



City of Montebello

Its Structural Deficit and Poor Operational Processes Threaten the City's Financial Stability and Delivery of Public Services

December 2018



REPORT 2018-802





CALIFORNIA STATE AUDITOR

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December 11, 2018
2018-802

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents the results of our audit concerning the city of Montebello (Montebello), conducted as part of our high-risk local government agency audit program.

This report concludes that Montebello is a high-risk city because of its significant financial and organizational risks. Specifically, for much of the past decade, Montebello has struggled to generate sufficient revenues to meet its expenses and as a result, it suffers from a structural deficit. Further, Montebello has relied on one-time revenues to balance its budget and its recent plans to increase revenues and decrease expenditures are not adequate to eliminate its structural deficit. Additionally, Montebello's enterprise activities, including a municipal golf course, water utility, and two hotels, pose a significant financial risk to the city's general fund. For example, over the past five fiscal years, Montebello's municipal golf course has relied on subsidies of \$800,000 per year, on average, from the city's general fund. Further, we found that the city did not competitively bid 10 of 16 agreements we reviewed and did not adequately justify the lack of competitive bidding in most cases. To address these risk factors, we developed recommendations for the city to implement, such as exploring alternate uses for its golf course. We also recommend that the city amend its municipal code to require competitive bidding for most procurements to ensure that Montebello obtains the best value from the services it receives.

Respectfully submitted,

A handwritten signature in black ink that reads "Elaine M. Howle". The signature is written in a cursive, flowing style.

ELAINE M. HOWLE, CPA
State Auditor

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HIGH RISK ISSUES

City of Montebello, Los Angeles County

Risk Designation: **High Risk**

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RISKS FACING THE CITY OF MONTEBELLO

This audit report concludes that the city of Montebello (Montebello) is a high-risk local government agency because of several risk factors related to the city's financial and organizational management. These risk factors include the following concerns:

- Montebello's ongoing revenues are not sufficient to meet its expenditures without using funds from one-time sources.
- The city's current plans for its municipal golf course, water system, and hotels do not sufficiently address significant financial risks to the city's general fund associated with those enterprise activities.
- The city's weak financial processes, noncompetitive contracting practices, and lack of adequate staff expose the city to significant risks for fraud, waste, abuse, and mismanagement.

To help Montebello address these risks in a reasonable amount of time, we recommend several actions the city can take, including selling its water utility, exploring alternatives for its golf course, and strengthening its financial processes and contracting practices. By implementing our recommendations, Montebello would take steps toward eliminating its structural deficit and reducing the city's risk for fraud, waste, abuse, and mismanagement.

For much of the past decade, Montebello has struggled to generate sufficient revenues from ongoing sources—such as property taxes, sales taxes, and fees for services—to meet its expenses and as a result, the city suffers from a structural deficit. Figure 1 on the following page shows the difference between ongoing revenues and expenditures. To balance its budget, the city has relied on one-time revenues. For example, for the past five fiscal years, Montebello has traded

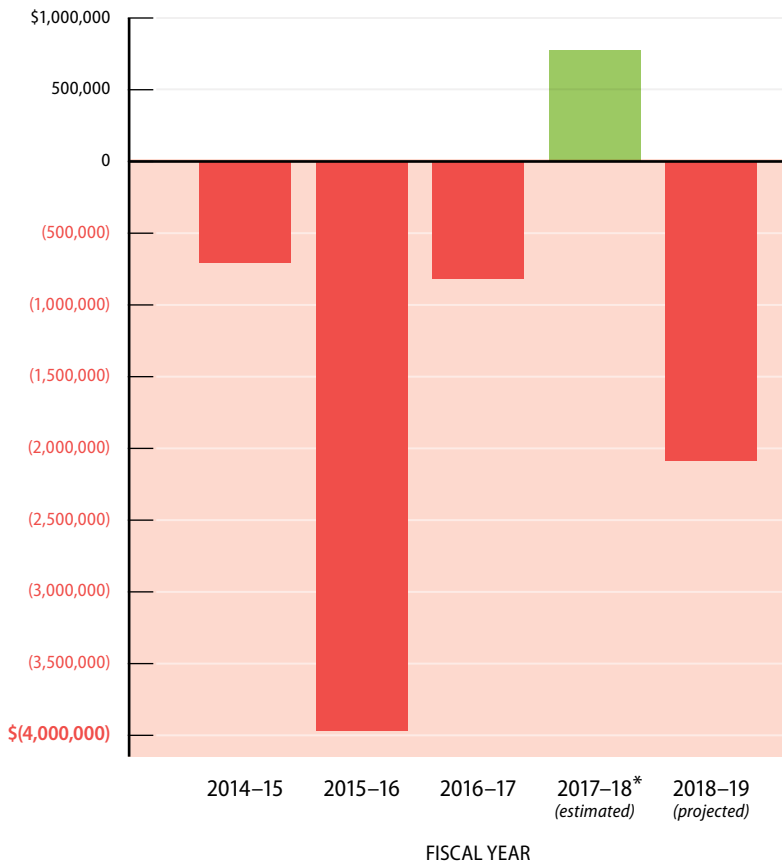
restricted transportation funds to another city for a smaller amount of unrestricted funds. From these one-time revenues, Montebello has managed to preserve—and, in some cases, increase—the reserve in its general fund. However, if the city is unable to raise sufficient one-time revenues, it will see its reserve shrink or even disappear. For example, in fiscal year 2016–17 Montebello added \$4.7 million in restricted redevelopment funds to its general fund balance. Had it not done so, the city would have ended the fiscal year with a slight operating deficit.

Montebello's enterprise activities, including a municipal golf course, water utility, and two hotels, place further pressure on the city's general fund. The golf course and water utility have relied on loans from the general fund to cover operating deficits in recent years. The bonds issued to construct the hotels, meanwhile, continue to expose the city's general fund to significant financial risks. As we discuss in this report, if hotel revenues are insufficient to cover hotel-related costs, which include bond debt payments, Montebello's general fund may be required to make these payments.

The city's water system has been a drain on the city's finances because it has not been self-supporting, and it does not have the resources to address its own infrastructure needs. This water system serves less than 3 percent of the city's population, but the city has subsidized it with general fund loans in recent years. As a result of recent rate increases, the city expects that its water system will operate with a slight budget surplus beginning in fiscal year 2017–18. The city plans to pay \$100,000 per year toward the \$800,000 the water system owes Montebello's general fund. Nevertheless, the city has yet to address nearly \$50 million in needed capital improvements to its water system, which may burden the general fund in

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Figure 1
Difference Between Montebello's Ongoing General Fund Revenues and Expenditures



Source: Analysis of Montebello's financial reports and most recent budget.

* Based on its unaudited financial information, Montebello estimates that it will receive sufficient revenues from its ongoing revenue sources to meet its needs in fiscal year 2017-18. However, Montebello's fiscal year 2017-18 budget originally projected a \$2.7 million budget deficit.

the future. In 2016 the city attempted to sell its water system and voters rejected the move. However, in September 2018, the Governor signed legislation that allows Montebello and two other cities to try to sell their water systems without first obtaining voter approval.

Montebello's hotel enterprises, meanwhile, may pose ongoing risks to the general fund and they have not yet generated revenue to the city's general fund. Montebello financed its first city-owned hotel in 2001, and it began constructing a second hotel in 2016. As Figure 2 shows, the city's hotels and an

event center called Quiet Cannon (event center) are located near the city's municipal golf course. So far the city's original hotel has yet to generate any revenue for the general fund. When deciding to construct a second hotel in 2016, city leaders assumed that the new hotel would provide revenue to the city's general fund soon after opening. However, the new hotel may not meet that goal because of construction delays. The city is currently scheduled to pay up to \$3.7 million annually for its 2001 and 2016 hotel construction bonds, which expire in 2033 and 2046, respectively. The city has pledged hotel and occupancy tax revenues to pay for the bonds, but if hotel revenues fall short, the city may have to use general fund revenues to cover the bond payments to avoid default.

We also found that Montebello engaged in poor contracting practices related to construction of the second hotel and that the city did not take adequate steps to ensure that it received the best value from closely related businesses that operate the two hotels and the event center. The city gave bidders for the city's second hotel construction contract in 2016 only 10 days to develop and submit proposals for the \$36 million project, an amount of time insufficient for projects of this magnitude. The city received only one bid. Furthermore, one individual—the hotel operator—holds the franchise rights to both hotels and owns or co-owns the companies that manage both hotels and the event center. In November 2017, the city council voted to extend the hotel operator's management agreement without attempting to competitively bid for the services because an existing agreement with another of the hotel operator's companies would have made it difficult to do so.

Figure 2
Montebello’s Event Center and Hotels Are Located Next to the Municipal Golf Course



Source: Map data from Google.

Further, Montebello’s lack of controls over its operations put the city at greater risk for waste, fraud, and abuse. For example, we reviewed a contract that the city manager on leave¹ appears to have signed for an amount that would eventually exceed her signature authority. Specifically, she approved hourly services for a consultant to assist the city’s planning department, and the contract did not include a maximum dollar amount. The city ultimately spent over \$149,000, and a contract of this magnitude should have received city council approval.

¹ In November 2017, the city council placed its city manager on a leave of absence. We refer to her as *city manager on leave* throughout this report. The city has hired another individual to act as city manager while she is on leave.

In 2011 the State Controller’s Office (State Controller) conducted an audit of Montebello’s operational and accounting processes and in its report made a number of recommendations to correct deficiencies. We reviewed 21 of these deficiencies and found that Montebello has yet to fully address nine of them. Finally, Montebello has had difficulty maintaining senior-level staff, which can make it difficult to implement consistent processes for its finances and operations. For example, since February 2017, the city has not had a permanent director of finance.

The Local High Risk Program

In October 2017, the California State Auditor (State Auditor) informed Montebello that it had selected the city for review under its high-risk local government agency audit program (local high risk program). This program authorizes the State Auditor to identify local government agencies that are at high risk for potential waste, fraud, abuse, or mismanagement, or that have major challenges associated with their economy, efficiency, or effectiveness. We initially identified Montebello as a possible high-risk local government entity based on publicly available information. We completed our initial assessment of Montebello in January 2018, identifying concerns related to the city’s enterprise fund deficits, projected general fund budget shortfall, unmet water system infrastructure needs, and lack of progress toward implementing the State Controller’s recommendations from a 2011 audit.

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In January 2018, Montebello provided us with an update on its progress in addressing the risk factors we identified. The city's response highlighted its \$9.3 million general fund reserve, one-time revenues, and plans for a future housing development. However, based on our continuing concerns over the challenges we highlighted above and that we discuss in more detail in this report, we recommended an audit of Montebello, which the Joint Legislative Audit Committee approved in May 2018.

Agency's Proposed Corrective Action

Montebello stated that it supports many of the conclusions reached in the report and is working on its corrective action plan, but did not address the report's recommendations specifically in its response.

Montebello's Enterprise Funds and Long-Term Obligations Pose a Significant Financial Risk to the City

Montebello faces immediate and long-term challenges to balancing its budget and delivering public services. For years, Montebello's ongoing revenues have not been sufficient to meet its operating expenses. As a result, the city has used one-time revenues, primarily from an exchange of county transportation funds with other localities, to balance its budget and avoid depleting its general fund reserve. Nevertheless, the city's general fund has contributed more than \$6 million to the city's golf course fund over the past 10 fiscal years. Meanwhile, Montebello's water system needs \$1.6 million in urgent repairs, and its operating surplus will not be sufficient to fund them. In addition, the city's retirement costs and health benefit obligations continue to grow, and these expenses will place increasing pressure on the city's finances.

Montebello Relies Heavily on One-Time Revenues to Balance Its Budget

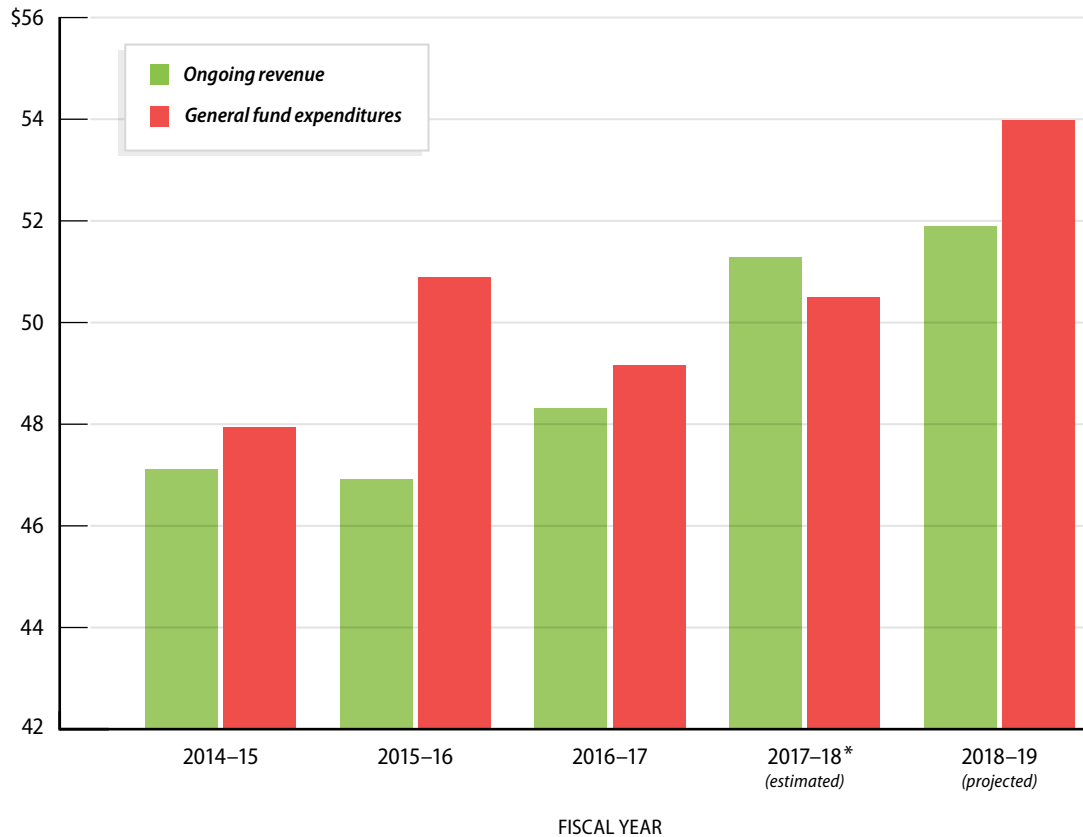
For much of the past decade, Montebello has struggled to generate sufficient ongoing revenues to meet its expenses. Montebello collects most of its general fund revenues from property taxes, sales taxes, and fees for city services. The city's general fund covers the cost of many city services, including the fire department, police department, and parks. Montebello receives additional revenue from a special property tax to pay for the retirement expenses of city employees and from the state gas tax to pay for street maintenance and construction. However, as Figure 3 on the following page shows, Montebello's expenses have outpaced ongoing revenues. As a result, the city suffers from a structural deficit.

Nevertheless, the city has managed to maintain a reserve in its general fund—and, in some cases, increase that reserve—by relying on one-time revenues. Historically, the city has generated such one-time revenues primarily through Proposition A exchanges. Proposition A was a ballot measure approved in 1980 by Los Angeles County voters that designates funds for local transportation projects. It allows cities to exchange any of these restricted funds for unrestricted general fund revenue. However, the general fund money that cities receive is discounted. For example, in 2018 Montebello transferred to Pasadena \$1 million in restricted Proposition A funds in exchange for \$750,000 in unrestricted general fund money. Montebello has relied on these exchanges for the past five fiscal years to bolster its general fund, but there is no guarantee that the city will be able to negotiate such an exchange in any given fiscal year. Furthermore, the city could be using its Proposition A funds for what they were originally intended—improvements to Montebello's transit system, for example—rather than trading them for discounted general fund money.

According to its fiscal year 2016–17 audited financial statements, Montebello's \$9.3 million reserve provides the city with a cushion if it cannot raise enough general fund revenues in any given year. However, the reserve could disappear if the city cannot identify sufficient one-time revenues to cover all of its expenditures. In fiscal year 2017–18, Montebello's budget projected that the reserve would decline by \$2.7 million before the city found additional one-time revenues and reduced expenditures. Additionally, the city acknowledged in its fiscal year 2016–17

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Figure 3
Montebello's General Fund Expenditures Have Outpaced Its Ongoing Revenues
(In Millions)



Source: Analysis of Montebello's financial reports and most recent budget.

* Based on its unaudited financial information, Montebello estimates that it will receive sufficient revenues from its ongoing revenue sources to meet its needs in fiscal year 2017-18. However, Montebello's fiscal year 2017-18 budget originally projected a \$2.7 million budget deficit.

financial report that if it had not transferred to the general fund \$4.7 million in funds that are restricted to certain uses, the general fund would have ended the year with a slight deficit. However, Montebello transferred these restricted funds as part of the process of dissolving its redevelopment agency, and the city cannot use these revenues for general operating needs. Therefore, we do not consider the \$4.7 million to be part of Montebello's general fund reserve. In unaudited financial documents for fiscal year 2017-18, Montebello's finance department staff also excluded these restricted funds from the general fund reserve.

Montebello's recent plans to increase revenue and decrease expenditures will not be sufficient to eliminate the city's structural deficit. In a presentation to the city council, the acting city manager outlined several steps the city has taken to balance its budget for fiscal year 2018-19. Some of these steps, such as adjusting the city's user fees—charges that the city assesses to cover services such as permits and emergency medical services—will increase the city's ongoing revenue. However, in that budget presentation, the acting city manager acknowledged that even with these plans, the city's structural deficit will continue in fiscal year 2018-19. He further told us that a major housing development will

add to the city's future revenue in multiple ways, including revenue from increased property tax and vehicle license fees from new residents. However, according to the acting city manager, the housing developer will not begin construction until 2020.

Meanwhile, Montebello may not be able to increase its sales tax before the city shows voters that it has improved its fiscal and management practices. In May 2017, the city council voted to declare a fiscal emergency and place a measure on the ballot that proposed increasing the city's sales tax rate by 1 percent. City staff initially estimated that the increase would raise tax revenues by \$9.5 million. According to its resolution declaring a state of fiscal emergency, the city needed the additional sales tax revenue to address its deficit and public safety needs. Nevertheless, in November 2017, Montebello residents rejected the measure by a significant margin. However, surrounding cities have successfully passed sales tax increases. Voters in El Monte and Huntington Park, for example, recently approved sales tax increases. Pico Rivera and city of Commerce, both neighboring cities of Montebello, have previously approved such measures. Nonetheless, in Montebello, the 2017 measure received significant opposition, even from current and former elected officials in the city. They cited the council's failure to balance the city's budget, mismanagement, and improper contracting practices as reasons to reject the sales tax increase.

Montebello's ongoing structural deficit has prevented it from addressing important staffing, capital improvement, and employee retirement needs. For example, to balance its fiscal year 2018–19 budget, the city has delayed making building improvements such as roof repairs on its police facility. According to the acting city manager, the city will not be able to defer these capital improvements indefinitely. Meanwhile, Montebello has not filled several positions affected by a hiring freeze enacted in 2017 as part of a city council declaration of fiscal emergency. According

to the acting city manager, the city plans to fill the positions on a case-by-case basis and as the hiring freeze is still in effect, doing so requires council approval. As a result, several key city staff positions, such as finance director, remain vacant.

“**Montebello's ongoing structural deficit has prevented it from addressing important staffing, capital improvement, and employee retirement needs.**”

Montebello Has Not Addressed Its Municipal Golf Course's Increasing Debt to the City's General Fund

Montebello's municipal golf course, which includes the event center, has continually relied on loans from the city's general fund. The city records revenues and expenses related to the golf course and the event center in its golf course fund. Revenues include golf course green fees, special event revenue, and rent and concession revenue from the event center. Expenses include administrative costs, maintenance and labor costs, and debt service. Montebello's municipal code states that the golf course fund should not require any assistance from the general fund. However, Figure 4 on the following page shows that the city's general fund has contributed more than \$6 million to the golf course fund to cover operating losses since fiscal year 2010–11. Although the city has not consistently recorded the general fund

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Figure 4
Montebello's General Fund Has Subsidized the Municipal Golf Course in Seven of the Past Eight Fiscal Years



subsidies as loans, according to the acting city manager, to the extent feasible, Montebello should consider repaying to the general fund all or part of the subsidies to the golf fund. Over the past five fiscal years, Montebello has paid more than \$800,000 per year, on average, to the golf fund from the general fund. Based on the city's fiscal year 2018-19 budget, we expect this trend to continue.

A consultant has provided the city with options for reducing the subsidy to the golf course, but these options will not adequately address the problem in a reasonable amount of time. In June 2018, the city hired a consultant to create a plan for increasing revenue and decreasing costs in order to reduce the amount of general funds required to support the golf fund. The consultant made several recommendations, including contracting for maintenance, improving marketing for the course, and adjusting its fees. In a September 2018 report to the city council, city staff presented options from the consultant's report that could collectively decrease the general fund subsidy by \$680,000 per year. However, the city council chose to postpone its decision until the city's golf commission—an advisory body charged with making recommendations on golf course operations and improvements—had an opportunity to comment on the consultant's recommendations. The city also expects that the golf course will no longer require assistance from the general fund once some of the bond obligations expire in 2025. Nevertheless, even if the city implements the consultant's

recommendations immediately, by 2025 the golf fund's debt to the general fund could increase to over \$8 million.

Despite this increasing debt to the general fund, Montebello's leadership has not pursued alternatives for the golf course property because, according to the acting city manager, the city intends to continue operating the golf course until the city council provides alternate direction. The acting city manager went on to say that because of many political, legal, and labor concerns, the city would need to complete significant analysis before pursuing options and it could take several years to sell or redevelop the property. Nevertheless, the golf course includes a significant amount of land that the city could sell or use for other purposes. Until Montebello takes steps to address the golf course's burden on city finances, the golf course will continue to drain the general fund and divert money needed for other essential city services.

Recommendations to Address This Risk

To repay the golf fund's debt and reduce the city's structural deficit, Montebello should immediately make a decision on implementing the golf consultant's recommendations. By December 2019, the city should also evaluate the effectiveness of its current plans and consider alternate uses for the golf course property.

Unless Montebello Sells Its Water System or Secures Alternative Financing, Necessary Improvements Could Burden the City's General Fund in the Future

Unlike the golf course, Montebello's water system now generates sufficient revenue to cover its operating costs. Nevertheless, it may need general fund subsidies to complete necessary repairs. As a result of recent rate increases, the city expects the water system

to have a small operating surplus in fiscal year 2018–19 and in future fiscal years. The city plans to use this operating surplus to pay \$100,000 per year toward the \$800,000 that the water system borrowed from the city's general fund between fiscal years 2013–14 and 2016–17.

However, these surpluses will not be sufficient to fund necessary repairs to the water system. In a 2017 water system inspection, a consultant identified nearly \$1.6 million in urgent repairs needed to the city's water system infrastructure. These repairs include computer control system upgrades and replacing a reservoir's interior and exterior protective coating. The firm contracted to operate Montebello's water system suggested that not completing some of the work could lead to service interruptions as well as violations of state workplace health and safety regulations. In May 2018, city staff recommended that the city increase its water rates to pay for these repairs, in order to avoid relying on the city's general fund. The city council voted to begin a process to consider increasing the city's water rates to pay for these urgent repairs. However, according to the acting city manager, the city council has not yet decided whether it will increase water rates. According to the city's public works staff, the city's water rates are generally higher than average compared to the four other water systems operating in Montebello. Therefore, it is unclear whether it will be feasible for the city to increase the water rates enough to fund the urgent repairs.

Apart from the urgent repairs, the city has not addressed nearly \$50 million in long-standing capital improvements needed for the water system. An engineer for Montebello outlined these capital improvements in a 2012 evaluation report. The report also identified some repairs—such as replacing a water main—that the city needed to address that year, in 2012, and it recommended that Montebello establish annual programs to make other repairs over 10- to 30-year periods.

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City leadership has been aware of these needed repairs since 2012, but it still has not developed a plan to complete them.

Montebello has attempted to sell its water utility. Existing law requires a municipality to obtain voter approval before selling a public utility, and in 2016 the city asked voters to approve selling the water system. However, voters rejected the measure. As a result, Montebello's public works director acknowledged in July 2018 that Montebello needed to focus on funding capital improvements to the water system specifically needed within the next five years. In September 2018, the Governor approved legislation that could help Montebello resolve its issues with its water system. The legislation, which becomes effective in January 2019, would allow Montebello and two other cities to sell their water systems without seeking voter approval. According to the acting city manager, the city council has not yet decided on selling the water system, but he stated that the city should revisit its options.

In addition to raising rates or selling the water system, the city could seek loans from the State to complete necessary improvements. However, the city did not apply for these loans, even though securing them would allow it to complete necessary improvements to its water system. In a 2016 water rate study, a consultant identified loan options for funding these improvements. For example, the State Water Resources Control Board (State Water Board) offers low-interest loans through its drinking water revolving fund program to help cities make improvements to their water systems. Payments on the loan would begin one year after project completion, and the consultant indicated that Montebello might qualify for principal forgiveness on the loan if it meets the disadvantaged community requirements.

However, Montebello's public works director indicated that the city lacks the staff or resources necessary to pursue state

funds. The State Water Board's application instructions state that cities should complete the environmental portion of the loan application first, because it generally takes the longest time to review. This process would require the city to complete an analysis to ensure that the project would satisfy state environmental laws. In our judgment, the city could retain a consultant for this purpose. The acting city manager said he would be open to hiring a consultant to assist in state loan applications because the city has typically hired consultants for similar work.

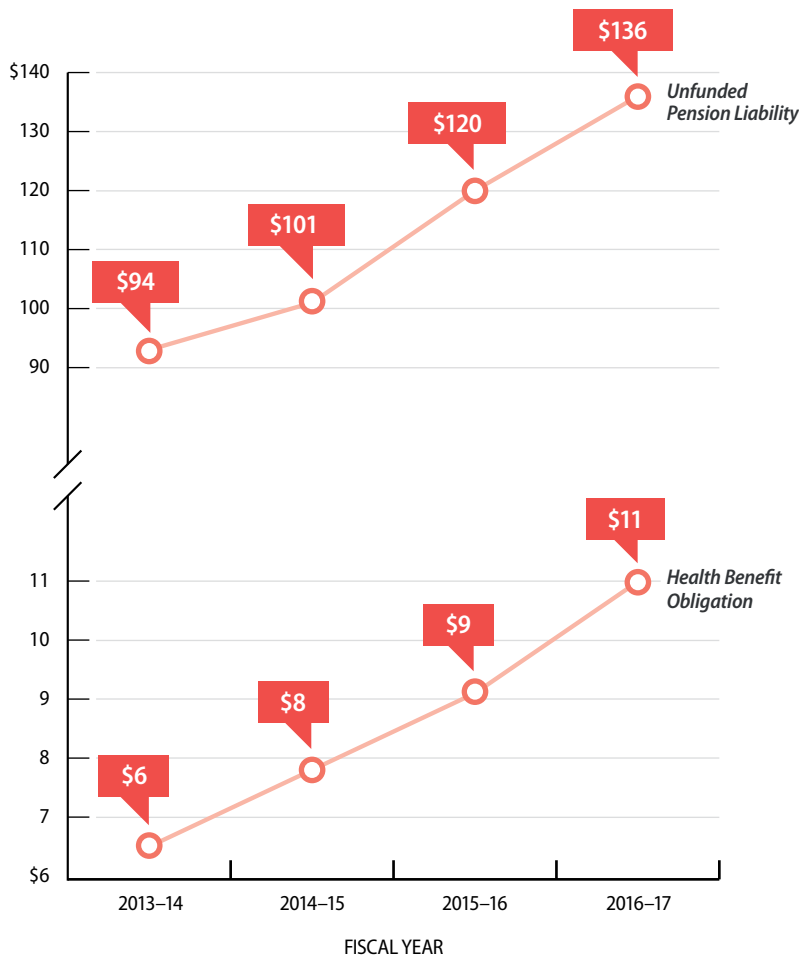
Recommendation to Address This Risk

To address the long-term needs of its water system, Montebello should, by March 2019, reevaluate selling its water system in light of recent legislation or retain a consultant to assist the city in applying for state loans and identifying other options for funding capital improvements.

Montebello's Retirement Costs Could Burden the City's Finances in Future Years

Because of past unfunded retiree pension and ongoing health benefit obligations, city leadership faces higher annual retirement expenses. Montebello makes the annual payments that the California Public Employees' Retirement System (CalPERS) requires to fund its pension costs; however, due to CalPERS rate changes and investment fund underperformance, these payments had not been sufficient to cover all of the city's unfunded obligations. CalPERS factors the increased unfunded liability into the city's annual payments, resulting in higher retirement costs. Additionally, Montebello contributes less than its annual required contribution to its retiree health benefit plan. As a result, the amount of retirement costs for which Montebello is still responsible continues to grow. Figure 5 shows that as

Figure 5
Montebello's Unfunded Pension Liability and Retiree Health Benefit Obligation Have Increased Significantly in Recent Years
(In Millions)



Source: Annual financial reports and CalPERS projections for Montebello.

of June 2017 the city's unfunded pension liability had increased to nearly \$136 million, while its unfunded retiree health benefit obligation reached nearly \$11 million.

Montebello's choice to cover employees' required retirement contributions has added financial stress to the retirement fund. The statutes that govern CalPERS generally require employers and employees to share annual retirement costs, but the law recognizes that employers have negotiated

cost-sharing agreements as a benefit to their employees. Historically, Montebello has chosen to cover its employees' required pension contributions in addition to the required employer contribution. The city temporarily suspended this practice for some classifications in fiscal year 2011-12. However, the city has continued to cover employee contributions in subsequent fiscal years for employees who, according to Montebello human resources staff, CalPERS does not identify as restricted by the 2013 Public Employees' Pension Reform Act (PEPRA). PEPRA prohibits employers from covering employee contributions for new hires after July 2013, but it allows employers to continue their existing cost-sharing agreements with employees hired before that date.

According to CalPERS records for Montebello, in fiscal year 2016-17, the city had 316 employees hired

before July 2013, and it paid about \$1.3 million for employee contributions from its retirement fund that year. According to the acting city manager, the city's payment of the employees' share of retirement contributions is important to employee retention since it allows the city to provide additional compensation. Nevertheless, the city risks burdening the general fund with these payments if retirement fund expenditures continue to increase. The city is currently negotiating with its employee groups to renew expiring or expired contracts.

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Montebello has some resources available to cover retirement costs, but these resources could become inadequate over time. In 1946 Montebello voters approved an increase in the city's property taxes allocated to retirement costs, and voters again increased those taxes for the same purpose in 1976. The city keeps track of these restricted property tax proceeds in its retirement fund. Historically, Montebello's portion of property tax revenue designated for retirement has been sufficient to cover the city's retirement expenses without requiring any contribution from the general fund. Nevertheless, CalPERS projects that Montebello's annual required retirement contribution will increase significantly in the future, and based on our analysis, the city's retirement fund revenue will not keep pace with these increased costs. However, it is unclear when the city's general fund will have to contribute to retirement expenses because of the retirement fund's current reserve balance, the fact that the city's transit fund covers the transportation department's share of retirement costs, and CalPERS has not projected beyond fiscal year 2024–25.

Montebello would like to explore options for addressing its increasing retirement costs. The acting city manager stated he would like the city to work with CalPERS to restructure the city's payment schedule. He also said the city plans to hire a consultant by June 2019 to develop a plan for addressing its retirement costs. However, he acknowledged that the city does not have any concrete plans. Finally, increasing property taxes to generate revenue for its retirement fund is not an option, as current state law related to property taxes prevents Montebello from further increasing its property tax portion for employee retirement. Until city officials take steps to address Montebello's increasing retirement costs and ongoing health benefit obligations, the city will risk needing general fund dollars to supplement its payments in the future—reducing funds available for other city services.

Recommendations to Address This Risk

To address higher retirement costs and obligations for retiree health benefits, Montebello should, by June 2019, retain a consultant to help it identify ways to reduce the financial risks that such obligations pose.

To address increasing retirement payments, the city should consider ceasing payment of the employee portion of retirement costs for employees hired before July 2013. It should renegotiate this payment the next time it renews contracts with its employees.

Montebello's Hotels Pose an Ongoing Risk to the City's General Fund

City leadership has exposed the general fund to significant financial risks through its hotels. Although the first hotel has generated sufficient revenues in the past, the city risks having to pay up to \$3.7 million per year from its general fund for hotel bond payments if hotel revenues fall short of expenses. Also, city leadership has continued to enter into agreements that disproportionately favor the hotel operator's financial interests—while Montebello carries most of the financial risk for the hotels. Furthermore, by mismanaging hotel revenues, the city has paid \$1.6 million in avoidable interest to the hotel operator.

Montebello's Hotel Bonds Could Impair the City's General Fund

Montebello has used certain financing tools to fund the construction of two city-owned hotels, and these pose significant financial risks to the city's general fund. Montebello leadership financed both of the city's hotels in 2001 and 2016 using lease revenue bonds, which we define in the text box. The California Constitution (state constitution) does not permit cities to take on debt that is backed by their general fund revenues without voter approval. However, because courts have excluded bonds that are payable exclusively from special fund revenues from the prohibition on municipal indebtedness, cities are able to finance projects through certificates of participation and lease revenue bonds without holding a municipal election. According to the California State Treasurer's (State Treasurer) guidelines, unlike general obligation bonds, which would require voter approval, cities are not legally required to levy taxes to pay for these alternatives. To pay off certificates of participation and lease revenue bonds, cities rely on a project's revenues or

lease payments. However, if a project's revenues are insufficient to meet these obligations, cities must find other revenues to use, including general fund money, to avoid default. In Oakland, for example, city officials currently budget up to \$12 million in general fund money every year in case it is needed to pay for lease revenue bond payments related to its stadium.

Because the state constitution does not require a city to obtain voter approval for certificates of participation and lease revenue bonds, city councils and financial institutions—not residents—decide which projects the city will finance. The acting city manager indicated that he believes it is unlikely that the general fund will have to cover hotel bond payments because of the hotel's past performance and unique setting. Additionally, the city has bond reserves for its hotels; however, these reserves do not cover the entire bond payments in the event of more than one year of underperformance. The city also made an agreement with its former redevelopment agency to lend it money for the first hotel in the event of a shortfall. However, the city would still have to repay that loan. Further, the city does not have such an agreement

Definitions of Certain Methods for Municipal Borrowing

Lease Revenue Bonds:

Bonds that fund a project and pledge that project's future revenues as the repayment source.

Certificates of Participation:

Financial instruments that entitle their owners to a proportionate share of lease payments made by a government agency pursuant to a lease agreement.

Source: State Treasurer's guidelines.

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for its second hotel. Therefore, the general fund is ultimately at risk of having to cover a significant amount of hotel bond payments should the hotels fail to generate sufficient revenue. The State Treasurer's guidelines for lease revenue bonds state that agencies should establish a maximum bond payment capacity, typically less than 8 percent of annual projected general fund revenues. The amount of Montebello's bond payments is already about 8 percent of the city's budgeted fiscal year 2018–19 general fund revenues. If hotel revenues fall short of expenses for multiple fiscal years, Montebello's general fund would be responsible for up to \$1.1 million for the first hotel and \$2.6 million for the second hotel annually in hotel bond payments in order to avoid default. The total of these amounts is also half of the city's general fund reserve. Montebello is already in a structural deficit, so draining its reserve by such an amount would significantly threaten the city's ability to provide essential services.

Further, as part of its bond agreements, Montebello's hotel tax revenues go toward paying the hotel's debt rather than contributing to the city's general fund. Cities levy certain taxes on hotels, including occupancy taxes. In addition to occupancy tax, the city collects a hotel land use fee and energy tariffs. These tax revenues typically go directly into the city's general fund. In fact, in fiscal year 2016–17 Montebello collected about \$550,000 in hotel taxes from hotels that it does not own. But for the hotels the city does own, the city's bond agreements require it to use tax revenues from its hotels to pay bond principal and interest. This arrangement only benefits the city if the hotel generates more total revenue than it needs to pay its bond principal and interest as well as management fees. Notably, the city's general fund has yet to receive revenue from its existing hotel, which opened 15 years ago.

Over the past five years, Montebello has used nearly \$3.5 million in hotel tax revenues to make bond payments for its first hotel. Based

on a consultant's estimates, after adding its second hotel, the city will contribute more than \$2 million in tax revenue annually to make its hotel bond payments. The two hotels' bonds do not expire until 2033 and 2046, respectively. When the bonds are fully paid, the hotels will pose significantly less risk to the general fund, provided that they generate sufficient revenue to meet expenses.

Recommendation to Address This Risk

To ensure that Montebello does not expose its general fund to additional financial risk, the city should refrain from taking on additional debt in the form of certificates of participation and lease revenue bonds until the city's financial situation improves.

The City's Mismanagement of Hotel Revenues Has Cost Montebello at Least \$1.6 Million

Montebello failed to pay for the first hotel's management fees and accrued \$2 million in interest costs by the end of fiscal year 2016–17. The bond statement for the first hotel stipulates that the city is to use hotel revenues to pay for certain expenses, including operating expenses, debt, and management fees. Any remaining revenues after these payments are available for the city to transfer into its general fund. The city contracts with a company to provide hotel management services—including maintenance and operations—for the first hotel and has a similar agreement for the second hotel. From fiscal years 2002–03 through 2013–14, however, the city did not pay about \$5.9 million in management fees and about \$1.5 million in associated interest even though revenue was available to pay at least part of the fees in most of those years.

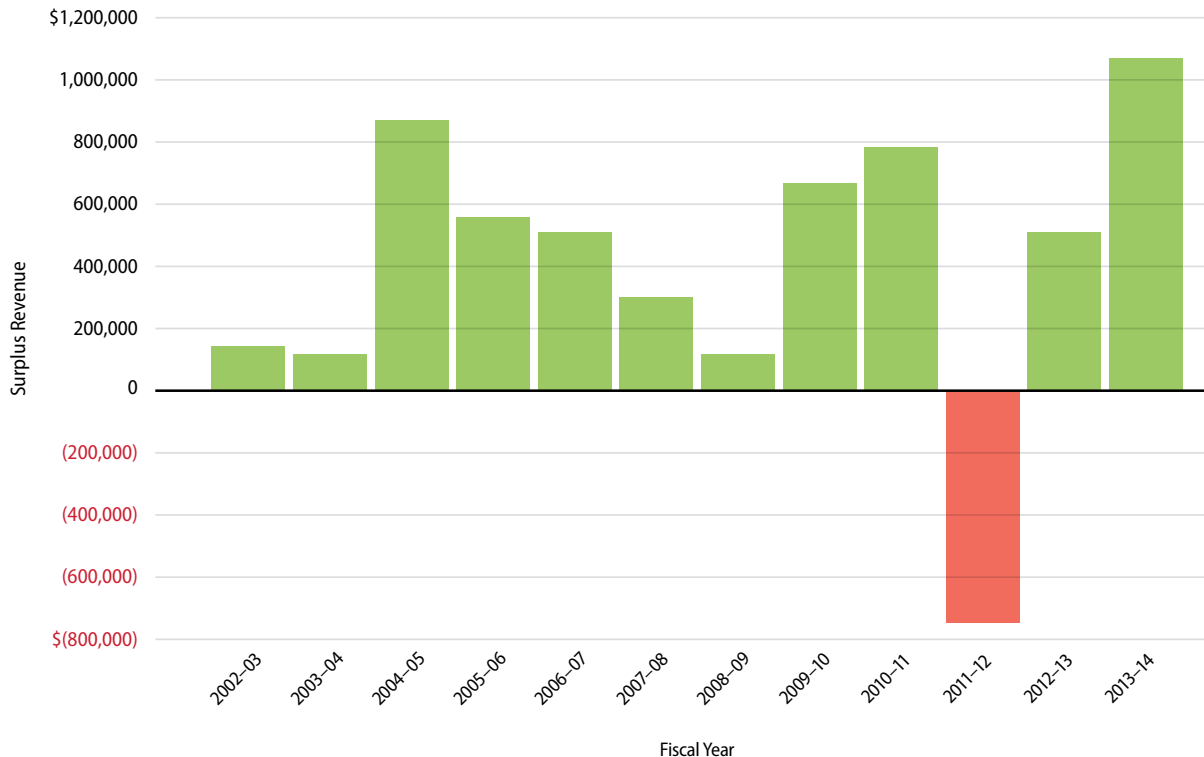
The city could have saved at least \$1.6 million in interest costs through fiscal year 2016–17 if it had paid the management fees with hotel revenue as the money became available.

We used the city consultant’s calculations of the first hotel’s performance to estimate that from 2003 through 2014, the hotel generated revenue in 11 of the 12 years and the city could have applied those funds toward accrued management fees and interest after it made bond payments. Figure 6 shows the hotel revenues the city could have applied to management fees from fiscal years 2002–03 through 2013–14. Instead, the city allowed this revenue to accumulate in the hotel’s bank accounts. As Figure 7 on the following page shows, had the city applied these revenues as partial payments for management fees and interest, we estimate that Montebello would have paid only about \$394,000 in interest costs on its management fees, saving about \$1.6 million. Furthermore, we estimate that Montebello could have received a total of \$782,000 in hotel revenues for its general

fund by fiscal year 2017 if it had appropriately used its hotel revenues to pay outstanding management fees.

The city took action in 2015 to pay hotel management fees and interest; however, city officials could not explain why it originally made the decision to forego payments for such an extended time. In 2015 the city began to pay off what it owed for accrued management fees and interest. As of June 2018, the city has paid a total of \$9.1 million for management fees and interest costs accrued from fiscal years 2002–03 through 2017–18, and according to the city’s consultant, Montebello anticipates paying the remaining amount by 2019. The city does not have records of the rationale for its decision not to pay the management fees in a timely and cost-effective way.

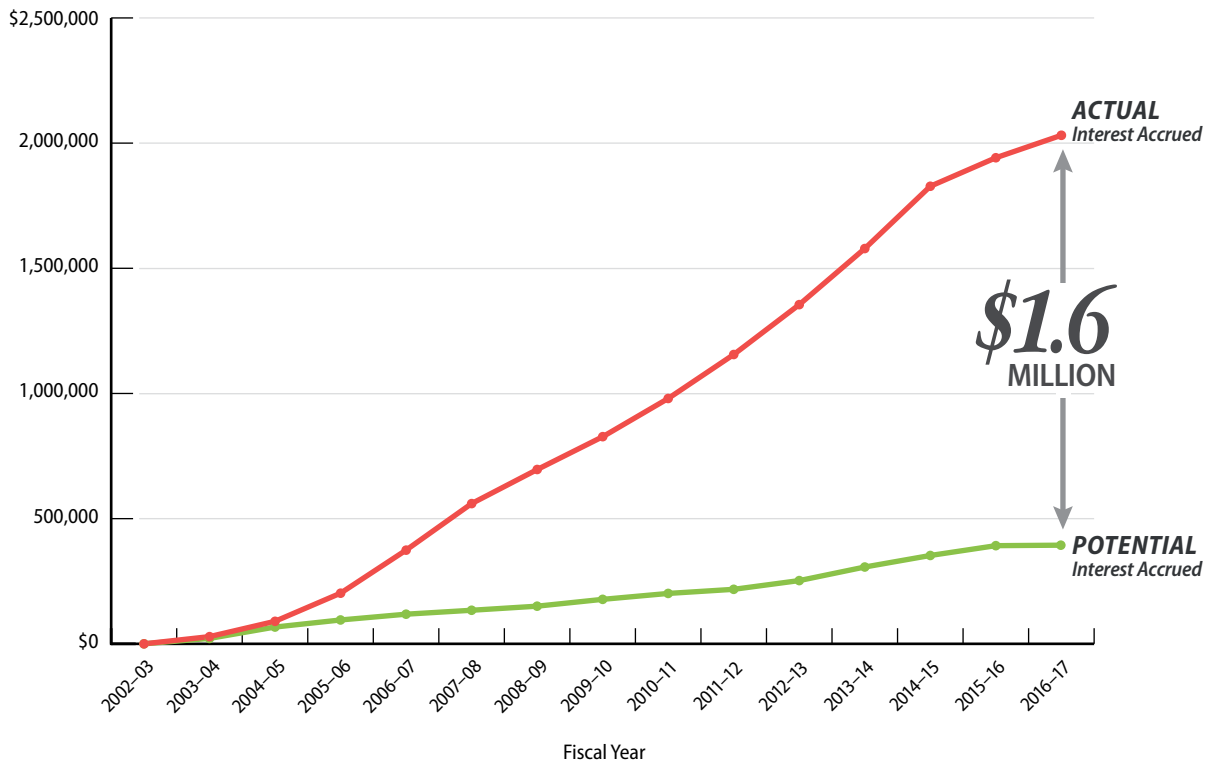
Figure 6
The Annual Hotel Revenues Montebello Could Have Applied to Management Fees From Fiscal Years 2002–03 Through 2013–14



Source: A presentation by a consultant for Montebello on the first hotel’s performance.

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Montebello Could Have Saved at Least \$1.6 Million in Interest Costs Had It Paid Hotel Management Fees When It Had Sufficient Revenue to Do So



Source: Review of the hotel management company's fee accrual schedule and a presentation by a consultant for Montebello on the hotel's financial performance.

Recommendations to Address This Risk

To ensure that the city does not accumulate additional interest expenses, Montebello should pay off the remaining accrued interest for late management fees by the end of 2019, as planned. To avoid paying interest on future hotel management fees and to ensure that all hotel obligations are paid on time, the city should immediately develop a formal process that requires the city to pay all outstanding bills related to the hotels if hotel revenues are available.

Montebello Has Not Ensured That It Receives the Best Value From Its Agreements With the Hotel Operator

For decades, city leadership has approved extensions and amendments to the management agreement for Montebello's event center. Separate companies—each owned at least in part by one individual, the hotel operator—manage Montebello's event center as well as each of the city's hotels. The city has an agreement with the hotel operator to manage the event center, which includes a golf clubhouse. In exchange, the city receives a share of gross revenues—between 5 percent and 10 percent—depending on the total revenue the operator generates from the facility. City leadership has amended the hotel operator's agreement to manage

the event center 10 times since 1974. Three of those amendments extended the contract term, which is now set to expire in 2064, 63 years after the last extension amendment was signed. According to a consultant's report on Montebello's municipal golf course, the city's contract term with the hotel operator's company to manage the event center is unusually long.

Several of these amendments and extensions have made it difficult for the city to competitively bid contracts related to its hotels and golf course. The city's original agreement with the hotel operator gives the event center—which is managed by one of the hotel operator's companies—exclusive concession rights to the golf course. In 2001 and again in 2016, the city amended this agreement to provide the hotel operator with exclusive concession rights at each of the city's hotels. At a 2017 city council meeting, the city attorney cited this concession agreement as the reason the city should extend the hotel operator's management contract for the first hotel instead of requesting bids from other management companies. The city attorney also cited the fact that the hotel operator has the Hilton franchise. Under this reasoning, the hotel would lose its franchise rights if the city did not extend its agreement with the operator. Additionally, the city would have immediately owed the operator more than \$2 million in unpaid management fees and accrued interest. Nevertheless, absent a breach of contract by the hotel operator or a buy-out agreement, the city will need to maintain these three contracts until their terms expire to avoid penalties.

With the current arrangement, the city's agreements with the hotel operator favor the operator's financial interests while the city assumes significant financial risk. As we discussed earlier, if the hotels do not generate sufficient revenue to cover the city's bond payments, the city's general fund will be under pressure to cover them. In contrast,

if the hotels lose money and are unable to pay management fees, the hotel operator will receive interest resulting from unpaid management fees. In addition, the hotel operator, through the company managing the event facility, secured a loan on the city's behalf to finance renovations and signage for the event center. At a November 2017 city council meeting, a Montebello council member said the hotel operator used his own credit to secure financing for necessary improvements when the city could not secure a loan because of its poor financial condition. The city has agreed to pay for the loan by reducing the lease payments that the hotel operator makes to the city by an amount equal to the loan payments.

“If the hotels do not generate sufficient revenue to cover the city's bond payments, the city's general fund will be under pressure to cover them.”

Further, Montebello entered into exclusive concession agreements with the hotel operator without following a competitive process. In addition, the city amended the hotel operator's management contract for the event center twice in order to give the hotel operator exclusive rights to sell food and beverages at each of the city's hotels. One such agreement requires the city's new hotel to reimburse the event center management company for food sold at the hotel at a 30 percent profit. Per this agreement, the city paid more than \$300,000 for food and nearly \$2 million for

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other contract services and administrative expenses at its hotel in fiscal year 2016–17. Without having followed a competitive process, the city cannot be sure that this was the best deal, one that would maximize the potential revenue from the hotel that it might receive for its general fund.

The city is also missing an opportunity to strengthen its oversight of these agreements. The agreements require the hotel operator to submit various information regarding operations—such as financial reports—to the city. According to its acting city manager, Montebello lacks the hotel industry experience required to determine whether the hotel expenses are reasonable. He said the city plans to compare the hotel’s expenses detailed in these reports with a consultant’s initial projections to determine whether the hotel is operating efficiently. Without strong monitoring of its agreements with the hotel operator, the city cannot safeguard its interests in the contracts.

Recommendation to Address This Risk

To ensure that the city safeguards its interests in various agreements and to ensure that the hotel operator meets the requirements in those agreements related to hotel and event center operations, beginning in January 2019, the city should begin to routinely review information submitted to the city by the hotel operator. At least annually, city staff should report to the city council and the public on the efficiency and effectiveness of hotel operations.

Its Poor Contracting Practices and Unresolved Staffing Needs Hinder Montebello's Ability to Provide Services to Its Residents

Montebello did not consistently use competitive processes to ensure that it received the best value for its procurements, has still not addressed some recommendations from an audit in 2011, and continues to have vacancies in key positions. Specifically, out of 16 agreements we reviewed, Montebello did not competitively procure 10 of them; and in most cases, the city did not adequately justify its decision not to seek multiple bids. In addition, the city has not adequately implemented the changes necessary to address nine of the State Controller's 21 recommendations from a 2011 audit of city practices. Finally, turnover and vacancies in key positions have reduced organizational stability.

Montebello Should Do More to Monitor the City Manager's Contracting Activities

We found that Montebello's city manager on leave approved work above her authorization limit. Of the 16 contracts that we reviewed, she authorized one contract that exceeded her \$50,000 signing authority, and another contract that city staff inappropriately amended. At the time she executed the contracts, the municipal code allowed the city manager to sign professional and special services contracts up to \$50,000 without council approval.

However, the city manager on leave authorized a contract that exceeded her authority and did not obtain council approval. In January 2016, she signed a contract for plan review services at an hourly rate. The contract did not have a maximum value and ultimately the city paid more than \$149,000

on this contract. The city's municipal code requires that the city council approve all contracts over \$50,000; however, the council did not review and approve this contract. Further, the city's municipal code requires that the city attorney sign all contracts for services over \$50,000. The contract was not signed by the city attorney, who stated to us that his practice for such a contract would be to require that it have a maximum value. The acting city manager indicated that staff turnover in the planning department might have created an emergency and that the city might have needed to enter into a contract quickly to ensure that the work was performed. Nevertheless, because the agreement was for hourly services, the city manager could have approved a contract below her authority and later asked the city council to amend it as necessary. In this case, the city manager bypassed the city council and prevented it from reviewing the contract in a public forum.

We also found that the city manager on leave presented an amendment to the city council for the wrong contract, resulting in the city paying more for services than the city council had authorized. In May 2016, she authorized a \$50,000 contract for an audit of the city's transportation department payroll. Because this contract amount was within her signature authority, this contract did not go to city council for approval. In June 2016, the city council approved an \$88,000 amendment for similar audit services under a different contract with the same contractor. Because the city manager on leave did not make the council aware that she had already contracted for this work, the city council did not know the city was paying a total of \$138,000 for

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these services. The city's accounting manager stated that the finance director at the time likely referenced the wrong agreement when presenting the amendment to the city council; however, the memo to the council describing the amendment was from the city manager on leave. The fact remains that the documents on record do not indicate that the city council was aware of the May 2016 contract for an audit of the transportation department's payroll when it approved the amendment. As a result, the city paid \$138,000 for an audit the council believed would cost \$88,000. Neither the minutes of the council meeting nor the related agenda reflect the greater amount.

Montebello has taken some steps to monitor the city manager's contract administration. In May 2017, the city council passed a resolution that requires any contract exceeding \$20,000 be submitted to the council for approval. Further, the resolution requires that the city manager or finance director provide an update to the council on any new contracts the first time a payment on that contract is listed on the payment register, a resolution the city is currently following. The resolution also required the city council to establish a quarterly limit on the city manager's contract approval authority when it approved the budget for the 2017–18 fiscal year. According to the acting city manager, the council has not imposed a quarterly limit. He also stated that a limit on the city manager's signing authority would make it difficult for the city to conduct its business effectively. We agree that this limit could reduce the city's ability to operate and provide services to residents timely. Nevertheless, this resolution is still in force and should be followed.

The city plans to further clarify and improve its existing procurement policies and practices. According to the acting city manager, the 2017 resolution created significant confusion for staff because it was not aligned with the municipal code. To address this confusion, the city's current interim finance

administrator is in the process of streamlining the city's purchasing policies because they are outlined in six different documents, which contradict each other at times. He intends to propose recommendations to the city council that, if approved, would consolidate the city's fiscal policies into a single ordinance amending the city's municipal code, thereby superseding all other existing policies. His suggestions to revise the city's municipal code include requiring formal competitive bidding for professional and special services costing more than \$50,000 and providing department heads with contract authorization up to \$10,000. According to the interim finance administrator, these changes will reduce confusion for staff and facilitate the city's business operations. Additionally, he plans to recommend updating the municipal code to limit the city manager's contract signing and approval authority to \$50,000. These changes are reasonable and, if followed, would improve the city's procurement practices. However, the interim finance administrator noted that all of these proposed changes are contingent upon the approval of the city manager and city council.

Recommendations to Address These Risks

To monitor the contracting activities of its city manager, the city council should do the following:

- *Ensure by March 2019 that the municipal code reflects the council's desired limit on the city manager's contracting authority.*
- *By March 2019, establish a quarterly limit on the city manager's contracting authority, pursuant to the council's resolution, or modify the resolution to eliminate that provision.*

To ensure that the city council reviews and approves contracts that exceed the city manager's authority, the city should establish a policy by March 2019 that any agreement to pay for services

by the unit—such as hourly—should contain a maximum value and receive the appropriate approvals based on that value.

To reduce confusion among city staff and facilitate efficient procurement, city staff should bring its proposals for streamlining and updating the city's procurement policies to the city council for review by March 2019.

The City Did Not Always Follow Competitive Bidding Processes and Has Not Adequately Ensured That It Receives the Best Value for Services

Montebello entered into 10 of the 16 agreements that we reviewed without competition and although it is a best practice, the city's municipal code does not require competitive bidding for services. The city's municipal code requires a competitive bidding process for obtaining supplies and equipment, and the city may dispense with competitive bidding for supplies and equipment only if there is an emergency, upon a four-fifths vote of the city council, or if the purchase is less than \$25,000. The city council approved one of the contracts we reviewed without competitive bidding by a four-fifths vote, noting that the contractor was in a unique position to provide the equipment and related services.

However, the city's municipal code does not contain similar provisions related to procuring services. Instead, some of its competitive bidding provisions are permissive rather than required. For example, the municipal code states that "the acquiring of professional and special service contracts shall be procured through a negotiated contract, and should include a request for proposals." In other words, the city requires negotiated contracts for services but only suggests using a formal process to request proposals. Additionally, the municipal

code does not explicitly require that city departments use a competitive process. Instead, it recommends that they should contact three firms for contracts of \$50,000 or less, and that they should use a sealed bidding process for contracts that exceed \$50,000. In May 2017, the city council stated that all contracts, regardless of the estimated cost, shall be competitively bid in accordance with the municipal code; however, the municipal code was not amended to reflect more stringent requirements for competition.

“The city requires negotiated contracts for services but only suggests using a formal process to request proposals.”

Competitive bidding is a generally accepted method for ensuring that public entities obtain goods and services from the most qualified vendors for a fair and reasonable price. Regardless of whether the municipal code requires such a practice, the city should use competitive methods to ensure that it receives the best value for goods or services with few exceptions—such as for very small purchases or legitimate emergencies. In fact, we have observed procurement policies in other governmental entities that specifically limit the circumstances under which the entities may forego competitive bidding and that require justification of such a decision. Otherwise, the city risks not obtaining the best value for the services it seeks and it risks accusations of unethical contracting practices.

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In fact, public interest in the lack of competition for an agreement on one project in Montebello may have delayed needed repairs that the city could have made if it had competitively bid the agreement. In December 2015, the city manager on leave authorized building improvements to the city's transit data center without competitive bidding. According to the city's information manager, the city terminated the project after a news report alleged that the project had not been competitively bid. He later acknowledged that the work in question was part of an allegation by a local news source that someone—either the city or the contractor—had fabricated bids to make it appear as though the work had been competitively procured. As of November 2018, the city is engaged in ongoing litigation with the contractor.

During the summer of 2018, the computer servers in the transit data center essentially stopped working when the room they were in overheated, according to the information manager. He noted in August 2018 that the transit data center was still in need of additional repairs and renovations and that the city was developing a request for proposals (RFP) to competitively bid work that would reduce the risk for future heat damage. Nevertheless, had the city competitively bid the project to begin with, it would have avoided the criticism that prompted it to cancel the contract and possibly could have avoided the later problems with its servers this past summer.

We also identified three instances in which the city contracted for architectural and engineering services but did not conduct a competitive process to identify firms that might qualify to meet the city's needs, nor did it adequately justify the lack of a competitive process. State law requires that government agencies procure architectural and engineering services pursuant to a fair, competitive selection process based on demonstrated competence and on the

professional qualifications necessary to satisfactorily perform the services required. However, in January 2016, the city entered into a contract for plan review services—an engineering function—at an hourly rate but with no contract maximum and in August 2017, the city entered into an \$18,600 contract for engineering services related to its water utility. In neither case did the city have records showing that it identified these firms through a competitive selection process.

The city could not provide a clear explanation for not using competitive bidding in these two cases. According to the assistant city manager, these contracts were awarded by the planning and community development department. The individual serving as director of this department at the time is no longer employed with the city and therefore could not provide his perspective. Furthermore, the acting city manager—who was not working for the city at the time of these contracts—stated that the city's municipal code does not require a competitive process and permits such contracts to be granted based on demonstrated competence. Nevertheless, state law requires local governments to conduct such procurements in a fair and competitive manner, and the city has no process to document its rationale for procuring services without competition.

“The city could not provide a clear explanation for not using competitive bidding.”

Without competition, the city cannot ensure that it is receiving services from the most qualified firms at a fair price. According to

the assistant city manager, the city's lack of staffing and absence of a purchasing administrator have significantly hampered the city's capacity to undertake competitive processes. Nevertheless, without a policy guiding city staff, the city cannot be sure that it is complying with state law and awarding architectural and engineering contracts using a fair and competitive process.

In the third instance of awarding an architecture and engineering contract without a competitive process, the city awarded a construction management contract for its second hotel in a manner that may have deprived the city of its ability to ensure that it selected the best contractor. As with architectural and engineering services, state law requires that local agencies select firms for construction project management services based on demonstrated competence and on the professional qualifications necessary to satisfactorily perform the services required. Specifically, Montebello granted a contract to manage construction of the second hotel to the same entity that is now the operator of that hotel. Within the contract, the city states that it has no expertise with respect to developing a hotel facility and desires quality construction management services. However, there is no evidence that the entity submitted a proposal or any other formal documentation that would demonstrate competence or professional qualifications, nor is there evidence that the city created a formal request for qualifications. Further, the city did not consider the fact that this entity, as the franchisee and operator of both hotels, already had significant, closely related business interests with the city.

According to the city attorney, the city awarded its construction management contract without using a competitive process because the contractor offered to provide the service for no fee, the contractor had an existing relationship with the city, and the city held a favorable view of his past performance in other endeavors with

the city. While we do not dispute the value of receiving services for no fee, we question whether the city performed adequate procedures to review the qualifications of the entity to whom it awarded the contract. Further, the city did not take steps to identify and obtain the qualifications of other firms that might have been better able to provide the services.

“*The city awarded its construction management contract without using a competitive process.*”

We also found that while Montebello conducted a competitive procurement to build its second hotel, it did so in a manner that may have stifled competition. When it requested bids on the hotel in April 2016, the city gave prospective bidders only 10 days to submit proposals. In our judgment, this was not adequate time for a project of this scope and scale. During our review, we noted that for another, less complex contract for which the city conducted competitive bidding, the city gave bidders significantly more time to submit proposals. The city provided prospective bidders five weeks to submit RFPs for construction management services for a contract valued at about \$55,000, which is less than .002 percent of the value of the \$36 million construction contract awarded for the design and construction of the second hotel.

The fact that the hotel operator met with construction firms to ascertain their qualifications before the city released its RFP mitigates—but does not eliminate—the argument that the bidders did not have

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enough time. Further, we question why the city did not conduct these meetings itself or retain documentation. According to the hotel operator, he met with potential firms before the city released its RFP and city representatives were present at some but not all of the meetings. When the city was not able to provide information about these meetings, we asked the hotel operator. He provided a list of six firms he met with and from which he received information before the city released its RFP. Nevertheless, as this is a contract between the city and a construction firm, we expected the city to have conducted or at least been present at all such meetings and to maintain records of those meetings. Further, the hotel operator was not yet under contract as the construction project manager when these discussions took place; thus, we question his authority to conduct such meetings on behalf of the city. Without adequate participation from city staff in meetings with potential bidders and without adequate time for firms to place bids, Montebello cannot demonstrate that it has taken the steps necessary to ensure that it selected the best firm and that it protected city interests in the handling of this project.

Although it was not specifically a procurement agreement, we also reviewed the franchise guarantee agreement between Montebello and Hilton for the second hotel and found that this agreement also was not submitted to the city council for review and approval. The city manager on leave entered into this agreement, guaranteeing that the city would make payments on any debts owed to Hilton if the franchisee—who is also the hotel operator—should not make payments. Our review of council meeting minutes for 2016 and agendas around the date of the agreement do not indicate that it was on any agenda or approved by the council. Given that the potential cost to the city under this agreement could exceed the city manager's authority to sign contracts of up to \$50,000 without council approval, in our judgment the city council should have had the opportunity to consider the risks involved in such an agreement before it was signed.

Recommendations to Address These Risks

To ensure that Montebello obtains the best value for the services it receives, the following should occur:

- *City staff should immediately begin to follow all recommendations in the city's municipal code related to procuring goods and services. Should the city have a valid reason for deviating from these recommendations for a specific procurement, it should document such rationale in its procurement files.*
- *The city council should amend its municipal code by March 2019 to require competitive bidding for most procurements and to outline procedures for—and identify circumstances in which—the city may procure professional and special services from a single source.*
- *The city should develop a policy by June 2019 that describes how it will comply with state law regarding future architectural and engineering contracts, including how it will ensure that it awards such contracts pursuant to a fair and competitive process.*
- *By March 2019—and annually thereafter—the city should train all staff involved in procurement regarding city procurement requirements as well as state law pertaining to certain public procurements.*
- *The city should establish a policy by March 2019 that requires the city council to review and approve any agreement that binds the city financially in a way that cannot have a maximum value attached—such as the franchise guarantee agreement for the second hotel.*

Montebello Has Not Addressed Some of the Deficiencies Identified by the State Controller

The city has not implemented some of the recommendations the State Controller issued seven years ago during an audit of Montebello's administrative and accounting practices. In 2011 the State Controller performed a review of those processes, and it issued multiple recommendations pertaining to the development of policies and procedures, and the implementation of improved accounting practices. In an internal document that Montebello provided to us, city officials indicated that the city had addressed the recommendations and that no further action was needed. However, when we reviewed the status of 21 specific recommendations the State Controller made to improve Montebello's control over its activities, city officials could only provide information demonstrating that it had addressed 12. The table on the following page outlines the items the city still needs to address.

Some of the same weaknesses highlighted by the State Controller in 2011 persist today, such as insufficient staff training. Employees we interviewed indicated they have not received adequate training to conduct their work. For example, two staff members stated they received limited on-the-job training and that they were predominately self-taught regarding the use of accounting systems and the implementation of purchasing procedures. Similarly, the controller indicated he had taught himself how to set permissions to the city's accounting and human resources software and that he believed that the responsibility was more appropriately suited for the information system manager or finance director to perform. According to the city attorney, who provided historical perspective based on his experience with the city, some of the internal control weaknesses that the State Controller identified may still exist because of turnover in personnel. He elaborated, stating that since the State Controller's report was issued, the city has had several city managers

and has experienced many changes in its department head and director positions. When city staff do not receive training on their roles and responsibilities, it increases the risk of waste and creates additional opportunities for fraud, abuse, and mismanagement.

“Some of the same weaknesses highlighted by the State Controller in 2011 persist today.”

Montebello's finance department has made some efforts to improve the quality and frequency of its training and to develop additional policies and procedures. For example, the city's accounting manager updated training documents on purchasing in 2016 and 2017, and she offered additional training in 2018. Her goal is to offer the training at least annually. Further, as we discuss below, according to the controller, the city is developing a credit card policy.

The city has recently addressed some of the issues the State Controller identified, however, it still lacks policies to protect against those issues recurring. In its 2011 review, the State Controller noted that the city did not approve its budget in a timely manner for two fiscal years and that it had closed its financial records late in one fiscal year. According to minutes of city council meetings and city documents, the city has adopted its budget on time and closed its accounting records on time for several years. Nevertheless, according to the accounting manager, the city does not have formal policies or procedures outlining the steps it should take or the schedule it should follow to ensure that it always meets these deadlines. Without such policies in place, the city risks not taking the necessary steps to prevent delays in its accounting and budgeting.

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Montebello Has Taken Action on 12 of 21 State Controller Recommendations We Reviewed**MONTEBELLO HAS:**

| | |
|---|---|
| Ensured that it appropriately reported to CalPERS severance pay from settlement agreements. | ✓ |
|---|---|

Established procedures to address:

| | |
|--|---|
| Timeliness of the reconciliation of its accounting records to its bank statements. | ✓ |
|--|---|

| | |
|---|---|
| Reconciliation and reporting of outstanding checks. | ✓ |
|---|---|

| | |
|--|---|
| Untimely recording of corrections to payroll checks. | ✓ |
|--|---|

| | |
|---|---|
| Missing deposit slips for its transit department. | ✓ |
|---|---|

| | |
|--|---|
| Time delays between bank deposits and when it records revenue in its accounting records. | ✓ |
|--|---|

| | |
|--|---|
| Differences between amounts in its bank statements and accounting records. | ✓ |
|--|---|

| | |
|--|---|
| Transactions in its bank statements that were not accounted for in its accounting records. | ✓ |
|--|---|

| | |
|---|---|
| Inadequate support for entries into its accounting records. | ✓ |
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|---|---|
| Its potential use of cash in restricted funds to pay for general operating costs that should be paid from the general fund. | ✓ |
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| | |
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| Ensuring timely communication between its departments regarding personnel employment status. | ✓ |
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| | |
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| The proper segregation of incompatible accounting and payment functions. | ✓ |
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MONTEBELLO MUST TAKE STEPS TO:

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| Develop a remedial plan to address the deficiencies noted in the State Controller's 2011 report. Provide periodic updates at public meetings of the progress in implementing this remedial plan. | ■ |
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| Ensure that policies and procedures relating to petty cash controls are updated when appropriate and enforced consistently. | ■ |
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| Require that all future contracts for engineering services over \$50,000 be competitively bid. | ■ |
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| Develop a comprehensive list of policies and procedures for all financial processes and provide training to staff. | ■ |
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| Review and update its policy manual to ensure that it is consistent with current processes and organizational structure. | ■ |
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Adopt policies and procedures to ensure:

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| The timely year-end closing of financial records. | ■ |
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| The timely adoption of its budget. | ■ |
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| That access to computer systems that support human resources and payroll activities is restricted to appropriate staff. | ■ |
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| | |
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| That bonuses are reported as required on the proper Internal Revenue Service form. | ■ |
|--|---|

Source: Review of Montebello's policies and procedures, documentation related to various transactions, and interviews with Montebello's finance department staff.

The acting city manager believed that the city responded to and has continued to address the State Controller's recommendations while balancing its many priorities. He further stated that while there is always room for improvement, the city did take significant steps in response. Nevertheless, the city has had significant time to evaluate and respond to the State Controller's report, which is now seven years old. If it does not implement strong policies governing the city's financial management, Montebello will continue to be at high risk for fraud, waste, and abuse.

Recommendation to Address This Risk

To reduce the risk of fraud, waste, and abuse, Montebello should, by December 2019, address all of the State Controller's recommendations regarding its accounting practices, policies, and procedures. Beginning in March 2019, the city manager or a designated staff member should report quarterly to the city council on the progress of addressing the State Controller's recommendations. The report should identify timelines for addressing each recommendation, outline the specific steps taken to respond to the recommendation, and name the staff responsible for any new processes or controls put in place.

Montebello's Poor Control Over Its Petty Cash and Its Lack of Credit Card Policies and Procedures Could Lead to Fraud

Montebello still lacks policies regarding the city's petty cash practices. The city maintains separate petty cash funds to reimburse its transit, fire department, and other staff for city-related purchases such as office supplies. Although the city has not documented a reimbursement limit in its policies, the form the city currently uses indicates a \$100 limit to petty cash reimbursements. For purchases that exceed \$100, employees

must use another appropriate method for obtaining reimbursement for the purchase, such as a warrant request. In its 2011 report on Montebello's accounting controls, the State Controller took exception to an instance in which a city employee circumvented the \$100 limit by splitting a purchase into multiple receipts. Similarly, in our review of the city's latest petty cash transactions, we found multiple instances in which city staff circumvented the \$100 limit by splitting purchases into multiple receipts, and the finance department approved the separate reimbursements. For example, we found one instance in 2016 where a city employee submitted three separate petty cash reimbursement forms, totaling \$300, for separate transactions from the same retailer within one minute of each other. In another example from 2018, an employee made two separate purchases from the same restaurant within one minute of each other totaling about \$180 and submitted separate reimbursement forms for the two receipts. In each of those cases, city finance staff approved the reimbursements. A lack of strong policies regarding the use of petty cash allows city staff to circumvent approvals for reimbursements and increases the risk of fraud and abuse.

“We found multiple instances in which city staff circumvented the \$100 limit by splitting purchases into multiple receipts.”

In addition, Montebello's lack of documented policies and procedures has enabled its staff to use city credit cards without following proper purchasing protocols. The city's

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finance department is responsible for eight credit cards for various city departments with limits ranging from \$5,000 to \$16,000. The Government Finance Officers Association's best practices state that cities should establish clear, written credit card policies that outline what constitutes appropriate credit card use and the payment approval process. According to the city's controller, the city does not have standard operating procedures documenting its specific credit card policies and practices although the city's purchasing policies also apply to credit cards. The city controller further stated that the city has a practice of requiring city officials to check out credit cards and document the purchases made, but he could not provide documentation demonstrating that officials always follow that policy. He stated that typically, in order to use a credit card, a city staff member must submit a credit card request form describing the reason for requesting the card and documenting departmental approval.

The city's municipal code requires that payments greater than \$500 be coordinated with the finance department through either a request for warrant or a purchase order—depending on the type of purchase. We reviewed 20 of the city's credit card transactions greater than \$500 from fiscal year 2017–18—totalling more than \$17,000—and found that the city did not follow its purchasing procedures for any of the 20 payments. For example, we found that the city only documented a correctly filled-out credit card request form for one of the 20 payments; moreover, the city did not document purchase approval in that instance. Montebello's controller attributed this to the city's transportation and police departments having kept their credit cards rather than returning them to the finance department, and he stated that credit cards should be used for emergencies and travel. Based on our review of the credit card statements for fiscal year 2017–18, we did not see a sufficient difference in the police and transit departments' credit card use

compared to the other departments to justify them being exempt from coordinating credit card purchases with the finance department. In general, the credit card purchases could be grouped into travel, training, supplies, and food expenses. Credit cards, when tightly controlled, can provide a city with the convenience of allowing employees to make small, necessary purchases quickly; however, such transactions also create a significant opportunity for fraud and abuse. Montebello's controller stated that the city is in the process of drafting policies related to the use of credit cards.

Recommendations to Address These Risks

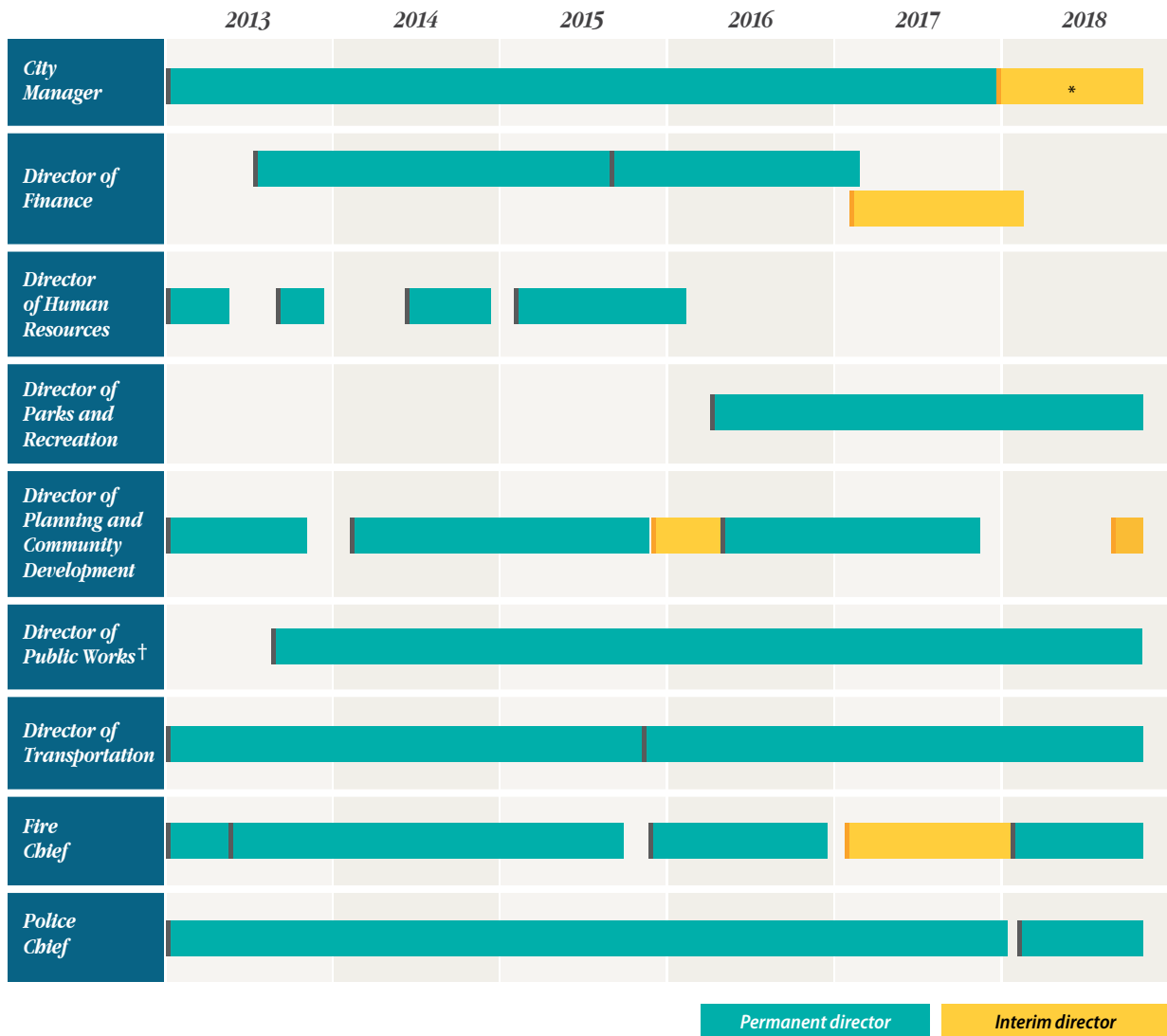
To protect against fraud and abuse, by March 2019, Montebello should establish an official petty cash policy that includes reimbursement limits and that prohibits splitting purchases to circumvent the city's established reimbursement limits.

By March 2019, Montebello should establish an official credit card policy that aligns with best practices from the Government Finance Officers Association.

Lack of Consistent Leadership and Competitive Salaries Have Reduced the Effectiveness of the City's Departments

Vacancies in Montebello's director positions and a hiring freeze have inhibited the city's ability to operate effectively. In May 2017, the city enacted a hiring freeze that has continued into fiscal year 2018–19. Meanwhile, it still has not appointed permanent directors for its human resources and finance departments. As Figure 8 shows, the city has had significant turnover in key positions since 2013. For example, five individuals have held the director of community planning and development position since 2013. According to the acting city manager, the turnover in key positions

Figure 8
Some Montebello Departments Have Had a High Degree of Turnover in Their Director Positions Since 2013



Source: Analysis of Montebello's personnel reports.

* In November 2017, the city council placed its city manager on a leave of absence. The city has hired another individual—whom we refer to as the *acting city manager* throughout the report—to act as city manager while she is on leave.

† Montebello's assistant city manager oversees the Department of Public Works.

has reduced organizational stability, affected the ability of city employees to understand past practices and protocols, and created a lack of institutional knowledge. He also stated that the city will fill the vacant positions that had been frozen on a case-by-case basis—provided the council approves hiring for the positions despite the freeze—and it plans to prioritize key positions.

Meanwhile, the city's lack of a permanent city manager has worsened its leadership vacuum. In November 2017, the city council placed its city manager on a paid leave of absence. The city has not officially disclosed the reasons for doing so. Since December 2017, Montebello has operated with an acting city manager. At the same time, the city has continued to pay the city manager on leave her regular salary,

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and as of October 2018, she was still on leave. Until the city can resolve the circumstances regarding the city manager on leave, the city will not have a permanent city manager providing ongoing leadership.

Montebello has also had trouble hiring and retaining qualified staff members because it pays low starting salaries compared with neighboring cities. We identified two cities—Monterey Park and Pico Rivera—based on their similarity to Montebello in terms of proximity, land area, general fund revenue, and population. As shown in Figure 9, Montebello offers a lower starting salary than these comparable cities for eight of the 10 administrative positions we reviewed. For example, the city's controller position has a starting salary of \$88,000, while a similar position in Monterey Park has a starting salary of \$116,000. Additionally, as shown in Figure 10, five of the 10 administrative positions that we reviewed in Montebello have not had a salary increase in over 10 years. The city has struggled to recruit staff because the city's salaries are not competitive, according to the acting city manager, but the city is currently going through labor negotiations and is reviewing certain positions and salaries to determine the city's competitiveness.

Finally, Montebello has not determined whether its current number and type of positions are best for the city. The acting city manager is not aware of any studies the city has completed to assess whether it has the right number of authorized positions and whether it has the right mix of positions to accomplish city business efficiently. Without information on the appropriate level and mix of positions, the city cannot effectively determine whether it can or should cut positions from the budget to streamline its operations or whether it needs more positions overall.

Recommendations to Address This Risk

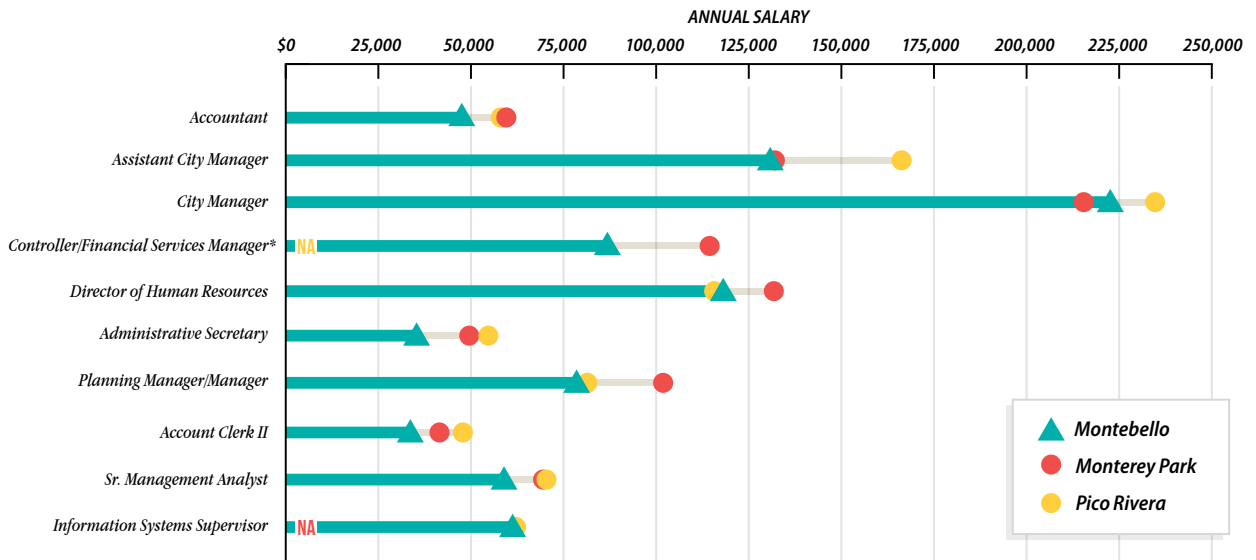
To help ensure that Montebello operates effectively, the city council should, by March 2019, develop and follow through with plans to hire individuals in key leadership positions.

To ensure consistent executive leadership, the city council should resolve the status of its city manager on leave and, if necessary, begin recruiting for a new, permanent city manager.

To ensure that Montebello can recruit and retain qualified candidates, and to ensure that its salaries are competitive for its current staff, the city should, by December 2019, complete a salary survey and adjust salaries as necessary.

To determine the correct level and mix of positions in the city, by June 2019, city staff should present a proposal to the city council for studying Montebello's staffing levels.

Figure 9
Montebello Administrative Staff Salaries Are Lower Than Salaries in Comparable Cities

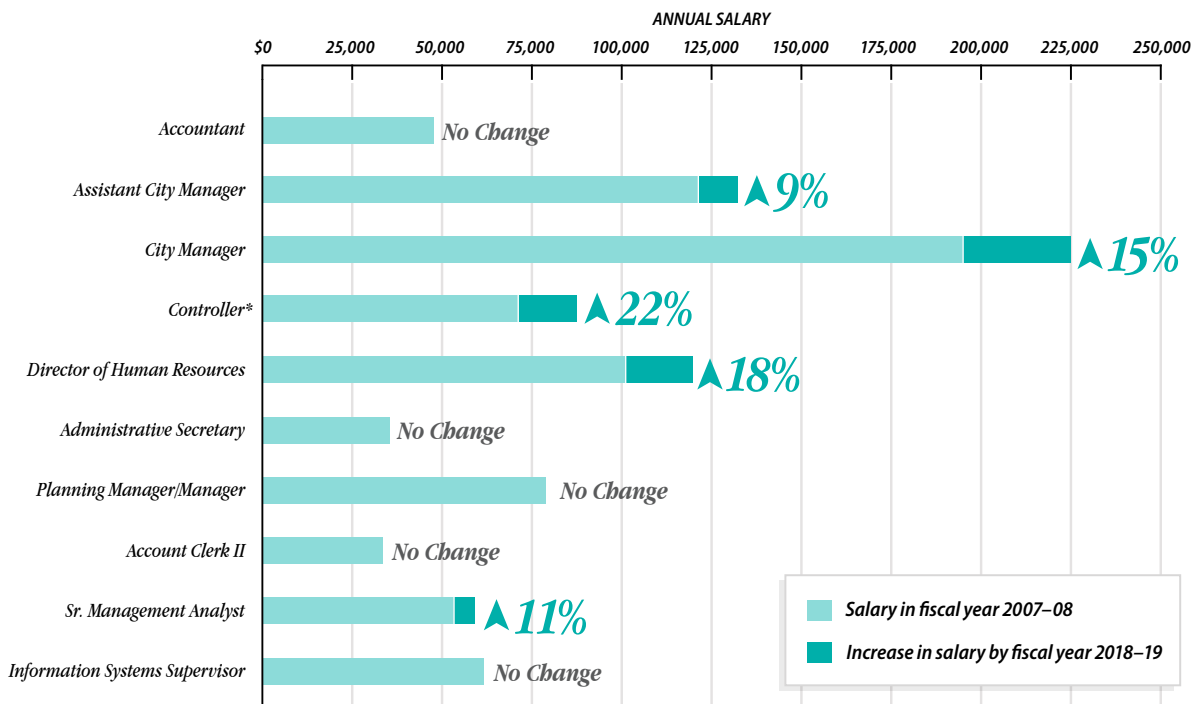


Source: Analysis of the latest budgets of the cities of Montebello, Monterey Park, and Pico Rivera.

NA = City did not fund for this position in the fiscal year.

* Monterey Park funds a financial services manager position in lieu of a controller.

Figure 10
Montebello Administrative Staff Salaries Have Not Increased in More Than 10 Years for Half of the Positions We Reviewed



Source: Analysis of Montebello's annual budgets.

* Because Montebello did not have a controller position from fiscal years 2007-08 through 2015-16, we used the controller's salary for fiscal year 2006-07 to determine whether Montebello increased that position's salary.

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We conducted this audit under the authority vested in the California State Auditor by Government Code 8543 et seq. and according to 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 specified in the Scope and Methodology section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA
California State Auditor

December 11, 2018

Appendix A

Scope and Methodology

In May 2018, the Joint Legislative Audit Committee (Audit Committee) approved a proposal by the State Auditor to perform an audit of Montebello under the State Auditor's high-risk local government agency audit program. We completed an initial assessment of Montebello in January 2018, during which we reviewed Montebello's financial and operating condition to determine whether it demonstrated characteristics of high risk pertaining to the following six risk factors specified in state regulations:

- The local government agency's financial condition has the potential to impair its ability to efficiently deliver services or to meet its financial or legal obligations.
- The local government agency's ability to maintain or restore its financial stability is impaired.
- The local government agency's financial reporting does not follow generally accepted government accounting principles.
- Prior audits reported findings related to financial or performance issues, and the local government agency has not taken adequate corrective action.
- The local government agency uses an ineffective system to monitor and track state and local funds it receives and spends.
- An aspect of the local government agency's operation or management is ineffective or inefficient; presents the risk for waste, fraud, or abuse; or does not provide the intended level of public service.

Based on our review, we identified concerns about Montebello's financial condition, financial stability, and the effectiveness of aspects of its operations. Table A on the following page lists the objectives that the Audit Committee approved and the methods we used to address them.

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Table A.1
Audit Objectives and the Methods Used to Address Them

| AUDIT OBJECTIVE | METHOD |
|--|---|
| 1 Review and evaluate the laws, rules, and regulations significant to the audit objectives. | Identified and reviewed relevant laws, regulations, and other background materials applicable to the city of Montebello. |
| <p>2 Review and evaluate the operations of Montebello's business activities, including but not limited to, the following:</p> <p>a. Montebello's plans for addressing deficits in its transit system, water utility, and golf course, including whether it will be able to avoid using general fund dollars to support these programs in the future.</p> <p>b. Montebello's plans for addressing infrastructure needs related to its water utility.</p> <p>c. The revenue projections for Montebello's hotels to determine whether they are reasonable estimates of future revenue and assess Montebello's plans for using those projections when developing future budgets.</p> | <ul style="list-style-type: none"> • Interviewed relevant Montebello staff and reviewed documentation they provided. • Reviewed audited financial statements for fiscal years 2009–10 through 2016–17, as well as unaudited financial documents and budgets through fiscal year 2018–19. • Evaluated Montebello's plans for paying off debts and reducing deficits in its enterprise funds. • Reviewed financial information for Montebello's transit system and determined that its deficit in fiscal year 2015–16 was caused by an error in requesting grant funds; Montebello corrected this error in fiscal year 2016–17. • Interviewed city officials, including the city manager and public works director. • Reviewed studies on water rates and repairs to Montebello's water system. • Reviewed city ordinances and presentations to the city council related to the water utility. • Interviewed Montebello finance and administrative department staff. • Reviewed council meeting minutes and other city documentation. • Reviewed Montebello's projections for the hotels to assess their reasonableness. We determined that projections for the second hotel are premature because the second hotel opened in September 2018, nine months later than planned. However, Montebello is not using the projections to develop its budget. |
| 3 To the extent possible, assess Montebello's financial condition and ability to pay its obligations. | <ul style="list-style-type: none"> • Interviewed Montebello finance and administrative department staff. • Reviewed Montebello's financial documents, including audited financial statements, Montebello's budgets, and unaudited general fund account reports from Montebello's finance department staff. • Developed historical trends for Montebello's revenues and expenditures from fiscal year 2009–10 to present. • Reviewed Montebello's projections for revenue, expenditures, and debt service in its fiscal year 2018–19 budget. • Reviewed the 2018 CalPERS actuarial valuation reports for Montebello and Montebello's projections for retirement expenses. • Reviewed and assessed Montebello's plans to increase revenue and reduce expenditures. • Identified similar cities to Montebello based on revenues from the cities' fiscal year 2016–17 financial reports, land area data from the United States Census, and population data from the California Department of Finance. • Compared Montebello's current debt payments to that of similar cities based on the framework used by the Government Finance Officers Association. We found that Montebello's level of debt payments is comparable to that of Monterey Park and Pico Rivera, which are similar neighboring cities. |
| 4 Assess Montebello's actions taken in response to the recommendations the State Controller included in its 2011 report. | <ul style="list-style-type: none"> • Reviewed Montebello's <i>Administrative Policy Manual</i> and assessed if Montebello has made updates and if it has addressed the State Controller's identified deficiencies. • Reviewed the finance department's policies and procedures. For a selection of 15 payments, reviewed a selection of payment-related internal controls to determine their effectiveness. • Reviewed and assessed Montebello's policies and practices related to the use of city credit cards and petty cash. |

| AUDIT OBJECTIVE | METHOD |
|--|---|
| <p>5 Evaluate Montebello’s compliance with procurement policies and best practices for ensuring that it receives the best value for the goods and services it purchases.</p> | <ul style="list-style-type: none"> • Evaluated if Montebello’s procurement policies and practices are aligned with relevant laws, regulations, and procurement best practices related to competitive bidding and other areas. • Reviewed Montebello’s contract log, payment records, and meeting minutes to identify agreements for review. For fiscal years 2015–16 through 2017–18, judgmentally selected 16 agreements based on contract size, whether the contract was sole source, and the nature of the work. • Assessed the selected agreements for compliance with Montebello’s procurement policies and best practices. |
| <p>6 Review and assess any other issues significant to the audit.</p> | <ul style="list-style-type: none"> • Using data from the State Controller and Montebello’s budgets, determined whether a selection of current administrative positions have salary ranges below comparable positions in the region. Assessed the extent to which the salary ranges have changed over time. • Reviewed statement of economic interest disclosures and did not identify any issues. • Reviewed city documentation and city council meetings and interviewed city officials regarding the multiple business relationships between the hotel operator and the city. |

Source: Analysis of the Audit Committee’s audit proposal number 2018-802, as well as information and documentation identified in the column titled *Method*.

Assessment of Data Reliability

In performing this audit, we relied on electronic reports that we obtained from the city of Montebello’s accounting system for the purposes of identifying agreements that Montebello entered into from fiscal years 2015–16 through 2017–18, and for reviewing authorizations for payments. The U.S. Government Accountability Office, whose standards we are statutorily obligated to follow, requires us to assess the sufficiency and appropriateness of computer-processed information we use to support our findings, conclusions, or recommendations. We performed dataset verification and testing of key data elements in these reports and did not identify any issues. To assess completeness, we randomly selected purchase order numbers in the ranges that the reports represented,

and we noted that some were missing. Therefore, we determined that the reports were not complete for the purposes of this audit. Further, authorizations for payments were electronic and therefore we could not test these for accuracy because there were no paper records for comparison. Although we recognize that these limitations may affect the precision of numbers we present, there is sufficient evidence in total to support our audit findings, conclusions, and recommendations.

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Appendix B

The California State Auditor's High-Risk Local Government Agency Audit Program

California Government Code section 8546.10 authorizes the State Auditor to establish a local high risk program to identify local government agencies that are at high risk for potential waste, fraud, abuse, or mismanagement, or that have major challenges associated with their economy, efficiency, or effectiveness. Regulations that define high risk and describe the workings of the local high risk program became effective July 1, 2015. Both statute and regulations indicate that the State Auditor must seek approval from the Audit Committee to conduct high risk audits of local entities.

California Cities

To identify local entities that may be high risk, we analyzed publicly available information, such as financial reports and prior audit reports or analyses, for more than 450 California cities. Using this analysis, we identified various cities for which we performed a more detailed financial analysis. This detailed analysis included using the financial data to calculate fiscal indicators that may be indicative of a city's fiscal stress. We also reviewed publicly available information to assess the city's fiscal outlook over the next several years, using financial and budgetary reports and other information that could affect the city's operations. We then analyzed the results to determine whether each city is at risk for potential waste, fraud, abuse, and mismanagement, or has major challenges associated with its economy, efficiency, or effectiveness.

Based on our initial analyses, we recently identified five cities, including Montebello, which appeared to meet the criteria for being at high risk. To better understand the factors that led us to this determination, we visited each of the five cities and conducted an initial assessment to determine the city's awareness of and responses to those issues and to identify any other ongoing issues that could affect our determination of whether the city is high risk. After conducting our initial assessment, we concluded that Montebello warranted an audit. In May 2018, we sought and obtained approval from the Audit Committee to conduct an audit of Montebello.

If we designate a local agency as high risk as a result of the audit, it must submit a corrective action plan. If it is unable to provide its corrective action plan in time for inclusion in the audit report, it must provide the plan no later than 60 days after the report is published. It must then provide written updates every six months after the audit report is issued regarding its progress in implementing the corrective action plan. This corrective action plan must outline the specific actions the local agency will perform to address the conditions causing us to designate it as high risk and the proposed timing for undertaking those actions. We will remove the high risk designation when the city has taken satisfactory corrective action.

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City of Montebello

November 15, 2018

Elaine M. Howle*
State Auditor
621 Capitol Mall, Suite 1200
Sacramento, CA. 95814

Re: Response to November 7, 2018 letter from State Auditor

Dear Ms. Howle:

The following is the City of Montebello's response to your draft report, which was received by the City on November 7, 2018. The report focused on various areas of operational concern and stems from your audit efforts, aided by City staff's full cooperation and participation, from June of 2018 to the date of this letter.

The City of Montebello believes this report augments and complements actions that the City has already undertaken and/or is currently developing, and will help confirm issues and concerns that the City has shared with its community. The City of Montebello appreciates the common ground that was created by City staff's sharing of information with the State Auditor and supports many of the conclusions reached in the report. In fact, as your staff is aware, the City has already identified many of the same conclusions in your report and taken many steps toward improving its fiscal and operational efficiencies. As we all recognize, while much improvement has been made, there are still areas that the City needs to address. The City of Montebello has and will continue to make the needed improvements that are necessary to improve operational effectiveness and productivity.

A strong contributory factor for many of the underlying operational concerns contained in your report is City staff turnover in key positions. This was also recognized by both the City and State Controller in the Controller's 2011 audit report. This factor has been an ongoing challenge for the City, particularly in the past few years.

Your report recommends solutions to sell assets in order to improve the City's economic picture. While these solutions may be operationally necessary in the future, they will not entirely solve the City's fiscal challenges essential to operating as a full-service city. The Montebello community will need to understand that these solutions and many actions already being taken by the City are steps, not final solutions, toward resolving the fiscal issues facing the City. Some of

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* California State Auditor's comments begin on page 45.

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- ① your recommendations reflect many of the same actions that the City has already pursued and been expressly criticized for in the past, such as “selling its assets to meet short-term needs.”

The City of Montebello needs to develop a better communication system to educate the community and develop the trust necessary to create sustainable long-term solutions to properly staff its departments to a level that the community wants and needs.

It is important to highlight the significant issues and challenges that have confronted the City, the internal and external influences and factors the City has responded to, and the specific steps the City has taken to address its fiscal issues to date. For well over a decade, different City Councils and different City Administrations have adjusted and adapted to formulate strategies for operating this full-service city.

Over the past decade, the City has experienced the following economic, political, and organizational challenges:

- Since 2003, CALPERS has modified pension assumptions at least 5 times, causing an increase to the unfunded pension liability from \$89,000,000 to \$136,000,000. This represents a \$47 million increase. The City has no control over these changes.
- In 2009, the City investigated contracting out public safety services in an effort to reduce costs, but voters responded with a ballot measure (Measure M) requiring a 55% voter approval prior to any transfer of the City’s fire or police services to another public entity. This voter approved Measure substantially limited the City’s ability to adjust to meet the increasing public safety service costs.
- In 2016, the City Council in recognizing the limitations in operating the water system, including the cost to users and the need for ongoing repairs, chose to present a ballot measure to the community seeking approval to sell the City’s struggling water system in order to raise additional revenue for the City. The voters rejected this measure, thus tying the hands of City leadership in their desire to properly address a significant water infrastructure problem.
- In 2017, the City Council sought voter support to minimize the impact of layoffs and service cuts by presenting a ballot measure to the electorate seeking approval to raise the sales tax by up to 1 cent to finance public safety and general municipal services and address budget shortfalls. Montebello voters once again rejected this measure.

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Despite these many ongoing challenges, the City of Montebello has persevered by implementing improvements and taking corrective actions. Prior to your report, the City had already updated policies and procedures to increase internal controls, raised additional revenue, and implemented cost-saving measures in order to maintain financial stability. These actions include the following:

- Since 2013, the City has exchanged restricted Proposition A transportation funds with neighboring communities who could continue to meet the mandate of addressing regional transportation needs. These funds were used to increase the City's available General Fund cash reserves and also were used for deferred capital improvement projects. These exchanges of funds did not adversely impact the City's transportation services, but instead provided needed funds for other City priorities.
- In 2016, it became evident that additional changes were needed. The City initiated layoffs and, in 2017, initiated hiring freezes to reduce its expenses. Many of the hiring freezes are still in effect today, and as a result, the FY 2017-18 operating revenues exceeded operating expenditures by \$2.7 million.
- In August 2016, the City adopted a debt management policy.
- In 2016 and 2018, the City's Finance Department provided citywide purchasing training as a result of the purchasing department's decentralization and to implement proper purchasing practices.
- In 2017, the City formally drafted and implemented a capital asset policy, a federal grant procurement policy, and a grant management policy.
- In 2018, the City updated and formalized standard operating procedures (SOPs) regarding accounts payable payments and invoice approval, cash receipts and refunds, bank account reconciliation, payroll and collections.
- In 2018, the City reviewed and increased user fees for FY 2018-19.
- In 2018, the City received \$2 million of a \$5 million advance for a new development project. These funds are not included in the current year's budget projections.
- The City has interviewed several financial advising firms and is in the process of selecting a consultant to assist with debt and investment decisions.

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Page 4

- The City is in the process of analyzing its hotel cash flows, comparing them to the associated bond documents and identifying areas of needed improvement.
- The City is in the process of reviewing and updating its policies and procedures regarding procurement, contracts, petty cash, credit cards, etc.
- In 2013, 2014 and 2017, the City raised its water rates to cover ongoing expenses and eliminate subsidizing of the City's water system. As a result, the City's Water Fund operating revenues exceeded operating expenditures by \$800,000 at the end of FY 2017-18. As a result, the Water Fund will begin to pay down loans made by the General Fund to the Water Fund, while still completing some deferred capital improvements.
- In 2018, after years of planning, the City will see reductions in the Golf Course operating deficit through the use of reclaimed water.
- Since 2017, the City has prepaid to CALPERS the annually billed unfunded liability, saving the City 3% of the annual amount.

The aforementioned list is not all-inclusive but illustrative of the City's commitment to improving operational efficiencies. The City has taken many other actions and has many additional planned improvements. The City will continue to prioritize its services in order to balance its budget.

- ③ Not addressed in your report but materially important to the City's fiscal condition is the fact that there is a major housing development underway in the community. This project consists of 1,200 new homes and is anticipated to generate over \$4 million annually in new property and other tax revenues at build-out.

Lastly, while the City agrees with many of the conclusions reached within the report, there are areas the City believes need clarification or correction, including the following:

- ④ 1. The draft report (page 5) references that "in fiscal year 2016-2017 Montebello added \$4.7 million in restricted redevelopment funds to its general fund balance. Had it not done so, the city would have ended the fiscal year in an operating deficit."

- ⑤ The City takes issue with this statement as written since it is misleading. The City never intended to use the \$4.7 million restricted funds to balance its budget. The funds as noted were specifically excluded from the "unassigned fund balance." The City actually ended the year with an operating deficit of approximately \$71,000. This amount, in context of the City's overall budget, is negligible.

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State Auditor
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2. The draft report states that the “the city unfunded retiree pension . . . obligations continue to grow, and these expenses will place increasing pressure on the city finances.”

CALPERS has recently changed its pension billing methods to fully amortize the unfunded liability over 30 years. Therefore, the current unfunded liability pension obligation will reduce over time. ⑥

3. The draft report (page 13) references that “Montebello has relied on these exchanges for the past five fiscal years to bolster its general fund but there is no guarantee that the city will be able to negotiate such an exchange in any given fiscal year.”

The statement is partially correct. The City has historically exchanged Proposition A funds in the past five years. The City did not use the exchange to bolster its General Fund. The City used the funding to address more than \$1.9 million in deferred street improvements as is evidenced from the FY 13-14 through FY 15-16 CIP budgets. The City did not use the funds to balance the FY 17-18 budget but improved its city reserves. FY 18-19 is the first year in which the City identified this exchange as a budgeted item for balancing the budget. ⑦

4. The draft report (page 5) references that “the bonds issued to construct the hotels, meanwhile, continue to expose the city’s general fund to significant risks.”

We agree that there is a slight risk, but it is important to note that the investment risk factors and remedies are fully disclosed in the bonds’ official statements. The risks are not extraordinary, but typical for investments of this nature. In addition, the risks for both hotels are not the same inasmuch as the first hotel has additional remedies through the RDA. Further, there is no indication that the hotel revenues will fall short of its expenses. ⑧

In examining the overall efforts of the City of Montebello, the City Council and City management, the collective City team should be commended for its efforts in addressing the difficult economic challenges that face not just the City of Montebello, but all local governmental agencies throughout the State of California. We recognize the need to apply “best practices” in providing services to the residents of our City. Change is welcomed, but any unfounded criticism is detrimental to the continued progress of the City.

Montebello has for many years been the “jewel” of the San Gabriel Valley and the County of Los Angeles. Many developers, businesses and new residents find Montebello to be a wonderful location to live, work and operate their businesses. The City will take seriously the recommendations of the State Auditor, but will challenge any attempt to extend and direct improper criticism towards the hard work of the City’s leadership and management team.

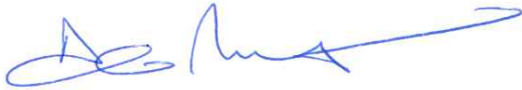
LOCAL HIGH RISK

Elaine M. Howle
State Auditor
November 15, 2018
Page 6

We thank the State Auditor's Office for your review of the City's operations. The City of Montebello stands committed to improve upon our efforts to make Montebello the best it can be.

Sincerely,

CITY OF MONTEBELLO



Andrew G. Pasmant
Acting City Manager

Comments

California State Auditor’s Comments on the Response From the City of Montebello

To provide clarity and perspective, we are commenting on Montebello’s response to the audit. The numbers below correspond to the numbers we have placed in the margin of Montebello’s response.

The city states that we recommend that the city sell assets; however, our recommendations offer several options, which may include selling assets. On page 9, we note that the city has the ability to sell the golf course. However, we recommend that the city evaluate the effectiveness of its current plans and consider alternate uses for the golf course. Further, on page 10 we note that the city had already attempted to sell its water utility, but was not successful. We recommend that Montebello reevaluate selling its water system in light of recent state legislation that would allow for the sale without seeking voter approval, among other options. We made these recommendations not to meet “short-term needs” but because these enterprises have been a drain on the general fund.

①

Throughout this audit report we acknowledge steps the city has taken and plans to take to maintain financial stability. For example, we discuss the city’s hiring freeze on pages 7 and 28, updated procedures on page 25, and increased water rates on page 9.

②

The city is incorrect. We include the acting city manager’s perspective on this housing development on pages 6 and 7 and note that construction will begin in 2020.

③

While preparing our draft report for publication, some page numbers shifted. Therefore, the page numbers Montebello cites in its response do not correspond to the page numbers in our final report.

④

Our statement is accurate. In its financial report for fiscal year 2016–17, Montebello states that its surplus in that fiscal year was due to a transfer of \$4.7 million of restricted funds to its general fund. The city notes that without taking the transfer into consideration, its general fund would have ended the year with a slight deficit, as we discuss on page 6.

⑤

LOCAL HIGH RISK

- ⑥ We stand by our conclusion that the city faces increasing retirement costs. The city did not make us aware that CalPERS included payments to Montebello's unfunded liabilities in the payments CalPERS required the city to make until the day we received the city's response to our draft report. However, after reviewing additional documentation, we modified the text discussing retirement costs—beginning on page 10—and updated our recommendation on page 12 to reflect this new information.
- ⑦ As shown in Figure 1 on page 2, without one-time revenues—including exchanges of the Proposition A transportation funds for unrestricted funds—the city would have had an operating deficit in its general fund in three of the last four fiscal years.
- ⑧ We acknowledge on page 13 that the city made an agreement with its former redevelopment agency to lend money for the first hotel in the event of a shortfall. However, we note that the city would still have to repay the loan in future years. Further, such an agreement does not exist for the second hotel. Therefore, we stand by our conclusion that the city's general fund is exposed to significant financial risks.