community Services District*, 32 Cal.4th 409 (2004).

The Investment Policy of the City (the “Investment Policy”) generally applies to all funds, entities and investment activities under the Director of Finance’s control and specifically applies to “Special Revenue Funds”, “Capital Projects Funds” and “Enterprise Funds”. Section 2.0. Section 3.0 generally of the Investment Policy generally provides that City Investment Officials performing duties in furtherance of the investment program, shall act as fiduciaries subject to the Prudent Investor Standard which shall be applied in the context of managing an overall portfolio.

The Investment Policy specifically permits investments in bonds issued by the City, but only if certain eligibility criteria are met. Section 12 of the Investment Policy permits investment in bonds issued by the City or an agency of the City if (1) the securities are rated AA or better by two of the three nationally recognized credit rating organizations (and if that rating is the issuer’s underlying rating, irrespective of credit enhancements obtained from third party organizations); (2) such securities account for no more than 5% of the total portfolio for each separate legal entity with an agreement limit in bonds issued by the City, not to exceed 15% of the total portfolio; and (3) the maturity of the securities does not exceed 5 years. Section 15 provides that ineligible securities are securities “that could result in zero interest accrual” and any investments not specifically authorized by the Investment Policy that are not otherwise approved by the City Council.

Section 15.3 of the Investment Policy provides that, while the Investment Policy prescribes various maximums, minimums and other relatively arbitrary numerical limits, it is intended primarily to be a management tool. When the Director of Finance determines that an exception to one of the Investment Policy’s numerical limits is in the best interest of the City, and is otherwise consistent with the Investment Policy, such exception is permitted so long as it is consistent with applicable City, State and Federal laws. Whenever an exception or violation of

APPENDIX C

the Investment Policy is made, however, that fact is required to be reported to the City Manager and City Council within one business day of its discovery.

The Investment Policy does not expressly address the treatment of interfund loans.

There is little general case law addressing the treatment of interfund loans of municipalities under California law. In *Mahoney v. City and County of San Francisco*, 201 Cal. 248, 257 P. 49 (1927), the Supreme Court of California held that certain interfund loans made by the City of San Francisco were not authorized based on a specific provision in the city's charter prohibiting interfund transfers. In *Klassen v. City of San Carlos*, 149 Cal. App.2d 225 (1957), the court held that certain interfund transfers were not permitted unless authorized by law.

Transfers from the HNVF Fund. Section 4.80.1830 of the City's Municipal Code sets forth specific restrictions on the uses of the HNVF Fund:

Moneys in the anti-tobacco master settlement agreement revenue fund may be expended only for the following purposes:

A. *Anti-tobacco programs.* Twenty-five percent of the settlement proceeds collected in any fiscal year shall be expended for existing or new anti-tobacco programs, including but not limited to licensing of tobacco sales, law enforcement, code enforcement, anti-tobacco public education or marketing, anti-smoking and smoking cessation programming, and healthcare programs.

B. *Education.* Fifty percent of the settlement proceeds collected in any fiscal year shall be expended for new educational programs or expansion of existing education programs, including, but not limited to art and music education, homework centers, mentoring, school safety, gang prevention/interfund centers, and healthcare programs.

C. *Seniors.* Twenty-five percent of the settlement proceeds collected in any fiscal year shall be expended for healthcare programs or new senior programs or the expansion of existing senior programs, which may include an element of anti-tobacco programming, and for senior discount programs for city provided services.

1. *City funded programs may include, but are not limited to: malnutrition programs, senior adult day care, elder abuse protective services programs and senior housing programs.*

2. *City senior discount programs may include discounts for sewer, garbage, transit, recreation, and other services or programs either provided by the city or sponsored by the city for its residents.*

3. *For the purposes of this section, the term discount shall mean the reduction of a fee or charge in any amount, up to and including a 100% reduction.*

APPENDIX C

Section 603 of the City Charter provides as follows: "No section of any ordinance or of any code shall be amended unless the whole section to be amended is set forth as amended."

Discussion and Analysis

Interfund loans. In light of the foregoing authority, there is a possible basis for the City to take the position that restrictions on Funds 539 and 540 are "municipal affairs" governed by the Charter and Municipal Code, and not by the State Government Code, to the extent that such uses do not implicate the provisions of the Constitution of the State. We acknowledge that there is ambiguity regarding the scope of the "municipal affairs" doctrine in this context, and believe that it is reasonable for the City to take the position that the provisions of the State Government Code may apply.

In any event, however, the restrictions imposed on Funds 539 and 540 by the City's Municipal Code are similar to the restrictions imposed by California Government Code section 66013. Although the specific wording of the Municipal Code provisions is somewhat different than the Government Code provision, both the Municipal Code and the Government Code in substance provide that amounts in the funds may be used only for the specific purpose for which the charges were collected.

In interpreting these restrictions, we believe that the provisions contemplate a distinction between expenditure and investment. The Municipal Code implicitly contemplates that amounts in the funds may (and in fact should) be prudently invested. Section 66013 of the Government Code more expressly references investments, and appears to reference interfund loans as possible investments. If an interfund loan is not made for sewer connection purposes and is not in substance investment, however, it is an expenditure for an unauthorized purpose, and is not permitted.

The Investment Policy of the City expressly permits investments in obligations of the City, subject to certain eligibility criteria. Interfund loans do not generally appear to meet all of the technical requirements of the Investment Policy, including the requirement of a minimum rating of AA. Under certain facts and circumstances, however, interfund loans might have characteristics that are in substance comparable to the specific eligibility requirements of the Investment Policy. The Investment Policy does not expressly reference interfund loans.

Section 8(15) of the Investment Policy permits an investment not specifically authorized by the Investment Policy, provided that it is otherwise approved by the City Council and provided that it is not a specifically listed unauthorized investment. Accordingly, if the investment is specifically approved by the City Council, it is not required to meet all of the eligibility requirements listed in the Investment Policy.

The Charter, the Municipal Code and the Investment Policy together indicate that the Finance Director is required to make investments according to a prudent investor standard. Section 806 of the Charter requires the Finance Director to make investments "in accordance with principles of sound treasury management." Section 3.0 of the Investment Policy generally

APPENDIX C

requires that City Investment Officials follow a “Prudent Investor Standard” including prudence, discretion and intelligence and requires investments “not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.”

Accordingly, in our view approval of an otherwise ineligible investment by resolution of the City Council cannot override the prudent investor standard that is implied by the Charter and Municipal Code.

Read together, we are of the opinion that these provisions at a minimum require interfund loans from Funds 539 and 540 meet the prudent investor standard, such that they have terms that a prudent investor would require. Whether an interfund loan meets this requirement depends on all the facts and circumstances, including (1) the source of and security for repayment of the interfund loan, (2) the reasonable expectations regarding repayment on the date the interfund loan is made, (3) the interest rate on the interfund loan, (4) the term of the interfund loan and (5) the formality taken in documenting the terms of the interfund loan..

Under this standard, we are of the opinion that the authority to enter into the long term loan to finance the Fiber Optic Network and the long term loan to finance the Coyote Valley Water Project was questionable. On the other hand, the authority to enter into short-term bridge financing loans requiring repayment from the General Fund and reasonable interest rate terms has a sounder basis. In addition, under this standard, we are of the opinion that any interfund loan that did not provide for the payment of any interest should be presumed to be unauthorized.

To the extent that any amounts in Funds 539 and 540 are subject to the restrictions imposed by Article XIID of the Constitution of the State, we believe that a similar analysis applies, based on the provisions of the Constitution and the general laws of the State.

Based on our review, the Joint Use Sanitary Sewer Agreement appears to contemplate only the sharing and allocation of costs, not the sharing and allocation of revenues, including investment earnings on sewer funds. Accordingly, we believe that the Joint Use Sanitary Sewer Agreement is not relevant to the analysis of whether the interfund loans from Fund 540 were authorized because investment losses in separately held funds do not appear to be “costs” within the meaning of this agreement.

Transfer from the HNVF Fund. As is set forth above, section 603 of the City Charter specifically provides that “No section of any ordinance or of any code shall be amended unless that whole section to be amended is set forth as amended.” Thus, we do not believe that the adoption of the City’s 2003-04 Operating Budget can be properly regarded as an amendment to the specific restrictions on the HNVF Fund imposed by Section 4.80.1830 of the Municipal Code. If the basis for the transfer was that the adoption of the operating budget in substance amended that provision of the Municipal Code, we do not believe that the transfer was properly authorized.

In *Collier v. City and County of San Francisco*, 141 Cal. App. 4th 1326 (2007), a California appellate court considered certain interfund transfers made from San Francisco’s

APPENDIX C

Building Inspection Fund. Under the San Francisco Administrative Code, use of the Building Inspection Fund was restricted to certain specified purposes. San Francisco adopted certain annual budget ordinances approving transfers of amounts in its Building Inspection Fund for planning purposes. The court held that the transfers did not violate San Francisco's Administrative Code because San Francisco had the legislative authority to amend or repeal ordinances by enacting subsequent, inconsistent ordinances such as the annual budget ordinances.

In so holding, the *Collier* court noted that the amendment of the Administrative Code was consistent with the San Francisco charter, which provided that San Francisco could not amend or repeal its charter by ordinance. The *Collier* holding is distinguishable from the City's transfers from the HNVF Fund, because the City Charter sets forth a specific procedure for amendments to the Municipal Code, not just a procedure for amendments to the City Charter.

On the other hand, we note that the stated purposes of the HNVF Fund are quite broad. If the basis for the \$10 million transfer was that the HNVF Fund was providing to the General Fund moneys sufficient to make expenditures within the listed categories, we believe that there is a reasonable position that the transfer was properly authorized, provided that a reasonable basis to establish a relationship between the transfer and the permitted expenditures is demonstrated. In analogous contexts, California courts have indicated that municipalities may have considerable flexibility to establish that interfund transfers are applied for authorized purposes. See, e.g., *Collier v. City and County of San Francisco*, *supra*. In general, a city charter bears the same relationship to ordinances as the State Constitution does to statutes. *Citizens for Responsible Behavior v. Superior Court* 1 Cal. App.4th 1013, 1014 (1991).

Consequences of Unauthorized Interfund Loans and Interfund Transfers

Unauthorized interfund loans and interfund transfers may raise questions regarding the legal authority to impose the fees that were deposited into the fund making the interfund loan or interfund transfer. These questions regarding legal authority may include whether a fee that is not applied to the purpose for which it is imposed is a "special tax" subject to the restrictions of Article XIII A, section 4 of the California Constitution. See, e.g., *Collier v. City and County of San Francisco*.

In addition, Section 424(a) of the California Penal Code provides that each officer of a city within the State and "every other person charged with the safekeeping, receipt, transfer, or disbursement of public moneys who either 1. Without authority of law, appropriates the same, or an portion thereof, to his or her own use, or to the use of another" or "2. Loans any portion thereof; makes a profit out of; or uses the same for any purpose not authorized by law" is "punishable by imprisonment in the state prison for two, three or four years, and is disqualified from holding any office in this state."

In *Stark v. Superior Court*, 140 Cal. App. 4th 567 (2006), the defendant, a county auditor-controller, made several transfers from the county's general fund to the waterwork's district fund totaling \$336,485. The California Supreme Court has granted review of this case and the opinion has been superseded.

APPENDIX C

In the superseded opinion, the appellate court examines what sort of mens rea is required to be found in violation of the statute. The court said:

"... to be convicted of violating section 424(a)(1), the public official must have known he was acting without authority of law in appropriating the money and thereby *intended* to act without legal authority. This is not to say that the public official must know he is violating section 424(a)(1) by his action; only that he must know he has no legal authority to appropriate the money for himself or another." 140 Cal.App.4th 567, 589.

As to whether the defendant knew whether his actions were unauthorized, the appellate court allowed grand jurors to infer that he did based on his many years of experience as the county auditor, stating:

"From the fact that [defendant] had been the County's auditor-controller for nearly 20 years, and the other evidence before them, the grand jurors could reasonably entertain a strong suspicion that [defendant] was conversant in the law governing his position and therefore knew he did not have legal authority to transfer money from the County's general fund to the Waterworks District." 140 Cal.App.4th 567, 593.

Recommended Policies and Procedures

We recommend that the City should adopt as a best practice a formal policy and procedure for making interfund loans. This policy should be that no interfund loan will be made unless (1) the Finance Director makes a specific finding that the interfund loan meets the prudent investor standard, (2) the Finance Director makes a specific finding that the interfund loan is consistent with the purposes of the fund from which the loan is made, and (3) the interfund loan is formally documented in a manner consistent with a standard form approved by the City Attorney.

We recommend that the procedures to implement this policy as a best practice should be as follows.

In determining whether an interfund loan meets the prudent investor standard, the Finance Director should make the following findings: (a) the security for repayment for the interfund loan provides for reasonable certainty regarding repayment, and is not speculative; (b) there is a reasonable expectation that all payments of principal and interest will be repaid when due; (c) the interest rate established for the interfund loan is a market rate for a loan with comparable security and repayment terms, (d) the City Attorney has provided assurances that the interfund loan is enforceable.

In determining whether the interfund loan is consistent with the purposes of the fund from which the loan is made, the Finance Director should determine a schedule of the reasonably expected expenditures from the fund. The Finance Director should specifically determine that the repayment terms of the interfund loan will be consistent with such reasonably expected expenditure needs.

APPENDIX D

DEFINITIONS OF PRIORITY 1, 2, AND 3 AUDIT RECOMMENDATIONS

The City of San Jose's City Administration Manual (CAM) defines the classification scheme applicable to audit recommendations and the appropriate corrective actions as follows:

Priority Class ¹	Description	Implementation Category	Implementation Action ³
1	Fraud or serious violations are being committed, significant fiscal or equivalent non-fiscal losses are occurring. ²	Priority	Immediate
2	A potential for incurring significant fiscal or equivalent fiscal or equivalent non-fiscal losses exists. ²	Priority	Within 60 days
3	Operation or administrative process will be improved.	General	60 days to one year

¹ The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation which clearly fits the description for more than one priority class shall be assigned the higher number. (CAM 196.4)

² For an audit recommendation to be considered related to a significant fiscal loss, it will usually be necessary for an actual loss of \$25,000 or more to be involved or for a potential loss (including unrealized revenue increases) of \$50,000 to be involved. Equivalent non-fiscal losses would include, but not be limited to, omission or commission of acts by or on behalf of the City which would be likely to expose the City to adverse criticism in the eyes of its citizens. (CAM 196.4)

³ The implementation time frame indicated for each priority class is intended as a guideline for establishing implementation target dates. While prioritizing recommendations is the responsibility of the City Auditor, determining implementation dates is the responsibility of the City Administration. (CAM 196.4)