

Draft Report
City of Beaumont
Financial Analysis of City Funds
May 5, 2015

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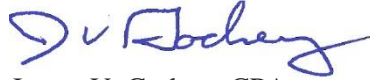
May 5, 2015

Ad Hoc Committee on Internal Controls
C/o Nancy Carroll, City Treasurer
City of Beaumont
550 E. 6th Street
Beaumont. CA 92223

Dear Ms. Carroll:

I am pleased to present to the Ad Hoc Committee our draft report on the Financial Analysis of the City Funds. We will be pleased to meet with you and the Committee to discuss this report at your convenience. Please call me at (213) 408-8666 or Byron Matson, Manager, at (916) 765-3337 if you have questions or concerns.

Very truly yours,



James V. Godsey, CPA
Partner

Background

The City Council requested MGO to conduct a financial analysis of the City of Beaumont (City). This action was prompted by concerns of new City Council members and the City Treasurer over inter-fund advances between City funds and monies due to the General Fund as a result of loans made to the Redevelopment Agency (RDA).

Objectives

The objective of this review is to provide a financial analysis of City funds. Specifically, we sought to determine and analyze:

- Revenue and expenditure patterns during the fiscal periods under review.
- Whether the General Fund has enough unrestricted monies to pay off obligations due to other funds, and if not, determine the plan for repayment.
- The impact of funds loaned to the RDA from the General Fund and the potential for reimbursement back to the General Fund.
- The City's methodology for forecasting future revenues, expenses and cash flows, including any austerity measures.
- The impact of pending litigation on the City.

Scope

The scope of work included the current 2014-15 fiscal year and the four prior fiscal years, beginning with the fiscal year ending June 30, 2011.

Methodology

The methodology employed included:

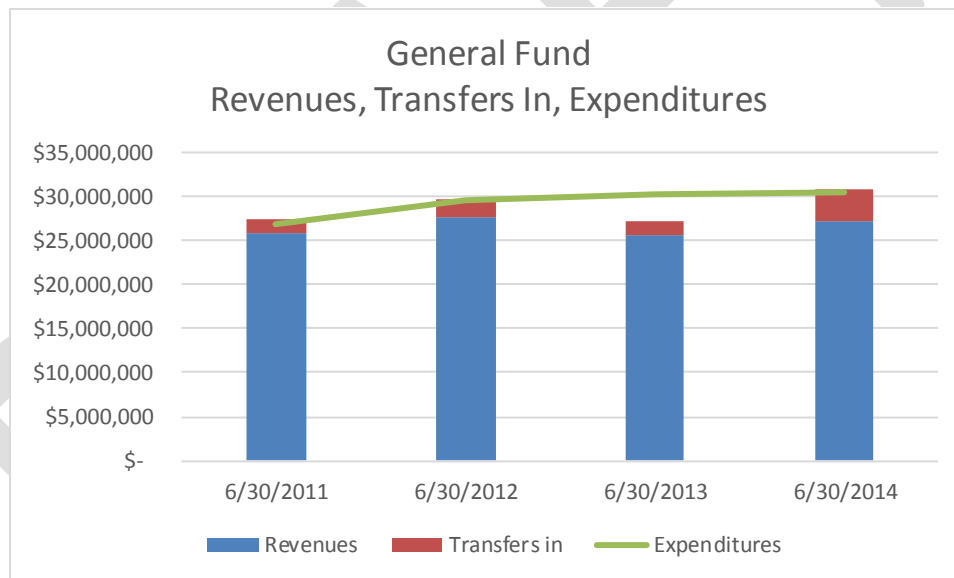
- Interviews with City officials, including the City Treasurer,
- Documents received from California State agencies,
- Annual audit reports from Moss, Levy & Hartzheim, LLP, and
- Documentation and reports received from the City.

Observations

The General Fund Cannot Sustain a Surplus

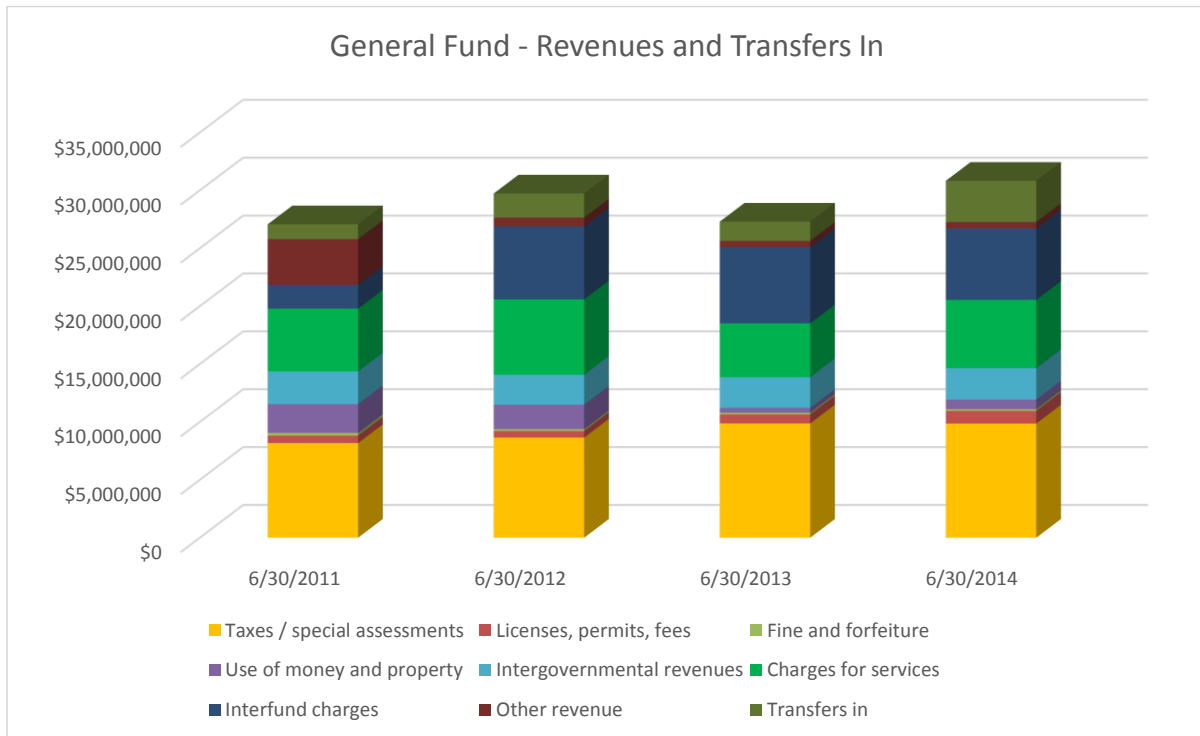
Based on the audited financial statements, revenues have not exceeded expenditures over the last four fiscal years as shown in the chart below. Despite austerity efforts, such as a city-wide hiring freeze, the measures taken have been only marginally effective at reducing expenditures over the last two fiscal years. In the current year, City officials are forecasting that actual expenditures are running about \$1 million less than budgeted, according to the General Fund Revenue and Expense Report, dated February 28, 2015, posted on the City’s website. Revenues, according to this same report, are running at approximately budgeted levels.

Our analysis was based on amounts as reported in each year’s audited basic financial statements. During our analysis, we noted that the “General Fund Detail” pages of the City’s 2014-15 budget document uses somewhat different amounts that indicate General Fund revenues slightly exceeded expenditures. City management believes these differences are due to slightly different methodologies employed for combining and reporting some account balances, such as the inclusion of the Liability and Workers’ Compensation Reserve by the auditors. However, regardless of which approach is more accurate, the fact remains that the General Fund is not able to generate a surplus of any material magnitude.



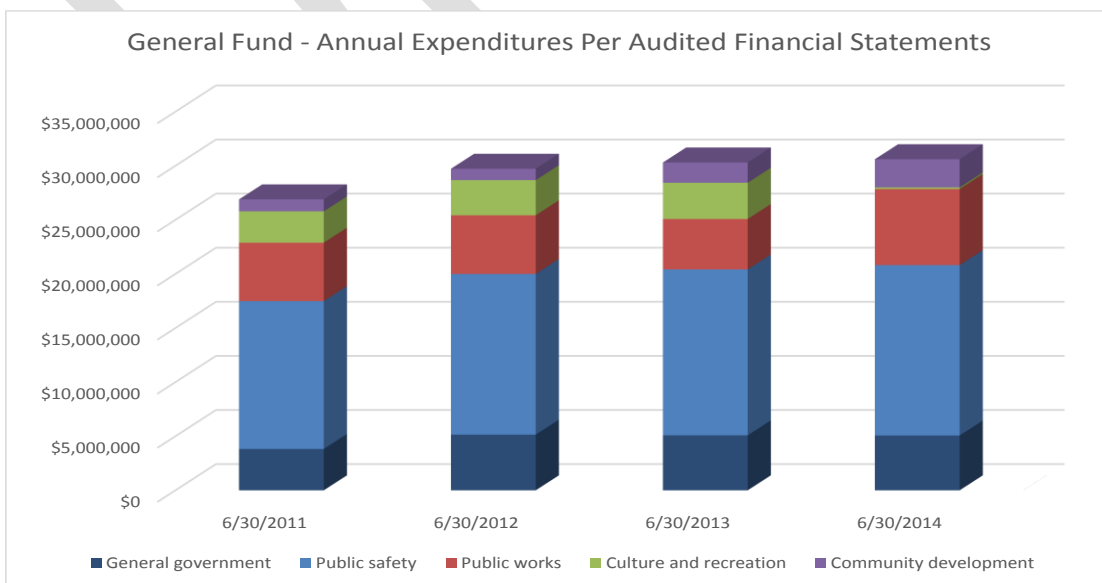
Revenues

As shown in the chart below, General Fund revenue consists of eight categories—taxes and special assessments; licenses, permits and fees; fine and forfeiture; use of money and property; intergovernmental revenues; charges for services; inter-fund charges; and other revenue. The Finance Director stated that revenue has been trending at budgeted levels and he expects real estate tax levels to improve as the housing market continues to recover.



Expenditures

General Fund expense includes five major categories—general government, public safety, public works, culture and recreation, and community development as shown in the chart below. As shown, the total expenditures have remained stable over the last three fiscal years. In contrast, revenue growth has not exceeded expenditures, resulting in a constant need to borrow from the Community Facilities Capital Projects (CFCP) fund as described in the next observation.



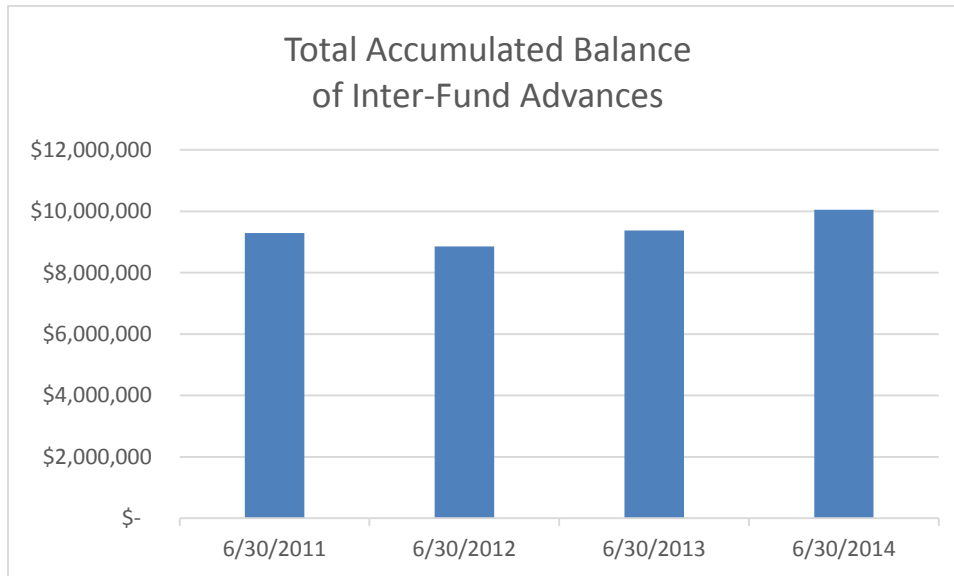
The City's Finance director, in analyzing these changes in major categories over time added the following:

- General Government saw an increase in the fiscal year ending 6/30/2012, resulting from a significant increase in legal fees due to the WRCOG lawsuit.
- Public Safety increases are primarily due to increases in insurance and PERS contributions, radio upgrade costs, and the required (per Police Memorandum) 5 percent annual salary increases.
- Public Works increase in the fiscal year ending 6/30/2014, resulting from a reclassification of the Parks Department to Public Works, which was reflected by a corresponding decrease in Culture and Recreation.
- Further decreases in Culture and Recreation in the fiscal year ending 6/30/2014, resulting from a delay of some planned projects.
- Community Development increases due to continuing development projects and the associated costs.

The General Fund Consistently Maintains a Negative Cash Balance at Year-End Which Necessitates Inter-fund Advances

For the last four fiscal years we reviewed, the General Fund was advanced funds from the Community Facilities Capital Projects (CFCP) Fund in order to maintain a positive cash balance at year-end. City management believes that, according to an opinion issued by an outside attorney, the use of CFCP funds in this manner is legal. (We have requested a second opinion on this issue from the new City Attorney.) This inter-fund transfer scenario has been occurring since at least 2009. The amount owed by the General Fund during the last four fiscal years beginning July 1, 2010 to the CFCP Fund has been in the range of \$8-10 million per year. For example, in the fiscal year ending June 30, 2014, the CFCP Fund was owed \$10,050,741 by the General Fund. This amount was not all advanced in each fiscal year but represents the total accumulated outstanding balance of all previous advances to the General Fund, which came almost entirely from the CFCP Fund.

The chart below illustrates the year-end inter-fund advance balances for the last four fiscal years.



The City has no formal plan to repay advances owed by the General Fund.

City officials stated that they have no formal plan to repay advances from other funds. The City is relying on the possibility of receiving RDA repayments, which would provide a surplus to the General Fund that could be used to repay these advances. The City has established an account receivable in the amount of \$21.5 million, which represents funds loaned to the RDA during its existence. This amount is made up of the cost of projects and the city’s administrative costs. When the RDA was dissolved by the State, it was expected that some or all of the funds owed to the City would be paid back. The City Attorney has advised City officials that “to the extent that the City of Beaumont’s Successor Agency Oversight Board agree that the \$21,500,000 loaned to the Redevelopment Agency represent Enforceable Obligations, those loans will be repaid by way of semi-annual payments assuming, of course, that the California Department of Finance or the California State Controller’s Office does not overrule the decisions of the Oversight Board concerning the repayment of \$21,500,000 in loans.”

Based on our review of documentation related to the issue of RDA dissolution, the expectation of these funds being repaid is dependent on a number of factors, most notably, AB 1X26, which invalidated loans between the primary government and the RDA and AB 1484, which introduced the “Finding of Completion” concept that could eventually lead to the State repaying cities for some or all of the debts of the RDA. If the State would issue a “Finding of Completion”, the Successor Agency could then establish the \$21.5 million on the Recognized Obligation Payment Schedule (ROPS) and begin the process of collecting these funds loaned to the RDA. However, there are a number of issues that will affect the potential amount to be repaid.

First, there is an issue of the City repaying an “outstanding due diligence review debt” of approximately \$2.875 million. This must be paid to the State in order to be issued a Finding of Completion by the CA Department of Finance (DOF). The City cannot expect to receive any repayments until this debt is paid back in its entirety. Currently, the City has agreed to repay \$300,000 per year to satisfy that obligation. At that rate of repayment, it would take the City at least 9 years to satisfy the debt. At that time, a Finding of Completion could be issued by the State, after which the City could add the \$21.5 million to their ROPS and begin actions to recover the funds.

It should also be noted that the City is currently claiming \$250,000 per year for administrative costs of operating the Successor Agency. DOF stated in a March 20, 2015 letter to the City it believes this amount is excessive, even though it falls at the minimum amount allowed by the Health and Safety Code (HSC). HSC, section 34171(b) states that the administrative cost allowance shall not be less than \$250,000 for any fiscal year unless the Oversight Board reduces this amount. Given DOF's position, Beaumont's Successor Agency Oversight Board may agree with DOF and reduce the administrative cost allowance below \$250,000. City officials stated that they sent supporting documents to DOF that justified a six month charge of \$125,000. Given that, the Finance Director feels the annualized charge of \$250,000 is justified.

Secondly, there is an "Asset Transfer Review" report by the State Controller which has resulted in the State Controller ordering the City to "reverse transfers totaling \$6,517,519 and turn over the assets to the Successor Agency." While the City does not agree to this finding, the City believes that any amount could returned to the Successor Agency could eventually be added to the ROPS, which in effect would increase the obligation owed to the City. This, however, is highly uncertain and must be approved by DOF.

A third complicating factor has to do with the interest rate the City charged the RDA for the funds loaned. The City used the maximum rate allowed—12 percent-- under the Health and Safety Code. The City's auditors have pointed out that the 'Department of Finance could challenge and disallow the interest payments and advances after further review.'" Should this occur, the City would be required to repay the excessive interest to the Successor Agency.

In summary, the collectability of the debt owed to the City by the RDA is (1) highly uncertain, (2) of an undeterminable amount, and (3) if repaid, cannot be expected to be received by the City for at least 9 years.

The City currently does not prepare long range revenue, expenditures or cash flow projections; instead relies on one year budget projections prepared as part of the annual budget approval process.

The City does not prepare formal long term revenue, expense or cash flow projections. Shorter term, one year projections are prepared based on current year-to-date amounts and other data as part of the annual budget approval process. The City held budget planning sessions in April. At the time of our fieldwork, there were no projections available for us to review.

A Special Gas Tax Street Improvement Fund Audit Finding Puts Even More Pressure on the General Fund

The State Controller performed a special gas tax audit covering the period July 1, 2004 through June 30, 2013, and found that the City had understated the fund by \$383,838, mostly due to unsupported overhead costs. The City has agreed with the finding and will reimburse this amount to the Gas Tax Fund.

Western Riverside Council of Governments judgment clouds City's financial future and creates Going Concern issues.

The Western Riverside Council of Governments (WRCOG) filed suit against the City for back payments of Transportation Uniform Mitigation Fees. In May 2014, the judge in this case issued an oral ruling expressing the intent to award WRCOG a judgment against the City for \$42,994,879 plus interest of no more than 7% per annum. In September 2014, an amended judgment was filed in this case. This judgment awarded WRCOG \$42,994,879 in Transportation Uniform Mitigation Fees, plus prejudgment interest calculated at 7% in the amount of \$14,809,096, with additional interest accruing in the amount of \$8,246 per day. The City had been using a substantially lower interest rate to accrue interest based on the belief that the judgment was a "fee dispute". The City's auditor accepted the accrued interest using the lower rate, however, the City Council has not accepted the Auditor's report precisely because they disagree with this position.

In March 2015, an additional \$2,077,525 in legal fees and trial costs was awarded. In total, the City is now up against a judgment totaling \$ 59,881,500 with additional interest accruing daily.

In response to the judgment, in September 2014 the City filed an appeal. The appeal stays the judgment until the Court of Appeals rules on the trial court's decision. The City believes the appeal will be successful, and will take approximately two to three years to resolve.

Due to the unknown time frame of the appeal and difference in interest rates used, the final amount to be paid if the appeal is unsuccessful cannot be determined. Based on our analysis, the City is currently not in a financial position to pay the judgment as awarded.

The City has instituted austerity measures in response to the growing financial crisis, however, these measures do not appear to be having a measurable effect on reducing expenditures. Annual expenditures in the General Fund are not trending downward to a great extent. The City stated in its most recent audit report that it has taken steps to control expenditures, which includes a City-wide hiring freeze, first begun in the 2012-13 fiscal year. However, total General Fund expenditures in 2013-14 were about the same as in the prior year. For 2014-15, expenditures appear to be running slightly lower.

Conclusion

The City's fiscal health presents a significant challenge. Expenditures consistently run at a level that prevents accumulating a surplus which would allow the General Fund to pay back advances to the CFCP and preclude future borrowing from that fund. While revenues have improved, the gap between expenditures is not sustainable.

The City does no long range financial planning and forecasting.

The City is hoping for repayment of all or part of the \$21 million it loaned to the RDA to help them improve the City's finances. As shown in our analysis, the collectability is highly uncertain, and the receipt of funds from this obligation, if any, will likely be far less than \$21 million and will not occur for many years unless more proactive measures are taken.

Looming significantly over all other issues is the judgment, currently in the amount of \$59.8 million, from the WRCOG lawsuit. If the City were forced to pay this amount, it will result in an insurmountable deficit in the General Fund.

Recommendations

We recommend that the City Council and City officials work closely to develop a long range financial plan to provide a roadmap for strengthening the City's finances. This plan should:

- Explore all possible ways to both raise new sources of revenue and lower expenditures;
- Target any idle funds that could be invested in short-term instruments as a means of raising additional cash;
- Develop a plan to repay at a faster rate the obligations that need to be addressed in order to recover all or some of the outstanding \$21 million from the loans made to the RDA from the General Fund;
- Consider approving and reclassifying the inter-fund advances from the CFCP Fund as permanent inter-fund transfers, if legally able to do so; and
- Involve citizens, financial advisors, and legal experts to assist with building the plan and periodically reviewing results.