



June 11, 2010

Mr. Kevin O'Rourke  
Interim City Manager  
City of Stockton

Mr. Steve Leonesio  
President  
Stockton Police Officers Association

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22 East Weber Avenue, Suite 150  
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Gentlemen:

We have completed our review of the City of Stockton's Comprehensive Annual Financial Report (CAFR) for the years ending June 30, 2007, 2008 and 2009; the adopted budgets for FY 2008-09 and FY 2009-10; and mid-year budget projections prepared by the Stockton City Manager. Based on our review of these documents, as of June 30, 2009 the financial condition of the City of Stockton was fair to weak. However, the City's financial health is at a critical juncture during this current economic downturn. While the City should be commended for taking quick and immediate action to address shortfalls in projected discretionary revenues over the last two years, significant historical financial activities have been subsidizing operations in special revenue, capital project, redevelopment, and enterprise funds and are distorting the financial status of the General Fund and the City in general. These financial activities include significant interfund loans and transfers and reliance upon future revenues as indicated by deficit fund balances. The City should evaluate each of these activities, and associated loans and transfers, with respect to financial viability and policies going forward. The decisions made during the next one to two year cycle will have significant long-term impacts on the financial health of the City.

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As of June 30, 2009, the General Fund had a fund balance amounting to approximately \$22.8 million, or 13.1 percent of the City's \$174.1 million annual General Fund operating expense. Of the total \$22.8 million fund balance, approximately \$8.6 million was unreserved fund balance, and thus was available at the discretion of the City Council. The \$14.2 million reserved fund balance included \$11.2 million in loans to other City funds, including \$9.9 million to the Stormwater Utility Enterprise Fund for subsidizing historical operations.

The City has also established over 20 special revenue funds to account for restricted revenues that are used for a variety of purposes. While a majority of these funds and resources cannot be used for General Fund purposes due to legal and contractual restrictions, some special revenue funds may have been created by policy of the City for specific purposes and, in some cases, would otherwise be General Fund resources except for specific actions by the City Council and administration. Such actions may have been taken many years ago by an entirely different Council and management. The current Council may have the authority to modify the ordinances that determine the amount of monies that go into these funds and the type of expenditures that can be made from these funds. Our review of these funds indicates that potentially \$2.2 million may be available resources and further analysis may yield additional funds.

Additionally, the City held fund balances related to general government operations in nine internal service funds. As described in more detail below, cash balances in these funds could yield as much as approximately \$30.5 million in additional resources if returned to initial funding departments and funds, most of which would be the General Fund.

The City operates three utilities and four other proprietary operations, which are accounted for in enterprise funds. Several of these funds have been historically, and continue to be, subsidized by other operating funds, including the General Fund. The enterprise funds with negative unrestricted net assets and/or interfund loans include the Stormwater Utility, Central Parking District, Solid Waste, Downtown Marina, and Golf Courses activities. The City should review the operating health of each enterprise to determine whether:

- The enterprise could be economically viable by identifying on-going and available revenue sources or reclassifying current loans from contributing funds as one-time transfers of resources; or
- If not economically viable, the enterprise should be merged into other City operations and funds or whether the activity should be altogether exited.

Finally, the City operates two capital projects funds, the Capital Improvement Fund and the Redevelopment Agency Fund, that are used to account for resources for the construction of facilities and to make certain capital acquisitions. As with the enterprise funds, these activities appear to be significantly subsidized by other City funds including the General Fund. The City should develop formal loan agreements, debt repayment schedules and a long-term financial plan which would enable the City's policy makers to review these activities in light of financial and policy considerations.

Attachment 1 to this report provides a high-level analysis of the City's major funds by fund category.

## General Fund Balance

The City of Stockton's General Fund balance for the year ended June 30, 2009 amounted to \$22,782,000, or 13.1 percent of FY 2008-09 operating expenditures. This reflects a slight increase since FY 2006-07, when the fund balance represented 11.9 percent of annual operating expenditures. The following table provides a comparison of Stockton's General Fund Balance during the past three years.

**Table 1**

### History of the City Of Stockton General Fund Balance

Year Ended	Fund Balance	Unrestricted Portion	Annual Expenditures	FB as a % of Expenditures
June 30, 2007	20,930,000	15,761,000	176,488,000	11.9%
June 30, 2008	23,125,000	9,627,000	182,000,000	12.7%
June 30, 2009	22,782,000	8,607,000	174,132,000	13.1%

As shown in Table 1, the City's General Fund balance increased by \$1.9 million, or 8.8 percent, from the \$20.9 million level as of June 30, 2007 to approximately \$22.8 million as of June 30, 2009. However, the unrestricted General Fund balance has declined substantially by 45.4 percent, or \$7.2 million, primarily due to classifying historical General Fund subsidies of the City's Stormwater Utility as a loan from the General Fund resulting from a settlement agreement with the Howard Jarvis Taxpayers Association in 2009. Over the three year period reviewed, annual General Fund expenditures decreased by \$2.4 million, or 1.3 percent, to \$174.1 million from \$176.5 million reported in FY 2006-07.

As can be seen in the table, the City's General Fund financial status, as indicated by fund balance level, has remained relatively stable over the past three years. This is significant in light of the economic downturn as well as two significant settlement agreements approved by the Stockton City Council in 2009 and reflected in the FY 2008-09 financial statements. With

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regard to the economic downturn, the City has taken quick and immediate action, as can be seen from the overall reduction in expenditures of \$7.9 million, or 4.3 percent from FY 2007-08 to FY 2008-09. Additionally, the City was able to maintain its revenue level despite significant decreases in property and other taxes by increasing miscellaneous revenue collections, which are typically one-time and non-recurring in nature<sup>1</sup>. The net impact of the two settlement agreements resulted in a one-time reduction of General Fund balance of \$6.3 million<sup>2</sup>. However, as noted above, because the City maintained revenues, while decreasing expenditures, the City was able to sustain its General Fund balance at \$22.8 million at year-end.

Table 2, on the next page, provides a comparison of the original budgeted expenditures and revenues to actual performance over the five-year period FY 2004-05 through FY 2008-09. The data shows that before the current economic downturn, the City was conservative in its approach to budgeting revenues and used excess resources that resulted from those conservative estimates minimally during the year. However, in FY 2007-08, a 3.0 percent decrease in revenues amounting to \$5.7 million during the year was partially offset by a 1.2 percent decrease in operating expenditures of \$2.1 million, resulting in a net operating deficit for the year of \$3.6 million. While these results were not included in the FY 2008-09 original budget, actions during the year resulted in a net operating surplus of \$8.6 million for FY 2008-09, which assisted in maintaining a stable fund balance despite the extraordinary impacts of the settlement agreements on the General Fund, as noted above.

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<sup>1</sup> Stockton CAFR, as of June 30, 2009, Management's Discussion and Analysis, Page 15.

<sup>2</sup> The details of these settlement agreements can be read in the Stockton CAFR, as of June 30, 2009, Notes to the Financial Statements, Note 15, Pages 113-117.

**Table 2**  
**City of Stockton Revenue and Expenditure Performance**  
**Between FY 2004-05 and FY 2008-09**

<b>Revenues</b>				
	Original Budget	Actual	Surplus (Deficit)	Percent Variance
FY 2004-05	155,871,000	167,392,000	11,521,000	7.4%
FY 2005-06	167,832,000	183,312,000	15,480,000	9.2%
FY 2006-07	176,162,000	186,476,000	10,314,000	5.9%
FY 2007-08	192,988,000	187,287,000	(5,701,000)	-3.0%
FY 2008-09	195,102,000	187,226,000	(7,876,000)	-4.0%
5-Year Avg	177,591,000	182,338,600	4,747,600	2.7%
<b>Expenditures</b>				
	Original Budget	Actual	Surplus (Deficit)	Percent Variance
FY 2004-05	156,719,000	157,168,000	(449,000)	-0.3%
FY 2005-06	164,828,000	168,062,000	(3,234,000)	-2.0%
FY 2006-07	173,250,000	177,585,000	(4,335,000)	-2.5%
FY 2007-08	185,499,000	183,360,000	2,139,000	1.2%
FY 2008-09	191,322,000	174,804,000	16,518,000	8.6%
5-Year Avg	174,323,600	172,195,800	4,774,000	2.7%
<b>Net Results of Operations</b>				
			Net Surplus (Deficit)	% of Budgeted Expenditures
FY 2004-05			11,072,000	7.1%
FY 2005-06			12,246,000	7.4%
FY 2006-07			5,979,000	3.5%
FY 2007-08			(3,562,000)	-1.9%
FY 2008-09			8,642,000	4.5%
5-Year Avg			9,521,600	5.5%
<small>Note: Table is not to be used to show fund balance, but merely the variance in budgeting demonstrated by historical reporting in the City's CAFR.</small>				

### General Fund Balances

The FY 2009-10 Adopted Budget projects that the City will collect \$162,698,663 in General Fund revenue and other financing sources and authorizes \$162,698,662 in General Fund expenditures and other financing uses, for essentially no net impact on the City's General Fund balance and financial status during the year. While the FY 2009-10 Adopted Budget assumes a beginning and ending unreserved fund balance of \$6,843,929, as shown in Table 1, the actual unreserved General Fund balance shown in the audited financial statements was \$8,607,000 as of June 30, 2009. Therefore, the FY 2009-10 Adopted Budget understates available fund balance by approximately \$1,763,000. However, the City currently projects a year-end operating deficit in the General Fund of \$987,000 which partially offsets the \$1,763,000. As part of Phase 2, we will analyze more recent information and updates to the City's projections, and factor-in any adjustments to the General Fund balance, as appropriate.

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### *Fund Balance Designated for Budget Uncertainties and Catastrophic Events*

The City Council has adopted policies to accumulate and then maintain 5 percent of annual appropriations for catastrophic events and 5 percent for budget uncertainties in fund balance, or a combined total of 10 percent of annual appropriations. The Governmental Finance Officers' Association (GFOA) recommends such reserves be set at between 5 percent and 15 percent of annual operating expenditures. As of June 30, 2009, the City has designated \$1,620,000 to be held for catastrophic events and \$1,620,000 to be held for budget uncertainties, which are approximately 0.9 percent of annual appropriations each, or a total of \$3,240,000 and 1.8 percent of annual operating expenses.

### *Activities Impacting the Financial Status of the General Fund*

During our review, we have noted significant financial activities that have direct and indirect impact of the health of the General Fund. These activities include significant interfund loans and transfers, and reliance upon future revenues as indicated by deficit fund balances. As of June 30, 2009, the General Fund was owed approximately \$4,444,000 in short-term loans typically recorded when other funds overdraw cash balances. Longer term loans payable to the General Fund totaled approximately \$11,163,000, whereas the General Fund owed the Water and Wastewater utility funds approximately \$8,148,000. In all, the City had a combined interfund loan total of \$70,350,000.

Further, for FY 2008-09, there was a combined \$46,434,000 in operating transfers throughout the City "to finance expenditures, subsidize operating losses, and service debt."<sup>3</sup> Deficit unreserved fund balances existed in the Capital Improvement, Redevelopment Agency, Stormwater Utility, Central Parking District, Gas Tax, Measure K Sales Tax, and Development Services, among others.

The City should evaluate each of these activities, and associated loans and transfers, with respect to financial viability and policies going forward in an effort to simplify the City's dependencies and make the policy implications more transparent.

## **Special Revenue Funds**

The City has established over 20 special revenue funds to account for restricted revenues that are used for a variety of purposes. The City's CAFR identifies only one special revenue fund as a major fund, Public Facilities Impact Fees, which accounts for the collection of fees as a condition of new development and expenditures of such fees on public facilities.

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<sup>3</sup> Stockton CAFR, as of June 30, 2009, Notes to the Financial Statements, Note 4, Page 68.

Additionally, the City has over 19 smaller special revenue funds that have a total combined fund balance of approximately \$130.1 million. A majority of these funds and resources cannot be used for General Fund purposes due to legal and contractual restrictions. However, substantial undesignated fund balances supported by cash on hand for select special revenue funds as of June 30, 2009 are as follows:

**Table 3**  
**Select Special Revenue Funds**  
**Undesignated Fund Balance as of June 30, 2009**

<b>Special Revenue Fund</b>	<b>Undesignated Fund Balance</b>
Solid Waste and Recycling	2,080,000
City-County Library	3,989,000
Special Assessments	8,292,000
Redevelopment Agency Loan	8,583,000
Other Special Revenue	1,068,000
<b>Total</b>	<b>24,012,000</b>

Financial, legal, administrative and other services are typically provided by the General Fund to support special revenue fund activities, and reimbursement for the cost of these support services may be allowable. Because of the substantial undesignated fund balances, the City should analyze the activities performed for each special revenue fund by General Fund departments and agencies to determine whether additional costs can be reimbursed. Further, because special revenue fund activities may parallel activities performed in the General Fund, the City should conduct a review to see if there is any duplication and whether activities occurring in the General Fund would meet the criteria specified by any special revenue fund restrictions.

The City has emphasized, and as noted above, there are several special revenue funds with deficit fund balances. While these impact the overall financial health of the City, we believe these should be resolved by reducing future spending in these funds until such time as revenues once again bring fund balance positive.

Finally, some special revenue funds may have been created by policy of the City for specific purposes and, in some cases, would otherwise be General Fund resources except for specific actions by the City Council and administration. The City maintains several special revenue funds, such as for Emergency Communications, Recreation Services, and the City Administration Building that in many jurisdictions are frequently funded by and operated out of the General Fund. These three funds have a total undesignated fund balance as of June 30, 2009 of approximately \$2,233,000 that may be considered available fund balance. The City should

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conduct a review to determine which of these special revenue funds are subject to City Council authority, allowing modification of the ordinances that determine the amount of monies that go into these funds and the type of expenditures that can be made from these funds.

## **Internal Service Funds**

The City operates nine internal service funds which can be categorized into three functional areas, internal service funds to account for and manage vehicles and equipment (four funds), insurance activities (three funds), and employee benefits administration (two funds). Overall, these funds show a total combined deficit in net assets of \$47.4 million as of June 30, 2009. However, as can be seen in Attachment 2, the vehicle and equipment and employee benefits administration funds have net assets as of June 30, 2009 of \$19.0 million and \$46.4 million, respectively. The insurance internal service funds report significant deficit net assets totaling \$72.7 million as a result of recognizing long-term, actuarially determined liabilities.

Financial reporting requirements, or General Accepted Accounting Principles (GAAP), for long-term liabilities that are frequently accounted for in insurance and employee benefit internal service funds have reduced the financial position of many local governments. Historically, these activities were frequently accounted for and funded on a cash, or pay-as-you-go, basis by local governments. These governments, including the City of Stockton, will need to develop funding models to pay for these future requirements over time because the liabilities, such as for retiree pension and health care benefits, are substantive. Therefore, the following analysis considers cash balances and current funding requirements in addition to net assets and presents findings as short-term solutions to ease budgetary pressures, but not as a solution to fund on-going general City obligations.

These funds, grouped into three categories, are discussed in detail below.

### *Vehicle and Equipment Internal Service Funds*

The City maintains four internal service funds to account for and manage vehicles and equipment as follows:

Central Garage Internal Service Fund to account for the financing, operating and maintenance of vehicles and other similar equipment provided to City departments on a cost reimbursement basis.

Computer Equipment Internal Service Fund to account for the financing, service and maintenance of all computer and related equipment provided to City departments on a cost reimbursement basis.

Radio Equipment Internal Service Fund to account for the financing, service and maintenance of radio equipment provided to City departments on a cost reimbursement basis.

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Other Equipment Internal Service Fund to account for the financing, operating and maintenance of other smaller equipment, such as telephone, print and mailing, and office equipment, and provided to City departments on a cost reimbursement basis.

As of June 30, 2009, these funds had combined total net assets of \$19.0 million, of which \$11.0 million was held in cash and investments and \$9.0 million was unrestricted. The accumulation of significant excess assets is specifically prohibited by Federal Office of Management and Budget (OMB) Circular A-87 and the California State Controller, who comments that "An ISF's objective is not to make a profit but to recover, over a period of time, the total costs of providing goods or services . . . ISFs should not produce any significant profit or loss in the long run."<sup>4</sup> When defining the amount of assets that may accumulate in an ISF, the Controller makes the further comment that "In addition to the full recovery of costs, charges by an ISF may provide for the establishment and maintenance of a reasonable level of working capital reserve. Unrestricted, undesignated net assets up to the amount required to pay for 60 days of average cash expenses are considered a reasonable working capital reserve."

OMB Circular A-87 does not allow for the assessment of fees and charges for the purpose of accumulating funds for capital investment. To fund large equipment acquisitions in these internal service funds, the City can use capital lease financing as it did most recently to fund communications infrastructure.

In FY 2008-09, these internal service funds expended a total of approximately \$19.4 million. Therefore, a reasonable 60 day working capital reserve would be approximately \$3.2 million. Accordingly, approximately \$5.8 million of the accumulated net assets in the fund should be considered excess, since they far exceed working capital needs. This entire balance was in the form of cash as of June 30, 2009. Therefore, such excess funds should be returned to the contributing departments in the form of transfers or reduced charges for services during FY 2009-10 or FY 2010-11.

#### *Insurance Internal Service Funds*

The City maintains three internal service funds for insurance purposes, as follows:

General Liability Insurance Internal Service Fund to account for premiums and claims paid and administration of general liability insurance provided to City departments on a cost reimbursement basis.

Workers' Compensation Insurance Internal Service Fund to account for premiums and claims paid and administration of workers' compensation insurance provided to City departments on a cost reimbursement basis.

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<sup>4</sup> California State Controller, *Handbook of Cost Plan Procedures for California Counties*.

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Health Benefits Insurance Internal Service Fund to account for premiums and claims paid and administration of health benefits insurance provided to City departments on a cost reimbursement basis.

As of June 30, 2009, the CAFR reported a deficit unrestricted fund balance for these funds of \$72.7 million. As noted in the Notes to the Financial Statements, the City budgets revenues and expenses based on an analysis of cash flow in these funds, also known as "pay-as-you-go".<sup>5</sup> However, Generally Accepted Accounting Principles (GAAP) require reporting of all liabilities in the financial statements, even those long-term in nature and actuarially determined.

For the Workers' Compensation self-insurance liability fund, the City's estimated liability is determined using analyses performed by its claims adjusters and actuaries, who estimate the probable settlement costs for filed claims as well as Incurred But Not Reported (IBNR) claims. The City then uses this estimate to determine the amount of reserves that are necessary to fund the current cost (claims payable within one year) and future cost (claims payable after one year).

Reserves established at expected cost are technically referred to as being set at a "50% confidence level", which is a measure of statistical probability that reserves are sufficient to pay claims cost. A 50% confidence level means that there is a 50% chance that the actual claims cost can be paid with reserves; and, a 50% chance that the actual claims cost cannot be paid with reserves. Confidence levels above 50% increase the probability that sufficient funds will be available to pay the cost of existing and IBNR claims (i.e., if actual claims costs are higher than estimated claims costs, additional funds will be available to ensure claimants are paid).

The California Code of Regulations requires that private sector self insurance plans fund estimated liabilities at the 80% confidence level.<sup>6</sup> The purpose of this conservative requirement is to ensure that companies have set aside sufficient funds for their estimated claims liability in the event they declare bankruptcy or otherwise become incapable of funding their claims cost. However, because governments have taxing authority and are considered to be perpetual entities, public sector self insurance funds are not subject to these same regulations.

Despite this distinction, some public jurisdictions follow more conservative private sector practices. However, many jurisdictions do not follow these more conservative practices and, instead, have adopted policies that provide sufficient resources to pay the current cost of self-insurance claims liability and modest reserves for extraordinary settlement costs. In these instances, the jurisdictions' conduct a secondary analysis of their patterns of claim payments and exposure, fund current costs on a pay-as-you-go basis, and establish reserves at a lower level than would otherwise be necessary if following the actuary's assumptions. In these jurisdictions, management has recognized that maintaining extraordinary reserves for workers' compensation and other liability is unnecessary and can adversely impact current service levels.

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<sup>5</sup> Stockton CAFR, as of June 30, 2009, Notes to the Financial Statements, Note 13, Page 111.

<sup>6</sup> California Code of Regulations, Chapter 8, Subchapter 2, Article 13, §15475(d)(8).

For General Liability and Workers' Compensation, the City has established a 70% confidence level, which means that there is a 70% chance that sufficient reserves will be available and a 30% chance that reserves will not be available to pay the actual cost of claims. The table below shows five years of workers' compensation claims history.

**Table 4**  
**Historical Workers' Compensation Activity**  
**Based on the City's Audited Financial Statements**  
**FY 2005-06 through FY 2008-09**

Workers Compensation	FY 2004-05	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09
Beginning Unpaid Claims	40,847,000	43,219,000	35,077,000	37,246,000	40,097,000
Incurred (Includes IBNR)	8,471,000	-	8,177,000	9,723,000	13,051,000
Total Unpaid Claims	49,318,000	43,219,000	43,254,000	46,969,000	53,148,000
Actual Claim Payments	6,099,000	8,142,000	6,008,000	6,872,000	8,091,000
Ending Unpaid Claims	43,219,000	35,077,000	37,246,000	40,097,000	45,057,000
Due within One Year	6,519,000	6,921,000	6,373,000	6,245,000	6,735,000
Due After One Year	36,700,000	28,156,000	30,873,000	33,852,000	38,322,000
Total Assets	12,077,000	18,393,000	25,800,000	30,585,000	25,294,000
Over (Under) Total Claims Liability	(31,142,000)	(16,684,000)	(11,446,000)	(9,512,000)	(19,763,000)
Over (Under) Current Claims Liability	5,558,000	11,472,000	19,427,000	24,340,000	18,559,000
Cash Balance June 30	12,002,000	18,291,000	25,586,000	30,285,000	21,800,000

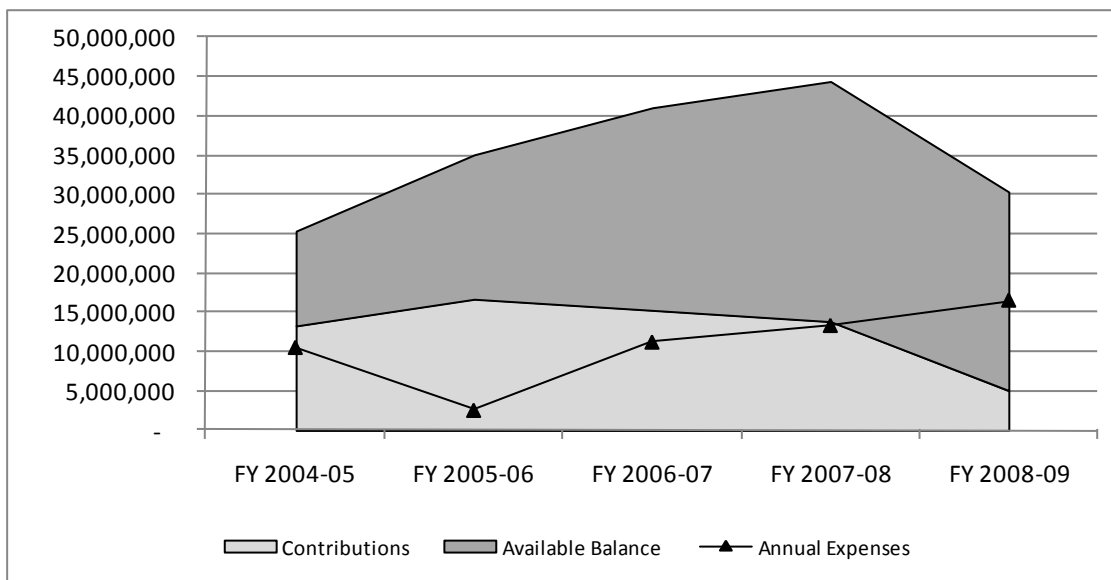
As shown, the annual budgeted resources available to the City to pay for the current annual cost of workers' compensation have historically far exceeded annual needs. For example, as of June 30, 2009, the City had resources amounting to approximately \$25.3 million for workers' compensation claims liability. While the City had a projected actuarially determined liability of \$45.1 million, only \$6.7 million was expected to be payable within one year. Further, the five-year average for actual claims payments totaled only \$7.0 million, with a high of \$8.1 million.

Many jurisdictions fund workers' compensation costs on a pay-as-you-go basis and establish reserves at a lower level than would otherwise be necessary if following the actuarial assumptions. In these jurisdictions, management has recognized that maintaining extraordinary reserves for workers' compensation and other liability is unnecessary and may adversely impact current service levels. The risks associated with this policy are best illustrated in the chart,

below, that compares fund balance and annual contributions by the City with actual claims expense.

### Exhibit 1

#### Comparison of Annual Department Charges, Annual Expenses and Liability Reserves for the Workers' Compensation Insurance Fund



Similarly, the City has now established a practice of budgeting and paying claims on a pay-as-you-go basis. This can be seen in the annual adopted budget by the significant reduction in the last two years of annual contributions. While we cannot reliably estimate the amount that could be returned at this time, due to activities and updated projections since June 30, 2009, based on the information available for this report, there appears to be up to \$18,559,000 million in reserve funding in the Workers' Compensation Insurance Internal Service Fund that could be made available in the short-term. The City may wish to consider utilizing a portion of these reserves to discount its funding obligations for Workers' Compensation in FY 2010-11.

Based on our review, neither the General Liability Insurance Internal Service Fund nor the Health Benefits Insurance Internal Service Funds held unrestricted fund balance or significant cash assets as of June 30, 2009.

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### *Employee Benefits Administration Internal Service Funds*

The City maintains two internal service funds for employee benefits administration as follows:

Retirement Benefits Internal Service Fund to account for the accumulation and payout of resources for the City's defined retirement plan administered through the California Public Employees' Retirement System (CalPERS) on a cost reimbursement basis. As detailed in the June 30, 2009 CAFR, the City has over-funded its Annual Required Contribution for the last two fiscal years for both the Safety Plan for sworn Police and Fire department personnel and for the Miscellaneous Plan which covers all other full-time employees. Further, the Safety and Miscellaneous plans were 95.6 percent and 95.9 percent funded, respectively. As of June 30, 2009, this fund had total unrestricted net assets of \$9.0 million, of which \$6.3 million was held as cash and investments.

Other Benefits Internal Service Fund to account for premiums and claims paid and administration of smaller insurance funds and benefits such as long-term disability, and life and insurance and termination pay benefits (i.e. compensated absences). Based on our review, given the trend of increasing expenditures, while the City has reduced charges for services in the Other Benefits Internal Service Fund over the past three years, no additional funds appear to be available over operating requirements.

## **Enterprise Funds**

The City of Stockton maintains four major enterprise funds and three smaller enterprise funds. Of the seven funds, only two, the Water Utility and Wastewater Utility Enterprise Funds appear to be economically self-sustaining with substantial unrestricted net assets of \$27.7 million and \$23.8 million, respectively. The other enterprise funds, including the Stormwater Utility and the Central Parking District, maintained deficit unrestricted net assets as of June 30, 2009, supported through loans from other funds.

As discussed in the Notes to the Financial Statements, a settlement agreement with the Howard Jarvis Taxpayers Association and approved by City Council in March 2009 established applicable services and costs to be funded from Water Utility, Wastewater Utility, and Stormwater Utility fees. Because the City had levied Water Utility and Wastewater Utility fees in prior years in excess of what was determined to be allowable per the settlement agreement, significant operating subsidies and loans to the General Fund were recognized in the financial statements as of June 30, 2009 for prior year activities.<sup>7</sup> Conversely, the General Fund had historically subsidized the Stormwater Utility and therefore, per the settlement agreement, a loan from the General Fund to the Stormwater Utility was also recognized in the financial statements as of June 30, 2009. In general, with the exception of support services, charges for services are restricted to funding enterprise operations and cannot support general government activities. Therefore, the substantial unrestricted net assets in the Water Utility and Wastewater Utility

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<sup>7</sup> Stockton CAFR, as of June 30, 2009, Notes to the Financial Statements, Note 15, Page 115-116.

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enterprise funds must be retained within the utilities, to reduce future charges or to fund future capital investments.

Many jurisdictions have consolidated wastewater and stormwater utility functions in one enterprise. The City should determine whether the Wastewater Utility and Stormwater Utility can be merged. This would not only ensure the on-going viability of Stormwater activities, but also allow for the consolidation and repayment of various loans, most importantly a net \$6.6 million due to the General Fund.

For the other enterprise funds, including the Central Parking District, Solid Waste, Downtown Marina, and Golf Courses activities, the City should review the operating health of each enterprise to determine whether:

- The enterprise could be economically viable by identifying on-going and available revenue sources or reclassifying current loans from contributing funds as one-time transfers of resources; or
- If not economically viable, the enterprise should be merged into other City operations and funds or whether the activity should be altogether exited.

## **Capital Projects Funds**

The City operates two major capital projects funds, the Capital Improvement Fund, and the Redevelopment Agency Fund, which are used to account for the acquisition, construction, and improvement of capital facilities. The Capital Improvement Fund has a reserved fund balance totaling \$24.3 million, primarily the result of \$20.5 million in loans to other City funds, of which \$17.1 million is a loan to the Redevelopment Agency. However, this reserve is \$7.9 million greater than available fund balance, indicating that the fund has been subsidized, primarily by the Water and Wastewater utilities, which was the subject of the recent settlement agreement. While 30-year repayment schedules have been developed for the amounts due to the Water and Wastewater Utilities, no such repayment plan exists for the Redevelopment Agency loan.

The Redevelopment Agency Fund's primary revenue is property tax increment receipts, which is restricted by law. The Redevelopment Agency Fund has a reserved fund balance totaling \$72.3 million, of which \$54.5 is reserved for capital projects. Additionally, the Redevelopment Agency is reporting loans of \$33.5 million as of June 30, 2009, including the \$17.1 million from the Capital Improvement Fund noted above, which has subsidized operations. In total, the Redevelopment Agency is showing deficit unrestricted net assets of \$45.3 million.

These capital project and redevelopment activities have been historically funded from a variety of sources, including bond proceeds, property tax increment, intergovernmental revenues, and transfers from other City funds, including the General Fund. The City reports that it is has

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detailed reconciliations of historical funding sources and uses by project. The City should then review these activities and balances in light of financial and policy considerations and develop specific repayment schedules and a long-term financial plan. Of particular importance is for the City to develop formal loan agreements for the Redevelopment Agency debt owed to other City funds. These loan agreements should always consider repayment schedules as well as any interest that should be accrued.

## **Comparison with Other Cities**

As part of this study, we compared financial information obtained for the City of Stockton with certain information obtained from other California cities. The cities chosen for this comparison have similar populations and scope of services that are provided to their citizens. As shown in Table 5, below, the City of Stockton had fund balance per capita of approximately \$78, which is 51.3 percent below the average of the surveyed jurisdictions of \$161. In addition, the City of Stockton had a lower fund balance as a percentage of annual expenditures than the average of 25.4 percent for surveyed jurisdictions. However, City of Stockton annual expenditures and expenditures per capita were comparable with the averages for surveyed jurisdictions.

As can be seen in the following table, the City of Stockton's General Fund balance, as measured per capita, is in the lower third of surveyed jurisdictions, and about 55 percent of the next highest jurisdiction, Chula Vista. In order to achieve greater General Fund balance reserves that are more consistent with peer agencies, the City will likely have to expend significantly less than average per capita than surveyed jurisdictions. Of interest is that the most comparable jurisdiction appears to be the City of Modesto, which is geographically proximate to the City of Stockton.

**Table 5**  
**Comparison of General Fund Balances**  
**in California Cities with Comparable Populations**

Rank	City	Annual Expenditures	General Fund Ending Balance	Percent of Annual Expenditures	Estimated Population	Expenditure Per Capita	Fund Balance Per Capita	Date of Financial Statements
1	Glendale	150,941,000	125,663,000	83.3%	207,303	728.12	606.18	06/30/09
2	Irvine	162,957,000	110,196,000	67.6%	212,793	765.80	517.86	06/30/09
3	Riverside	218,572,000	77,379,000	35.4%	300,430	727.53	257.56	06/30/09
4	Bakersfield	161,595,848	51,074,468	31.6%	333,719	484.23	153.05	06/30/09
5	Anaheim	252,732,000	52,259,000	20.7%	348,467	725.27	149.97	06/30/09
6	Fremont	123,293,029	31,099,353	25.2%	215,636	571.76	144.22	06/30/09
7	Chula Vista	144,160,193	33,149,521	23.0%	233,108	618.43	142.21	06/30/09
8	Modesto	111,939,414	14,753,758	13.2%	210,088	532.82	70.23	06/30/09
9	Santa Ana	217,274,663	16,335,714	7.5%	355,662	610.90	45.93	06/30/09
10	San Bernardino	144,052,242	2,708,319	1.9%	204,483	704.47	13.24	06/30/09
	AVERAGE	170,730,710	43,217,237	25.3%	268,265	636.43	161.10	06/30/09
	Stockton	174,132,000	22,782,000	13.1%	290,409	599.61	78.45	06/30/09

While full examinations of the financial statements for the surveyed jurisdictions were not conducted for this study, it is clear from this limited review that the City of Stockton has a lower General Fund balance, both per capita and as a percentage of annual expenditures, as compared to jurisdictions surveyed.

## Summary

Based on our review of the City of Stockton's Comprehensive Annual Financial Report (CAFR) for the years ending June 30, 2007, 2008 and 2009; the adopted budgets for FY 2008-09 and FY 2009-10, we have identified up to a potential \$32.9 million in additional resources, which after further review could be recognized by the City Council and made available to fund various department expenditures. A summary of each source is provided in the following table.

**Table 6**  
**Summary of Potentially Available Resources**  
**As of June 30, 2009**

Source	Description	Potentially Available
Special Revenue Funds	Unrestricted fund balance that appears to not be restricted by any third party or legal requirements	2,233,000
Internal Service Funds - Vehicle and Equipment Funds	Unrestricted fund balance not required for working capital needs per Federal and State guidelines	5,778,000
Internal Service Funds - Workers' Compensation Insurance Fund	Surplus cash and investment balance that exceed expenses to be payable within one year	18,559,000
Internal Service Funds - Retirement Benefits	Unrestricted net assets supported by surplus cash and investment balance	6,283,000
TOTAL		\$ 32,853,000

Note: Phase 2 of our analysis found that the City has significantly reduced the available resources in the Workers' Compensation Insurance Fund to ease the financial pressures on the General Fund, as recommended in this report. Please refer to the Phase 2 report for additional information.

Included in the internal service fund (ISF) monies listed in the table would be some amounts that would appropriately be returned to funds other than the General Fund. However, most of these amounts would be General Fund monies. An additional consideration for the availability of the internal service fund cash balances is that the City's bond ratings, required for debt issuance including the annual Tax Revenue Anticipation Notes (TRANS), is dependent upon the City's liquidity and availability of cash balances to repay obligations should revenues not be realized.

Please note that these estimates are based on historical balances and activities and may be impacted by current financial activities and projections for FY 2009-10 and the next fiscal period. An assessment of where actual results of operations might differ significantly from estimates included in the FY 2009-10 budget, preliminary projections for FY 2009-10, and the FY 2010-11 forecast will be the focus of the next phase of our analysis.

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If you have any questions regarding this report, we can be reached at (415) 552-9292 or by email at [sfoti@harveyrose.com](mailto:sfoti@harveyrose.com) and [cmartin@harveyrose.com](mailto:cmartin@harveyrose.com).

Sincerely,

Stephen Foti  
Principal

**List of Attachments:**

Attachment 1: City of Stockton Analysis of Fund Balances  
Attachment 2: City of Stockton Analysis of Internal Service Funds

## CITY OF STOCKTON ANALYSIS OF FUND BALANCES

Use of Fund Surpluses/Balances	FY 2006-07	FY 2007-08	FY 2008-09
<b>General Fund</b>			
Beginning Fund Balance*	31,468,000	28,992,000	23,125,000
Reserved	5,169,000	13,498,000	14,175,000
Unreserved But Designated	15,761,000	9,627,000	8,607,000
Unreserved and Undesignated			
Ending Fund Balance	20,930,000	23,125,000	22,782,000
Cash and Investments	3,959,000	3,463,000	6,934,000
Annual Operating Expenses	176,488,000	182,000,000	174,132,000
Surplus	0	0	0
Fund Balance as a % of Annual Operating Expenses	11.9%	12.7%	13.1%

\* FY 2007-08 Beginning Fund Balance restated by an increase of \$8,062,000 due to a prior period adjustment recording an advance to the Other Governmental Development Services Fund.

## CITY OF STOCKTON ANALYSIS OF FUND BALANCES

Use of Fund Surpluses/Balances	FY 2006-07	FY 2007-08	FY 2008-09
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### SPECIAL REVENUE FUNDS

#### Public Facilities Impact Fees

Beginning Fund Balance	55,246,000	58,997,000	60,517,000
Reserved	58,997,000	60,517,000	50,691,000
Unreserved But Designated			
Unreserved and Undesignated			
Ending Fund Balance	58,997,000	60,517,000	50,691,000
Cash and Investments	60,291,000	61,607,000	51,401,000
Total Revenue	24,687,000	27,686,000	8,087,000
Total Expenses	20,847,000	26,029,000	17,776,000
Total Surplus	0	0	0

## CITY OF STOCKTON ANALYSIS OF FUND BALANCES

Use of Fund Surpluses/Balances	FY 2006-07	FY 2007-08	FY 2008-09
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### CAPITAL PROJECTS FUNDS

#### Capital Improvement Fund

Beginning Fund Balance	32,100,000	23,797,000	33,085,000
Reserved	21,121,000	22,039,000	24,322,000
Unreserved But Designated for Capital Projects	2,676,000	11,046,000	(7,907,000)
Unreserved and Undesignated			
Ending Fund Balance	23,797,000	33,085,000	16,415,000
Cash and Investments	66,000	11,479,000	12,888,330
Total Revenue	8,840,000	12,316,000	7,323,000
Total Expenses	10,806,000	46,942,000	13,569,000
Total Surplus	0	0	0

#### Redevelopment Agency

Beginning Fund Balance	(20,510,000)	70,411,000	45,559,000
Reserved	100,986,000	81,912,000	72,268,000
Unreserved But Designated for Capital Projects	(30,575,000)	(36,353,000)	(45,341,000)
Unreserved and Undesignated			
Ending Fund Balance	70,411,000	45,559,000	26,927,000
Cash and Investments	106,140,000	81,384,000	63,674,000
Total Revenue	29,990,000	33,231,000	32,459,000
Total Expenses	21,873,000	39,287,000	54,832,000
Total Surplus	0	0	0

## CITY OF STOCKTON ANALYSIS OF FUND BALANCES

Use of Fund Surpluses/Balances	FY 2006-07	FY 2007-08	FY 2008-09
<b>ALL OTHER GOVERNMENTAL FUNDS</b>			
Beginning Fund Balance*	92,350,000	121,524,000	149,948,000
Reserved	113,643,000	124,900,000	137,336,000
Unreserved But Designated	233,000	503,000	358,000
Unreserved and Undesignated	18,687,000	24,545,000	7,741,000
Ending Fund Balance	132,563,000	149,948,000	145,435,000
Cash and Investments	43,278,000	59,538,000	48,528,000
Total Revenue	118,437,000	91,759,000	76,514,000
Total Expenses	124,582,000	103,116,000	99,670,000
Total Surplus	18,687,000	24,545,000	7,741,000

\* FY 2007-08 Beginning Fund Balance restated by a decrease of \$11,039,000 due to several prior period adjustments including reducing federal revenues recorded, increasing deposits held, and recording a liability for an advance from the General Fund.

## CITY OF STOCKTON ANALYSIS OF FUND BALANCES

Use of Fund Surpluses/Balances	FY 2006-07	FY 2007-08	FY 2008-09
<b>PROPRIETARY OR ENTERPRISE FUNDS</b>			
<b>Water Utility</b>			
Beginning Net Assets	99,492,000	109,730,000	116,066,000
Investments in Capital Assets net of Related Debt	87,305,000	90,381,000	95,936,000
Restricted	2,951,000	3,801,000	3,206,000
Unrestricted and Undesignated	19,474,000	21,884,000	27,725,000
Ending Net Assets	109,730,000	116,066,000	126,867,000
Cash and Investments	22,197,000	22,833,000	21,303,000
Annual Operating Revenues	23,092,000	22,875,000	24,253,000
Annual Operating Expenses	19,952,000	20,301,000	22,408,000
Surplus	19,474,000	21,884,000	21,303,000
Net Assets as a % of Annual Operating Expenses	550.0%	571.7%	566.2%
<b>Wastewater Utility</b>			
Beginning Net Assets	289,129,000	294,243,000	297,168,000
Investments in Capital Assets net of Related Debt	240,552,000	246,931,000	243,129,000
Restricted	43,854,000	35,722,000	32,157,000
Unrestricted and Undesignated	9,837,000	14,515,000	23,760,000
Ending Net Assets	294,243,000	297,168,000	299,046,000
Cash and Investments	10,679,000	11,510,000	7,160,000
Annual Operating Revenues	33,094,000	33,640,000	35,593,000
Annual Operating Expenses	36,782,000	34,867,000	44,410,000
Surplus	9,837,000	11,510,000	7,160,000
Net Assets as a % of Annual Operating Expenses	800.0%	852.3%	673.4%

## CITY OF STOCKTON ANALYSIS OF FUND BALANCES

Use of Fund Surpluses/Balances	FY 2006-07	FY 2007-08	FY 2008-09
<b><u>Stormwater Utility</u></b>			
Beginning Net Assets	49,098,000	53,404,000	56,636,000
Investments in Capital Assets net of Related Debt	50,843,000	52,901,000	52,506,000
Restricted			
Unrestricted and Undesignated	2,561,000	3,735,000	(7,852,000)
Ending Net Assets	53,404,000	56,636,000	44,654,000
Cash and Investments	2,550,000	3,096,000	2,345,000
Annual Operating Revenues	5,088,000	6,160,000	5,498,000
Annual Operating Expenses	7,219,000	6,663,000	8,129,000
Surplus	2,550,000	3,096,000	(7,852,000)
Net Assets as a % of Annual Operating Expenses	739.8%	850.0%	549.3%
<b><u>Central Parking District</u></b>			
Beginning Net Assets	8,465,000	8,434,000	7,799,000
Investments in Capital Assets net of Related Debt	9,588,000	8,030,000	7,490,000
Restricted	45,000	45,000	45,000
Unrestricted and Undesignated	(1,199,000)	(276,000)	(171,000)
Ending Net Assets	8,434,000	7,799,000	7,364,000
Cash and Investments	87,000	709,000	859,000
Annual Operating Revenues	3,474,000	3,815,000	3,934,000
Annual Operating Expenses	2,588,000	3,357,000	3,086,000
Surplus	(1,199,000)	(276,000)	(171,000)
Net Assets as a % of Annual Operating Expenses	325.9%	232.3%	238.6%

## CITY OF STOCKTON ANALYSIS OF FUND BALANCES

Use of Fund Surpluses/Balances	FY 2006-07	FY 2007-08	FY 2008-09
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### INTERNAL SERVICE FUNDS

<u>All Funds</u>			
Beginning Net Assets*	3,776,000	7,415,000	(10,602,000)
Net Assets- Unrestricted	1,378,000	(20,740,000)	(57,395,000)
Ending Net Assets	12,293,000	(10,602,000)	(47,353,000)
Cash and Investments	48,961,000	55,684,000	45,124,000
Total Assets	185,637,000	195,962,000	191,224,000
Total Liabilities	173,344,000	206,564,000	238,577,000
Annual Operating Revenues	102,343,000	108,061,000	101,549,000
Annual Operating Expenses	97,451,000	122,882,000	135,509,000
Surplus	1,378,000	(20,740,000)	(57,395,000)

\* FY 2007-08 Beginning Net Assets restated by a decrease of \$4,878,000 to record a liability for compensated absences.

## CITY OF STOCKTON ANALYSIS OF INTERNAL SERVICE FUNDS

	FY 2006-07	FY 2007-08	FY 2008-09
<b>All Internal Service Funds</b>			
Beginning Net Assets*	3,776,000	7,415,000	(10,602,000)
Net Assets- Unrestricted	1,378,000	(20,740,000)	(57,395,000)
Ending Net Assets	12,293,000	(10,602,000)	(47,353,000)
Cash and Investments	48,961,000	55,684,000	45,124,000
Total Assets	185,637,000	195,962,000	191,224,000
Total Liabilities	173,344,000	206,564,000	238,577,000
Annual Operating Revenues	102,343,000	108,061,000	101,549,000
Annual Operating Expenses	97,451,000	122,882,000	135,509,000
Surplus	1,378,000	(20,740,000)	(57,395,000)

\* FY 2007-08 Beginning Net Assets restated by a decrease of \$4,878,000 to record a liability for compensated absences.

<b>Vehicle and Equipment Funds (1)</b>			
Beginning Net Assets	17,485,000	16,359,000	17,541,000
Net Assets- Unrestricted	5,444,000	7,490,000	8,973,000
Ending Net Assets	16,359,000	17,541,000	18,972,000
Cash and Investments	6,707,000	8,736,000	11,034,000
Total Assets	17,630,000	20,097,000	22,779,000
Total Liabilities	1,271,000	2,556,000	3,807,000
Annual Operating Revenues	15,512,000	18,994,000	19,924,000
Annual Operating Expenses	19,081,000	20,063,000	19,438,000
Surplus	5,444,000	7,490,000	8,973,000

(1) Comprised of the Central Garage, Computer Equipment, Radio Equipment, and Other Equipment Internal Service Funds.

## CITY OF STOCKTON ANALYSIS OF INTERNAL SERVICE FUNDS

	FY 2006-07	FY 2007-08	FY 2008-09
<b>Insurance Funds (2)</b>			
Beginning Net Assets	(20,946,000)	(13,231,000)	(37,153,000)
Net Assets- Unrestricted	(13,231,000)	(37,153,000)	(72,690,000)
Ending Net Assets	(13,231,000)	(37,153,000)	(72,690,000)
Cash and Investments	31,477,000	34,850,000	25,760,000
Total Assets	31,914,000	35,969,000	30,078,000
Total Liabilities	45,145,000	73,122,000	102,768,000
Annual Operating Revenues	45,316,000	46,225,000	41,088,000
Annual Operating Expenses	40,233,000	72,409,000	79,830,000
Surplus	(13,231,000)	(37,153,000)	(72,690,000)

(2) Comprised of the General Liability Insurance, Workers' Compensation Insurance, and Health Benefits Insurance Internal Service Funds.

<b>Employee Benefit Funds (3)</b>			
Beginning Net Assets*	7,237,000	4,287,000	9,010,000
Net Assets- Unrestricted	9,165,000	8,923,000	6,322,000
Ending Net Assets	9,165,000	9,010,000	6,365,000
Cash and Investments	10,767,000	12,098,000	8,330,000
Total Assets	136,090,000	139,896,000	138,367,000
Total Liabilities	126,928,000	130,886,000	132,002,000
Annual Operating Revenues	41,515,000	42,842,000	40,437,000
Annual Operating Expenses	38,137,000	30,410,000	36,241,000
Surplus	9,165,000	8,923,000	6,322,000

\* FY 2007-08 Beginning Net Assets restated by a decrease of \$4,878,000 to record a liability for compensated absences.

(3) Comprised of the Retirement Benefits and Other Benefits Internal Service Funds.