City of West Covina

Its Deteriorating Financial Situation Threatens Its Fiscal Stability and Its Ability to Provide City Services

December 2020

REPORT 2020-806

LOCAL GOVERNMENT HIGH RISK

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Elaine M. Howle *State Auditor*

December 1, 2020
2020-806

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 directed by the Joint Legislative Audit Committee, my office presents this audit report regarding the city of West Covina (West Covina), which we conducted as part of our high-risk local government agency audit program.

This report concludes that West Covina is a high risk city because of the significant risks it faces related to its financial and operational management. West Covina reduced its year-end general fund reserve balance by $10.6 million—more than half—during the past several fiscal years, primarily due to its inability to address substantial increases in citywide expenditures and its significant pension liability. The city has also likely underestimated the financial impact of the COVID-19 pandemic during this current fiscal year.

West Covina made certain financial decisions that appear questionable or were based on insufficient analyses. Moreover, the city has not developed a formal financial recovery plan with specific timelines, monitoring, and reporting to improve its long-term financial health. We also identified instances of inadequate management that limit West Covina's ability to ensure that public funds are used appropriately and that its procurement efforts provide the best value.

To address these concerns, we present several recommendations, such as pursuing opportunities to better manage or reduce spending, preparing multiyear financial forecasts to quantify the impact of its decisions, and establishing and following procurement policies. We also recommend that West Covina develop a formal financial recovery plan to prioritize resources and assign responsibility for monitoring progress in implementing the plan.

Respectfully submitted,

Elaine M. Howle

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HIGH RISK ISSUES

City of West Covina, Los Angeles County

Risk Designation: **High Risk**

ISSUE	PAGE
West Covina's Ineffective Fiscal Management Threatens Its Ability to Meet Its Financial Obligations and to Provide City Services	
Continual diminishing of reserves • *Relied on its general fund reserves to support its operations for years, thereby significantly reducing its reserve balance.* • *Encountered substantial increases in citywide expenditures, including its unfunded pension liability and associated annual payments.* • *Allowed the fire department to routinely exceed its budget by more than $1 million each year, primarily because of excessive overtime costs.* • *Will be further threatened by revenue decreases resulting from the COVID-19 pandemic.*	3
Questionable use of city resources • *Paid a greater proportion of its employees' health benefits than the average proportion paid by state and local governments on the West Coast.* • *Used general fund revenue to subsidize city services rather than increasing the fees it charged to the users of those services.*	14
Financial decisions based on insufficient analyses • *Did not adequately quantify the financial consequences of budget adjustments for the city council.* • *Did not begin to develop projections of its long-term outlook based on financial trends until after our initial assessment and has not included key assumptions in its forecast.*	16
Lack of a formal financial recovery plan • *Has not developed a comprehensive plan with clear timelines, monitoring, and reporting to improve its long-term financial health.*	18
West Covina's Weak Enforcement of Its Procurement Policy Increases the Risk of Waste and Fraud	
Inadequate management of purchase cards • *Lacks documentation demonstrating that managers appropriately approved increases to the dollar limits for purchase cards.* • *Allowed requests for limit increases on purchase cards to be granted indefinitely despite its own policy restricting such increases to specific time frames.*	21
Lack of oversight to ensure that contracts provide best value • *Violated its own competitive bidding requirements when contracting for human resources and claims administration services.* • *Approved amendments to its contract for waste collection services that contain overly-restrictive terms, including lengthy time extensions and a nontermination clause.*	22
Appendices	
Appendix A—*Scope and Methodology*	27
Appendix B—*The State Auditor's Local High Risk Program*	31
Agency Response	
City of West Covina	33

Risks Facing the City of West Covina

In December 2019, the California State Auditor's Office (State Auditor) informed the city of West Covina (West Covina) that it had been selected for review under the high-risk local government agency audit 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 face major challenges associated with their economy, efficiency, or effectiveness. We first identified that West Covina might be classified as a high-risk local government entity based on publicly available information. We conducted an initial assessment of the city in January 2020 and identified concerns regarding its financial stability. Its general fund reserves had steadily declined over the past several years, potentially straining its ability to continue providing essential services to its community and to meet its obligations in the event of a fiscal emergency. In addition, we identified operational risks related to West Covina's governance and management controls. The city had experienced significant turnover of key management positions, and the State Controller's Office reported in 2015 that it had serious and pervasive weaknesses in its administrative and internal accounting controls, concluding that such controls were in effect nonexistent.

West Covina agreed with the risks that we identified in our initial assessment, but it asserted that it was taking actions to address our concerns. For example, the West Covina city council (city council) had authorized a special election so that residents could vote on a local tax measure that the city estimated would increase its revenue by $9.7 million annually; however, the city's residents did not ultimately approve the measure. The city's leadership also planned to issue municipal bonds to raise more than $200 million to pay down its California Public Employees' Retirement System (CalPERS) unfunded pension liability. Despite these efforts, based on our continued concerns regarding its financial and operational management, we recommended an audit of West Covina, which the Joint Legislative Audit Committee (Audit Committee) approved in February 2020.

Our audit found that West Covina faces several significant risks related to its financial and operational management. In particular, its financial condition is rapidly deteriorating, as demonstrated by the city's continued reliance on its general fund reserves to support its operations, its questionable uses of city resources, and its lack of sufficient analyses to support its financial decisions. West Covina's year-end general fund reserves dwindled from $20.5 million in fiscal year 2014–15 to $9.9 million at the end of fiscal year 2018–19, placing the city on a path to further deplete its reserves. The city also faces rising employee salary and benefit costs. Finally, its purchasing and contracting processes have deficiencies that its leadership has allowed to persist over several years, exposing the city to the risk of fraud and perpetuating its susceptibility to wasted public funds.

West Covina's leadership has identified several actions that the city has taken or plans to take that the city manager believes will improve its financial condition. For example, the city is in the process of selling a large parcel of land; if completed, this sale will result in a one-time revenue gain of $13.5 million that will be used to repay bond debt and replenish its reserve balance. Additionally, the city became a member of the California Joint Powers Insurance Authority (CJPIA), which the city manager believes will reduce the city's exposure to significant litigation expenditures. Further, as it had planned, the city sold $204 million in municipal bonds to pay down the amount it owes to CalPERS for pension costs; as a result, although the city will pay significantly smaller unfunded pension liability payments to CalPERS, it will need to make bond debt payments through fiscal year 2044–45. However, the city's leadership has not performed the analysis necessary to determine the combined results of these actions, nor has it created a comprehensive plan to ensure its success in implementing them. As a result, West Covina continues to be at risk of depleting its general fund reserves and of not being able to adequately provide public services in the near future.

To help West Covina address the risk factors we identified, we have developed numerous recommendations the city could implement, including the following:

- Increase city fees and seek opportunities for cost sharing to eliminate its reliance on its general fund reserves to support its operations.
- Prepare financial analyses that evaluate both the short-term and long-term financial implications of significant spending decisions.
- Develop a financial recovery plan that accounts for the city's rising costs and the actions that it will take to improve its financial condition. The plan should include a long-term financial projection, prioritize the resources that the city will use to improve its financial condition, identify individuals responsible for monitoring the city's progress in implementing each action, and outline when the city anticipates it will complete key milestones related to each action.
- Improve its internal processes to reduce its susceptibility to waste and fraud.

West Covina's Ineffective Fiscal Management Threatens Its Ability to Meet Its Financial Obligations and to Provide City Services

West Covina's Leadership Has Continually Made Decisions That Have Diminished the City's Financial Reserves

West Covina is at high risk of being unable to meet its future financial obligations and provide effective city services. Since fiscal year 2014–15, its past and present leadership has relied on the city's general fund reserves to support its operations rather than pursuing solutions involving generating additional revenue or reducing expenditures, such as increasing fees for city services or negotiating with its employee unions to have its employees pay a greater share of their benefits. In particular, the city has relied on its general fund reserves for salary and benefit costs for its public safety employees, its litigation costs, and its pension fund payments. Because of these factors and the city's financial condition at the end of fiscal year 2018–19, we determined that West Covina was at high risk. The effects of the COVID-19 pandemic (pandemic) have now further threatened the city's financial stability. If West Covina does not implement immediate and long-term strategies to control its expenditures and maximize its revenue, it may be forced to reduce the services it provides to its residents.

General Fund Reserves

As we reported in our November 2020 update of our local government high risk dashboard, we continue to designate West Covina at high risk in several indicators of financial health. Based on financial information from fiscal year 2016–17, we initially reported that West Covina was at high risk in five of the 10 established risk indicators. As Table 1 shows, the risk indicator for its general fund reserves has since worsened from moderate risk for fiscal year 2016–17 to high risk for fiscal years 2017–18 and 2018–19, a consequence of city leadership relying on these reserves to support the city's operations. Nearly all of the city's other financial risk indicators continue to be high risk or moderate risk.

By operating with a structural deficit—a condition in which operating revenue is insufficient to cover operating expenditures—West Covina has diminished its general fund reserves by more than half during the past several fiscal years. Figure 1 shows that the city reduced its year-end reserve balance from $20.5 million at its recent peak in fiscal year 2014–15 to $9.9 million in fiscal year 2018–19. Although the city council adopted balanced budgets for fiscal years 2015–16, 2016–17, and 2018–19, in each of these years, city management subsequently requested—and the city council approved—budget amendments to increase expenditures significantly, contributing to general fund deficits averaging $3 million annually during each of those three fiscal years. And although West Covina's general fund revenue exceeded expenditures in fiscal year 2017–18, city management nevertheless reduced the city's general fund reserve balance by $2.1 million primarily to reclassify revenue that would not be available to the city for discretionary purposes. By continually choosing to reduce the city's reserves, city leadership has left West Covina vulnerable to unexpected expenditures or reductions in anticipated revenue, thus jeopardizing its ability to meet its financial obligations without reducing services to the community.

Table 1
West Covina's Financial Risk Indicators Have Remained the Same or Worsened Since Fiscal Year 2016–17

	FISCAL YEAR 2016–17	FISCAL YEAR 2017–18	FISCAL YEAR 2018–19
	INDICATOR EVALUATION	INDICATOR EVALUATION	INDICATOR EVALUATION
General Fund Reserves	MODERATE RISK	HIGH RISK	HIGH RISK
Debt Burden	MODERATE RISK	MODERATE RISK	MODERATE RISK
Liquidity	LOW RISK	LOW RISK	LOW RISK
Revenue Trends	MODERATE RISK	MODERATE RISK	MODERATE RISK
Pension Obligations	HIGH RISK	HIGH RISK	HIGH RISK
Pension Funding	HIGH RISK	HIGH RISK	HIGH RISK
Pension Costs	HIGH RISK	LOW RISK	HIGH RISK
Future Pension Costs	HIGH RISK	HIGH RISK	HIGH RISK
OPEB Obligations*	MODERATE RISK	MODERATE RISK	MODERATE RISK
OPEB Funding*	HIGH RISK	HIGH RISK	HIGH RISK

Source: State Auditor's local high risk dashboard at https://www.auditor.ca.gov/local-high-risk-dashboard.
* OPEB = Other Post-Employment Benefits

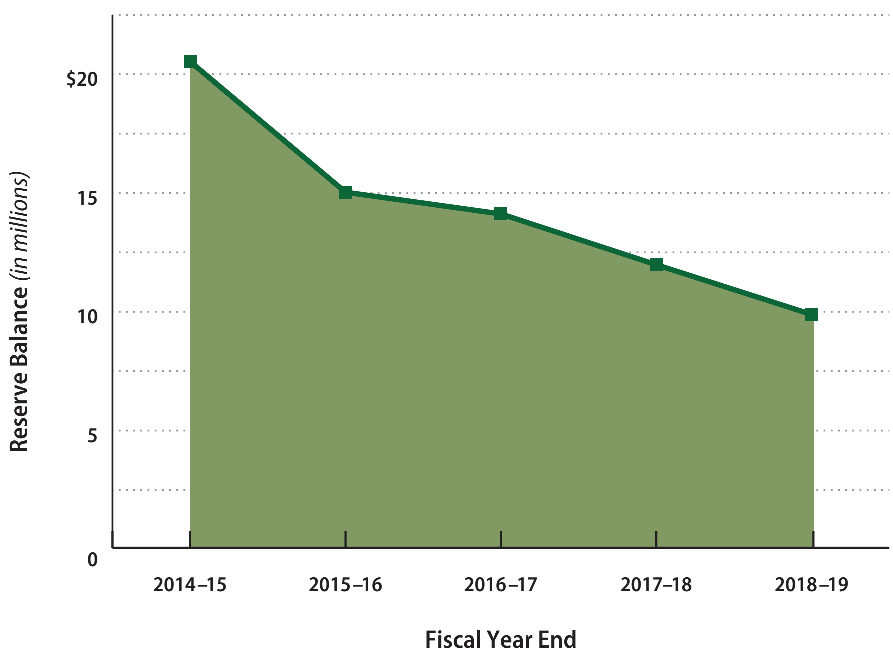
As of the end of October 2020, the city had not completed its year-end closing procedures to record all financial activity for fiscal year 2019–20.[1] Based on its financial records at that time, the city projected a general fund deficit for fiscal year 2019–20 resulting from its general fund expenditures exceeding its revenue by $904,000. During this time, however, city management determined that the city would be able to reclassify other revenue that had previously not been available for discretionary purposes and concluded that its general fund reserve balance would increase to $11.2 million. After the city completes its year-end closing procedures and undergoes its annual financial audit, it will be able to confirm the actual impact of its financial activity on its general fund reserves. To the extent that the financial activity reported in its audited financial statements is consistent with its projections, the city's general fund reserve balance for fiscal year 2019–20 will have increased slightly from the prior year, although the city will have continued to maintain a structural deficit.

City management has described a number of strategies to improve its financial condition, such as finalizing a $13.5 million land sale to a development firm, and it intends to dedicate $8.6 million of the proceeds from the sale to repay bond debt, leaving $4.9 million available to replenish the reserve balance. However, the structural nature of the city's general fund deficits suggests that large one-time revenue sources will be insufficient on their own to reverse the city's negative financial trend and rebuild its reserves.

If West Covina is unable to resolve its structural deficit, it risks becoming embroiled in the lengthy and complex process of declaring municipal bankruptcy. Figure 2 summarizes the process a city must follow and the conditions it must satisfy to declare bankruptcy and to obtain the assistance needed to continue its operations. According to federal bankruptcy law, a city's declaration of bankruptcy provides

[1] Because West Covina had not completed its year-end closing procedures, its financial statements for fiscal year 2019–20 had not been audited as of October 2020.

Figure 1
West Covina Reduced Its General Fund Reserve Balance by More Than Half From the End of Fiscal Year 2014–15 to the End of Fiscal Year 2018–19



Source: West Covina's audited comprehensive annual financial reports for fiscal years 2014–15 through 2018–19.

protection from the city's creditors, then allows it to adjust its debt while continuing its day-to-day operations. However, bankruptcy also results in significant ongoing legal costs to a city, occupies a significant amount of staff attention, and has a negative effect on a city's credit rating. Municipal bankruptcy may also result in lower levels of service to residents and may impede a city's economic development and maintenance of its infrastructure, such as buildings and streets.

Substantial Citywide Financial Obligations

West Covina's largest financial burden is its public safety costs, which include fire department and police department expenditures. Those costs totaled $58.1 million during fiscal year 2018–19—including $53.1 million paid from the general fund—and made up nearly 60 percent of the city's total expenditures. From fiscal years 2014–15 through 2018–19, the amount of annual public safety costs the city paid from its general fund increased by $10.9 million, or 26 percent, primarily because of rising salary and benefits costs. Moreover, effective January 2020, the city council approved new 12 percent salary raises for the city's firefighters and police officers, which will result in an estimated additional $2 million per year of salary expenditures beginning in fiscal year 2020–21, the first full year of the raises.

Another of the city's significant financial burdens is the cost of litigation. Until recently, the city was a member of an insurance pool that covered general liability losses greater than $1 million, while West Covina was responsible for paying claim losses of up to $1 million. Nevertheless, the city budgeted for only $200,000 in self-insurance

Figure 2
A City's Declaration of Bankruptcy Requires Negotiation With Stakeholders and Approval From the Bankruptcy Court

Source: Analysis of federal and state law, and Legislative Analyst's Office's and League of California Cities reports.

claim expenditures in fiscal year 2018–19, despite paying nine individual general liability claims from fiscal years 2014–15 through 2017–18, each ranging between $221,000 and $796,000. During fiscal year 2018–19, West Covina exceeded its budget for self-insurance claims by $2.2 million, primarily because it incurred greater litigation expenditures than the city anticipated. The human resources director during that time described the claims that resulted in these higher expenditures as unexpected anomalies. The city subsequently increased its budget for self-insurance claims for fiscal years 2019–20 and 2020–21 to $908,000 each year. Although the current finance director stated that the previous city management based this adjustment on an analysis of claims in previous years, the city still exceeded its budget for self-insurance claims in fiscal year 2019–20 by $573,000, or 63 percent. West Covina's current human resources and risk management director (human resources director) again characterized the claims that caused these expenditures as unanticipated anomalies.

> ***"West Covina exceeded its budget for self-insurance claims by $2.2 million, primarily because it incurred greater litigation expenditures than the city anticipated."***

After its former insurance pool stopped offering services, West Covina became a member of CJPIA in May 2020, which the city manager asserts will help improve the city's risk management practices and control its litigation costs. For an annual fee of $1.6 million, membership in CJPIA allows West Covina to pool its insurance payments with the payments from other members to cover general liability and workers' compensation losses. In addition, the city delegates its handling of liability claims and settlement of claims to CJPIA. The city manager anticipates that West Covina's participation in CJPIA's risk management program will reduce the amount and frequency of losses and decrease the city's cost of handling claims.

Nevertheless, under this agreement, the city continues to be responsible for paying for any of its losses up to $1 million per claim. Further, CJPIA has the right to cancel a member's participation in its programs if it determines that the frequency or severity of that member's claims has an adverse impact on other members. Thus, West Covina's membership in CJPIA is not a substitute for its city management's responsibility to budget appropriately for litigation expenditures and to minimize its general liability losses. To ensure its continued ability to participate in CJPIA, the city is collaborating with CJPIA staff to prioritize and develop a plan to resolve specific risk areas identified by CJPIA.

An additional significant expenditure West Covina faces is its annual payment to CalPERS. Each year, the city must make payments to CalPERS for the cost of pension benefits earned by its employees that year—referred to as *annual normal payments*. However, a city may also have to make annual unfunded pension liability payments (unfunded liability payments) to CalPERS to decrease the unfunded portion of its pension liability. An entity's pension liability is the total amount of benefits that its employees and retirees have earned that the entity is obligated to pay. The unfunded portion of this liability is the difference between the entity's total pension liability and the assets that the entity has invested in its pension fund, which CalPERS maintains. West Covina incurred an unfunded pension liability in part because, like many other California cities, it offered pensions with favorable retirement benefits to its employees, which increased its total pension liability. Another contributing factor was that the market value of its pension fund assets decreased as a result of the financial crisis of 2008 (financial crisis).

West Covina offered generous pension plans to hundreds of employees that it hired before 2011, creating a significant, ongoing financial obligation. Figure 3 shows that the city offered pensions following retirement benefit formulas that allow its public safety employees and miscellaneous employees hired before 2011 to receive retirement payments amounting to significant percentages of their highest-earned salaries. West Covina's total pension liability thus grew significantly in the years before 2011 as the city continued to hire new employees who were eligible to participate in these pension plans. Further, its liability has continued to increase since that time as these employees have accumulated years of service. In addition, because of the financial crisis, CalPERS experienced large decreases in the market value of the investments it held to cover the cost of these retirement obligations. The impact of these factors contributed to West Covina's inability to maintain sufficient funds invested with CalPERS, thereby resulting in an unfunded pension liability.

> ***"Total pension liability thus grew significantly in the years before 2011 as the city continued to hire new employees who were eligible to participate in these pension plans."***

In the aftermath of the financial crisis, West Covina adjusted its retirement benefit formulas for miscellaneous employees and public safety employees hired in 2011 and 2012. These formulas were further revised for both categories of employees when the State Legislature passed the Public Employees' Pension Reform Act of 2013 (PEPRA) in part to establish specific retirement formulas for new public employees. The overall effect of the changes in the formulas was to decrease the percentage of employees' salaries used in determining their retirement benefits and to increase the minimum age for employees to be eligible to receive benefits. Under these new formulas, West Covina's future pension obligations for more recently hired employees will be lower than its obligations for employees hired before 2011. Nevertheless, as Figure 3 shows, the city remains obligated to pay the larger retirement benefits it offered employees hired before the city revised its retirement formulas and PEPRA was enacted, including at least 156 active employees who had not retired as of June 2019.

Specifically, West Covina's unfunded pension liability grew from $128 million in June 2015 to $187 million in June 2019, an increase of 45 percent in four years. The city's unfunded liability has continued to increase over time for additional reasons:

- CalPERS has decreased its expected rate of return on its investments.
- West Covina has given its employees raises, which increase their salary base for benefits.
- The population of retirees has tended to live longer and draw upon pension assets for longer than initially anticipated. As of June 2019, the city had 278 active employees contributing to CalPERS and 792 retirees receiving pension benefits, including 78 individuals who have been retired for more than 20 years.

Figure 3
Before 2011 West Covina Offered Generous Pension Plans That Increased Its Pension Liability

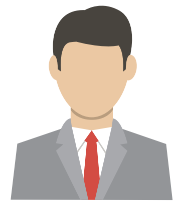
Example
PUBLIC SAFETY EMPLOYEE
Hired before 2011

- Started working for city at **age 25**.
- Retired from city at **age 50**.
- Received retirement benefits based on highest-earned salary of **$100,000**.
- Retirement formula: ***3 percent at age 50***.

25 years of service
x 3 percent of salary per year

= 75 percent of $100,000
= **$75,000 retirement benefit per year for life**

Example
MISCELLANEOUS EMPLOYEE
Hired before 2011



- Started working for city at **age 25**.
- Retired from city at **age 55**.
- Received retirement benefits based on highest-earned salary of **$100,000**.
- Retirement formula: ***2.5 percent at age 55***.

30 years of service
x 2.5 percent of salary per year

= 75 percent of $100,000
= **$75,000 retirement benefit per year for life**

*Number of Pre-2011 Pension Plan Participants as of June 2019 **

– *At least 96 of 151 active employees*
– *Up to 211 retired employees*

– *At least 60 of 126 active employees*
– *Up to 359 retired employees*

Source: Analysis of CalPERS annual valuation reports as of June 2019 and city benefits schedule.

* Data from CalPERS valuation reports do not provide specific detail to determine the exact number of employees and retirees who enrolled in pension plans before 2011.

As a consequence of its growing unfunded pension liability, the city's annual payments to CalPERS increased from $8.8 million in fiscal year 2017–18 to $13.5 million in fiscal year 2020–21. CalPERS projected in its annual valuation report as of June 2019 that the amount of the city's unfunded liability payments would grow to a high of $21 million in fiscal year 2029–30, an increase of 138 percent from fiscal year 2017–18.

In an attempt to address its large unfunded pension liability, the city issued $204 million in municipal bonds in July 2020 and concurrently transferred $186 million of the bond proceeds to CalPERS, thereby increasing the amount of funds CalPERS invests on the city's behalf to about 97 percent of the city's total pension liability. As a result, the city will begin making significantly lower annual unfunded liability payments although it will continue to make its annual normal payments to CalPERS. However, the city must now pay back the bond debt it acquired, at an average annual interest rate of 3.7 percent. Under the terms of the bond agreement, the city is required to make annual bond debt payments for 25 years. Those payments will gradually increase from $10.7 million in fiscal year 2021–22 to $16.4 million in fiscal year 2044–45. The lower cost of the bond payments compared to its planned CalPERS payments will initially reduce the city's total annual expenditures by about $6 million annually, and the city estimates that its total savings during the 25-year period of the bond will be about $53 million. Nevertheless, this reduction still may not entirely resolve the city's structural deficit if city management cannot control its increasing expenditures.

Although the city's payment of its bond revenue to CalPERS reduced its unfunded pension liability to only 3 percent of its total pension liability, its approach carries risks. For example, if CalPERS achieves lower than expected or negative returns on its overall investment portfolio, the value of the investments that CalPERS holds on West Covina's behalf will decrease, creating more unfunded liability. Such poor performance is not unprecedented: CalPERS returned 3.7 percent or less in eight of 21 years from fiscal years 1998–99 through 2018–19, most recently in fiscal year 2015–16. Most significantly, in the aftermath of the financial crisis, CalPERS experienced a 24.8 percent decline in the value of its investment portfolio in fiscal year 2008–09. Aside from the potential for increased unfunded liability payments each year, West Covina could experience a loss on its overall investments if CalPERS' rate of return ultimately ends up being less than the interest rate the city pays on the bonds.

Additionally, the city had an unfunded liability of $59 million as of June 2019 pertaining to its retirement health care benefits—known as *other post-employment benefits* (OPEB). The city's unfunded OPEB liability grew 185 percent in four years, from $20.6 million in June 2015 to the $59 million most recently reported by CalPERS. However, city management has not developed a plan to reduce this obligation. The city manager informed us that his first priority was to address the city's unfunded pension liability before considering strategies to address the OPEB liability.

Significant Fire Department Expenditures and Budget Overages

The consistently excessive costs incurred by West Covina's fire department represent another substantial cost burden to the city. Table 2 shows that in the four years from fiscal years 2015–16 through 2018–19, the fire department exceeded its total budgeted expenditures by an average of $1.6 million annually. The primary cause of the fire department exceeding its budget was its excessive overtime costs—a component of its total expenditures. For example, the fire department exceeded its budgeted overtime costs for fiscal year 2018–19 by $1.4 million, which accounted for nearly all of the department's total budget overage in that fiscal year.

The fire chief told the city council that once the department became fully staffed, it would no longer need to incur excessive overtime costs to ensure that it had the required number of firefighters available on a given day. As we discuss later in this report, the city attempted to address its fire department costs by approving raises in November 2019 that became effective in January 2020, which the fire chief believed would allow him to hire and retain a sufficient number of staff. After approving the raises, the department became fully staffed in the first half of fiscal year 2019–20. Nevertheless, even after the fire department became fully staffed, it still exceeded its fiscal year 2019–20 budget

Table 2
The Fire Department Has Routinely Exceeded Its Budget, Primarily Because of Excessive Overtime Costs
(dollars in millions)

	FIRE DEPARTMENT'S TOTAL COSTS			FIRE DEPARTMENT'S OVERTIME COSTS		
FISCAL YEAR	ADOPTED BUDGET	ACTUAL EXPENDITURES	DIFFERENCE	ADOPTED BUDGET	ACTUAL EXPENDITURES	DIFFERENCE
2015–16	$17.5	$18.3	$0.8 (5%)	$1.3	$2.7	$1.4 (108%)
2016–17	17.6	19.9	2.3 (13%)	1.2	2.9	1.7 (142%)
2017–18	17.9	19.5	1.6 (9%)	1.8	3.6	1.8 (100%)
2018–19	19.3	20.8	1.5 (8%)	1.8	3.2	1.4 (78%)
2019–20	20.4	22.5	2.1 (10%)	2.1	2.6	0.5 (24%)
	Average over budget (fiscal years 2015–16 through 2018–19)		**$1.6 (9%)**	*Average over budget (fiscal years 2015–16 through 2018–19)*		**$1.6 (107%)**

Source: West Covina's budgets and financial reports.

for overtime costs by $490,000. Further, in that same year, it exceeded its overall budget by $2.1 million. Although the high overtime costs may have partially been attributable to the department's not being fully staffed for the entire year, the fact that it exceeded its overall budget by such a significant amount suggests that other factors have contributed to its overspending.

> ***"Even after the fire department became fully staffed, it still exceeded its fiscal year 2019–20 budget for overtime costs by $490,000."***

When preparing its budget for fiscal year 2020–21, the fire department reduced its projected overtime costs to only $568,000. However, we question whether this estimate is realistic, particularly given that it incurred $2.6 million of overtime expenditures during fiscal year 2019–20, when it was fully staffed for the latter half of that year. Further, the fire department has consistently demonstrated its inability to adhere to its budgets for overtime.

To address the excessive costs of its fire department, West Covina is pursuing alternatives to its current method of fire service delivery. Specifically, it is considering either contracting for its fire services with the Los Angeles County Fire Department (county fire department) or reducing its number of firefighter paramedics and contracting with a less costly private ambulance service. Under the first option, the city could potentially reduce costs by no longer having to pay salary, benefits, maintenance, or equipment costs. Instead, it would pay the county fire department an annual fee that the fire chief estimates would be lower than the city's current costs and remain lower than the city's projected future costs, though the city's forecast did not account for the county's annual fee increasing more substantially after the first five years of the contract. Under the second option, the contracted ambulance service would provide patient transport that the city's fire department currently handles, allowing the city to reduce the number of firefighter paramedics it pays. However, the city did not develop a forecast of the ambulance service's expected costs or the city's potential cost savings or revenue loss.

In response to our request for a cost analysis of potential fire service delivery options, city management provided draft agreements with the county and the ambulance service. However, city management could not demonstrate that it has performed a specific analysis comparing the long-term costs of the two alternatives. If the city does not find a more cost-effective option to provide services, it will likely need to continue to draw upon its general fund reserves to meet its fire department's high costs. Alternatively, if the city directs the fire department to restrict off-duty firefighters from working overtime to cover for absences or temporary vacancies, the city may be forced to temporarily close fire stations that do not meet minimum required staffing levels on certain days when backup is unavailable. Consequently, West Covina's residents and businesses could receive reduced levels of fire and emergency medical services.

The Financial Impact of the Pandemic

Although West Covina appears to have withstood the financial impact of the pandemic on its fiscal year 2019–20 revenue, it has likely underestimated the effect the pandemic will have on its fiscal year 2020–21 budget. In May 2020, the city manager submitted a staff report to West Covina's mayor and city council proposing that the city declare a fiscal emergency. The accompanying resolution included an estimate of potential budget impacts associated with the pandemic that the finance director had developed in April. The estimate concluded that the city would not receive $2.8 million of general fund revenue that it had anticipated in its fiscal year 2019–20 budget. However, it appears that the initial financial impact to the city was not as severe as this estimate projected. As of the end of October 2020, the city had recorded actual revenue of $69.2 million for fiscal year 2019–20, which was $782,000 more than the budget it adopted before the start of the pandemic.

West Covina was in the process of developing its annual budget for fiscal year 2020–21 during the initial months of the pandemic. The final budget that the city council adopted included a projection of $66.7 million of general fund revenue for that year. However, this projection was only $2.5 million less than the total general fund revenue the city had recorded for fiscal year 2019–20. We find this problematic given that the city experienced the negative effects of the pandemic in only a single quarter of fiscal year 2019–20—after the State and Los Angeles County issued stay-at-home orders in March 2020—and numerous health research organizations predict that governments will continue to address the pandemic through all of fiscal year 2020–21.

The finance director explained that to develop her revenue projection for fiscal year 2020–21, she considered her April 2020 estimate of the impact of the pandemic on the city's fiscal year 2019–20 revenue, tax revenue forecasts that one of the city's consultants created, and the annual revenue that the city had received historically. Specifically, the finance director estimated the revenue that the city would have received if the pandemic had not occurred and then reduced it by an amount comparable to the effect that she estimated the pandemic would have on fiscal year 2019–20 revenue. However, she could not provide specific documentation supporting her analysis and could not demonstrate the reasonableness of her estimates. Further, the finance director did not factor in the likelihood that a greater portion of fiscal year 2020–21 would be affected by the pandemic than fiscal year 2019–20. As a result, we believe that the city's projection is overly optimistic and does not adequately account for the uncertainty of the pandemic's duration.

> ***"We believe that the city's projection is overly optimistic and does not adequately account for the uncertainty of the pandemic's duration."***

Moreover, West Covina did not appear to take into consideration the impact of the pandemic on specific sources of revenue when developing its overall revenue projection for fiscal year 2020–21. Many of the city's sources of revenue are dependent on the city's level of economic activity. For example, in fiscal year 2019–20, West Covina received $6 million from charges for city services such as recreation programs and facility rentals. For fiscal year 2020–21, the city budgeted $7.1 million for this revenue category—an increase of $1.1 million—despite the effects of the pandemic likely resulting in decreased use of these city services because of social-distancing orders. Similarly, West Covina's transient occupancy tax—a surcharge on hotel stays and other forms of lodging—directly relates to tourism and business travel. As expected, the city experienced a reduction in this revenue from its budget of $1.9 million to actual revenue of $1.5 million in fiscal year 2019–20 because of the lower volume of travel. Nevertheless, West Covina once again budgeted $1.9 million in revenue from its transient occupancy tax in fiscal year 2020–21.

If these and other revenue sources decline as the pandemic persists, West Covina's revenue for fiscal year 2020–21 may be significantly lower than it projected in its budget. The city already projected in its fiscal year 2020–21 budget that its total general fund expenditures would equal its total general fund revenue. If the city's actual revenue falls short of its expectations because of the pandemic, city leadership will be forced to reduce the city's expenditures or further deplete its general fund reserves.

Recommendations to Address This Risk

- *After it completes its land sale, West Covina should set aside the resulting revenue to compensate for any shortfalls in revenue that it experiences as a result of its underestimates of the effects of the pandemic on its fiscal year 2020–21 budget. It should use any remaining revenue from the land sale not already committed to repay bond debt to replenish its general fund reserves.*

- *To ensure that it manages those litigation costs for which it will continue to be responsible, West Covina should use historical data and other reasonable assumptions to develop budgets for the costs of claim payments.*

- *To ensure that it can continue to maintain its membership in CJPIA, West Covina should develop a plan to manage its risks and exposure to litigation.*

- *To address the excessive costs it currently incurs providing fire and emergency medical services, West Covina should perform cost-benefit analyses of the other options that it has identified for procuring these services.*

- *To better ensure its ongoing financial stability, West Covina should implement a process for better developing reasonable budget projections that adequately account for the impact that significant events may have on revenue.*

Despite West Covina's Continual Budget Shortfalls, City Leadership Has Made Questionable Decisions Regarding Its Use of Resources

The questionable decisions of West Covina's leadership regarding the city's use of resources have resulted in significant reductions to its financial reserves. For example, the city pays a greater share of its employees' health care benefit premiums than the average share paid by other government organizations. According to a 2020 U.S. Bureau of Labor Statistics survey, state and local governments in the West Coast region pay on average about 86 percent of benefit premiums for employees with employee-only plans and 75 percent for employees with family plans. In fiscal year 2019–20, West Covina contributed 95 percent of its employees' total health care premiums. If the city had instead contributed 86 percent, it would have saved about $329,000 in general fund expenditures in fiscal year 2019–20, and if it had contributed 75 percent, it would have saved about $726,000.[2]

City management recently negotiated with the various employee unions to reduce the city's expenditures for employee benefits; however, most of these are temporary reductions and will not significantly affect West Covina's long-term financial health. After declaring a fiscal emergency in May 2020 because of the pandemic, city management negotiated with its employee unions to temporarily suspend or reduce certain employment benefits. From July 2020 to October 2020, the city council approved agreements with various employee unions that suspended certain benefits for six-month periods. For example, the unions agreed to have their represented employees increase their contributions to their CalPERS retirement plans by 3 percent to 10 percent. The unions also agreed to allow the city to suspend its contributions to the retiree health savings plan and to suspend cash payments for unused sick leave balances.[3] City management estimates it will achieve savings of $1 million from these reductions.

The city also took actions to temporarily reduce its costs related to its management's benefits. Specifically, department directors throughout the city agreed to a 10 percent reduction in the city's payment of their health insurance premiums and other benefit contributions from July 2020 through December 2020. The city manager similarly agreed to an 11.5 percent reduction in the city's contributions to his benefits, including his health savings plan, health insurance, and vehicle allowance. These temporary benefit reductions are reasonable actions to address the short-term impact of the pandemic, but they are not a long-term solution to improve the city's financial condition. Once the effects of the pandemic subside, the city would benefit from negotiating similar reductions with its employees for a longer period as part of its effort to eliminate its structural deficit.

In addition, city management has not adjusted the fees it charges for services so that they align with the full cost to the city of those services. When its fees do not cover its costs, West Covina has been relying on the city's general fund revenue to subsidize those services. Under state law, the city may establish its fees at levels that would allow it to recoup the full cost of the services it provides without exceeding those costs— a concept referred to as *full cost recovery*. However, until recently, the city's leadership did not calculate the full costs of its services so that it could adjust its 741 distinct fees

2 West Covina's human resources records do not provide specific detail on the number of city employees enrolled in employee-only plans and the number of employees enrolled in family plans. Consequently, we did not have the information that would allow us to calculate the actual savings.

3 A retiree health savings plan is a savings account that the employee and the city contribute to regularly to cover future medical costs upon the employee's retirement. Upon retirement, the employee is eligible to receive annual payments based on years of service that may be used for medical care.

accordingly. As communicated in a staff report to the city council, the city hired a consultant in 1993 to determine the costs of its services, and city management relied on that analysis for more than 20 years when updating the city's fees. Consequently, the city established hundreds of its fees at levels significantly lower than full cost recovery and did not charge fees for some services.

Although West Covina increased some of its fees in fiscal year 2017–18, it is still charging less than full cost recovery for a significant number of services. In September 2015, the city contracted with a consultant to identify the full cost of providing its various categories of services. The text box describes examples of city departments that charge fees for services and the types of services they provide. The consultant found that the city had set more than 400 fees lower than full cost recovery. City staff then compared the full cost for each service with the fee charged and recommended a suggested fee level. The consultant presented both the full cost recovery amount and the city's suggested fee for each service in a report it issued in April 2017. The city council subsequently adopted all of the suggested fees to take effect in fiscal year 2017–18.

Though most of the suggested fee levels were at full cost recovery, the city chose not to increase some fees to the full cost recovery amounts that the fee study identified. In particular, we identified 55 building fees for which the city council adopted fee amounts that were an average of 60 percent less than full cost recovery. When adopting the fiscal year 2017–18 fee schedule, the city did not explicitly provide a rationale for establishing these fees below full cost recovery. The consultant stated in its report that the city's primary intention was to create a comprehensive and up-to-date fee schedule and that city staff made the ultimate determination of the suggested fees.

Examples of City Fees

The 2017 fee study evaluated fees at the following six city departments:

- Planning
- Public Works
- Police
- Fire
- Community Services
- Finance and Administrative Services

These departments provide services that are grouped among 30 categories, including the following:

- Engineering permits
- Building permit and construction plan review
- Fire suppression inspection

Source: West Covina 2017 Fee Study.

In fiscal year 2019–20, city management increased some of its engineering and building fees above their fiscal year 2017–18 amounts but continued its approach of not raising all building fees to levels that would achieve full cost recovery. When increasing the fees, city management reported that it based the amounts on Los Angeles County's fees for similar services, which city management noted is a common practice among cities. City management informed the city council that it adjusted the city's engineering fees to amounts equaling the county's fees and adjusted the city's building fees to amounts reflective of the county's fees marked up by 65 percent, which city management justified based on the city's unique topography and quality of construction. However, the city adjusted 39 of the 55 building fees that it had set below full cost recovery in 2017 to levels that continue to be 6 percent to 97 percent lower than the amounts that the consultant had identified in 2017 as necessary to fully cover the city's cost of providing the services.

Our review of a selection of building permits indicates that the city has been missing an opportunity to maximize its revenue each year because it charges less than full cost recovery. The city does not maintain sufficient detail in its records to allow us to determine the total revenue it has forgone by charging less than full cost recovery for its engineering and building services because a single permit contains multiple fees, not all of which are set below full cost recovery. However, to provide some context, we reviewed individual building services fees that the city charged for the plumbing and electrical permits of four construction projects. Based on that review, we estimate that the city's decision not to adjust fees for its plumbing and electrical permit services for full cost recovery likely cost it about $191,000 in forgone revenue from these four projects alone. West Covina issued 803 electrical permits and 466 plumbing permits in 2019, which underscores the magnitude of the missed opportunity. Moreover, those two services accounted for less than 20 percent of the city's budgeted revenue pertaining to the building division in fiscal year 2019–20, meaning that the impact of undercharging for other services may also be substantial. Although city management may prefer not to burden residents and businesses by increasing all of its fees at once, increasing the fees in phases over several years would allow it to align the fees with its actual costs, while recognizing some amount of additional revenue during the interim.

Recommendations to Address This Risk

- *To limit its costs related to employee health care benefits, West Covina should renegotiate employee union agreements once the effects of the pandemic subside so that its employees contribute a reasonable percentage of their premiums. To determine that percentage, West Covina should consider options such as using survey data from comparably sized cities in its region.*
- *To ensure that the fees it charges for services align with its costs, West Covina should use a phased approach that steadily increases its fees each fiscal year until they fully cover the costs of the services it provides. It should also reassess the full costs of its services at least every three years.*

The City's Management Failed to Perform Sufficient Analyses When Making Important Financial Decisions

City management did not always provide complete information to the city council when requesting approval for budgetary or organizational changes. For example, in November 2019, the fire chief requested that the city council approve 12 percent salary raises for firefighters following contract negotiations between city representatives and the firefighters union. The fire chief defended the proposal by asserting that the raises would save money in the long term because competitive salaries would attract and retain firefighters, thus allowing him to fully staff the fire department and reduce overtime costs. However, he did not present a documented analysis to support this assertion. Although city council members questioned the lack of analysis and expressed concern that the chief was unable to demonstrate how the raises would decrease overtime costs, the city council approved the raises without requiring the fire chief to provide a cost-benefit analysis. As we discuss previously, the fire department continued to exceed its budget for overtime expenditures despite becoming fully staffed in fiscal year 2019–20. The recurrence of such overspending underscores the importance of performing thorough analyses to justify significant financial decisions.

In another instance, city management requested that the city council approve a plan to reduce costs by reorganizing the city's community services, planning, and public works departments. City management estimated that the reorganization would save about $275,000 per year, including $125,000 from the general fund, primarily by eliminating two management positions, including the public works director who also served as the city engineer. However, city management noted that those estimated savings excluded the cost of contracting for a city engineer, which staff had not quantified because they had not yet sought proposals. The city council approved the plan in October 2018 without questioning the lack of information about the costs of contracting for replacement services. In November 2018, the city contracted with a firm to provide city engineering services at a cost of $95,000 for fiscal year 2018–19. In April 2019, city management requested a budget amendment, increasing that contract to $145,000. Ultimately, the city council's decision to approve the reorganization resulted in cost savings for the city in fiscal year 2018–19 of less than half of the amount that city management originally claimed.

In addition to its insufficient analyses of the effects of its firefighter raises and department reorganization, city management did not thoroughly address West Covina's long-term financial outlook until after our initial assessment in January 2020. Given the city's ongoing deteriorating financial condition, we expected that it would have a process for developing projections of its planned expenditures and anticipated revenue for the next several years. In fact, the Government Finance Officers Association (GFOA) recommends that cities prepare multiyear revenue and expenditure forecasts as part of their annual budget process to determine the likelihood that they can sustain services and to highlight future financial issues they will need to address. However, the current city management had not performed fiscal forecasting of this nature before we conducted our assessment. At that time, we requested that West Covina's management provide us with any financial forecasts the city had developed. Although the finance director found a document labeled as a five-year forecast, she was unfamiliar with its source or the context of its creation, and she informed us that the city was not using the information from the document for any current budgeting or forecasting efforts.

Had city management routinely developed multiyear forecasts, city leadership would have likely had greater insight when making long-term decisions, such as approving budget amendments and salary increases. Such forecasting would also have informed the city council of the city's financial outlook beyond the next fiscal year. In April 2020, the city contracted with a consultant to prepare a forecast for the period from fiscal years 2020–21 through 2026–27. In June 2020, the consultant provided the city with a spreadsheet showing a general fund financial forecast based on data from April 2020. The forecasting model included anticipated revenue and expenditures, the resulting projected trend of its general fund reserves, and placeholders to input assumptions such as tax rates and salary increases. In his delivery of the forecasting model to the city, the consultant noted that maintaining the multiyear forecast should be an ongoing effort and that the city should update it frequently with current projections and new assumptions so that it can better anticipate its fiscal needs.

City management included in the forecasting model the potential cost savings of issuing the bonds to reduce its unfunded pension liability we previously discussed, and concluded that the city could quickly rebuild its financial reserves by replacing its unfunded liability payments with lower annual debt payments. However, as of October 2020, city management had not yet added several key assumptions into the forecast. These assumptions include rising salary costs, anticipated litigation expenditures, planned but unfunded capital improvement projects, long-term OPEB obligations, and the full anticipated amount of lost tax revenue resulting from the pandemic. City management has also not included in its forecast all of the additional revenue and reduced expenditures that it anticipates the city will receive or incur from the actions it intends to implement to improve the city's financial condition. Until the city updates its financial forecast with accurate, comprehensive financial information, city leadership will continue to make decisions based on incomplete information. As a result, these decisions are unlikely to fully address current or upcoming challenges.

Recommendations to Address This Risk

- *To ensure the effectiveness of the cost savings proposals it adopts, West Covina should require such proposals to clearly identify and support how they will deliver cost savings and the extent of those savings.*
- *To ensure that city management and the city council are able to make informed, rational decisions, West Covina should update its multiyear financial forecast at least annually to include all projected revenue and expenditures and to add information on new assumptions, unanticipated costs, and cost-saving actions. It should then use the forecast to quantify the long-term impact of its decisions on the city's financial condition.*

West Covina's Management Has Not Adopted a Comprehensive Financial Recovery Plan to Improve the City's Fiscal Condition

Despite operating with yearly structural deficits and significantly declining reserves, city leadership has not developed a comprehensive financial recovery plan to improve its long-term financial health or to address the specific issues we discuss in this report. The city's general fund reserve balance policy requires city management to maintain a reserve balance of 17 percent of the city's annual general fund operating expenditures. This threshold represents the equivalent of two months of reserves—the minimum amount that the GFOA recommends. The policy further requires city management to develop an approach for rebuilding the reserves within three years if the balance falls below 17 percent. Because the reserve balance dropped to 14.4 percent at the end of fiscal year 2018–19, we elevated West Covina's risk indicator for its general fund reserves to *high risk* in our updated local high risk dashboard. Although city management described a number of strategies it intends to implement to improve the city's financial condition, it has not developed a formal approach to rebuilding its reserve. According to the finance director, city management's current approach is to rebuild the reserves through savings generated when the city's bond debt payments are lower than the unfunded liability payments it would have paid.

In addition to following the requirements of the city's financial reserve policy, city leadership would benefit from creating a formalized financial recovery plan to ensure that it identifies the most effective combination of strategies to address its financial condition and that it remains committed to implementing its strategies. The GFOA notes that a written financial recovery plan is a useful tool that can identify key strategies, help city leadership focus its direction, and give its stakeholders greater confidence in the recovery process. The GFOA further explains that key elements of an effective financial recovery plan include financial forecasts and an operational action plan. Presently, city leadership lacks a formal approach for committing resources to perform the actions it has described to us or for analyzing the intended financial results of those efforts. Further, city leadership has not implemented timelines, progress monitoring, or reporting to ensure that it follows through on its commitments.

By creating a comprehensive financial recovery plan with the characteristics we describe above, city leadership can introduce multiple levels of accountability into its fiscal recovery process. This accountability is particularly critical for providing consistency in goals and actions when the city experiences turnover among its managers, which has occurred repeatedly in recent years. From fiscal years 2012–13 through 2019–20, the city had five different city managers and eight finance directors, including individuals serving in interim or acting positions. Without a written financial recovery plan that is sustainable over time and across all levels of leadership, the city will be unlikely to follow through on the actions its current management has described.

Such a plan would also provide the city council with a means to hold city management accountable because it would provide the council with benchmarks for determining whether the city is making adequate progress over time. Such a plan could withstand any turnover among city council members and provide future council members with a basis for evaluating the city's performance. Finally, a formalized plan would give stakeholders, including city residents, greater assurance that the city is taking steps to improve its financial condition, as well as a means to evaluate the city's performance. With access to a documented plan, residents could be informed and prepared to ask specific questions about the city's progress at city council meetings.

Recommendation to Address This Risk

To ensure accountability in its fiscal recovery process, West Covina should develop a financial recovery plan by June 2021 that describes its intended corrective actions, prioritizes its resources, identifies individuals responsible for monitoring its progress in implementing each action, and outlines when it anticipates completing key milestones related to each action. City management should also inform the city council quarterly of the city's progress in implementing the plan.

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West Covina's Weak Enforcement of Its Procurement Policy Increases the Risk of Waste and Fraud

The City Has Inadequately Managed Components of Its Purchasing Card Processes

West Covina has not consistently followed its administrative processes for purchasing goods and services. Although the city has developed policies and procedures for its procurement activities, our review of selected transactions identified a number of instances when staff did not comply with these policies and procedures. For example, the city established a formal purchase card program to provide an efficient, cost‑effective method of paying for purchases of $2,500 or less. The $2,500 limit is significant because purchase card transactions do not require preapproval, unlike purchases using contracts or purchase orders. When city employees need to use a purchase card to purchase items above this threshold, they may request an exemption—referred to as a *temporary increase*—by completing a request form for a specific, defined purchase that includes a clear justification and the time frame during which the purchase will be made. However, for the three purchase card transactions that we reviewed for purchases greater than $2,500, the city had insufficient documentation demonstrating that managers had authorized temporary increases.

In the first instance, the finance department did not prepare a request form to seek a temporary increase for its purchase of several laptop computers in March 2020, for a total cost of $6,185. According to the finance director, the department needed the laptops so that some of its staff members could work from home at the onset of the pandemic. The finance department used its purchase card because it wanted to acquire laptops that were immediately available from a store. When we asked the city manager about the purchases, he explained that he verbally approved the purchase of the laptops for the finance department. However, the city's policy requires such approvals to be documented on a request form.

In the second instance, the finance director approved a request form for the public services department to purchase two computers in December 2019, at a total cost of $4,853. However, that request form is undated, raising concerns about whether the temporary increase was actually authorized before the purchase was made. The finance director acknowledged that the undated approval of the increase for these computers was an oversight.

Finally, in the third instance, multiple city officials approved two temporary increases in July and August 2019 for automotive repairs totaling $7,455. Although both request forms included the required approval signatures, the staff member who requested the increases did not provide a description of the transaction on one of the forms or the time frame on either form. When we asked about the missing time frame, the city manager and finance director informed us that the increases were permanent, despite city policy stating that transaction limit increases should exist for only a limited period. The lack of specific restrictions for the temporary increase could have resulted in the staff member purchasing an item or service of more than $2,500 that did not meet the intent of those who authorized the transaction. Moreover, the city manager did not provide an explanation for why he authorized the temporary increase for the request form that did not describe the transaction.

The weaknesses in documentation of purchase approvals may be indicative of systemic issues that, if left unaddressed, could result in increased risk of excessive expenditures or potential fraud. In total, the three purchase card transactions we reviewed involved nearly $11,000 of costs beyond the standard limit that did not follow the city's procurement requirements for proper preapproval. A July 2015 audit of West Covina's administrative and accounting controls by the State Controller's Office (SCO) identified similar deficiencies in the city's use of purchase cards from July 2011 through June 2013. That review questioned the appropriateness of $32,219, or 22 percent, of the city's purchase card activity during that period, including many expenditures incurred or directed by former city managers. The SCO recommended that the city implement management processes to ensure proper review and approval of charges relating to the expenditure categories about which it had concerns: meals, lodging, and incidental expenditures. Our review determined that city management is not ensuring that staff follow policies and procedures for using purchase cards for other types of purchases.

Recommendation to Address This Risk

To ensure that its purchases align with its needs, West Covina should adhere to its purchase card program policies, including effectively documenting its management's approval of temporary increases in purchase card limits.

West Covina Has Failed to Ensure That Its Contracting Practices Result in Contracts That Provide the Best Value to the City and Community

West Covina violated its competitive bidding requirements when it contracted with a consulting firm to provide human resources and claims administration services from November 2019 through October 2020. Under the provisions of this contract, West Covina agreed to pay the consulting firm a maximum of $29,000 to provide a variety of personnel-related services, including work related to general liability claims, workers' compensation, and some of the city's insurance policies. According to the city manager, the city experienced significant turnover among its risk management staff soon after it hired its current human resources director in September 2019, which prompted the city to seek an external resource to provide those services. The human resources director recommended the consulting firm to the city based on her knowledge of the firm through her previous employer. However, under West Covina's contracting policy for professional and consulting services, the city should have used a competitive bidding process that would have enabled it to compare firms to ensure that it received the best value. The policy states that for professional and consultant services valued from $20,001 through $30,000, the city is required to obtain price quotations from a minimum of three vendors. Although West Covina's accounting records show that the consulting firm did not invoice for services beyond March 2020, the city nevertheless paid $12,550 for the firm's services without assurance that the contract represented the best value.

Further, West Covina approved multiple amendments to its contract with a waste collection company that include terms that may not be in the best interest of the city and its residents. West Covina's waste collection contract is a franchise agreement that establishes the waste collection company's exclusive right to engage in the business of collecting solid waste, recyclables, and other waste within the boundaries of the city. In exchange for this right, the waste collection company pays the city a franchise fee of 10 percent of its gross receipts resulting from the agreement. The contract also specifies the rates that the waste collection company can charge to residents and businesses for its services and authorizes the company to request an annual rate increase in accordance with the consumer price index. This type of arrangement appears to be common among similar cities in Los Angeles County.

> ***"West Covina approved multiple amendments to its contract with a waste collection company that include terms that may not be in the best interest of the city and its residents."***

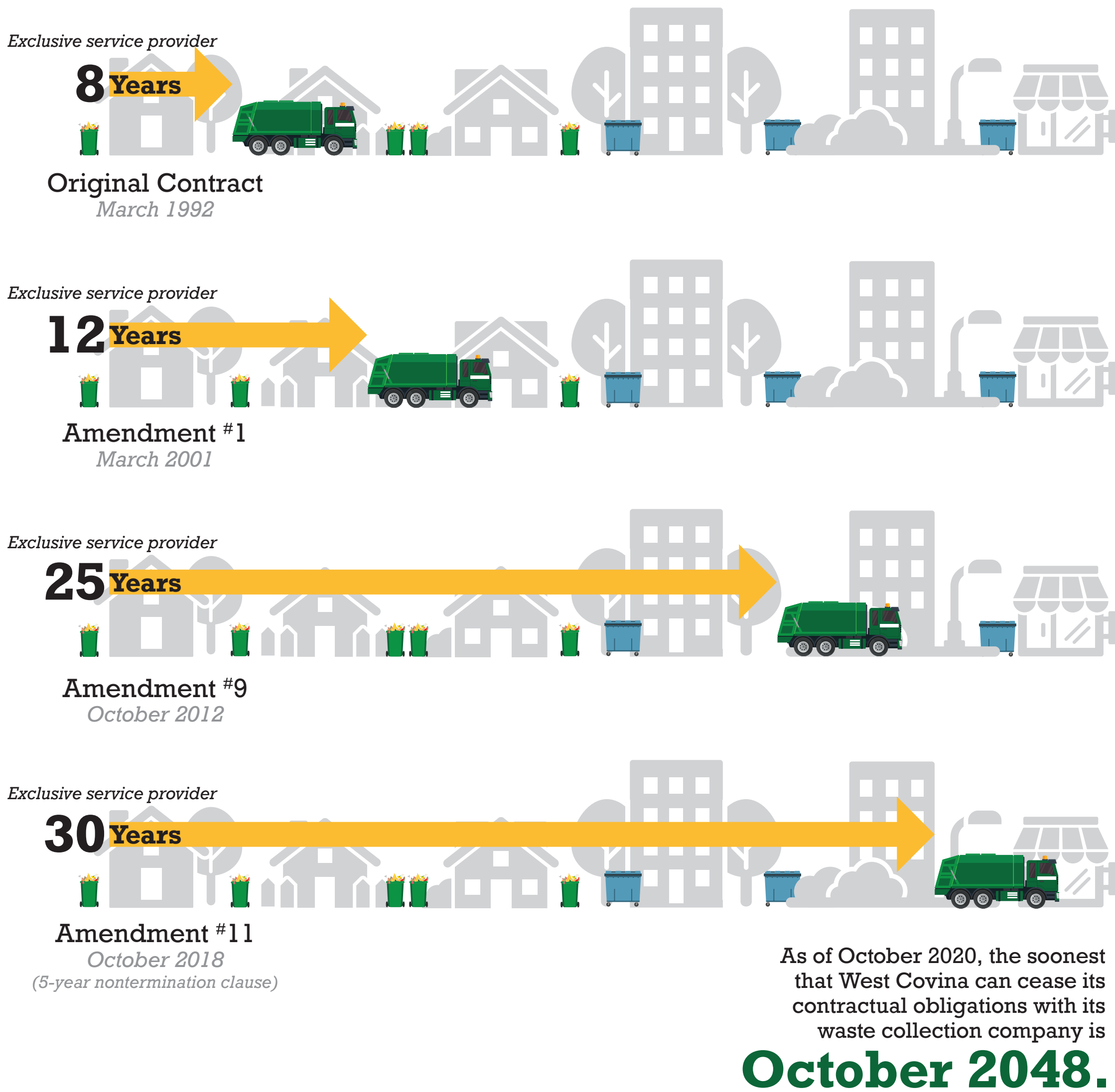
As Figure 4 shows, West Covina initially contracted with the waste collection company in 1992. However, the contract contained a clause that annually extended the contract's duration by one year, thereby ensuring it maintained an ongoing service period of eight years (known as an *evergreen period*). In other words, in 1997 the expiration date for the contract was 2005, while by 1999 the expiration had extended to 2007. In March 2001, the city council adopted the first of 11 amendments to that contract, which extended its evergreen period from eight to 12 years, while in October 2012, the city council approved another amendment that extended the evergreen period to 25 years. That amendment also stipulated that either party's notification to terminate the contract would result in the contract terminating 25 years from the date of that notification. In addition, the waste collection company agreed to make a one-time payment of $2 million to the city and annual recurring payments of $100,000 in addition to the franchise fee.

In November 2016, the city council approved an amendment to the same contract for a series of rate increases to customers for waste collection services. That amendment also increased the annual recurring payments from the waste collection company to $300,000 but stipulated that the city's notification of contract termination would void that payment clause. Finally, West Covina approved another amendment in October 2018 that included a clause preventing the city from exercising its annual option to terminate the contract until October 2023.

Neither West Covina's municipal code nor its purchasing policies require any limits on a contract's duration. Further, West Covina's contract policies do not address the extent to which the city may use amendments to modify its existing contracts. Nevertheless, we question the city's decisions to increase the duration of the evergreen period to 25 years and to establish a nontermination clause until 2023. These decisions are not in the city's best interest because they restrict the city's ability to seek more favorable terms from other vendors offering similar services. In reviewing the waste collection providers that other cities near West Covina use, we identified that at least two other companies could potentially serve West Covina. However, as a result of its amendments, the soonest the city could contract with another vendor would be October 2048.

The current city manager could not identify any information from the city's records to ascertain why the city initiated the October 2012 amendment to extend the evergreen period to 25 years even though the contract still had 12 years remaining

Figure 4
West Covina's City Council Approved Amendments That Significantly Extended the Length of Its Waste Collection Contract



Source: Analysis of West Covina's waste collection contract and amendments.

Note: West Covina approved other amendments to its waste collection contract that pertained to rate adjustments but did not modify the length of the contract.

on it at that time. Further, the city's current management could not explain why the 2018 amendment included the nontermination clause: the primary purpose of this amendment was to update the rates that residents and businesses pay to cover the cost of new state-mandated recycling of organic waste, so it is unclear why a nontermination clause was necessary or desirable from the standpoint of the city. Nevertheless, the city manager believes that West Covina does not have any recourse in addressing the terms of either amendment.

Despite the restrictive provisions of its contract, West Covina may be able to renegotiate certain terms if the waste collection company continues to seek amendments to adjust the rates it charges for its services. Our review of municipal contracts for waste collection services identified three cities in Los Angeles County that have contracts with durations that are more favorable than West Covina's 25-year evergreen clause. In fact, two of these cities—Los Angeles and Whittier—each contract with the same waste collection company as West Covina, yet their contract terms are only 10 years and eight years, respectively. Neither contract has an evergreen clause or a nontermination clause. Accordingly, it seems reasonable for West Covina to pursue alternatives to seek the best value for its residents and community.

Recommendations to Address This Risk

- *To ensure that it procures services that represent the best value, West Covina should follow its competitive bidding requirements. To avoid the circumvention of competitive bidding, it should establish policies clarifying the appropriate use of contract amendments.*
- *To ensure that the contracts it enters are effective and represent the best value, West Covina should amend its contracting policies to include a requirement that city management document its reason for entering into any contract or contract extension with a duration in excess of five years.*
- *To ensure that its waste collection contract represents the best value for the city, its residents, and its other community members, West Covina should negotiate with its waste collection company at the next available opportunity to revise key terms of its contract, including the contract's duration and the city's right to terminate the agreement.*

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 1, 2020

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Appendix A

Scope and Methodology

In February 2020, the Audit Committee approved a proposal by the State Auditor to perform an audit of West Covina under the local high risk program. We conducted an initial assessment of West Covina in January 2020, in which we reviewed the city's financial and operating conditions 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 initial assessment, we identified concerns about West Covina's financial condition and financial stability as well as aspects of its operations that were ineffective or inefficient. Further, West Covina could not demonstrate having taken adequate corrective action to address certain prior audit findings, including those addressing weaknesses that could expose it to increased risk of fraud or financial mismanagement. The Table lists the resulting audit objectives and related procedures that address these risk factors. We did not identify concerns during our initial assessment pertaining to the remaining two risk factors.

Table
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.	Reviewed relevant state laws, regulations, municipal code, and other background materials applicable to the city.
2	Evaluate West Covina's current financial condition and ability to meet its short-term and long-term financial obligations while continuing to provide services to its residents.	• Reviewed the city's fiscal policies, including those concerning fiscal sustainability and debt policies. • Reviewed the city's audited and unaudited financial statements to determine its current financial condition. • Reviewed and evaluated the city's plans and ability to pay for pension, OPEB, and other long-term debt obligations. • Reviewed and evaluated the city's plans to address deficit spending and revenue shortfalls.
3	Identify the causes of West Covina's financial challenges and determine whether the city has developed an adequate plan for addressing those challenges. This will include assessing the city's efforts to improve its financial condition by increasing revenue and reducing expenditures.	• Reviewed the city's audited and unaudited financial statements and its adopted budgets to determine the financial challenges the city had identified and assessed its plans to address those challenges. • Evaluated the city's financial records and internal documentation to identify additional causes of the city's fiscal challenges. • Developed strategies to improve the city's financial condition based on identified causes.
4	Determine whether West Covina's budgeting processes comply with best practices. In addition, evaluate the city's procedures and underlying assumptions for projecting future revenue and expenditures and determine whether they result in balanced budgets and accurate financial forecasts.	• Identified GFOA budgeting best practices and evaluated the city's budget policies for adherence to those best practices. • Reviewed budget documents and city council meeting minutes and related documentation to determine the extent to which the city adhered to its policies when developing its budgets. • Evaluated the city's past and current processes for establishing financial forecasts.
5	Assess West Covina's process for setting, increasing, or decreasing fees or rates to ensure that it complies with applicable laws, rules, regulations, and best practices. For a selection of these fees and rates, determine whether they cover the city's costs of providing services.	• Reviewed the city's fee schedules and related documentation to determine when the city last updated each of its fees, the process it used to determine the amounts of its fees, and the fees it did not set at full cost recovery. • Evaluated a selection of fees to estimate the amount of revenue the city did not receive by not setting its fees at full cost recovery.
6	Examine West Covina's efforts to fill key management and staff positions and maintain organizational and leadership continuity within city operations.	• Evaluated employment documentation related to West Covina's city managers and finance directors from fiscal years 2012–13 through 2019–20. Those positions and other key management positions are currently filled as of October 2020. • Evaluated budget documentation to determine the city's historical staffing trends.
7	Evaluate West Covina's efforts to address the deficiencies the SCO identified in its 2015 report.	• Reviewed the SCO's 2015 report and identified eight recommendations that are pertinent to the city's financial condition. • Evaluated the extent to which the city had addressed those recommendations. • Interviewed key staff at West Covina to gather evidence and perspective pertaining to the contracts into which the city entered and the documentation of those contracts. • Reviewed a selection of four contracts to determine whether West Covina adhered to its contracting policies. • Reviewed statements of economic interests for individuals involved in procuring and approving selected contracts and did not identify any apparent conflicts of interest. • Reviewed a selection of eight purchase card transactions to determine whether West Covina adhered to its credit card purchasing policies.

	AUDIT OBJECTIVE	METHOD
8	Review and assess any other issues that are significant to the audit.	Analyzed quarterly revenue and expenditure data from fiscal years 2015–16 through 2019–20 to identify trends and to evaluate the possible impact of the pandemic on West Covina's financial condition.

Source: Analysis of documents and data obtained from West Covina, and interviews with West Covina officials.

Assessment of Data Reliability

In performing this audit, we relied on data from West Covina's financial accounting system to review its revenue and expenditures for fiscal years 2015–16 through 2019–20. The U.S. Government Accountability Office, whose standards we are statutorily required to follow, requires us to assess the sufficiency and appropriateness of computer‑processed information that is used to support our findings, conclusions, and recommendations. We verified the accuracy of these data by selecting revenue and expenditure categories from the data and tracing the amounts reported to the city's audited financial statements and other supporting documentation. We verified the completeness of these data by comparing total revenue and expenditures for fiscal years 2015–16 through 2018–19 to the totals reported in the audited financial statements. Accordingly, we found the city's financial accounting system to be sufficiently reliable for the purpose of reviewing its financial condition.

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Appendix B

The State Auditor's Local High Risk Program

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 require that the State Auditor seek approval from the Audit Committee to conduct high risk audits of local entities.

To identify local entities that may be high risk, we analyzed audited financial statements and pension-related information for more than 470 California cities. This detailed review included using financial data to calculate indicators that may be indicative of a city's fiscal stress. These indicators enabled us to assess each city's ability to pay its bills in both the short and long term. Specifically, the indicators measure each city's financial reserves, debt burden, cash position or liquidity, revenue trends, and ability to pay for employee retirement benefits. In most instances, the financial indicators rely on information for fiscal year 2016–17.[4]

Based on our analysis from 2019, we identified several cities, including West Covina, which appeared to meet the criteria for being at high risk. We visited each of these cities and conducted an initial assessment to determine the city's awareness of and responses to these issues as well as to identify any other ongoing issues that could affect our determination of whether the city was at high risk. After conducting our initial assessment, we concluded that West Covina's circumstances warranted an audit. In February 2020, we sought and obtained approval from the Audit Committee to conduct an audit of West Covina.

If a local agency is designated as high risk as a result of an 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's publication. It must then provide written updates every six months after the audit report is issued regarding its progress in implementing its 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 agency has taken satisfactory corrective action.

4 As we describe earlier in this report, we conducted our initial assessment of West Covina in January 2020 based on this detailed review. In November 2020, we updated our financial indicators to include information through fiscal year 2018–19.

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City Manager's Office

November 2, 2020

Elaine M. Howle, CPA
California State Auditor
621 Capitol Mall, Suite 1200
Sacramento CA 95814-4761

Dear Ms. Howle:

This is a difficult time for California local governments. Without question, the COVID-19 pandemic will cause more California cities to consider bankruptcy. Most California municipalities predominantly depend on sales tax, property tax, and transient occupancy taxes to pay the bills. The pandemic has exacerbated the situation. California local governments must plan, without delay, for post-pandemic fiscal realities. With the possibility of a recession and what the State Director of Finance calls a "significant negative effect on state revenues", and considerable uncertainty about recovery, California municipalities must plan now.

With the goal of improving government performance, the Joint Legislative Audit Committee (JLAC) was established by the State Legislature. Audits considered by the JLAC include financial and financial-related audits of government and publicly created entities. In December 2019, the California State Auditor's Office informed the City of West Covina that it had been selected for review under the high-risk Local Government Agency Audit Program.

The City received the draft report prepared by your office titled "City of West Covina: Its Deteriorating Financial Situation Threatens Its Fiscal Stability and Its Ability to Provide City Services". The report details the audit conducted by your office, as the result of the audit proposal, which was approved by the California State Assembly Joint Legislative Audit Committee. I have reviewed the report and intend to prepare a corrective action plan to address the risks identified.

Sincerely,

David N. Carmany
City Manager

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