



City of Lincoln

Financial Mismanagement, Insufficient Accountability,
and Lax Oversight Threaten the City's Stability

March 2019

REPORT 2018-110





CALIFORNIA STATE AUDITOR

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March 21, 2019
2018-110

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

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report pertaining to the city of Lincoln and its administration of public funds and assets. This report concludes that Lincoln’s mismanagement of public funds, insufficient accountability, and inadequate oversight threatens its financial stability. Specifically, the city made questionable loans, transfers, and allocations during fiscal years 2013–14 through 2016–17 that did not always follow state law. The city used reserves from restricted funds designated for specific purposes for unrelated interfund loans and transfers, even though it was not able to demonstrate that the borrowing funds could repay them. Additionally, Lincoln misrepresented its financial position by temporarily transferring amounts from a restricted fund to offset significant year-end deficits, thereby presenting those funds as if they were solvent.

Lincoln also overcharged developers and builders for the cost of water infrastructure and capacity, which resulted in the city accumulating nearly \$41 million in its water connections fund as of June 2017. In addition, Lincoln undercharged developers for city staff costs to administer development projects. Until fiscal year 2018–19, Lincoln based these charges on cost data from 13 years ago, even though staff costs have increased by an average of 6 percent per year since that time. Further, Lincoln failed to pay for its own use of municipal utilities and instead passed these costs on to ratepayers, violating provisions of the state constitution. Although the city acknowledged that it should have paid more than \$1.6 million for its share of water, sewer, and solid waste services during a four-year period from January 2014 to February 2018, it has yet to provide equitable consideration to its ratepayers.

Finally, Lincoln did not establish or consistently follow key policies and procedures to ensure compliance and transparency in its financial practices, which resulted in questionable spending and management of public funds. In each of its past several financial audits, Lincoln’s external financial auditor reported recurring deficiencies, including the city’s inability to accurately prepare its financial statements at the end of each fiscal year.

Respectfully submitted,

A handwritten signature in black ink that reads "John Billington". The signature is written in a cursive, flowing style.

JOHN BILLINGTON
Chief Deputy State Auditor

Selected Abbreviations Used in This Report

CAFR	comprehensive annual financial report
GFOA	Government Finance Officers Association

CONTENTS

Summary	1
Introduction	3
Lincoln Made Questionable Loans, Transfers, and Allocations That Did Not Always Comply With State Law	9
Lincoln Did Not Accurately Charge the Public for Certain City Services	19
Lincoln Did Not Establish or Consistently Follow Key Policies and Procedures to Ensure the Appropriate Management of Public Funds	25
Other Areas We Reviewed	33
Appendix	
Scope and Methodology	37
Response to the Audit	
City of Lincoln	41

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SUMMARY

Incorporated in 1890, the city of Lincoln operates under the council-manager form of government: its city council is responsible for its governance, while a city manager oversees the city's operations. From 2000 through 2010, Lincoln was one of the fastest growing cities in the nation, expanding from 11,000 to 43,000 residents. However, by the end of the decade, the local and national economies were in decline, and Lincoln's development was severely curtailed. The city experienced significant fiscal challenges as a result. In fact, Lincoln fully depleted its unrestricted general fund balance in fiscal year 2008–09, although it had increased the balance to \$8.7 million by fiscal year 2016–17. In recent years, a citizens group raised concerns related to Lincoln's finances, including its interfund loans and transfers, the fees it charged the public, its use of municipal utilities, and its general management of public funds. Our report concludes the following:

Lincoln Made Questionable Loans, Transfers, and Allocations That Did Not Always Comply With State Law

Page 9

Lincoln established restricted funds related to its different functions to ensure that it uses the revenue it receives for the purposes for which that revenue was intended. However, it used those funds to make unrelated interfund loans and transfers that it may not be able to repay. Further, as a result of loans and transfers, the city misrepresented the financial position of several funds: although these funds had year-end deficits, the loans and transfers made them appear as though they had positive fund balances. Finally, Lincoln violated the state constitution by using surplus revenue that property owners in certain areas paid in landscaping and lighting assessments to cover costs associated with properties in other areas.

Lincoln Did Not Accurately Charge the Public for Certain City Services

Page 19

Lincoln overcharged developers and builders for water infrastructure and capacity, thereby accumulating a fund balance of nearly \$41 million as of June 2017. Further, Lincoln undercharged the public for other services, such as building inspections and permit administration. Lincoln also violated provisions of the state constitution by failing to pay for its own use of municipal utilities, including water, sewer, and trash collection; it instead passed these costs on to ratepayers through increased utility rates. Lincoln has not refunded or provided equitable consideration to ratepayers for the increases in their rates resulting from the city's use of utilities.

Lincoln Did Not Establish or Consistently Follow Key Policies and Procedures to Ensure the Appropriate Management of Public Funds

Lincoln lacks key policies and procedures to ensure consistency, compliance, and transparency in its financial practices. Moreover, Lincoln did not follow its existing policies by obtaining the appropriate approval from the city manager or the city council for expenditures, resulting in questionable spending.

In addition, we reviewed the city's failure to update its master fee schedule and its inability to substantiate fee credits it granted to developers, as well as other issues related to its investment portfolio and a councilmember's activities. We found that Lincoln could improve its processes in some of these areas, and we present the related recommendations in the section of this report titled Other Areas We Reviewed beginning on page 33.

Summary of Recommendations

To ensure that it complies with state law, Lincoln should immediately review all outstanding interfund loans and confirm that the loans can be repaid.

To comply with state law, Lincoln should immediately discontinue using restricted funds to subsidize other unrelated funds that have year-end deficits.

To ensure that its fees are commensurate with the cost of providing services, Lincoln should develop and begin following by June 2019 a timeline for conducting fee studies of each of its services.

Lincoln should develop a plan to provide equitable consideration to ratepayers for the utility costs they incurred that were higher than necessary because of the city's practice of not paying for its own municipal utilities.

Lincoln should establish and follow policies and procedures for financial practices recommended by the Government Finance Officers Association.

The city manager should immediately develop and implement procedures for staff to obtain and document the required approval from the city manager or the city council before committing city resources.

Agency Comments

Lincoln agreed with all of our recommendations and indicated that it has already begun implementing some of them. We look forward to reviewing Lincoln's 60-day, six-month, and one-year responses to our recommendations to evaluate its progress.

INTRODUCTION

Background

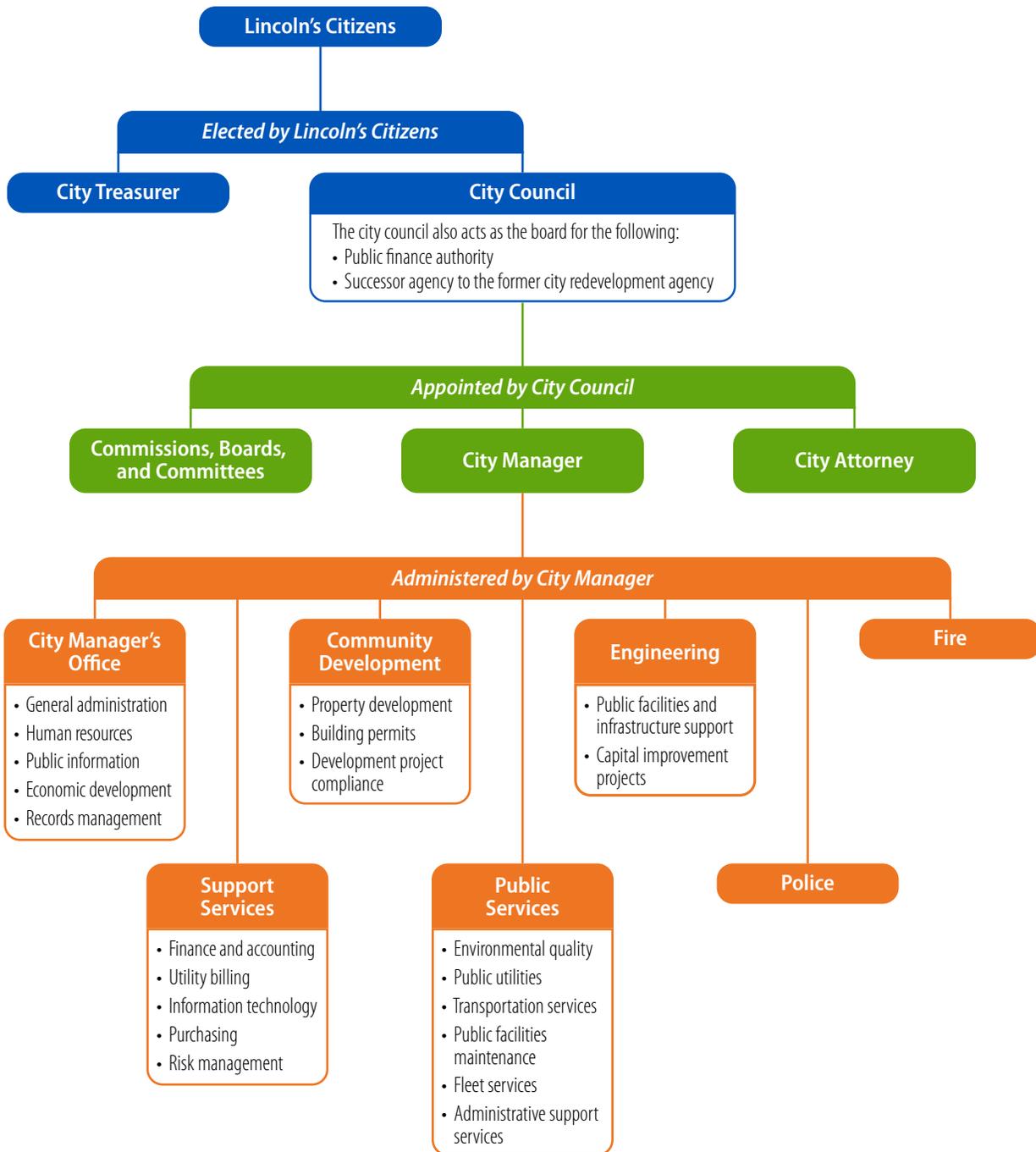
Incorporated in 1890, Lincoln is located 27 miles northeast of Sacramento in Placer County. The city, which occupies about 22 square miles, serves a population of more than 47,000 residents and administered more than 2,400 active business licenses as of December 2018. Lincoln employs about 150 full-time employees to provide a range of services, including public safety, water, sewer, garbage collection and disposal, library, community development, and general administration. It obtains water from a wholesale water supplier, Placer County Water Agency (Placer Water). Lincoln also operates a municipal airport and transit system.

City Governance

Lincoln is a general law city, which means that state law establishes its form of government and that it is subject to state law in its ability to govern municipal affairs. As a general law city, it operates under the council-manager structure: the city council is responsible for the city's governance, while the city manager administers its operations. The city council is composed of five elected officials, each serving a four-year term. Figure 1 on the following page shows Lincoln's elected officials, the positions that the city council appoints, and the departments that the city manager administers. The city uses a mayoral rotation system to select a councilmember to serve as mayor each year. Before the November 2018 election, four of the five councilmembers had served six years or longer. During the election, Lincoln voters elected two new councilmembers, who took office in December 2018.

The city manager reports to the city council and is responsible for the efficient administration of all Lincoln's operations. The city manager appoints and supervises the directors of the city departments, who present staff reports and recommendations to the city council. The city manager's office administers personnel functions, manages public information activities, oversees economic development activities, and coordinates records management. The city manager is also responsible for ensuring the enforcement of all laws and ordinances applicable to city governance. Lincoln's most recent city manager served from February 2015 through July 2018, when he resigned. The city council appointed an interim city manager in July 2018, and the term of his contract expired in January 2019. The city's director of public services, who also currently serves as Lincoln's interim director of support services, is now also serving as interim city manager until the council hires a permanent replacement.

Figure 1
Overview of Lincoln’s Government



Source: Lincoln’s comprehensive annual financial report, website, and ordinance.

One of the primary responsibilities of the director of support services is to oversee Lincoln's financial operations. In this capacity, the director of support services manages the city's financial reporting, utility billing, purchasing, information technology, and risk management. The director of support services also participates in the development of the budget and coordinates the city's interactions with the external auditor responsible for conducting its annual financial audits. The most recent director of support services, who had served in that role at various times since 2006, separated from the city in January 2019, during our audit.

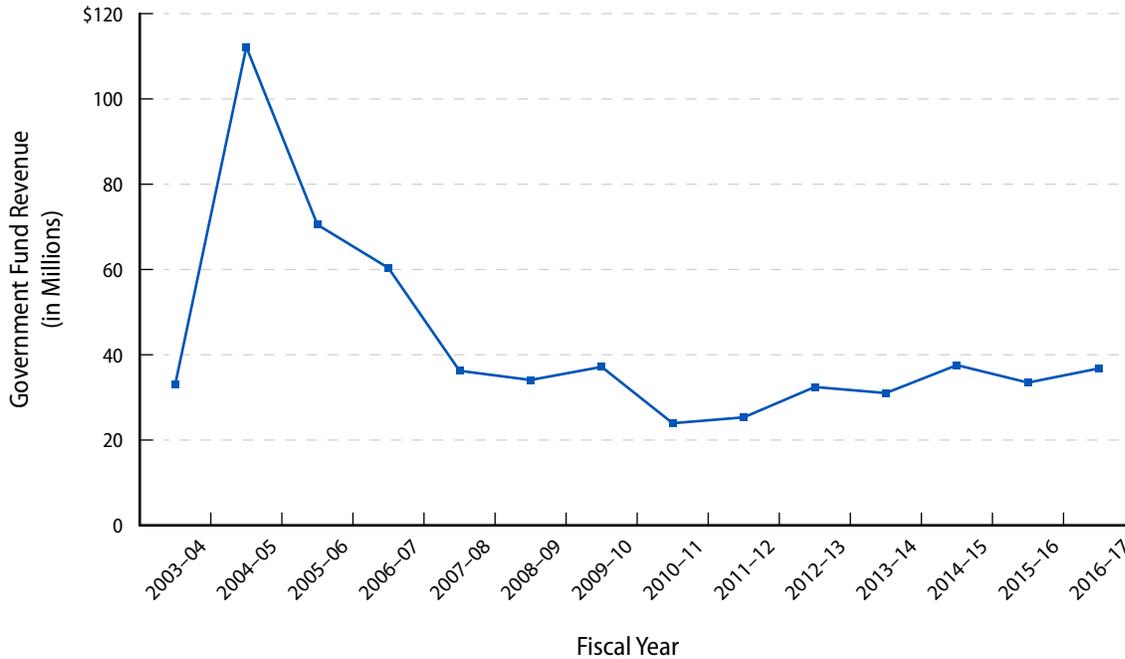
Lincoln, like other cities, uses fund accounting to comply with legal requirements. Among its other characteristics, fund accounting involves tracking financial activity using restricted and unrestricted funds. For example, Lincoln's general fund is classified as an unrestricted fund, meaning that the city can use revenue from this fund to pay for any type of government activity. However, other funds are classified as restricted funds, requiring that Lincoln use their revenue only for the specific purposes designated in state law or municipal code. For instance, state law requires Lincoln to spend revenue in the water connections fund only for expanding its access to water capacity. Additionally, Lincoln's municipal code requires it to spend revenue in its oak tree preservation fund to plant new oak trees or maintain existing trees within the city.

Rapid Growth Followed by a Sharp Decline

From 2000 through 2010, Lincoln experienced tremendous growth, expanding from 11,000 to 43,000 residents. In fact, during that decade, Lincoln was the nation's fastest growing city of more than 10,000 residents. From 2000 through 2005, it processed an average of 1,852 construction permits annually for new single-family dwellings, with a high of 2,845 permits in 2005. However, with the collapse of the national and local real estate markets after 2007, new construction permits for single-family dwellings in Lincoln fell dramatically, to only 90 permits for the entire year of 2010. Although the number of permits rose after 2010, averaging 229 each year from 2013 through 2017, it has yet to come close to the peak in 2005.

The change in Lincoln's governmental fund revenue was similar to the growth and decline in the city's construction. The majority of Lincoln's revenue in its governmental funds, which includes the general fund, comes from taxes and charges for services. As Figure 2 on the following page shows, the city's revenue peaked in fiscal year 2004–05 at \$112 million, followed by a sharp decline to less than \$24 million in fiscal year 2010–11. In recent years, the city has experienced some modest revenue growth, rising from \$31 million in fiscal year 2013–14 to \$37 million in fiscal year 2016–17.

Figure 2
Lincoln's Government Fund Revenue Rapidly Grew in Fiscal Year 2004–05, Followed by a Significant Decline



Source: Lincoln's comprehensive annual financial reports.

As Table 1 shows, Lincoln's general fund revenue has been higher than its expenditures in recent years. From fiscal years 2004–05 through 2016–17, Lincoln's general fund revenue fluctuated from \$10.6 million to \$17.8 million annually, while its general fund expenditures ranged from \$9.8 million to \$16 million during the same period. During that period, the city set aside a certain amount of its general fund balance for specific purposes. For instance, in fiscal year 2016–17, it set aside a \$2 million reserve in case of a catastrophic emergency. Since fiscal year 2004–05, Lincoln's unrestricted general fund balance has varied significantly, plummeting as low as \$0 in fiscal year 2008–09 and rebounding to \$8.7 million in fiscal year 2016–17.

Table 1
Lincoln's General Fund Revenue Generally Exceeded Its Expenditures
(in Millions)

FISCAL YEAR	REVENUE	EXPENDITURES	UNRESTRICTED FUND BALANCE
2004–05	\$10.6	\$9.8	\$4.2
2005–06	11.4	12.1	3.1
2006–07	13.9	13.3	5.3
2007–08	14.1	15.8	2.7
2008–09	12.9	16.0	0.0
2009–10	15.5	14.1	2.5
2010–11	12.3	13.0	4.1
2011–12	12.1	11.9	3.5
2012–13	13.9	13.2	3.7
2013–14	14.3	12.8	3.8
2014–15	15.7	13.7	5.6
2015–16	16.0	14.8	6.5
2016–17	17.8	15.5	8.7

Source: Lincoln's comprehensive annual financial reports.

Concerns Over City Finances

In 2016 a local citizens group began raising concerns about possible financial improprieties in Lincoln. In February 2017, the group initially submitted a claim to the city for refunds of overcharges, alleging that the city's water rates were not proportional to the city's actual cost of providing water to customers. The group alleged that Lincoln violated the provisions of Proposition 218, a constitutional amendment adopted by the voters in 1996 to limit the ability of local governments to impose taxes, assessments, charges, and fees based on property ownership. After the city denied the claim, the group sued it in April 2017. As a result of a mediated settlement, Lincoln agreed to refund residential ratepayers for overcharges from February 2016 to the date the city adopted new water rates, which it did effective October 2018. The city council later decided to provide refunds to commercial ratepayers and to extend its refunds for both groups back to January 2014, when Lincoln first implemented the contested water rates.

Concurrent with its review of Lincoln's water funds, the citizens group identified several other concerns. It claimed that Lincoln forgave millions of dollars in fees that developers owed the city,

while allowing them to continue with their projects. The group also claimed that Lincoln misused public funds by engaging in questionable interfund borrowing and overcharging citizens and ratepayers for rates or fees for services. The group further claimed in December 2017 that Lincoln had not paid for its own water use, and it also claimed that the city falsified reports to the California Department of Water Resources to conceal its water use. In January 2018, the city council initiated an independent investigation, which revealed that city councilmembers, former city managers, and certain city staff were in fact aware that Lincoln had not paid for its own water usage. According to the independent investigation, the city and the public were put on notice of this practice as early as 2004. The concerns that the citizens group raised ultimately led to this audit.

Lincoln Made Questionable Loans, Transfers, and Allocations That Did Not Always Comply With State Law

Key Points

- Lincoln risks violating state law by making loans between funds that it may not be able to repay. From fiscal years 2013–14 through 2017–18, the city council approved four interfund loans totaling \$13.6 million, even though none of the loan agreements demonstrate that the borrowing funds had the ability to repay the loans.
- Lincoln misrepresented the financial position of certain funds by temporarily transferring amounts to these funds from a restricted fund to offset significant year-end deficits. From fiscal years 2013–14 through 2016–17, Lincoln used surpluses from the water connections fund to offset negative cash balances in the airport, fire, drainage, parks, and regional sewer funds at the end of each fiscal year.
- Lincoln violated the state constitution by allocating surplus revenue from some landscaping and lighting zones—regional areas where the city charges the property owners for landscaping, lighting, and other services in public areas within those regions—to offset deficits in other zones. Because Lincoln did not discretely account for the revenue and expenditures from each zone, property owners in certain zones subsidized the costs of benefits that owners in other zones received.

Lincoln Risks Violating State Law by Making Loans Between Funds That It May Not Be Able to Repay

Lincoln did not follow its policies pertaining to interfund loans and advances, increasing its risk of violating state law. According to the interim city manager, Lincoln did not have a policy governing interfund loans until 2013. Once in place, the policy required the city council to approve loans and advances between funds that would not be repaid within 90 days of the end of the current fiscal year. The policy also required that the city establish a formal repayment schedule for each loan, demonstrate an ability to repay the loan without negatively affecting either the lending or borrowing fund, and identify the funding source that the borrowing fund would use to repay the loan.

However, we found that the city council approved loans from restricted funds to other funds that clearly did not have the capacity to repay those loans. Table 2 on the following page shows that from fiscal years 2013–14 through 2017–18, Lincoln had eight outstanding interfund loans. The city council approved four of these loans before it adopted its interfund loan and advance policy in 2013, whereas it approved the other four—which totaled \$13.6 million—after the adoption of the policy. None of the loans the city council approved from fiscal years 2013–14 through 2017–18 met the policy's requirements. For example, instead of containing repayment schedules, these loan agreements simply stated that repayment would begin when funds were available.

Further, none of the agreements or accompanying staff reports for the eight loans demonstrated that the borrowing funds had the ability to repay the loans. Although the loans made before 2013 were not subject to the interfund loan and advance policy, we would have expected Lincoln to have demonstrated the ability to repay the loans to show that they were truly loans, rather than subsidies.

Table 2
The City Council Approved Interfund Loans Without Payment Schedules or Repayment Ability, Leading to Several Loans Not Being Repaid

DATE OF LOAN	AMOUNT LOANED (IN MILLIONS)	LENDING FUND	BORROWING FUND	AMOUNT OUTSTANDING AS OF 6/30/18, INCLUDING INTEREST (IN MILLIONS)
Loans made before 2013 that remain outstanding				
September 1988	\$0.9	Sewer	Redevelopment	\$0.3
August 2008	1.9	Solid Waste	Drainage	1.0*
January 2010	3.9	Water Connections	Redevelopment	4.2
June 2010	0.9	Housing	Redevelopment	0.2
Subtotals	\$7.6			\$5.7
Loans made after the city established the 2013 interfund loan policy				
November 2014	\$3.7	Water Connections	Sewer	\$0.0
June 2016	5.3	Water Connections	Fire	5.3
June 2016	2.3	Library	Fire	0.0†
June 2016	2.3	Oak Tree Preservation	Fire	2.3
Subtotals	\$13.6			\$7.6
Totals	\$21.2			\$13.3

Source: Lincoln's loan agreements and tracking document.

* We identified two additional interfund loans that Lincoln made to its drainage fund to address the outstanding balance of this loan. Although Lincoln retroactively dated the loans as of June 30, 2018, the city council approved these loans in September 2018, after the end of fiscal year 2017–18. We, therefore, excluded them from this table.

† Lincoln repaid this loan using available funding from a developer forgoing a refund of impact fees.

When requesting the city council's approval of these loans, the former director of support services did not provide councilmembers with pertinent information in his staff reports. For example, in June 2016, the city council approved the refinancing of three interfund loans that Lincoln had used to build firehouses in 2006. The refinancing was necessary because the terms of the original loans had ended and the fire fund had not repaid them. The new loans totaled \$9.9 million, with terms of 10 years. In his staff report to the city council, the former director of support services correctly asserted that the interfund loan and advance policy requires that the city council approve in advance loans between funds that the funds will not repay within 90 days after the

end of the current fiscal year. However, he did not identify that the policy requires the city to provide specific documentation for such loans, including a repayment schedule. Although the former director of support services claimed that the previous city manager did not provide him guidance to include more information and detail in his reports, he acknowledged that city ordinances require him to keep the city council fully advised of the financial condition and needs of the city. Moreover, we believe that he and his staff should have been aware of the city's policy regarding interfund loans and followed it.

Notwithstanding the former director of support services failing to provide the city council with complete information regarding these loans, we would have expected the city council to ensure that the loans complied with city policy. Of the five city councilmembers serving during our audit, four were not only members when the city council approved the loans in 2016 but also were members when the city council approved the 2013 policy governing interfund loans and advances. The four councilmembers told us that they expect staff to provide them with adequate information to make policy decisions. Nonetheless, we believe that these councilmembers should have been aware of the interfund loan requirements. However, at the June 2016 city council meeting, the city council approved the three interfund loans that did not meet the city's policy requirements.

In addition to not following its own policy, Lincoln risked violating state law when it made these interfund loans because it used excess revenue from its restricted funds to provide loans to other funds that do not have similar purposes. As we discussed in the Introduction, cities such as Lincoln use restricted funds to set aside revenue designated for specific purposes according to state or local laws. However, Lincoln used several restricted funds—such as the water connections fund, the oak tree preservation fund, the solid waste fund, and the library fund—to make interfund loans to other funds with unrelated purposes. Under state law, restricted funds may make loans to other funds as long as the restricted fund has a surplus, the loan does not interfere with the purpose of the restricted fund, and the borrowing fund repays the loan as soon as possible, with interest. In addition, Lincoln's policy requires that the city establish evidence of the ability to repay the loan.

However, Lincoln could not demonstrate that it could repay any of the four loans it made from fiscal years 2013–14 through 2017–18, as its policy requires, or any of the four outstanding loans from before our audit period, as we would consider a good business practice. For example, the city council approved a \$3.9 million loan in 2010 from the water connections fund to its redevelopment agency, despite the fact that city staff identified that the redevelopment agency did not have the ability to repay the loan. In addition, as Table 2 shows, the fire fund owed about \$5.3 million to the water connections fund and \$2.3 million to the oak tree preservation fund as of June 2018, yet it had not made

any payments to either lending fund since the start of the 10-year loan period in 2016. Moreover, if the fire fund's revenue remains consistent with the amounts recorded from fiscal years 2013–14 through 2016–17, it will earn less than \$1 million in cumulative revenue over the next eight fiscal years—far less than the \$7.6 million outstanding on the loans. Therefore, it is unlikely that the fire fund will be able to repay its obligations by the end of the loan period in 2026. The former director of support services acknowledged that he had concerns when establishing the loans that the fire fund would not have the ability to repay them unless the city identified alternative funding sources. However, he could not explain why he proceeded with the loan and sought the city council's approval.

As we discuss previously, a city may loan surplus amounts from restricted funds to other funds as long as the loan does not interfere with the purpose of the lending fund. Table 3 identifies four such funds that had significant surplus revenue as of June 30, 2017. Although Lincoln currently has plans or is in the process of developing plans to spend the surpluses in three of these funds, it has not demonstrated a similar level of commitment to reducing the surplus of its water connections fund. The water connections fund includes water capacity charges that the city collects from developers and property owners, and the fund has accumulated a surplus because Lincoln overcharged these fees. In certain instances, it may be reasonable for a city to maintain surplus funds, such as when it is saving for major projects. However, Lincoln could not provide documentation that it was planning such projects for the water connections fund. In addition, the city was unable to explain why it did not reduce its water capacity charges to reflect the costs of providing the related service.

Table 3
Lincoln Accumulated Surpluses in Restricted Funds That It Used for Interfund Loans
(in Millions)

LENDING FUND	CASH BALANCE AS OF JUNE 30, 2017 (NET OF LOANS)*
Water Connections	\$24.1
Library	1.9
Solid Waste	1.8
Oak Tree Preservation	1.3
Total	\$29.1

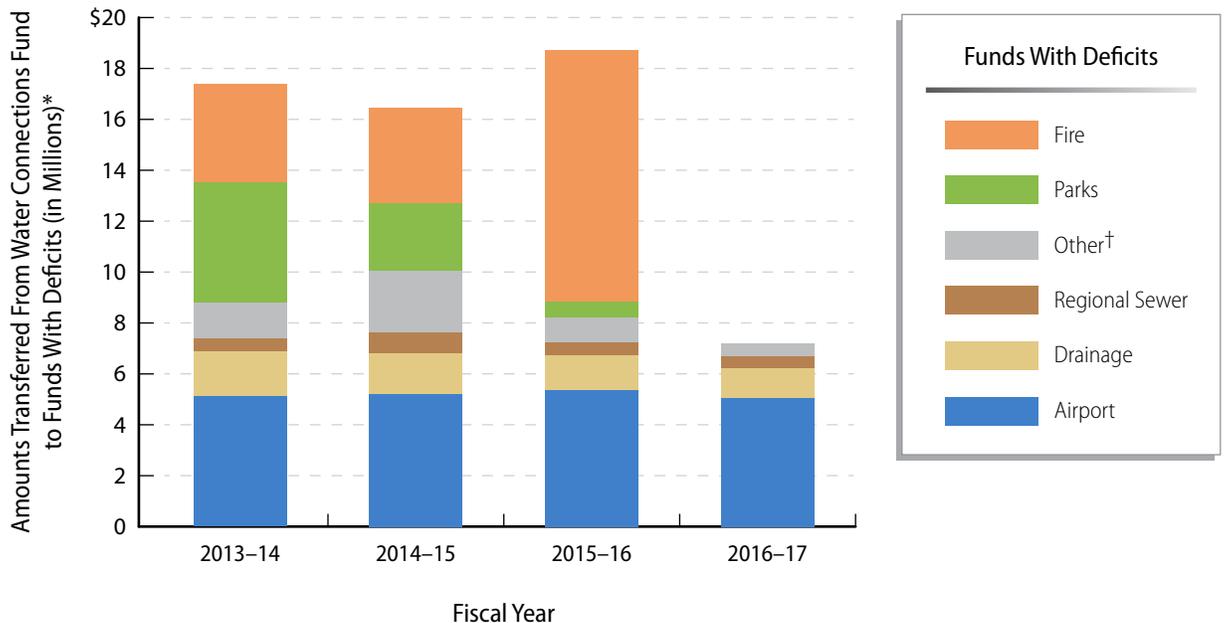
Source: Analysis of Lincoln's interfund loans, financial records, and comprehensive annual financial reports.

* We present the cash balance of each fund as of the end of fiscal year 2016–17 because Lincoln had not issued its audited financial statements for fiscal year 2017–18 at the time we conducted our analysis. The interim city manager anticipated that the financial audit for fiscal year 2017–18 would not be completed until March 2019.

Lincoln Inappropriately Utilized a Restricted Fund to Offset Year-End Deficits in Other Funds

In addition to making questionable interfund loans from its restricted water connections fund, Lincoln temporarily transferred amounts from this fund to offset significant year-end deficits in other funds, and as a result, it misrepresented its financial position in its annual financial statements. From fiscal years 2013–14 through 2016–17, some of Lincoln’s funds—including the airport, fire, drainage, parks, and regional sewer funds—ended most fiscal years with negative cash balances. These balances resulted from the city’s various practices, including operating its airport with an ongoing structural deficit and funding infrastructure projects, public facilities, and parks without having sufficient revenue from its fire, drainage, and parks funds to pay for these activities. As Figure 3 shows, Lincoln used interfund transfers ranging from a total of \$7 million to \$19 million each year to offset the year-end deficits in these funds.

Figure 3
Lincoln Inappropriately Transferred Reserves Each Fiscal Year From Its Water Connections Fund to Offset Year-End Deficits in Other Funds



Source: Analysis of Lincoln’s accounting records and financial statements.

* Lincoln posted these transfers to its accounting records to take effect on June 30, the last day of the fiscal year, but transferred the same amounts back to the lending fund the next day or shortly thereafter. The city repeated this process in subsequent fiscal years.

† Other funds include a federal grant fund and a capital project fund.

The city made these transfers on a temporary basis using the cash surplus in its water connections fund. Specifically, Lincoln posted journal entries to its accounting records when closing its books at the end of fiscal years 2013–14 through 2016–17. Recording these entries on June 30, the last day of the fiscal year, allowed the city to present the financial condition of the funds in its year-end financial statements as if they were solvent. Each year, the city reversed the journal entries effective July 1, or shortly thereafter, after preparing its financial statements. The former director of support services acknowledged that he was aware that these transactions from the water connections fund were potentially inappropriate at the time he made them, but he did so because the general fund did not have sufficient reserves to eliminate the other funds' year-end deficits. Further, he acknowledged that he authorized these transfers without seeking approval from the city manager or the city council, as the city's 2013 interfund loan and advance policy requires. Although these accounting transactions did not involve any actual transfer of money between financial institutions or bank accounts, they concealed the true financial condition of those funds with negative balances.

As a result of the transfers, Lincoln misrepresented its financial position by using the surplus in its water connections fund to offset year-end deficits in other funds, thereby presenting those funds as if they were solvent. For example, Lincoln's airport fund ended fiscal year 2016–17 with a negative cash balance of approximately \$5 million. The former director of support services authorized a journal entry to report a higher amount of cash in the airport fund, as well as several other funds, by reducing the ending balance of cash in the water connections fund. Consequently, he was able to report a positive cash balance of \$11,000 in the airport fund at the end of fiscal year 2016–17.

.....

Lincoln misrepresented its financial position by using the surplus in one fund to offset year-end deficits in other funds.

.....

According to guidance from the Government Finance Officers Association (GFOA), a transfer made without a reasonable expectation of repayment does not represent a loan. Instead, it should be classified as a subsidy. In the previous example, the former director of support services acknowledged that the airport fund was unable to demonstrate the ability to repay the loan. State law restricts the use of the water connections fund to certain activities, so Lincoln cannot use it to subsidize any unrelated city service.

Instead, Lincoln must use unrestricted funds, such as its general fund, to subsidize deficits in other funds. However, we confirmed the former director of support services' assertion that Lincoln's interfund loans and transfers exceeded its unassigned general fund balance in the years in question. Table 4 shows that Lincoln recorded significant interfund loans and transfers—ranging between \$26 million and \$37 million—from its restricted funds in its accounting records from fiscal years 2013–14 through 2016–17. In fiscal year 2016–17, Lincoln had an unassigned year-end general fund balance of nearly \$9 million, but this amount was insufficient to cover the city's \$26 million in interfund loans and transfers. Consequently, Lincoln will need to identify alternative financing or revenue sources, such as bonds or one-time revenue, to address these deficits.

Table 4
Lincoln Made Significant Loans and Transfers From Restricted Funds to Other Funds
(in Millions)

FISCAL YEAR	TOTAL AMOUNT OF OUTSTANDING INTERFUND LOANS	TOTAL AMOUNT OF INTERFUND TRANSFERS FROM THE WATER CONNECTIONS FUND	TOTAL
2013–14	\$16.8	\$17.2	\$34.0
2014–15	20.5	16.5	37.0
2015–16	14.4	18.7	33.1
2016–17	18.7	7.2	25.9

Source: Analysis of Lincoln's financial statements and its outstanding loans and transfers.

Lincoln's external auditor also reported similar concerns with the city's interfund loans and transfers. Specifically, in each of the annual financial audits from fiscal years 2013–14 through 2016–17, the external auditor reported deficiencies in Lincoln's interfund loan and transfer practices, which we believe resulted in the city's misrepresenting certain fund balances in its financial reports. In each fiscal year, the external auditor reported that Lincoln misstated its interfund borrowings by classifying interfund transfers as short-term borrowings, even though the city never demonstrated the ability of these respective funds to repay the transfers within the subsequent fiscal year. The city agreed with the finding each year and repeatedly stated that city staff would reclassify these transfers as long-term loans; however, it has not taken any such action.

Similar to what we observed, the external auditor reported that Lincoln used revenue from a restricted fund to offset the year-end deficits in other funds. According to the external auditor, Lincoln's

use of restricted funds for these transactions represented an “ineligible” use of funds because the city should not use restricted funds to offset its cash deficits. The external auditor recommended that Lincoln use its general fund as the source for future transfers. However, because the general fund has insufficient resources to cover the funds’ ongoing deficits, Lincoln may need to identify additional revenue sources, reduce its general fund expenditures, or take other actions to lessen the need for the transfers. Otherwise, increasing its other anticipated general fund expenditures could jeopardize the solvency of Lincoln’s general fund.

We asked Lincoln’s external auditor about its perspective on the city’s use of interfund transfers. Although it reported the city’s practice as a significant deficiency in its summary of findings in its recent audit report, the external auditor informed us that it did not consider the issue to rise to the level of significance that would lead it to change its audit opinion from an unmodified, or clean opinion. The external auditor indicated that the city fully disclosed the transfers, and that city management agreed to resolve the issue going forward. Nevertheless, we believe that by presenting the funds that received the transfers as having positive fund balances, the city misled the public regarding its financial stability and presented an artificially high general fund balance.

Lincoln Violated the State Constitution by Allocating Surplus Revenue to Offset Deficits in Its Landscaping and Lighting Zones

We also found that Lincoln allocated surplus revenue from some landscaping and lighting zones to offset deficits in other zones. State law authorizes cities to form landscaping and lighting maintenance districts, and within these districts to group similar regional areas into zones to pay for landscaping, lighting, and other services in public areas. These districts levy assessments to property owners to pay for public improvements or services—such as landscaping or lighting for parks and streetscapes—that benefit their properties. Lincoln has 33 zones within its district, each of which represents a group of properties that substantially receive the same degree of benefit from public improvements.

The state constitution imposes certain limitations on the ability of local governments to levy assessments, including that the amount of the assessment cannot be more than necessary to cover the reasonable costs of the landscaping and lighting services and that the allocation of the costs must bear a fair or reasonable relationship to the benefits each property owner receives. However, Lincoln did not discretely account for the revenue and expenditures from each of its zones, which is necessary to ensure that it allocates the appropriate costs to the property owners in each zone. Lincoln

failed to allocate these costs appropriately, resulting in property owners in certain zones subsidizing the costs of benefits received by property owners in other zones. Because it allocated costs to property owners that were not proportionate to services it provided to them, Lincoln violated the state constitution.

Lincoln allocated costs to property owners that were not proportionate to services it provided to them.

In April 2018, the director of public services provided a staff report to the city council acknowledging that the city had not historically tracked revenue and expenditures by zone. For fiscal year 2018–19, the city estimated that five of the 33 zones would have a combined deficit of \$474,000 because the costs of maintaining those zones' landscaping and lighting exceeded the assessment revenue the city collected from the zones' property owners. For example, in the staff report, Lincoln estimated that for fiscal year 2018–19, it will collect only \$498,000 in assessment revenue for one of its zones, despite expecting to incur costs of \$1,043,000 for landscaping and lighting services in that zone. Lincoln indicates it will contribute an additional \$116,000 to that zone from its general fund in fiscal year 2018–19, which would still leave a deficit of \$429,000. The staff report shows that this zone accounts for most of the five zones' combined deficit of \$474,000.

To address the five zones with ongoing deficits, the city will need to increase the assessments in those zones through voter approval by property owners. Otherwise, the city will need to reduce services in those zones or subsidize their deficits with the general fund. For most zones in the landscaping and lighting district, the city included an annual escalation factor in the assessment to account for inflation. However, it did not implement such a factor for the one zone previously mentioned when it was established in the 1980s, so the revenue for that zone has remained the same, while the cost of maintenance has increased over time.

In addition to the need for tracking revenue and expenditures discretely for each landscaping and lighting zone, Lincoln did not pay its share of expenditures for each of its zones. State law requires the city to conduct an evaluation and prepare a report each year to apportion the costs associated with the general benefit of city maintenance in each zone. The general benefit is the portion of costs for parks, streetscapes, and lighting that provides value to

nonresidents and the city overall for which the city should pay this share of costs from the general fund. However, contrary to state law, the city had historically not apportioned any costs to the general fund. In particular, Lincoln did not begin calculating and allocating the cost of the general benefit until April 2018. For fiscal year 2018–19, Lincoln estimates the total cost of its landscaping and lighting maintenance to be \$3.3 million, of which the city determined the general fund should pay \$324,000.

Recommendations

To ensure that it complies with state law, Lincoln should immediately review all of its outstanding interfund loans to determine whether the borrowing funds can repay the loans according to the terms. For any loan that is from a restricted fund and that does not have the capacity to be repaid, Lincoln should develop a plan that ensures repayment within a reasonable time frame, including seeking possible alternative financing or revenue sources, such as the general fund, bonds, one-time revenue, or a tax increase, to address the obligation.

To ensure that city staff provides the city council adequate information to make its decisions regarding interfund loans and transfers, the city council should immediately collaborate with the city manager and department directors to establish formal expectations regarding the content of staff reports, and it should hold the city manager accountable for ensuring all staff reports meet those expectations.

To ensure that it avoids accumulating surpluses, Lincoln should establish policies and procedures by August 2019 requiring it to review its fund balances at least annually and, if necessary, reduce its fees within a reasonable time frame.

To comply with state law, Lincoln should immediately discontinue its practice of using restricted funds to subsidize other funds that have year-end deficits and that lack the ability to permanently repay the transfers within 90 days of the close of the fiscal year.

To ensure that it complies with the state constitution, Lincoln should establish and adhere to procedures that account for revenue and expenditures in each landscaping and lighting zone separately, and it should discontinue its use of surplus revenue from one zone to offset a deficit in another zone. It should take these actions by June 2019.

By June 2019, Lincoln should establish accounting procedures to ensure that it records all costs of city maintenance from the appropriate funds, including apportioning the general benefit costs to the general fund.

Lincoln Did Not Accurately Charge the Public for Certain City Services

Key Points

- Lincoln overcharged developers and builders for the cost of water infrastructure and capacity. Because its capacity charges were not commensurate with the amounts it pays for water infrastructure and capacity, the city had accumulated a fund balance of nearly \$41 million as of June 2017.
- Lincoln charged developers for city services using hourly rates that did not represent the current costs of its staff time. Until fiscal year 2018–19, Lincoln used rates that it based on cost information from fiscal year 2005–06. Consequently, the city undercharged the public for many of its services.
- Lincoln violated provisions of the state constitution by failing to pay for its own use of municipal utilities, instead passing these costs on to ratepayers. The city acknowledged that it should have paid more than \$1.6 million for its share of water, sewer, and solid waste services during the four-year period from January 2014 through February 2018.

Lincoln Overcharged Developers and Builders for the Cost of Water Infrastructure and Capacity

Lincoln overcharged its customers, which include developers and builders, for water capacity charges. A water capacity charge is a one-time fee that Lincoln assesses at the time it issues a building permit. The water capacity charge is intended to cover the city's cost of obtaining specified amounts of water for a location, including the infrastructure needed to treat and transmit water to that location. It is not the charge for the actual water, but the charge for reserving water so that it is available when needed. In its contract with Placer Water, its water supplier, Lincoln defines *capacity* as the maximum amount of water per day that the city may require Placer Water to deliver.

State law prohibits the water capacity charge from exceeding the estimated reasonable cost of providing the service. According to guidance from the League of California Cities, a city should prepare a fee study when it identifies the public services and infrastructure that will require funding through its fees. Conducting a fee study provides the quantified basis for the imposition of fees and helps the city account for its current funds and capacity, as well as planned projects going forward. Therefore, at the time Lincoln purchased capacity from Placer Water, it should have conducted a study that contemplated these factors to ensure that the fees it planned to charge aligned with the costs of the capacity it purchased and of any anticipated future expansion of capacity.

In lieu of performing a fee study that considered the costs of Lincoln's current capacity and its future capacity needs, the city council enacted an ordinance to allow the city to charge its customers an amount based on Placer Water's assumption that an average dwelling would use 1,150 gallons of water per day. However, the director of public services informed the city council in September 2018 that an average dwelling in Lincoln uses only 650 gallons per day—slightly more than one half of Placer Water's assumption—leading us to question the reasonableness of the fees Lincoln charged its customers. According to the director of public services, the city staff members who were involved in setting those fees are no longer employed by the city. She speculated that Lincoln likely took this approach because Placer Water's fee incorporated what the city understood to be an industry-standard water usage amount per dwelling.

According to the former director of support services, Lincoln has not purchased additional water capacity since 2008. The director of public services informed us that Lincoln purchased more capacity and infrastructure than it needed at that time because it was able to take advantage of a discounted rate in anticipation of future growth. The city engineer indicated that depending on the rate of new development within the city, Lincoln may not need to purchase additional capacity for the next 10 to 25 years. Further, in a November 2018 staff report to the city council, he indicated that Lincoln currently has almost 5 million gallons in water capacity reserved with Placer Water beyond the amount the city would use on a peak day, which is 35 percent more than its current needs. Lincoln's actions appear to have contributed to the increase in the fund balance of its water connections fund, which the city reported was nearly \$41 million as of June 2017. Although it may be reasonable for Lincoln to maintain additional water capacity and to retain reserve funds for future water acquisitions, infrastructure needs, or unforeseen emergencies, the interim city manager stated that the city did not have documented plans as of January 2019 for any of these purposes. Rather, as we discuss previously, Lincoln has used these reserves to make loans and transfers to other funds.

Further, Lincoln continued to increase its water capacity charges unnecessarily each year. For example, the city charged \$12,909 for fiscal year 2013–14 for a low-density single-family dwelling but increased the charge over time to \$15,862 for fiscal year 2016–17, resulting in Lincoln collecting nearly \$4 million in capacity charges in fiscal year 2016–17. The director of public services informed us that she and the city engineer discovered in 2015 that the city's actual water usage did not align with Placer Water's per-dwelling usage assumption, resulting in the city overcharging for water capacity charges. However, we did not find any evidence that the city took action to align the capacity charges with the actual water usage per dwelling.

Therefore, by not conducting a fee study that contemplated Lincoln's actual capacity needs, accumulating a \$41 million fund balance without documented plans to expand its water capacity, and unnecessarily increasing its water capacity charges annually, the city overcharged its customers, which is a potential violation of state law. In November 2018, the city engineer recommended to the city council that it approve a fee study to establish appropriate water capacity charges. The city engineer also suggested approving a temporary ordinance adjusting water capacity charges until the study is complete. During that same month, the city council authorized a fee study to establish appropriate water capacity charges, and in January 2019, the city council adopted the temporary ordinance adjusting water capacity charges to align them with the anticipated actual water usage, which in many cases lowered the water capacity charge. Lincoln also issued a request for proposals in January 2019 for an external consultant to conduct a water capacity fee study.

Lincoln Did Not Fully Recover Costs of Its Staff's Time for City Services It Provided to Developers

In contrast to the overcharges we discuss previously, we identified certain services for which Lincoln undercharged the public. Lincoln's master fee schedule includes hourly rates for position classifications throughout the city, such as an accountant or a building inspector. These staff rates represent the amounts the city charges the public to cover the hourly cost for city staff to perform development services, such as conducting building inspections and processing permits. However, Lincoln has been using outdated staff rates that do not represent the current costs of staff time for these services.

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Lincoln has been using outdated staff rates that do not represent the current costs of staff time for services.

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Until fiscal year 2018–19, Lincoln used staff rates that it calculated based on cost information from fiscal year 2005–06. The city most recently recalculated its staff rates in fiscal year 2012–13, which reflected increases in personnel costs since fiscal year 2005–06. However, the former director of support services informed us that the city waited until July 2018 to adopt these updated rates. The former director of support services stated that Lincoln did not adopt the updated rates in 2012 because the city attorney at that time advised that the city council would need to approve the updated rates, and

city management did not believe that the city council would do so. The former director of support services indicated that Lincoln did not update its staff rates after 2012 because it did not have the requisite staff or time needed to produce a new hourly rate schedule.

Even after implementing the 2012 rate schedule in fiscal year 2018–19, Lincoln has apparently continued to undercharge the public for costs related to development projects because the staff rates it implemented are most likely outdated as a result of inflation and wage increases after 2012. The city was already aware of certain personnel cost increases during the previous six years from 2006 to 2012, when it developed its rates for 2012. For example, the rate for the director of development services increased by \$47 per hour from 2006 to 2012, while the rate for a senior planner increased by \$24 per hour. In fact, we noted that the rates for certain staff positions increased by more than 30 percent. According to its comprehensive annual financial reports for fiscal years 2014–15 through 2016–17, Lincoln’s overall general fund expenditures increased an average 6 percent each fiscal year primarily because of increased salary and benefit expenditures, which leads us to conclude that staff rates should also have increased. Lincoln incorporates both direct staffing costs, such as salaries and benefits, and indirect costs, such as administrative overhead, into its calculation of the staff rates. Likewise, the city includes these same costs in its annual budget, meaning that the city council essentially endorses the amount of the staff rates through its approval of the annual budget. Therefore, it would seem reasonable for the city to update the staff rates in its master fee schedule at the same time that the city council approves the annual budget.

Lincoln Did Not Pay for Its Own Use of Municipal Utilities

We also found that Lincoln violated provisions of the state constitution by failing to pay for its own municipal utilities—water, sewer, and solid waste services—and instead passing these costs on to ratepayers. The city uses these utilities in its general operations, such as using water for irrigating city parks. As we discuss previously, in 1996 the voters adopted Proposition 218, a constitutional amendment that limits the ability of local governments to impose taxes, assessments, charges, and fees based on property ownership. According to Proposition 218, the amount that the city can charge to ratepayers shall not exceed the cost of the service attributable to the parcel receiving the service. The city uses independent rate studies to determine the amount of fees to charge to ratepayers for their use of utilities. The rate studies identify the city’s anticipated cost to provide those services. However, the city’s 2013 utilities rate study did not include anticipated revenue that Lincoln should have paid from various funds, such as the general fund, to each of the utility funds for the city’s own use of these utilities.

According to a March 2018 staff report, by excluding the city's share of utility usage, the city's cost to provide these services to ratepayers was higher than if it had used this revenue to offset the costs factored in its calculation of rates. The staff report estimated that from January 2014 through February 2018, the city should have paid \$1.3 million for its water use, \$252,000 for its solid waste use, and \$55,000 for its sewer use, for an estimated total of more than \$1.6 million. However, the director of public services, who developed the staff report, explained that the amount that the city should have paid for its water use was difficult to estimate—and was likely underestimated—because the city had about 40 unmetered water accounts during that time. Because it did not track the water usage for these accounts, the city was unable to determine the costs pertaining to those accounts in its estimation of the city's water use.

Although various city councilmembers, former city managers, and department directors were aware of Lincoln's failure to pay for its municipal utilities, the city did not promptly correct the issue. In response to a group of concerned residents who questioned the city's practice of not paying for its own water, the city council authorized an independent investigation in January 2018 to determine when city officials first became aware that the city had not paid for its own water use. The external law firm the city assigned to the investigation issued its report in April 2018. It determined that city management and the city council were aware as early as 2004 that Lincoln did not pay for its own water use yet failed to rectify the issue. Specifically, the law firm found that a 2004 water rate study prepared by an external consultant highlighted that the city only partially metered its own water use and recommended that the city meter and pay for all of its water use to comply with Proposition 218.

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City management and the city council were aware as early as 2004 that Lincoln did not pay for its own water use yet failed to rectify the issue.

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Additionally, the investigative report cited interviews in 2018 with a former city attorney, a former councilmember, and the city's mayor at that time, each of whom recalled a closed session during a council meeting in 2011 in which the city council discussed Lincoln's practice of not directly billing itself for water. The mayor recalled management indicating that the city did not have the funds available to pay for its water use. According to the investigative report, many factors appear to have contributed to the city not

addressing these issues sooner, such as its unprecedented growth in the early 2000s, its financial problems resulting from the 2008 recession, and staff and management turnover, particularly within the support services department.

Furthermore, the city has not refunded ratepayers for increases in rates it charged them as the result of its own, unpaid use of utilities. According to the city attorney, claims for refunds related to the city's utility use have a statute of limitations of one year, meaning that ratepayers seeking refunds of fees or charges cannot recover any amounts the city collected more than one year before the ratepayers presented their claims to the city. Although Lincoln is not legally required to issue refunds, it could consider doing so as a matter of public benefit, which it has acknowledged. Specifically, a March 2018 staff report informed the city council that it could choose to refund the costs paid by ratepayers beyond the one-year statute of limitations by passing a resolution declaring the public purpose of the refund and the commensurate benefit to the city, such as improved public trust in local government. However, the city council had not chosen to issue refunds as of February 2019.

Recommendations

Lincoln should immediately commence a fee study that ensures its fees for water capacity are commensurate with the costs of current and planned future water capacity needs. To the extent that Lincoln has previously overcharged for water capacity fees, it should develop a plan to provide equitable consideration to those who overpaid such fees, and it should eliminate any unnecessary surplus in the water connections fund.

To ensure that its fees are commensurate with the cost of providing services, Lincoln should develop and follow a timeline by June 2019 for conducting periodic fee studies for each of its services, including updating its staff rates annually.

To the extent allowable by law, the city council should develop a plan by August 2019 to provide equitable consideration to ratepayers for the utility costs they incurred that were higher than necessary because of the city's practice of not paying for its own water, sewer, and solid waste services.

To ensure transparency to the public, beginning with its fiscal year 2019–20 budget, Lincoln should specify in its annual budget the amount that it intends to spend for the use of municipal utilities—water, sewer, and solid waste—and the funds that it intends to use to pay for these costs.

Lincoln Did Not Establish or Consistently Follow Key Policies and Procedures to Ensure the Appropriate Management of Public Funds

Key Points

- Lincoln did not establish sufficient financial policies and procedures to ensure that it manages public funds appropriately. Specifically, Lincoln’s lack of budgeting policies and procedures resulted in insufficient transparency with the public and a failure to provide adequate information to the city council so that it could make informed decisions.
- Lincoln did not consistently follow its policies and procedures for approving expenditures, resulting in the authorization of some questionable expenditures.
- Lincoln did not address audit deficiencies that its annual financial audits repeatedly noted. For example, it did not address the city’s lack of adequate year-end closing procedures, which resulted in material misstatements in its draft financial statements and delayed completion of the city’s comprehensive annual financial reports (CAFRs).

Lincoln Did Not Establish Sufficient Financial Policies and Procedures

Lincoln does not have sufficient policies and procedures to ensure consistency, compliance, and transparency in its financial practices. The GFOA recommends that governments implement specific financial, accounting, reporting, and budgeting policies and procedures, including those intended to facilitate the review, discussion, modification, and adoption of a proposed budget. The text box summarizes some of the key policies the GFOA recommends. In many instances, Lincoln has not established such policies and procedures, and in instances where it has established policies and procedures, it did not always follow them.

Lincoln could have addressed many of the issues we discuss throughout this report if it had sufficiently adopted and followed comprehensive financial

Key Budgeting Policies and Procedures That the GFOA Recommends

Fees and Charges: Adopt policies that identify the manner in which fees and charges are set. These policies may address the frequency with which cost-of-services studies will be undertaken.

Balancing the Budget: Develop a policy that defines a balanced budget and provides for disclosure when a deviation occurs.

Revenue Diversification: Adopt a policy that encourages a diversity of revenue sources. A diversity of revenue sources can improve a government’s ability to handle fluctuations in revenue.

One-Time Revenue: Adopt a policy limiting the use of one-time revenue for ongoing expenditures. A government should explicitly define one-time revenue and allowable uses for that revenue.

Debt Management: Adopt policies to help ensure that the government issues and manages debt prudently to maintain a sound fiscal position.

Budget Review: Develop a set of procedures that facilitate the review, discussion, modification, and adoption of a proposed budget.

Adjusting the Budget: Have procedures in place to determine when deviations from the budget plan merit adjustments to the budget.

Communication: Institute a process that includes an examination of strengths and weaknesses of the organizational structure and of the communication of goals and directives.

Source: GFOA’s Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting, (1998).

policies and procedures. For example, Lincoln does not have a policy pertaining to its establishment of fees and charges. Despite having maintained a significant reserve in its water connections fund for at least 10 years, Lincoln did not reduce the water capacity charges to its customers, as we discuss previously. Developing and following a policy pertaining to its fees would help Lincoln ensure that its fees align with the cost of services. Further, as we discuss in the Introduction, the recession had a significant negative financial impact on Lincoln. We find it surprising that Lincoln has not subsequently developed a revenue diversification policy to protect itself financially in the event of another severe market downturn.

Lincoln's lack of budget review procedures resulted in it taking actions that were not sufficiently transparent to the public and in staff failing to provide the city council with enough information to make informed decisions. The GFOA acknowledges that because most budgets inevitably reflect a compromise of goals and priorities, creating clear and accepted processes for facilitating the review, discussion, modification, and adoption of a proposed budget will help promote acceptance and timely approval. However, Lincoln has not established any such written procedures. The investigative report we previously discuss concluded that during the development of the fiscal year 2016–17 budget, the director of public services proposed including Lincoln's municipal water use as a distinct expenditure in the budget. However, the report states that the former director of support services was not comfortable including this item in the budget. Consequently, the city council does not appear to have discussed the director of public services' proposal, and the city continued to violate Proposition 218.

Lincoln's lack of budget review procedures resulted in it taking actions that were not sufficiently transparent to the public.

The city council's lack of formal expectations for its budget process resulted in practices that were not sufficiently transparent. Although the city council's investigative report indicated that some councilmembers were aware that Lincoln had not paid for its municipal water use, a majority of city councilmembers informed us that they learned in December 2017—months after the city council passed the budget—about Lincoln's failure to pay for its own use of municipal water. As we previously note, city councilmembers indicated that they expect staff to provide them with adequate information to make policy decisions. For instance,

one councilmember informed us that he relies on staff to highlight any significant changes they make to the budget. However, the duty statements for the city manager and the director of support services do not specify requirements for communicating with the city council about significant changes to the budget. Further, Lincoln does not have formalized procedures to guide its communication among city staff of goals and directives. Having such procedures would help the city council formally communicate its expectations to management, thereby mitigating instances of staff not sharing information from the city council and the public.

Although the former director of support services acknowledged that Lincoln did not have many written policies and procedures for budgeting, Lincoln included a summary in its approved fiscal year 2018–19 budget titled *Key Budget Policies* that the city informed us represents Lincoln’s formal policies and procedures. This summary cites some policies that Lincoln has formalized through city council resolutions, such as a debt management policy that describes the city’s policy objectives, parameters, and guidelines for issuing debt. However, the summary also references other areas for which Lincoln cannot demonstrate that it had established formal policies. For example, the summary addresses fees at a very high level, simply stating that the city will review its fees to assure that they reflect actual costs and that the city council will adopt a fee schedule. In contrast, the GFOA recommends that policies on fees and charges include specific detail on the frequency with which a city will undertake fee studies, which the city’s summary does not address. Based on the concerns that we previously describe about the city’s fees not always aligning with its costs of providing services, we believe that the city’s key budget policies do not provide the appropriate level of detail to guide city staff in their budgeting efforts.

Lincoln Did Not Follow Certain Existing Policies and Procedures

We also determined that Lincoln did not consistently follow some of its existing policies and procedures. Although Lincoln enacted an ordinance that established specific dollar thresholds and approval requirements for spending city funds, staff sometimes made expenditures without obtaining appropriate approvals. In 2014 the city council established an ordinance requiring the city manager’s approval for expenditures exceeding \$10,000 and the city council’s approval for expenditures exceeding \$25,000. The ordinance also requires city council approval for contract amendments exceeding 10 percent of the original contract value. However, the city did not obtain appropriate approval for three of the 20 expenditures we reviewed from fiscal years 2013–14 through 2017–18.

In fact, for one of these three circumstances in which the city made unapproved expenditures, the city could not even demonstrate the validity of a claim. To settle this claim, Lincoln made payments that totaled \$98,000 in August and October 2017 to reimburse a homeowners association (association) for utility costs, but Lincoln could not demonstrate that the city council approved the payments. In March 2016, the association submitted a claim for more than \$40,000 for reimbursement of electricity costs it paid to operate a water booster pump station from December 2014 through December 2015, even though it alleged it had been paying the costs since 2005. In its claim, the association indicated that the utility provider billed the association for the electricity and it mistakenly paid the bill on the city's behalf for several years. According to the director of public services, the original development agreement for the subdivision stated that Lincoln would pay for the electricity for the pump station and charge property owners within the association for these costs. However, Lincoln could not provide evidence of a formal agreement describing this arrangement, and the director of public services indicated that Lincoln never imposed such a charge on property owners. Regardless, in April 2016, Lincoln rejected the claim because the association did not submit it in the time allowed by law.

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Lincoln settled a claim that totaled \$98,000 but could not demonstrate that the city council approved the settlement.

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However, in a July 2017 closed session meeting regarding the water rates lawsuit, the city council discussed this previously rejected claim. The city's documentation from that meeting is insufficient to determine who raised the issue, how it was connected to the water rates lawsuit, or why the city revisited a claim it had previously denied. According to the current city attorney, who was not working for the city at the time and was not present at the meeting, the city council authorized the city manager to settle the association's claim during that meeting. Further, the interim city manager indicated that Lincoln resolved the claim to avoid litigation. However, the city's actions to resolve the claim violated state open meeting law. State law directs local agencies, such as city councils, to post an agenda in advance of a closed session meeting containing a brief general description of each item of business to be transacted or discussed in the meeting. Lincoln failed to make such a disclosure before the closed session meeting in which the

city council discussed this claim. Therefore, the city council violated state open meeting law by discussing the claim without having disclosed that topic on an agenda.

The city council violated state open meeting law by discussing a claim without having disclosed that topic on an agenda.

Further, Lincoln could not provide documentation that the city council directed the city manager to initiate settlement of the association's claim or that it entered into a settlement agreement with the association, which we would expect the city to have done to appropriately settle the claim. Given the importance of being transparent and accountable to the public in its use of public funds, we find it particularly concerning that Lincoln did not obtain a signed settlement agreement to protect it from potential future litigation. In addition, after the closed session meeting, two department directors—rather than the city manager—initiated the reimbursement to the association, even though department directors are not authorized to settle claims on behalf of the city. The city attorney asserted that the city council authorized payments totaling \$98,000 to the association at the August and November 2017 city council meetings when it approved its warrant lists—periodic lists of all checks Lincoln issued. However, because the city council approves warrant lists after it has already made the payments, we question how that action would constitute official authorization to settle a claim. In this instance, city staff issued the payments to the association several days before the city council approved the warrant lists.

In another instance, Lincoln allowed an engineering firm to conduct work for the city beyond the scope of its contract without obtaining prior approval from the city council, as required by city ordinance. Specifically, Lincoln entered into a contract with an engineering firm to provide temporary staffing in the community development department starting in September 2017. The contract's terms stipulated that payments for services would not exceed \$30,000. In November 2017, the director of community development needed the contractor to perform more work than the contract originally allowed. He spoke with the former director of support services, who indicated that the community development

department could use excess unspent salaries to fund the additional work. Therefore, the director of community development instructed the firm to continue working.

We reviewed written communication from the former city manager to the city council that indicated that in January 2018, the former director of support services incorrectly led staff to believe that city council approval was not required to use the unspent salaries to compensate the contractor. The former city manager indicated that after identifying the lack of city council approval, he instructed the director of community development to formally request a contract amendment for the additional costs incurred. The director of community development requested such an amendment at the next city council meeting, in February 2018. By that time, however, the engineering firm had already performed additional work and invoiced the city for a total of \$111,000, or \$81,000 more than the original contract. If the city council had denied the amendment, Lincoln might have been subject to litigation, as the city had already obligated itself to pay for the additional work.

We also found another instance when the city amended a contract without appropriate approval. In this case, a former city engineer authorized a change order that increased the amount of a contract for improving sidewalk ramps from \$20,400 to \$23,390, when he only had approval authority for contracts totaling \$12,500 or less. By amending the contract without acquiring the requisite approval, this individual violated Lincoln's purchasing ordinance. The current city engineer did not address the specific actions of his predecessor but informed us that he occasionally approves similar change orders, with the city manager's verbal approval, when it is not feasible to wait two weeks or more to obtain the city council's authorization. This approach appears to circumvent Lincoln's procedural control, which it likely adopted so that it could avoid excessive or inappropriate spending.

We also noted that when exercising their purchasing authority, Lincoln's former city managers, before July 2018, did not consistently follow ordinances concerning purchasing that the city adopted in 2014. Although the city manager has the authority to enter into contracts up to \$25,000 without prior approval of the city council, the purchasing ordinances requires the city manager to promptly report in writing all uses of this purchasing authority at a city council meeting. However, Lincoln could not demonstrate that its former city managers ever made such reports. Although the city claims that the warrant lists that the city council reviewed satisfied this requirement, we do not believe that the lists contained sufficient detail for the city council to identify instances when the city managers exercised their purchasing authority. Specifically, the list of checks did not identify who approved each expenditure.

Therefore, it is unclear whether the city council had any knowledge of purchases the former city managers authorized and whether it exerted sufficient oversight of those expenditures.

It is unclear whether the city council had any knowledge of purchases the former city managers authorized.

Lincoln Did Not Address Audit Deficiencies That Its Annual Financial Audits Repeatedly Identified

In addition to the unresolved audit deficiencies related to interfund loans and transfers that we discuss previously, the external auditor repeatedly reported that Lincoln did not have sufficient year-end closing procedures for preparing its financial statements, which the auditor found resulted in material misstatements in the city's draft financial statements. Despite the auditor recommending that Lincoln establish year-end closing procedures each fiscal year from 2013–14 through 2016–17, Lincoln did not address the recommendations. The material misstatements required the external auditor to reconcile the financial reports and conduct additional testing, which delayed completion of the city's CAFR in three of the five years from fiscal years 2013–14 through 2017–18. State law requires cities to issue their audited CAFRs within seven months after the close of each fiscal year. Because Lincoln's fiscal year ends on June 30, it must issue its audited CAFR by January 31 of the following year. However, Lincoln issued its CAFR 19 days late for fiscal year 2013–14 and 82 days late for fiscal year 2016–17. Additionally, as of the beginning of March 2019, the city had not issued its CAFR for fiscal year 2017–18, making it at least one month late.

The former director of support services informed us that Lincoln did not correct the deficiencies in its year-end closing procedures because of insufficient staff and high turnover in the finance division. However, the interim city manager acknowledged that the city has not conducted a staffing analysis to quantify its need for additional staffing. Although it was the former director of support services' responsibility to address the audit recommendations from the city's external auditor, he did not develop a formal process or schedule for doing so. The interim city manager stated that she plans to address the audit deficiencies going forward.

Although the city manager is responsible for city operations, the council did not hold the city manager accountable for addressing the audit deficiencies. The councilmembers offered different explanations for not doing so. According to one city councilmember, the external auditor provides the city's finance committee—which includes two city councilmembers—with the detailed audit findings, but only provides the full city council with a more high-level overview that does not describe all findings. Another councilmember stated that the city manager is responsible for ensuring that all findings in the annual financial audit are resolved, and it is not the city council's responsibility to manage these issues. Nevertheless, the city council has an oversight responsibility, and it did not hold the city manager accountable to ensure staff resolved the audit findings.

Recommendations

By August 2019, Lincoln should establish and follow policies and procedures for budgeting, preparing its financial statements at the end of each fiscal year, and approving expenditures based on the GFOA guidelines and other best practices.

To help ensure that the city manager fully informs the city council of all relevant information before the council approves the annual budget, the city should specify by July 2019 the supporting information that it expects staff to provide with the proposed budget. Lincoln should then update its duty statements to require the city manager and department directors to provide the city council with this information as part of the city's budget process.

To ensure that the city complies with its purchasing policy, the city manager should immediately develop and implement procedures for staff to obtain and document the required approval from the city manager or the city council before committing city resources. Beginning immediately, the city manager should also report to the city council on a regular basis all purchases that the city manager approves.

To ensure that city management holds city staff accountable for resolving deficiencies identified in its annual audits, Lincoln's city council should immediately require the city manager to track and report progress in addressing outstanding audit recommendations at least quarterly.

By June 2019, Lincoln should develop and follow a process to ensure that it accurately and promptly records all year-end closing entries in its general ledger and issues its CAFR within the period that state law requires.

OTHER AREAS WE REVIEWED

To address the audit objectives approved by the Joint Legislative Audit Committee (Audit Committee), we also reviewed the subject areas detailed in Table 5. The table indicates the results of our work in these areas and any associated recommendations that do not appear in the other sections of this report.

Table 5
Other Areas Reviewed as Part of This Audit

Master Fee Schedule
<p>The city has not updated its master fee schedule since 2012 to reflect the fees that it currently charges, thereby conveying inaccurate information to the public regarding the costs of city services. Lincoln’s municipal code directs the city council to establish and publicly issue a schedule of fees and charges for the provision of city services. Some of the fees that Lincoln has increased since 2012 include traffic mitigation fees, water capacity charges, drainage fees, water connection fees, and community service fees. The former director of support services acknowledged that the information on the schedule is outdated but informed us that the city has not had sufficient staff resources to update that information. Nevertheless, the city’s presentation of an outdated master fee schedule could lead to confusion for members of the public who attempt to understand the costs of city services.</p> <p>In addition, Lincoln has not conducted a comprehensive review of its fees since 2012. The municipal code requires the city council to review the fee schedule at the beginning of each fiscal year for possible revisions and amendments. In addition, the GFOA suggests that cities should review and update fees periodically based on factors such as inflation, the costs of other services, the adequacy of cost recovery, the use of services, and the competitiveness of current rates. In January 2019, Lincoln issued a request for proposals seeking a consultant to prepare a full cost allocation plan and perform a comprehensive review and evaluation of the city’s master fee schedule. Lincoln anticipates that the contractor will conduct an initial review and update of the fee schedule by the end of fiscal year 2018–19, and the city plans to have this contractor review the fee schedule annually through at least fiscal year 2021–22.</p> <p>Recommendation</p> <p><i>To ensure transparency in providing accurate fee information to the public, Lincoln should immediately update and publicly disclose its master fee schedule to reflect the fees that it actually charges. In addition, Lincoln should periodically review its fee schedule to identify outdated fees that do not accurately reflect the cost of providing services. It should revise those fees to incorporate the costs commensurate with those services and update its master fee schedule accordingly.</i></p>

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Developer Fee Credits

Lincoln could not always justify the amounts of fee credits it provided to developers. Lincoln charges developers and builders fees to recover certain costs that the city incurs to sustain new development, such as the costs of building and maintaining new city infrastructure and providing community services. When entering into a development agreement with Lincoln, a developer may choose to mitigate some of these costs by building new city infrastructure within its development project area. In return, the city awards credits to offset the fees (fee credits) that the developer pays. The city bases the fee credits on certain factors at the time it formalizes the development agreement, such as expected construction costs and the fees set forth in the city's master fee schedule. However, these factors can change between the time of the city's initial approval of the fee credit and the time that the developer obtains building permits to perform the work.

Under those circumstances, we would expect the city to maintain support detailing any revisions to the fee credits. Although Lincoln was able to support its rationale for initially awarding fee credits to developers, it could not always substantiate the fee credits it gave the developers when they commenced work. For example, when we reviewed a development agreement from 1998 and a corresponding agreement from 2003 to transfer the fee credits involved, we found that the agreements established fee credits of \$5,936. However, when the developer obtained a building permit in 2014, the city gave it a fee credit of \$9,813. City staff could not provide evidence to substantiate the increased fee credit. The interim city manager indicated that she and the city engineer are actively researching how Lincoln has established fee credits under development agreements to ensure that the city has applied appropriate fees. By not effectively tracking its establishment of fee credits over time, the city risks charging incorrect fees to developers and not collecting sufficient funding to cover the operating and maintenance costs that it will incur as a result of new development.

Recommendation

To ensure that it applies the correct fee credits to developers, Lincoln should develop policies and procedures by September 2019 for establishing fee credits and maintaining adequate documentation to justify modifications to fee credits, including credits it awards based on changes in fee schedules and updated development agreements.

Investment Portfolio Fees

Lincoln was unaware until recently of the fee amounts it paid for management services of its investment portfolio because the quarterly investment reports its investment advisor provided lacked this information. Although the reports presented a summary of the current value of the city's investments, including any earnings recognized during the period, the investment broker reduced the earnings by its fees, rather than presenting those fees separately. Lincoln's agreement with its broker did not stipulate the terms of the fees or how they were to be disclosed. Without this information, Lincoln could not ensure that the fees that it paid were accurate or reasonable.

In response to our inquiries, Lincoln requested that its broker identify the specific fees the city paid. The broker responded in December 2018 with a high-level summary of the fees for fiscal year 2017–18, which totaled almost \$300,000. Subsequent to our inquiries, Lincoln sought proposals from other investment management firms and awarded a contract in January 2019 to a different firm to serve as the city's investment advisor. The new contract specifies the fees Lincoln will pay based on a percentage of the portfolio's total value. The interim city manager estimated that the city will pay annual fees of around \$100,000. The contract also stipulates that the investment advisor will send the city monthly statements that indicate the basis for fees it charges to the city.

Councilmember's Financial Interests

We identified one city councilmember who did not fully disclose his financial interests. State law requires city councilmembers to disclose certain financial interests annually using a form referred to as a statement of economic interest. On his statements of economic interest for calendar years 2013 through 2016, this councilmember reported up to \$100,000 that he received each year through personal loans from his family trust. We found that Lincoln engaged in a development agreement with this trust in the past, before the councilmember's tenure on the city council. In response to our inquiry, the councilmember advised us that as of November 2018, he had not repaid the loans from the trust. However, we found that he failed to disclose these outstanding loans on his 2017 statement of economic interest.

We also identified a second concern related to this councilmember. Specifically, he may have also violated state conflict-of-interest laws by participating in and influencing governmental decisions that may have affected his financial interests. State law prohibits public officials at any level of state or local government from making, participating in, or attempting to use their official positions to influence governmental decisions when they know, or have reason to know, that those decisions will have material effects on their financial interests.

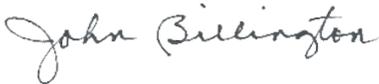
In 2018 the city council considered whether to establish community facilities districts to provide financial support for basic infrastructure and public safety services, including whether to impose a tax on residents that could affect the value of properties within the boundaries of the districts. Based on our interviews with the councilmember and our review of city council meeting minutes, we determined that the councilmember was appointed to a working group that met three times starting in early 2018 to discuss the formation of these districts. The councilmember told us that as part of the working group, he participated in discussions with city staff and representatives of the building industry regarding the terms and fees necessary to recover the city's costs of providing services in the districts. City council meeting minutes also show that the councilmember participated in a city council vote on March 27, 2018, to provide the working group with policy direction.

On August 28, 2018, the city council took up resolutions to approve a transfer of properties and the formation of a community facilities district, including a special tax to finance the district, which were based on the recommendations of the working group. The city council meeting minutes show that the councilmember recused himself from the vote on these items because he indicated they could have an effect on properties that his family owned. The interim city manager and city attorney subsequently informed us that the councilmember based his recusal on his desire to exercise an abundance of caution in addressing public perception. However, because the councilmember did not provide us with sufficient information about his ownership interest, we were unable to conclude whether there were any actual conflicts of interest.

State law broadly defines "making" and "participating in" a governmental decision to include providing information, an opinion, or a recommendation for the purpose of affecting that decision. According to the California Fair Political Practices Commission (commission), the agency charged with enforcing state conflict-of-interest laws, a city councilmember who is prohibited from voting on a final resolution as a councilmember also may not participate in discussions or make recommendations as a member of a subcommittee or working group in order to influence the city council's decision. Because the record shows that the councilmember recused himself from the city council's vote, we question whether the councilmember may have violated state conflict-of-interest laws through his participation in the working group. Accordingly, we referred this matter to the commission for consideration.

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,



JOHN BILLINGTON
Chief Deputy State Auditor

Date: March 21, 2019

APPENDIX

SCOPE AND METHODOLOGY

The Audit Committee directed the California State Auditor to examine Lincoln’s governance and operational structure, administration of public funds, and assets. Specifically, the Audit Committee requested that we review Lincoln’s policies and procedures, administration of utilities, interfund loans, and accounting for development activities. The table below lists the objectives that the Audit Committee approved and the methods we used to address them.

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, rules, and regulations, as well as Lincoln’s city ordinances.
2 Examine Lincoln’s governance and operational structure and assess its management controls and practices, including the extent to which management meets any applicable fiduciary duties to Lincoln’s residents. To the extent possible, identify alternative organizational structures that could result in more efficient and effective management of public funds and assets.	<ul style="list-style-type: none"> • Interviewed city staff and councilmembers and reviewed policies, procedures, organizational charts, committee membership, division of responsibilities, and reporting requirements for city management and the city council. • Identified the fiduciary duties for select management personnel, including the city councilmembers, the city manager, the director of support services, and the city attorney. • Researched alternative organizational structures and best practices to identify efficient and effective management methods. However, we did not identify any deficiencies in Lincoln’s organizational structure that would warrant specific changes.
3 Evaluate the adequacy of Lincoln’s financial processes during the most recent five fiscal years by performing the following: <ol style="list-style-type: none"> a. Review Lincoln’s audited financial statements and internal controls to determine whether there were any deficiencies and whether Lincoln took recommended corrective actions in a timely manner. b. Assess Lincoln’s practices and processes for determining how it uses public funds and assets, and its policies and procedures related to budgeting and expenditures. c. Assess Lincoln’s policies and practices regarding money transfers. d. Assess Lincoln’s policies and practices for depositing and collateralizing public funds. 	<ul style="list-style-type: none"> • Reviewed Lincoln’s CAFRs and single audit reports from fiscal years 2013–14 through 2016–17 and assessed its efforts to address deficiencies through corrective action. The city had not issued its CAFR for fiscal year 2017–18 as of early March 2019. • Compared Lincoln’s budgeting policies and procedures for its use of public funds and assets to guidance from the GFOA. • Tested a selection of Lincoln’s expenditures to determine if the city followed its policies for approving purchases, contracts, and settlements of claims. • Assessed Lincoln’s adherence to its policies regarding interfund loans and transfers by reviewing a judgmental selection of 20 interfund loans and transfers from fiscal years 2013–14 through 2017–18. • Compared Lincoln’s policies and practices for depositing and collateralizing public funds to state requirements and found that Lincoln’s deposits are appropriately collateralized. • Reviewed Lincoln’s contracts with its investment broker and advisor, examined its quarterly investment reports, and interviewed relevant city staff and the treasurer to determine whether Lincoln complied with its policies and paid appropriate investment fees.

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AUDIT OBJECTIVE	METHOD
<p>4 Determine whether Lincoln, to the extent it is required by law or regulations, reported its overall financial situation, income, spending, assets, and reserves during the most recent five fiscal years. Further, determine whether Lincoln, to the extent it is required by law or regulations, reported its water and sewage usage, customers, connections, rates, acquisitions, and related data during the most recent five fiscal years.</p>	<p>Identified state reporting requirements pertaining to financial reporting, drinking water, water quality, and water loss. Although the city was late in completing its CAFRs for three of the five years from fiscal years 2013–14 through 2017–18, we found that the city generally complied with its other reporting requirements.</p>
<p>5 Assess Lincoln’s process for collecting and reporting residential and commercial fees.</p>	<ul style="list-style-type: none"> • Interviewed staff to determine Lincoln’s practices for charging, collecting, and reporting residential and commercial fees. • Reviewed all developer account balances to determine how many accounts were in arrears and the total funds outstanding from fiscal years 2013–14 through 2017–18. We determined that during this period, Lincoln reduced the number of developer accounts with negative balances. Further, the combined amounts of negative balances through fiscal year 2017–18 totaled less than \$15,000, which we concluded was not significant. • Reviewed a selection of five developer deposit accounts and 10 building permits from fiscal years 2013–14 through 2017–18 and compared the fees the city charged developers and builders to the amounts disclosed in its fee schedule to ensure the city charged the correct fees.
<p>6 Determine whether the fees that Lincoln has been assessing ratepayers for water use have been in excess of the actual costs of providing the service during the most recent five fiscal years.</p>	<ul style="list-style-type: none"> • Interviewed staff and reviewed relevant documentation, including the 2013 and 2018 water rate studies, to determine how Lincoln established its 2018 water rates and evaluated whether the rates were commensurate with the cost to provide water. • In May 2018, Lincoln completed a new water rate study, which included consideration for its own use of water. The study recommended and Lincoln ultimately adopted a uniform rate for all customers based on volume, which appears reasonable.
<p>7 Determine whether Lincoln clearly communicates criteria for approving or denying applications for rate changes and whether this process is reasonably transparent.</p>	<ul style="list-style-type: none"> • Reviewed the rate change disclosure requirements in the state constitution and assessed whether Lincoln adhered to the required process in 2013 for disclosing and increasing water rates. We concluded that Lincoln generally complied with the disclosure requirements of Proposition 218 when changing its water rates in 2013. • Determined that the rate change in 2018 occurred in October, which was after our audit period.
<p>8 Determine whether Lincoln complies with relevant laws, regulations, policies, and guidelines regarding the use and distribution of redevelopment funds and, to the extent possible, assess the fairness and reasonableness of the criteria and methods Lincoln follows in its use and distribution of such funds.</p>	<ul style="list-style-type: none"> • Compared Lincoln’s redevelopment plans to the requirements set forth in state law and regulations, and determined that Lincoln’s redevelopment implementation plans contain the provisions necessary to comply with state law. • Reviewed three outstanding redevelopment projects to determine whether Lincoln complied with its redevelopment plan and relevant laws and regulations when using redevelopment funds and found that these projects complied with state law. • Did not further assess the fairness and reasonableness of Lincoln’s criteria and methods to use and distribute redevelopment funds because the State dissolved redevelopment agencies throughout California in 2011, which was before our audit period, and because our testing concluded that historically Lincoln’s redevelopment plans and projects complied with state law.
<p>9 Review and assess any other issues that are significant to the audit.</p>	<ul style="list-style-type: none"> • Obtained and reviewed documentation of whether Lincoln paid for its use of its own utilities from fiscal years 2013–14 through 2017–18, and whether Lincoln paid for these services from appropriate funds. • Assessed the city’s reliance on interfund loans to remain solvent.

Source: Analysis of the Audit Committee’s audit request number 2018-110 and information and documentation identified in the table column titled *Method*.

Assessment of Data Reliability

In performing this audit, we relied on electronic data files that we obtained from Lincoln's accounting and document management databases. The U.S. Government Accountability Office, whose standards we are statutorily obligated to follow, requires us to assess the sufficiency and appropriateness of computer-processed information we use to support our findings, conclusions, and recommendations. Because the city's accounting system is paperless, we were unable to perform completeness or accuracy testing. Furthermore, we did not perform a review of the controls over these data because of the significant resources required to conduct such an analysis.

To gain assurance that the financial records were complete and accurate, we identified major funds that were pertinent to our audit procedures for fiscal years 2013–14 through 2016–17—the first four years of our five-year audit period—and reconciled account totals from the general ledgers for those funds to the amounts reported in Lincoln's audited CAFRs. We were unable to perform a similar comparison for fiscal year 2017–18 because, as of early March 2019, the city had not yet issued the CAFR for that year. Additionally, because Lincoln's accounting system does not specifically distinguish transactions pertaining to interfund loans in a manner that would allow us to extract that data, we relied on spreadsheets prepared by city staff to track interfund and interagency loans during our audit period. To obtain assurance that the spreadsheets were complete, we reviewed interfund loan records in the city's document management system and did not identify any loan agreements that were not included in the spreadsheets. Although we found the financial data to be of undetermined reliability for the purposes of our audit and we recognize that these limitations may affect the precision of the numbers we present, there is sufficient evidence in total to support our audit findings, conclusions, and recommendations.

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March 1, 2019

John Billington
Chief Deputy State Auditor
621 Capitol Mall, Suite 1200
Sacramento, CA 95814

RE: Response to Draft Report of the California State Auditor

Dear Mr. Billington:

Thank you for the opportunity to comment on the draft report prepared by the California State Auditor, as requested by the Joint Legislative Audit Committee. In December 2018, the City began a comprehensive business process improvement initiative that is focused on all finance-related activities. This initiative includes the evaluation of all policies and procedures to identify areas where the City can improve accuracy, effectiveness, transparency and efficiency, and then redesign those processes or policies to realize the improvements.

This effort is long overdue and is needed to demonstrate the City's commitment to being good stewards of the public's money and to increase trust and transparency for our residents. The audit is beneficial to this effort and will serve as part of the framework for establishing a road map for moving forward. As a city, we can do better through the creation of strategic plans to correct course and improve the overall fiscal health and function of the City. Both staff and the City Council are committed to championing this effort.

Response to Audit Recommendations

The City responds to the recommendations as follows:

Section 1

Recommendation 1A: "To ensure that it complies with state law, Lincoln should immediately review all of its outstanding interfund loans to determine whether the borrowing funds can repay the loans according to the terms. For any loan that is from a restricted fund and that does not have the capacity to be repaid, Lincoln should develop a plan that ensures repayment within a reasonable timeframe, including seeking possible alternative financing or revenue sources, such as the general fund, bonds, one-time revenues, or a tax increase, to address the obligation."

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Administrative Services - City Manager's Office - Development Services
Fire - Library - Recreation - Police - Public Services

John Billington
Chief Deputy State Auditor
March 1, 2019
Page 2

***Response:** The City agrees with this recommendation. The analysis of all interfund loans is currently underway and a comprehensive plan for addressing all interfund loans will be presented to City Council for input and consideration. Paying off all associated debt will require a long-term implementation strategy.*

Recommendation 1B: “To ensure that it avoids accumulating surpluses, by August 2019, Lincoln should establish policies and procedures requiring it to review its fund balances at least annually and, if necessary, reduce its fees within a reasonable timeframe.”

***Response:** The City agrees with this recommendation and will include this requirement in a comprehensive budget policy that will be presented to City Council for consideration.*

Recommendation 1C: “To comply with state law, Lincoln should immediately discontinue its practice of using restricted funds to subsidize other funds that have year-end deficits and lack the ability to permanently repay the transfers within 90 days of the close of the fiscal year.”

***Response:** The City agrees with this recommendation. Beginning with the 2018/2019 fiscal year, the City will discontinue this practice except for short-term loans required for the fiscal year end Generally Accepted Accounting Principle (GAAP) presentation of the City’s financial statements. These types of loans are legal, repaid within 90 days, primarily made for cash flow reasons, and are typically funded by the General Fund.*

Recommendation 1D: “By June 2019, Lincoln should establish accounting procedures to ensure that it records all costs of city maintenance from the appropriate funds, including apportioning the general benefit costs to the general fund.”

***Response:** The City agrees with this recommendation and implemented this recommendation for fiscal year 2018/2019, beginning with the City Council’s adoption of the Lighting and Landscaping District Engineer’s Report on June 12, 2018. The City acknowledges full compliance will be demonstrated when its books are closed at the end of the fiscal year.*

Recommendation 1E: “To ensure that it complies with the state constitution, Lincoln should establish and adhere to procedures that account for revenue and expenditures in each landscaping and lighting zone separately, and it should discontinue the use of surplus revenue from one zone to offset a deficit in another zone. It should take these actions by June 2019.”

***Response:** The City agrees with this recommendation and implemented this recommendation for fiscal year 2018/2019. Importantly, however, the costs associated with the general benefit and any zone deficit that cannot be paid by the Lighting and Landscaping District are obligations of the General Fund. Payment of this obligation by the General Fund results in decreased revenue for public safety. In order to address this issue, consideration of an assessment increase for those deficit zones, as well as those areas of the City that do not currently pay an assessment for the use of parks,*

John Billington
Chief Deputy State Auditor
March 1, 2019
Page 3

landscaping, and lighting, will be necessary. The City acknowledges full compliance will be demonstrated when its books are closed at the end of the fiscal year.

Recommendation 1F: “To ensure that city staff provides the city council adequate information to make its decisions regarding interfund loans and transfers, the city council should immediately collaborate with the city manager and department directors to establish formal expectations regarding the content of staff reports, and it should hold the city manager accountable for ensuring all staff reports meet those expectations.”

Response: The City agrees to establish formal expectations among staff regarding the content of staff reports. Information provided to City Council should be reviewed and revised as appropriate to ensure the highest expectation for content.

Section 2

Recommendation 2A: “Lincoln should immediately commence a fee study that ensures its fees for water capacity are commensurate with the costs of current and planned future water capacity needs. To the extent that Lincoln has previously overcharged for water capacity fees, it should develop a plan to provide equitable consideration to those who overpaid such fees and it should eliminate any unnecessary surplus in the water connections fund.”

Response: The City agrees with this recommendation and has initiated the process by issuing a request for proposals to complete the required study. Proposals were received by the City on February 22, 2019, and it is anticipated that a contract will be proposed to City Council on March 12, 2019. The fee study will be used to inform any nexus for the future use of water connection revenue on hand. If a nexus is not identified, the City Council will then evaluate equitable considerations and the public benefit to determine the appropriate action to address any unnecessary surplus.

Recommendation 2B: “To ensure that its fees are commensurate with the cost of providing services, Lincoln should develop and follow a timeline by June 2019 for conducting periodic fee studies for each of its services, including updating its staff rates annually.”

Response: The City agrees with this recommendation. Below is the current status of the various fee studies that are completed or underway:

***Water Rates:** Complete. New rates were implemented October 1, 2018.*

***Solid Waste and Wastewater Rates:** Studies are underway. Draft rates are expected to be presented to City Council by August 2019.*

***Public Facility Element (PFE) Study:** Draft study completed. Final study anticipated to be presented to City Council by June 30, 2019.*

***Master Fee Schedule:** Contract awarded for preparation of the study on February 26, 2019. Anticipate completion by June 30, 2019.*

***Cost Allocation Plan:** Contract awarded for preparation of the study on February 26, 2019. Anticipate completion by June 30, 2019.*

John Billington
Chief Deputy State Auditor
March 1, 2019
Page 4

Water Connection Nexus Study: Proposals received. Contract will be proposed to City Council on March 12, 2019.

Moving forward, the City will create a schedule ensuring regular updates to its fees and rates.

Recommendation 2C: “To the extent allowable by law, the city council should develop a plan by August 2019 to provide equitable consideration to ratepayers for the utility costs they incurred that were higher than necessary because of the city’s practice of not paying for its own water, sewer, and solid waste services.”

Response: The City agrees with the recommendation that further discussion should take place related to this item. The City Council originally addressed this item at its March 13, 2018 meeting. At the end of that meeting, City Council concluded that any decision regarding the item should be postponed until the completion of the audit. Therefore, this item will now be brought back before the Council for consideration.

Recommendation 2D: “To ensure transparency to the public, beginning with its fiscal year 2019-20 budget, Lincoln should specify in its annual budget the amount that it intends to spend for the use of municipal utilities—water, sewer, and solid waste—and the funds that it intends to use to pay for these costs.”

Response: The City agrees to implement this recommendation.

Section 3

Recommendation 3A: “By August 2019, Lincoln should establish and follow policies and procedures for budgeting, preparing its financial statements at the end of each fiscal year, and approving expenditures based on the GFOA guidelines and other best practices.”

Response: The City agrees with this recommendation and has already initiated its implementation as part of the comprehensive business process improvement initiative. On February 12, 2019, the City Council adopted a Closing Policy and a Grants Management Policy. Staff is currently developing a comprehensive budget policy as part of budget planning for the 2019/20 fiscal year. The City will ensure that all policies and procedures required by the Governmental Accounting Standards Board (GASB) and its Generally Accepted Accounting Principles (GAAP) are adopted and implemented.

Recommendation 3B: “To help ensure that the city manager fully informs the city council of all relevant information before the council approves the annual budget, the city should specify by July 2019 the supporting information that it expects staff to provide with the proposed budget. Lincoln should then update its duty statements to require the city manager and department directors to provide the city council with this information as part of the city’s budget process.”

John Billington
Chief Deputy State Auditor
March 1, 2019
Page 5

Response: The City agrees with this recommendation and is currently developing a comprehensive budget policy that will be presented to City Council for consideration.

Recommendation 3C: “To ensure that the city complies with its purchasing policy, the city manager should immediately develop and implement procedures for staff to obtain and document the required approval from the city manager or the city council before committing city resources. Beginning immediately, the city manager should also report to the city council on a regular basis all purchases that the city manager approves.”

Response: The City agrees with this recommendation and is in the process of reviewing the policies and procedures that already exist to determine what modification is required to fully implement this recommendation.

Recommendation 3D: “To ensure that the city management holds city staff accountable for resolving deficiencies identified in its annual audits, Lincoln city council should immediately require the city manager to track and report progress in addressing outstanding audit recommendations at least quarterly.”

Response: The City agrees with this recommendation and will be regularly presenting this information to the Financial Investment and Oversight Committee and the City Council.

Recommendation 3E: “By June 2019, Lincoln should develop and follow a process to ensure that it accurately and promptly records all year-end closing entries in its general ledger and issues its CAFR within the period that state law requires.”

Response: Complete. The City Council adopted a new Closing Policy on February 12, 2019, which addresses this requirement. The City acknowledges full compliance will be demonstrated when its books are closed at the end of the fiscal year.

Section 4

Recommendation 4A: “To ensure transparency in providing accurate fee information to the public, Lincoln should immediately update and publicly disclose its master fee schedule to reflect the fees that it actually charges. In addition, Lincoln should periodically review its fee schedule to identify outdated fees that do not accurately reflect the cost of providing services. It should revise those fees to incorporate the costs commensurate with those services and update its master fee schedule accordingly.”

Response: The City agrees with this recommendation and began implementation on February 26, 2019, when the City Council approved a contract for services with a consultant tasked with completing a comprehensive update to the Master Fee Schedule and the Cost Allocation Plan, both with required annual updates.

John Billington
Chief Deputy State Auditor
March 1, 2019
Page 6

Section 5

Recommendation 5A: “To ensure that it applies the correct fee credits to developers, Lincoln should develop policies and procedures by September 2019 for establishing fee credits and maintaining adequate documentation to justify modifications to fee credits, including credits it awards based on changes in fee schedules and updated development agreements.”

Response: The City agrees with this recommendation and is addressing it primarily through the adoption of a new Public Facility Element (“PFE”) study. A draft study is completed, and the final study is anticipated to be presented to City Council by June 30, 2019. Additional procedures will be adopted for the accounting of these credits to ensure they are accurately tracked and managed.

Conclusion

The audit provided the City of Lincoln a valuable opportunity to look internally and improve its operational processes. City staff and the City Council look forward to engaging residents to address the heart of the City’s challenges, a shortfall in General Fund revenue, and the levels of service provided.

Should you have any questions or require any additional information, please do not hesitate to contact me.

Sincerely,



Jennifer Hanson
City Manager