



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

February 21, 2012

The Honorable City Council
Palo Alto, California

Finance Committee Recommendation to Accept the Audit of the Use of Library Bond Proceeds

The City Auditor's Office recommends acceptance of the Audit of the Use of Library Bond Proceeds. At its meeting on December 6, 2011, the Finance Committee approved and recommended the report 3-1. The Finance Committee minutes are included in this packet.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "J. Pelletier".

Jim Pelletier
City Auditor

Audit Staff:

Houman Boussina, Senior Performance Auditor
Ian Hagerman, Senior Performance Auditor

ATTACHMENTS:

- Attachment A: Audit of the Use of Library Bond Proceeds (PDF)

Department Head: Jim Pelletier, City Auditor



CITY OF PALO ALTO OFFICE OF THE CITY AUDITOR

December 6, 2011

The Honorable City Council
Attention: Finance Committee
Palo Alto, California

Audit of the Use of Library Bond Proceeds

The City has used Library Bond monies appropriately, but policies and procedures should be formalized

In accordance with the Fiscal Year (FY) 2012 Annual Audit Work Plan, the City Auditor's Office has completed an Audit of Library Bond Proceeds. The audit contains one finding with a total of four recommendations.

Finding 1: The City has used Library Bond monies appropriately, but policies and procedures should be formalized

Our review found the City has used Library Bond funds appropriately and established oversight processes to help ensure the proper use of Library Bond funds. However, the Administrative Services Department and Public Works Department should formalize policies and procedures to ensure on-going compliance with federal and state regulations. In addition, while Library Bond proceeds may be used to pay for staff labor costs associated with the Library Projects, the City does not have a policy on using Library Bond funds to pay for these costs. Staff should also ensure the City's contracting requirements are met prior to the delivery of services or payment.

We thank the staff of the Administrative Services Department (ASD), the Public Works Department (PWD), the City Attorney's Office, and the Library Department for their time, information, and cooperation during the audit process. This report will be presented to the Finance Committee on December 6, 2011.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Ian Hagerman".

Ian Hagerman
Senior Performance Auditor

Audit Staff:
Ian Hagerman, Senior Performance Auditor

Houman Boussina, Senior Performance Auditor

ATTACHMENTS:

- Attachment A: Audit of the Use of Library Bond Proceeds (PDF)

Department Head: Ian Hagerman, Sr. Performance Auditor

AUDIT OF THE USE OF LIBRARY BOND PROCEEDS

The City has used Library Bond monies appropriately, but policies and procedures should be formalized



OFFICE OF THE CITY AUDITOR

DECEMBER 2011



Honorable City Council
Attn: Finance Committee
Palo Alto, California

December 6, 2011

Audit of the Use of Library Bond Proceeds: The City has used Library Bond monies appropriately, but policies and procedures should be formalized

In accordance with the Fiscal Year (FY) 2012 Annual Audit Work Plan, the City Auditor's Office has completed an Audit of the Use of Library Bond Proceeds. The audit contains one finding and four recommendations.

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Respectfully submitted,

Ian Hagerman
Senior Performance Auditor

Audit Staff:
Houman Boussina, Senior Performance Auditor
Ian Hagerman, Senior Performance Auditor

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Introduction

In accordance with the FY 2012 Annual Audit Work Plan, the City Auditor's Office has completed an Audit of the Use of Library Bond Proceeds. The primary purpose of this audit was to determine whether the City has appropriately used General Obligation Bond (bonds) funds issued under the 2008 voter-approved Measure N and whether the City has established adequate policies and procedures to ensure that these funds are used appropriately in the future .

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

On August 4, 2008, City Council approved placing a \$76 million General Obligation Bond measure on the November 2008 ballot to fund construction and completion of a new Mitchell Park Library and Community Center, renovation and expansion of the Main Library, and renovation of the Downtown Library (Library Projects). On November 4, 2008, over 69 percent of Palo Alto voters approved Measure N and the issuance of the General Obligation Bonds. Key provisions of Measure N included:

- The proceeds from the sale of the bonds would be used to build a new Mitchell Park Library and Community Center, expand and renovate the Main Library, and renovate the Downtown Library.
- Costs for the Library Projects in excess of \$76 million are to be paid with other City funds.
- The estimated tax rate to property owners would be \$27 per \$100,000 of assessed property value.
- The City is required to comply with rules under State law for financial accountability and reporting.
- The Administrative Services Director is responsible for filing an annual report with the City Council regarding the amount of funds collected and expended as well as the status of the Library Projects.
- The City would create a citizen's oversight committee to monitor the projects and report to the City Council.
- Annual audits of the bond funds are required.

The Library Projects consist of the following components:

- Mitchell Park Library and Community Center: A new joint-use facility with larger library collections, reading and meeting areas and community center space. The renovation will also improve seismic and fire safety.
- Main Library: The Main Library will expand to allow for new group study and meeting rooms and more collection space. The renovation will also include seismic upgrades.
- Downtown Library: The renovation will improve seating and computer areas, meeting rooms, lighting, access for individuals with disabilities, and enhance seismic and fire safety.
- Temporary Facilities: The City constructed temporary library facilities at the Cubberley Community Center Auditorium to use while the Mitchell Park Library and the Community Center are under construction.

Staff recommended issuance of two series of bonds to pay for the \$76 million Library Projects. In June 2010, the City sold bonds that yielded net proceeds of \$58.5 million, as shown in Exhibit 1, for the Downtown and Mitchell Park Libraries and Community Center. The City is planning another bond issuance to pay for the remaining costs of the work on the Main Library in 2012.

Exhibit 1: Net Proceeds to the City for Issuance of Measure N General Obligation Bonds

Total Amount of Bonds Issued	\$59,071,208
<i>Less Underwriter's Discount</i>	<i>(\$348,010)</i>
<i>Less Estimated Cost of Issuance</i>	<i>(\$223,198)</i>
Net Proceeds to the City	\$58,500,000

Source: Official Statement on the Issuance of the Series 2010A Bonds

The City initially allocated the \$58.5 million in net proceeds as follows:

- The City reimbursed the Infrastructure Reserve \$4.2 million for all expenditures except staff labor charges associated with management of the projects dating back to March 2, 2009.
- The City deposited the remaining \$54.3 million into the City's California Asset Management Program (CAMP) account to pay for future costs of Library Projects.

Several City departments will play a key role in the management and oversight of the Library Projects. PWD has the primary responsibility for managing the construction projects and has hired a construction project manager to support and supplement the work of PWD staff. ASD is responsible for overseeing the bond issuance. ASD also hired a financial advisory firm to assist with bond issuance. The Library and Community

Services Department has coordinated temporary closures, as well as services and programming at the new facilities.

In accordance with Measure N, the City has implemented measures to provide oversight of the use of Library Bond monies. It has established a five-member Library Bond Citizen Oversight Committee to monitor bond fund expenditures. In addition, Measure N requires annual reports from the City's external financial auditor on the City's compliance with key provisions of Measure N. The first report was issued in October 2010 covering the period through June 30, 2010. The report stated the City appropriately deposited and used proceeds from the sale of the bonds for the purposes specified in Measure N. The report also recommended the ASD Director file a required annual report regarding the amount of funds collected and expended, as well as the status of the Library Projects approved in Measure N.

Objective, Scope, and Methodology

The objective of this audit was to evaluate controls for the use of the general obligation bond funds to ensure the funds are used in accordance with the bond requirements and federal regulations for the use of tax-exempt bonds. Our review was limited to pre-issuance costs dating back to March 2009 and other bond fund expenditures through July 11, 2011.

To assess whether the City used bond monies appropriately we reviewed a judgmental sample of 30 pre-bond issuance Library Project expenditures totaling \$1.5 million incurred during the period from March 2, 2009,¹ through July 21, 2010. We also reviewed a judgmental sample of 22 Library Project expenditures totaling \$1.3 million incurred during FY 2011. We selected samples to test a variety of vendors and expenditure amounts.

We also reviewed applicable sections of the California Constitution and the Internal Revenue Code, City Council Resolutions, City Manager Reports, and written guidance from the City's Bond Counsel. We also reviewed guidance from the California Debt and Investment Advisory Commission, and other jurisdictions' policies and procedures. We met with staff in ASD, PWD, the City Attorney's Office, and the Library Department. We also attended meetings with the Library Bond Oversight Committee.

To assess the adequacy of the City's policies and procedures for oversight and disbursement of bond funds we reviewed ASD and PWD's procedures and processes to track and classify Library Project expenditures paid with bond proceeds, and reviewed the City's process to contract for professional services associated with issuance of the bonds. The audit did not include a review of construction management and the adequacy of the oversight provided on the Library Projects.

¹ This is the City's inception date for financial reporting on the Library Projects.

Finding 1: The City has used Library Bond monies appropriately, policies and procedures should be formalized

The City has used Library Bond funds appropriately and established oversight processes to help ensure the proper use of bond funds. However, ASD and PWD should formalize policies and procedures to ensure on going compliance with Federal and State regulations. In addition, while bond proceeds may be used to pay for staff labor costs associated with the Library Projects, the City does not have a policy on using bond funds to pay for these costs. Staff should also ensure the City's contracting requirements are met prior to the delivery of services or payment and consider developing a checklist of steps to take to properly execute contracts.

Appropriate use of Library bond monies

Government issuers of tax-exempt bonds must comply with a variety of rules and regulations associated with the issuance and use of tax-exempt bond monies. In particular, these proceeds may only be used to finance the acquisition or improvement of real property and bond issuers must maintain adequate policies and procedures to ensure that bond monies are used appropriately. Bonds could lose their tax-exempt status from the Internal Revenue Service (IRS) for violations of rules and regulations of their bonds.

The City's Bond Counsel has provided additional guidance on the appropriate use of bond monies. Specifically, the bond counsel stated, "real property will be considered to include land, buildings, and fixtures (items of moveable tangible property which are affixed to a building in such a manner as to indicate a permanent location for that item of property). In addition, consistent with generally accepted accounting principles, any cost that an accountant would include in the capital cost of the improvement such as architect and engineering fees are treated as includable within the meaning of real property for purposes of interpreting Article XIII A, Section 1 (b)(2)."

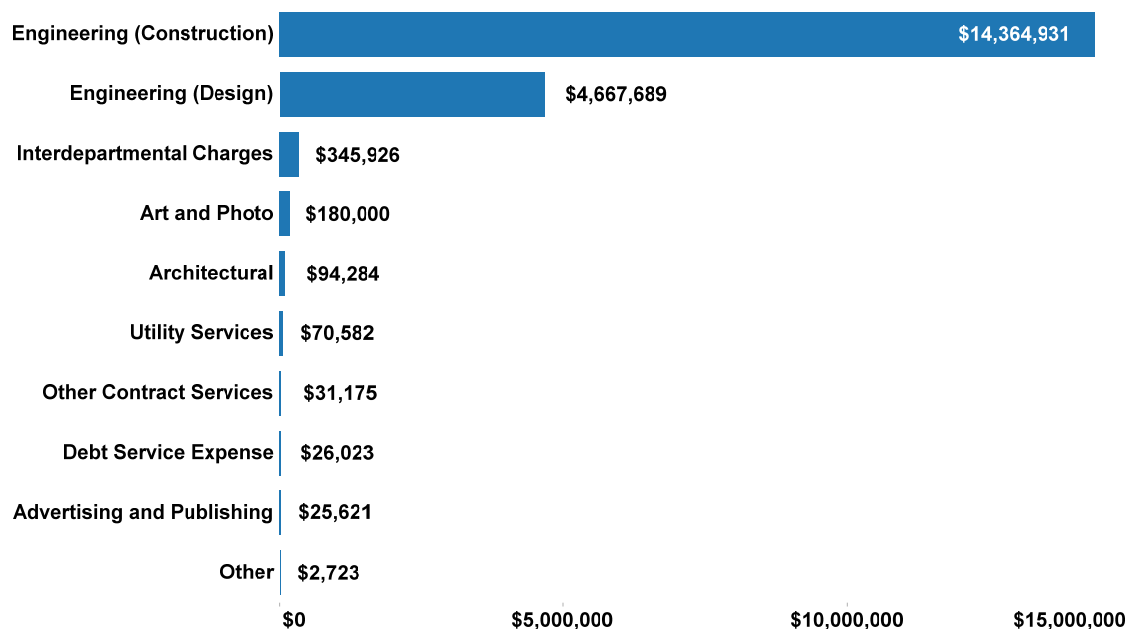
The City's Bond Counsel also stated that site improvements, costs of building a temporary library, and traffic signal improvements necessitated by the library project would also qualify to be paid for from bond proceeds.

The California Debt Issuance Primer (Primer) issued by the California State Treasurer also provides guidance on the appropriate use of general obligation bonds. Specifically, the Primer states "... labor costs, professional fees (such as for general contractors, architects, real estate appraisers, and brokers), real estate closing costs, and other costs directly connected to real property acquisition and improvement are probably also appropriately financed from general obligation bonds."

Library Bond monies were used appropriately, but the City should formalize policies and procedures regarding the oversight and expenditure of bond funds

From March 2, 2009 through July 11, 2011, the City spent approximately \$19.7 million on the Library Projects. Library Bond funds were used in accordance with Measure N, such as for engineering, construction, and architectural costs associated with the Library Projects. Exhibit 2 summarizes Library Project expenditures through July 11, 2011.

**Exhibit 2: Library Project Expenditures
from March 2, 2009 through July 11, 2011**

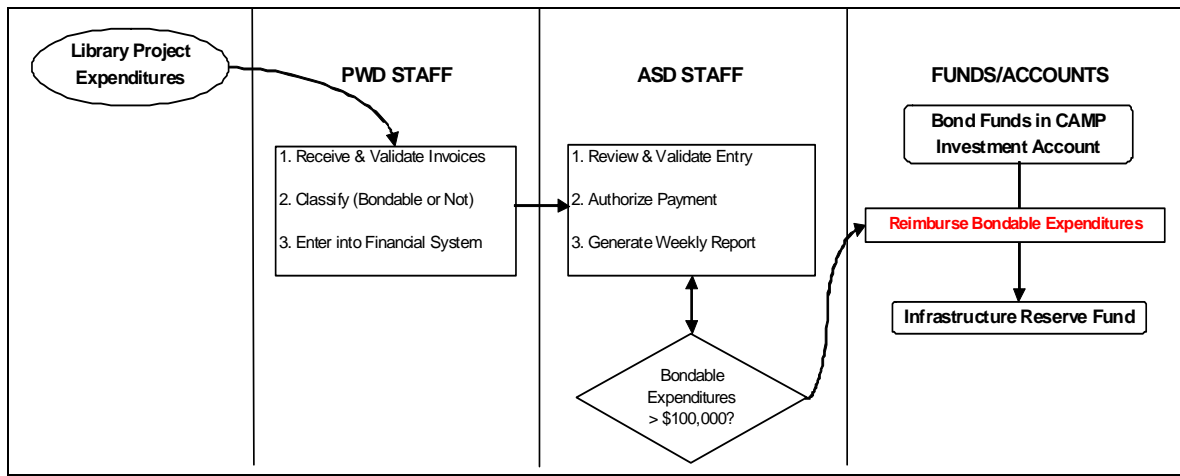


The City used bond funds to reimburse the Infrastructure Reserve for all expenditures except staff labor charges associated with management of the projects. The bond proceeds were properly used in most instances. We noted only minor ineligible expenses totaling approximately \$400 that were reimbursed with bond proceeds; however, staff reallocated these costs to other funding sources when notified.

The City has not issued General Obligation Bonds in over 30 years. According to staff, there were no known existing procedures to oversee the expenditures of General Obligation Bonds, so staff has had to develop new processes to ensure appropriate use of the bond monies. The City also utilized outside legal and financial expertise to assist in the issuance and oversight of the Library Bonds.

In general, the City has established processes which appear to be adequate to ensure Library Bond funds are used appropriately. Exhibit 3 summarizes the process used by staff to review, authorize and classify Library Project expenditures and use bond proceeds to reimburse the City's Infrastructure Reserve fund for bondable expenditures. According to staff, PWD receives Library Project invoices which are then reviewed to determine whether the expenditure is bondable and enters the invoices into the City's financial system where they are reviewed and authorized by ASD staff (for construction-related invoices, the City's construction manager reviews invoices and ensures that the work is done properly prior to forwarding invoices to PWD staff for review. When Library Project expenditures from the date of the last disbursement request reach a threshold of \$100,000, ASD staff prepares a disbursement request from the City's CAMP account to reimburse the Infrastructure Reserve for bondable expenditures.

Exhibit 3: Overview of the Process to Authorize, Classify, and Pay for Library Project Expenditures



Source: Interviews with staff and auditor's analysis of reimbursements

However, while ASD and PWD have taken steps to develop policies and procedures relating to the use of bond funds, the City does not yet have formalized policies and procedures regarding the oversight and expenditure of bond funds, which the IRS uses to evaluate post-issuance compliance. These procedures are important for assessing compliance related to the Library Projects and any future bond funded projects. The City Auditor's Office forwarded procedures to ensure proper use of bond monies, developed by the City of San Jose, for ASD staff to consider when developing policies for the City.

The IRS evaluates post-issuance compliance on a variety of factors including the availability of formal written procedures addressing:

- Proper use of bond proceeds
- Timely expenditure of bond proceeds
- Proper use of bond-financed property
- Arbitrage yield restriction and rebate
- Timely return of filings
- Roles and responsibilities to monitor post-issuance compliance
- Compliance with other general requirements

In 2007, the IRS Tax Exempt Bonds function (TEB) initiated a compliance project to evaluate the post-issuance and record retention policies, procedures, and practices of governmental issuers of General Obligation Bonds. In 2009, the TEB reported they issued a questionnaire to 200 selected government agencies to measure aspects of the post-issuance compliance.

The City Auditor's Office forwarded the IRS questionnaire and other guidance documentation to staff during the course of the audit. In the absence of formalized procedures, ASD is primarily relying on a memo from the City's Bond Counsel and its general accounting procedures to ensure proper use of bond funds. ASD and PWD should formalize policies and procedures regarding the oversight and expenditure of Library Bond funds to ensure continued compliance with federal and state regulations. In particular, policies and procedures should provide specific direction, based on applicable

regulations, best practices and legal guidance, for determining the eligibility and proper classification of Library Bond expenditures and contain documentation of management review and approval of the policies and procedures.

RECOMMENDATION #1: ASD should complete the IRS Governmental Bond Financings Compliance Check Questionnaire as a basis to evaluate compliance with IRS post-issuance requirements.

RECOMMENDATION #2: ASD and PWD should formalize policies and procedures regarding the oversight and expenditure of Library Bond funds to ensure continued compliance with federal and state regulations and best practices.

The City Council should consider providing policy guidance on the use of bond funds to pay for staff labor costs

As of July 13, 2011, the City's has incurred approximately \$619,000 in direct staff labor costs associated with project management of the Library Projects. Staff did not have an estimate of total staff costs over the life of the Library Projects available at the time of report issuance. Labor costs that are directly related to the completion of the project, such as project management costs, and that are specifically identifiable may be capitalized and included as bondable project costs. In addition, the text of Measure N does not prohibit the use of the bond funds to pay for staff labor costs associated with the project management of the construction. The City does not have a policy on using Library Bond funds to pay for these costs. However, staff costs related to management of other capital projects in the City are capitalized and are added to the total costs of projects. In our opinion, the City Council should consider providing policy guidance on the use of bond funds to pay for bondable staff labor costs related to the Library Projects and future bond funded projects.

RECOMMENDATION #3: The City Council should consider providing policy guidance on the use of bond funds to pay for bondable staff labor costs related to the Library Projects and future bond funded projects.

Staff should ensure the City's contracting requirements are met prior to delivery of services or payment

The City made payments on financial advisory and legal counsel contracts associated with the Library Bonds that had not been properly executed. In both instances, prior professional services contracts had expired and new agreements covering the Library Projects had not been signed or executed prior to payment by the City. While the City has subsequently remedied these situations, staff should ensure that the City's contracting requirements are met prior to the delivery of services or payment in the future and consider developing a checklist of steps to take to properly execute contracts.

RECOMMENDATION #4: ASD should ensure that the City's contracting requirements are met prior to the delivery of services or payment and consider developing a checklist of steps to take to properly execute contracts.

Conclusion

In August 2008, City Council approved placing a \$76 million General Obligation Bond measure on the November 2008 ballot to fund construction and completion of a new Mitchell Park Library and Community Center, renovation and expansion of the Main Library, and renovation of the Downtown Library. Our review found the City has used Library Bond funds appropriately and established oversight processes to help ensure the proper use of Library Bond funds. However, policies and procedures should be formalized to ensure on going compliance with federal and state regulations. In addition, while Library Bond proceeds may be used to pay for staff labor costs associated with the Library Projects, the City does not have a policy on using Library Bond funds to pay for these costs. Staff should also ensure the City's contracting requirements are met prior to the delivery of services or payment.

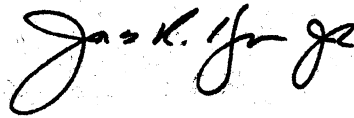
Recommendations

RECOMMENDATION #1: ASD should complete the IRS Governmental Bond Financings Compliance Check Questionnaire as a basis to evaluate compliance with IRS post-issuance requirements.

RECOMMENDATION #2: ASD and PWD should formalize policies and procedures regarding the oversight and expenditure of Library Bond funds to ensure continued compliance with federal and state regulations and best practices.

RECOMMENDATION #3: The City Council should consider providing policy guidance on the use of bond funds to pay for bondable staff labor costs related to the Library Projects and future bond funded projects.

RECOMMENDATION #4: ASD should ensure that the City's contracting requirements are met prior to the delivery of services or payment and consider developing a checklist of steps to take to properly execute contracts.

From: James Keene, City Manager 

By: Lalo Perez, Director Administrative Services/CFO

Date: December, 6, 2011

Subject: Staff Response to "Audit of the Use of Library Bond Proceeds"

Recommendations

ASD thanks the Auditor's Office for its detailed review of the use of Library Bond proceeds. Although the Auditor had one finding and four recommendations, staff believes they are relatively minor and that sufficient safeguards and reports have been implemented to assure the public, Council, and the Library Bond Oversight Committee that bond monies have and will be spent appropriately. Careful consideration should be given to adopting additional policies and procedures to ensure that any new requirements provide substantial benefits at an acceptable cost.

As mentioned in the audit, staff from the Attorney's Office, Public Works, and ASD met with outside Bond Counsel, who has significant expertise with General Obligation bonds, to determine what could and could not be covered by bond proceeds. Bond Counsel provided staff with written guidance regarding state law and proper expenditures for General Obligation bonds. To supplement this guidance, staff also consulted with a neighboring jurisdiction that recently issued General Obligation Library bonds to determine how their monies were spent. In addition, ASD and PW staff met to develop protocols for reviewing costs from the receipt of invoices through the payment of bills and the journaling of expenses. These procedures have been followed rigorously with the result that only small sums totaling \$400 were found by the Audit to be ineligible, with additional minor items found by the Library Oversight Committee and by staff. These were reallocated.

One of the Audit's major recommendations is that there is no policy concerning whether staff salaries should be paid by bond monies. Based on comments heard at Council meetings and the fact that projects approved by Council and the voters did not include staff salaries, staff acted on the premise that salaries were not to be covered by bond proceeds. Council directed that over \$1 million in early study and design costs be paid by the City to show good faith with voters and staff assumed at that time that its costs would not be reimbursable as well. Staff will, however, explicitly state or recommend in future City Manager Reports what bond proceeds will and will not cover.

In staff's view, the process followed here provided sufficient guidance and controls to address fundamental issues surrounding bond expenditures and to comply with Internal Revenue Service (IRS) requirements. It is not clear what

additional formal policies and procedures would provide substantial improvements at an acceptable cost. We note, for example, that compliance with Recommendations #1 and #2 will require staff time that will need to be diverted from other projects and duties.

More detailed responses to the Audit's recommendations can be found below:

RECOMMENDATION #1

ASD should complete the Internal Revenue Services' (IRS) Governmental Bond Financings Compliance Check Questionnaire as a basis to evaluate compliance with IRS post-issuance requirements.

Staff Partially Agrees and Disagrees:

In the future, staff will use the IRS Form 14002 (Compliance Check Questionnaire) as a checklist so we agree with using the tool. We disagree, however, with the possible implication from the recommendation that we were not in compliance with the Questionnaire and our responses to the sections of the Questionnaire follow:

- 1) Part I – “Post –Issuance Compliance – General”
This requirement primarily deals with having written procedures for proper use of bond proceeds (see recommendation # 2 for response)
- 2) Part II – “General Record Keeping”
City is in compliance – requires City have federal tax filing, audited financial statements, bond issuance documents, Council approved resolution authorizing the bond issuance, trustee statements, etc.
- 3) Part III – “Investments and Arbitrage Compliance”
City is in compliance – requires keeping interest earning records, records on investment instruments that the City isn't using (e.g. bond insurance and guaranteed investments contracts, swaps, etc.), arbitrage documents, etc.
- 4) Part IV – “Expenditures and Assets”
City is in compliance – as the title implies it requires supporting documents to be kept for all bondable expenditures and keeping list of bond financed assets
- 5) Part V – Private Business Use
This is not applicable to the City

RECOMMENDATION #2

ASD and Public Works should formalize policies and procedures regarding the oversight and expenditure of Library Bond funds to ensure continued compliance with federal and state regulations and best practices.

Staff Disagrees:

Administrative Service Department (ASD) has long established practices which incorporate what more formal written policy and procedures typically contain. Based on these, the City has met all regulatory and debt covenant requirements on all City bonds. ASD does maintain a checklist of debt covenant requirements for all City bonds. Library bonds have been added to this list. In addition, Public Works does have an internal written process for payment processing.

Based on the City's Auditor's recommendation, ASD and Public Works will consider writing more formal and detailed written procedures codifying existing guidelines and practices. This will incorporate the existing written Accounts Payable procedures for paying GO bondable expenditures. This task would be completed as time allows.

RECOMMENDATION #3

The City Council should provide policy guidance on the use of bond funds to pay for bondable staff labor costs related to the Library Projects and future bond funded projects.

Staff Disagrees:

General Fund capital project budgeting practice is to exclude staff time in project budgets. Consistent with this practice, staff labor costs were excluded. When Public Works' (PW) developed the original Library projects bondable budget of \$76 million (which included bond issuance costs), staff labor costs were excluded. This lessened the amount Palo Alto voters were asked to approve and was consistent with staff's interpretation of Council direction. The City Auditor's Office is correct, however, that staff costs could be reimbursed by bond proceeds. Going forward, staff will seek direction from the Council on inclusion of staff costs for bond-funded projects.

RECOMMENDATION #4

ASD should ensure that the City's contracting requirements are met prior to the delivery of services or payment and consider developing a checklist of steps to take to properly execute contracts.

Staff Agrees:

Slightly unique aspects of bond service contracts caused an oversight among ASD, the City Attorney's Office, and Bond Counsel that resulted in delayed execution of the contracts for Bond Counsel and the Financial Advisor. The Attorney's Office and ASD have created a checklist that requires the parties to review contract needs for bond issuance services prior to initiation of a bond process in order to provide sufficient time to ensure that contracts are executed in a timely manner. ASD will act to extend its Financial Advisor contract if it expires during a bond issuance.

CITY AUDITOR'S OFFICE RESPONSE TO THE CITY MANAGER'S RESPONSE

The City Auditor's Office (Auditor's Office) appreciates the assistance from the Administrative Services Department (ASD) in completing this audit.

Staff disagreed with Recommendation 1 on the basis of the possible implication from the recommendation that the City was not in compliance with IRS requirements. The audit report states that written procedures governing the use of bond proceeds are a factor the IRS uses to evaluate compliance, but does not make the argument that the City has not complied with those regulatory requirements nor has the Auditor's Office communicated such an opinion to management. In our opinion, there are no substantive areas of disagreement with the recommendation, and we caution against reading beyond the clear language of the recommendation and audit report which was to complete the IRS questionnaire as a means to evaluate and ensure continued compliance with regulatory requirements.

Furthermore, we do not agree with staff's assertion that compliance with Recommendations 1 and 2 would result in additional costs to the City and require diverting staff resources in any meaningful way. The audit does not make recommendations to substantively adopt additional policies and procedures, but rather to formalize the processes and procedures that staff is currently following to ensure ongoing compliance with regulatory requirements. In our opinion, this would not incur substantial cost or require significant staff resources. In addition, the Auditor's Office took steps to assist staff in these efforts by identifying and documenting processes and providing sample policies and procedures and IRS guidance.

While ASD does have general accounting policies/practices and legal guidance that it relies on to ensure proper use of bond monies, these should be formalized to ensure they are fully-defined, consistently applied, and tailored specifically to general obligation bond projects. The importance of regulatory compliance surrounding general obligation bonds, the possibility of future bond issuances, the public scrutiny of the use of bond monies, and the significant dollar amounts often associated with bond issuance further warrant specific attention from City management. Management's response mentions that the Public Works Department has an internal written process for payment processing related to the Library Projects. While this is accurate, this process, while written, was originally written down in an email to the Auditor's Office in response to our risk assessment and had not evolved beyond that stage by the time we completed audit work. In our opinion, this is an insufficient maturity level for policies and procedures that should ensure appropriate use of a \$76 million capital improvement project and any future bond issuances.

Lastly, staff disagreed with Recommendation 3 on several grounds. First, the response stated that staff costs are not normally included in General Fund capital budgets. While this may be the case, the City does separately capitalize General Fund Capital Improvement Project costs related to project management in its General Fund CIP and allocates those costs to CIP projects (see CIP project AS-10000 in the FY 2012 Capital Budget). In addition, staff was unable to provide any documentation of guidance or communication from the City Council regarding whether staff costs related to project management would be reimbursable by the bond. In the absence of a documented policy decision, we felt it would be prudent for direction to be given on this issue for the Library Projects and any future general obligation bond issuances.



FINANCE COMMITTEE

DRAFT EXCERPT

Special Meeting
December 6, 2011

1. Audit of the Use of Library Bond Proceeds

Ian Hagerman, Senior Performance Auditor, discussed the Audit of the Use of Library Bond Proceeds which was conducted in accordance with the Fiscal Year 2012 work plan. The Audit had one finding and four recommendations. The objective was to evaluate controls of the use of the general obligation bond funds. Staff reviewed pre-issuance costs dating back to March 2009, and expenditures back to mid-July 2011. They did not review the change order process or construction management for Mitchell Park. Staff sampled about \$3 million of costs for the library project. He reviewed the Measure N projects and Staff's recommendations to accomplish them. He reviewed the various department roles in the project as well as the oversight components to the project. He said the first required annual external audit report was issued last year which assessed appropriate use of monies as well as some additional requirements. He clarified that the money has been used appropriately, but Staff was recommending some formalized policies and procedures. Between March and July 2011 approximately \$20 million was spent on the Library Projects. Staff identified about \$400 in exceptions which was not significant. He recommended Staff complete an Internal Revenue Service (IRS) government bond financing compliance questionnaire. This questionnaire will help the City self-assess compliance with the rules and regulations associated with government issuers of tax exempt bonds. He recommended that the Administrative Services Division (ASD) and the Public Works Department (PWD) formalize policies regarding oversight. He stated that Staff disagreed with portions of these recommendations as indicated in the Staff response. He stated that ASD relied on the general accounting policies and procedures and legal guidance. PWD did have a written process for the library project. However that was written in an electronic mail (e mail) format and not formally adopted. He said such a large project should have a more mature and formal process. The IRS Tax Exempt Bond Compliance Program found that 60 percent government bond issuers stated they had written procedures for

use of bond proceeds, but further review demonstrated that only about 20 percent actually had written specific procedures. The IRS response was that this was a significant inattention to post-issuance compliance. This issue will continue to receive attention from the IRS. He said this risk warrants a specific approach to procedures. The third recommendation was for the City Council to recommend policy guidance on the use of bond funds to reimburse bondable staff labor cost related to project management. There had been about \$619,000 in Staff labor related to project management, these costs can be capitalized to the General Fund Capital Improvement Project (CIP). There had been undocumented discussion about these costs not being included in the project budget. It would be prudent for Council to discuss formalizing a policy regarding Staff management labor costs not only as it relates to the library projects but also as a permanent policy. Another recommendation was for ASD to ensure contract requirements would be met prior to services or payment. There were two professional services contracts in the Audit that were not properly executed prior to services being provided.

Joe Saccio, Assistant Director of Administrative Services said that he agreed with the Auditor's findings that some contracts were not properly managed. Staff had developed a procedure to address this issue going forward. Staff also agreed with the recommendation to use the IRS checklist. The City was compliant with and could provide back up documentation to demonstrate compliance with all of the IRS requirements. He said Staff understood from previous Council direction that Staff salaries were not to be included in the bond budget, and this is how the bond was addressed to the voters. These costs were assumed to be about \$1 to \$1.5 million dollars. Staff was open to the City Auditor's recommendation that Council review that process. This can be brought to the attention of the full Council and will affect bond rates. He stated the process and procedures were adequate and did not agree with the City Auditor's recommendation. There were sufficient measures in place. Staff requested Bond Council generate a letter indicating what could be covered. There was not much information available to make these determinations. Staff also reviewed the City of San Jose's processes. ASD Staff also worked closely with the Library Bond Oversight Committee, and PWD to ensure processes were in place. Workload limited Staff's ability to formalize many processes, when sufficient procedures were already in place. The email referred to by the City Auditor was created by PWD early in the project to ensure procedures were in place. Those procedures have been abided by.

Lalo Perez, Administrative Services Director, discussed the impact of the City Auditor's recommendations. The cumulative affect of all of the yearly City Auditor's recommendations were dramatic. He agreed it would be optimum to accommodate all of the recommendations, but a balance needed to be struck. Staff would accommodate any Council recommendations.

Chair Scharff asked if Staff was requesting the Finance Committee take action on this.

Mr. Hagerman said this was an unusual circumstance as Staff typically agreed with the City Auditor's recommendations. For this disagreement, Staff would appreciate guidance from the Finance Committee for follow-up purposes. As Staff prepares for future bond issuances, direction from Council on these recommendations would be useful.

Council Member Shepherd stated the Finance Committee discussed this in May and directed Staff to return with costs related to bond projects. She said there was \$619,000 that needed to be discussed as part of this request. She said she understood the need to spend public funds wisely, but she also wanted to know where money was being spent. That was the focus she wanted to take on this issue.

Mr. Perez said Staff did not have an issue with Council Member Shepherd's suggestion. The main issue would be for PWD and Library Staff to code their time. This was approximately \$1 million in operating costs that were unfunded that would need to be considered. Some operating costs and non-bondable costs could be covered.

Council Member Shepherd agreed and added this was a good discussion along with the Infrastructure Blue Ribbon Commission (IBRC) recommendations to determine how to sustain what was built.

Vice Mayor Yeh said the minutes from May should be reviewed, as he did remember that discussion. There had been some discussions to not count Staff costs to keep the bond costs as low as possible. There had also been discussions around a second issuance but it would not be for the balance to get to \$76 million. He asked if Staff had an estimate of what the 2012 issuance would be.

Mr. Saccio said there had been a discussion about change orders. He did not have specific information available, but thought they had issued \$7 or \$8 million but that had changed based on the change orders.

Mr. Perez said Staff could return with that information if directed to.

Vice Mayor Yeh confirmed there was Measure N authorization for about \$18 million more.

Mr. Saccio said that was correct.

Vice Mayor Yeh said that after all was said and done, he would like to tell the public they finished a higher number of projects below what was approved by the public for

Measure N. Including the Staff costs at this point could counter that goal. If we absorb the Staff labor costs as originally intended it creates a clear message that we stuck to the original approved plan.

Council Member Schmid said that if the original estimate was done without including Staff costs the obligation would be to complete the project in that way. The Council should discuss how to move forward.

Chair Scharff shared concerns about spending bond money on anything that has less than a 30 year life. Adding to the costs of the projects was concerning. He said more information was needed regarding this issue, the current library issue, future bond issues, what the impact will be, Council comments at the time, and what the language of Measure N actually includes. He suggested Staff take a clear report to the Finance Committee to allow them to make a recommendation to Council.

Council Member Shepherd said she considered this a bondable capital improvement and should be expensed over 30 years. She did agree that the dollars needed to be used efficiently. She suggested that Staff return with language for a policy to not include Staff costs.

Mr. Perez suggested Staff return with this information at mid year, which would typically be in February, to give Staff the time to gather the information.

Council Member Scharff agreed that mid year would be good timing as it would be after the IBRC report.

Mr. Perez said Staff would start listing the pending items on the back of the agendas to help the Committee and Staff keep track of added items.

Mr. Saccio asked if the Committee was requesting Staff document the background and make a policy recommendation.

Council Member Scharff said that if Staff developed a policy while working on this that would be fine, but he didn't need a recommendation as much as information and policy implications.

Mr. Perez said they would probably just bring facts back, versus recommendations. They would work with the City Clerk's office to find the appropriate minutes, and try to estimate the next issuance and perhaps a sense of the unfunded items.

Mr. Hagerman said this was an ideal resolution to this issue and was an important conversation.

Vice Mayor Yeh said there was a policy preference from the Committee that Staff labor costs should not be included for the library projects. He said Staff should return with documentation to help the discussions for mid-year and the City Clerk's records.

Mr. Perez clarified they also wanted an on-going policy.

Council Member Shepherd said on-going policy was a different discussion.

Council Member Scharff said Staff would return to remind Council of the discussions regarding the library bond issue. A second conversation was how to address the issue going forward which should have a hard-core analysis.

Council Member Shepherd said there was a portion of the CIP for supervising projects. This wasn't tied to any CIP and thus seemed unaccounted for. A policy should be created for this process.

Council Member Scharff asked if it should be a broader conversation than bonds.

Council Member Shepherd said it could relate to a CIP budget process as it might affect other projects.

MOTION: Vice Mayor Yeh moved, seconded by Council Member Scharff to recommend the City Council affirm that no Measure N proceeds will be used to pay for bondable Staff costs.

MOTION PASSED: 4-0

MOTION: Vice Mayor Yeh moved, seconded by Council Member Shepherd that staff return to the Finance Committee at mid-year with an analysis to enable policy discussion for the use of future bond funded projects and Staff labor costs.

Council Member Shepherd asked if the CIP budget was going to be changed.

Mr. Perez said the pending budget changes would focus on the Operating Budget.

Council Member Shepherd said she hoped this would help springboard changes.

Vice Mayor Yeh asked if the motion should include both bond and CIP.

Mr. Perez said Staff almost always included labor in CIP. They thought they were just dealing with bondable proceeds. He recommended they keep them separate.

MOTION PASSED: 4-0

Mr. Hagerman stated that there was not a strong disagreement with the first recommendation and suggested they move to the second recommendation.

Vice Mayor Yeh said this was a standard recommendation for controls. He understood the recommendations, but also wanted to have a better understanding of the impacts on Staff work-load.

Mr. Saccio said they had capable Staff to make existing procedures tighter. They had to consider not only the time it would take, but how deep they wanted to look into it. He said they did not want to lose sight of their other projects or goals by spending too much time writing procedures.

Mr. Perez agreed Staff could accommodate whatever Council directed them to do. He said this type of work did take away the creative work the department should be doing. He stated he was not objecting to the recommendation in principle, it was the practicality of it he was objecting to.

Vice Mayor Yeh said the recommendation focused on the library bond funds. The IBRC report would include alternatives for financing structure. Policies could help focus the process.

Mr. Hagerman stated the intent of the recommendation was not to develop a desk level procedure. Their intent was to, for example, some things bond monies could be used for and to handle certain circumstances such as drop-downs. Procedures should not live in Outlook. They should be more formal, even at a high level.

Council Member Schmid asked what level of oversight was appropriate. They only found \$400 in their random sample.

Mr. Hagerman said there was \$20 million in the sample; Staff looked at \$3 million. They used a generalized sample not a random sample.

Council Member Schmid asked for the level of confidence associated with the sample structure.

Mr. Hagerman said they cannot apply assurance that there was only \$400 misapplied entirely, but only for their sample. They had assurance that the processes were working.

Council Member Schmid asked about the library oversight.

Mr. Hagerman said the project manager reviews each invoice and verifies the work has been completed. The project manager is relied on to do a detailed review of the invoices.

Council Member Schmid said there were four oversights; 1) ASD completes an annual report on funds expended, 2) the Citizens Oversight Committee for the use of Library Bond Funds provides quarterly reports 3) the external auditor provides annual audits of the funds, and 4) the City auditor completes audits. They are all on expenditures, tracking what was already spent. He asked how oversight for items such as change orders that had not been expended yet.

Mr. Hagerman said auditing provides value by reviewing the items after the fact.

Council Member Schmid asked if the point then for creating policy was to allow for oversight prior to the project instead of only after the fact. He asked if, because these details were not expenditures there wouldn't be anything to catch.

Mr. Hagerman said it would not be limited to small items such as reviewing invoices.

Council Member Schmid said the amount of money to spend on a project was the first step in the process. His concern with so much oversight and then additional procedures were added, was the City should be able to spend what the citizens approved. If oversight was only after the fact it would be difficult.

Council Member Shepherd said much of the oversight though was not handled in house.

Council Member Schmid said his concern was that it was all done after the fact.

Council Member Shepherd said there were peaks throughout the process, but they needed people to see them. She said this was being reviewed now at an appropriate level. She said there was one other oversight too when ASD provides a checklist of debt requirements.

Council Member Schmid said Council oversight seemed very far removed.

Mr. Perez said there were different levels of responsibility. But high level management does review the process.

Council Member Schmid said the Council didn't receive feedback on the executive group oversight.

Mr. Perez said Mike Sartor, the Director of Public Works, would be the one to provide that oversight.

Council Member Shepherd said a procedure needed to be put in place. It did not need to be elaborate. She discussed the importance of internal controls to keep fraud out of the process.

MOTION: Council Member Shepherd moved, seconded by Vice Mayor Yeh, that the Administrative Services Division formalizes policies and procedures regarding the oversight and expenditure of Library Bond funds.

Mr. Hagerman said the library projects were unique, but this could help going forward as well.

Council Member Scharff said he was not going to support the budget. Spending money on this type of project could create cuts in services that have a higher priority to the community. Council should support Staff in this case. He asked what formalized procedures meant.

Mr. Hagerman said one aspect would be policies and procedures for funds that have to do with bond dollars. He said a level of formalization means a high level manager has seen and approved the procedures. Specific attention to this issue would be a component. He said this would not require a significant amount of Staff resources. The City Auditor's Office had already completed some of the pre-work involved by evaluating other programs such as the one in the City of San Jose.

Council Member Scharff asked how many Staff hours this should take.

Mr. Hagerman said, as a guess, less than 20 hours.

Council Member Scharff asked if he meant 20 hours for ASD and then 20 hours for PWD.

Mr. Hagerman said he didn't feel there needed to be separate procedures for the two departments.

Mr. Saccio said 20 hours was a lot of Staff time to embellish what was already in place.

Mr. Perez said he should show Council how many policies they had and how much time Staff spent updating them. At some point it is the cumulative effect they need to understand.

Council Member Scharff referring to Staff's regular references to the City of San Jose stated they were almost bankrupt. They were unable to move nimbly because they had so many procedures. If assembling these procedures detracts from the mission, it should not be done.

Mr. Hagerman said an organization with immature policies can waste a lot of time training and figuring out how things go wrong. With mature processes they can move more easily. The intent was not to hinder operations.

Vice Mayor Yeh said if creativity and innovation were a goal and policies and procedures were a hindrance, perhaps there were other ways to develop the procedures. Policy discussions should be captured to be able to make decisions that are appropriate.

Mr. Perez said he recognized a need for policies and procedures. He said that the City had a AAA rating. His department received good audits and financial awards. They are generally capable as a group. Every piece did not need to be formalized. He reiterated that he is not resisting following Council direction.

Vice Mayor Yeh said that open analysis of procedures seemed to be something that could provide time to be more strategic.

Mr. Perez with too many other tasks there is no time left to be strategic.

Vice Mayor Yeh agreed. He said if policies could be tied to that innovative model a lot of Staff time would be freed up.

Council Member Schmid said he would support the Motion. He said it would be helpful to have milestones that someone saw the completion of the steps. He said the recommendation was not to create more work.

Mr. Saccio said the bond oversight committee reviewed the work being done and made sure it was appropriate to the bonds. PWD would have to be involved in any process changes.

Council Member Schmid said it wasn't written anywhere that Turner Construction oversees the invoices.

Council Member Shepherd said Council did received detailed change order information.

Mr. Saccio said that could be incorporated in the future.

Council Member Shepherd said with approved procedures Staff has a burden of responsibility lifted from them. Yet they can be held accountable if a step is skipped.

Mr. Perez said he couldn't think of something in his department that didn't have an elaborate procedure already. Having these procedures does mean that disciplinary action can be taken if they are not followed.

MOTION PASSED: 3-1, Scharff no

MOTION: Council Member Schmid moved seconded by Vice Mayor Yeh to recommend acceptance of Audit of the Use of Library Bond Proceeds with minutes to accompany the audit report when it goes to the full Council.

MOTION PASSED: 3-1, Scharff no