



Finance Commission Agenda Report

DATE: June 9, 2022

FROM: Ken Louie, Interim Finance Director

SUBJECT: **2022 Finance Ad Hoc Committee Report**

Recommendation

It is recommended that the Finance Commission receive and file the 2022 Finance Ad Hoc Committee Report.

Background

The Finance Ad Hoc Committee was formed by City Council in September 2020 in an effort to review the fiscal year 2020-2021 budget and the Comprehensive Annual Finance Report (CAFR) for fiscal year 2018-2019, and following concerns of oversight and management of the City's budget process, under the purview of the previous leadership and administration at City Hall. The Ad Hoc Committee was tasked with making recommendations to improvements to the City's process, including timely completion of various milestones.

In February 2022, City Manager Chaparyan and her team evaluated the tasks and responsibilities of the cities numerous commissions, boards, and committees, including a review of the scope of work and expected work product for each ad hoc committee. In conversations with the previous representatives of the Finance Ad Hoc Committee, it was agreed that the Committee intended to submit a report summarizing their findings to the City Manager, at which point that Committee would have completed their scope of work and would automatically dissolve. The City Council approved this timeline. Attached is the Finance Ad Hoc Committee's Final Report, dated June 4, 2022, for the Finance Commission's review. With the receipt of this document, the Finance Ad Hoc Committee is officially dissolved.

The Report summarizes the previous administration and staff's budget processes and oversights. It highlights shortcomings of those efforts, as well as areas of improvement, detailing: (1) unexplained changes between proposed budgets for review, (2) the City Council's consideration of the budget ahead of the completion of timely audits, (3) the lead up to the creation of the Finance Ad Hoc Committee and its specific scope of work, and (4) the consideration of a forensic audit based on the need to improve upon internal controls and management and leadership of staff for a transparent process.

The Report offers a number of findings, many of which have been remedied and addressed:

- Finance Policies and Procedures were reviewed and recommended for approval by the Finance Commission in May 2022, and the City Council reviewed and discussed the draft document at their June 1, 2022 meeting. Staff anticipates a final document to be approved in Summer 2022.
- The Finance Director together with the City Manager are working diligently to address areas of concern, including timely monthly investment reports, a commitment to a comprehensive and transparent budget process, Mid-Year budget review, timely annual audit and milestones, and timely financial reporting.
- Other citywide improvements that include employee training and retention, as well as incorporation of better and best practices into our processes and service to the community
- The execution of the settlement agreement of the A. Smith legal matter

Next Steps

The City Manager commits to ongoing improvements to internal controls. The Interim Finance Director will work closely with the City Manager in bringing timely and regular reporting to the City Council. Additionally, the City Manager is working with Management services to hire a recruiter to assist with efforts to hire a permanent Finance Director focused on carrying forward and building upon these efforts. It is under the City Council's purview to direct staff on any further action in response to the findings or recommendations within the Report.

Fiscal Impact

There is no fiscal impact associated with receiving and reviewing this report.

Public Notification of Agenda Item

The public was made aware that this item was to be considered this evening by virtue of its inclusion on the legally publicly noticed agenda, posting of the same agenda and reports on the City's website.

Attachment: 2022 Finance Ad Hoc Committee Final Report

FINAL REPORT AND RECOMMENDATIONS OF THE FINANCE AD HOC COMMITTEE

I. HISTORY OF THE FORMATION OF THE AD HOC FINANCE COMMITTEE

On September 28, 2020, the City Council voted unanimously to form the Finance Ad Hoc Committee (the "FAHC"). The FAHC was originally proposed to the City Council on September 2, 2020, and ultimately approved by the City Council, in response to concerns raised by residents, the Finance Commission, and a former City Finance Director about the proposed fiscal year 2020-2021 budget and the delayed Comprehensive Annual Financial Report ("CAFR") for fiscal year 2018-2019.

A. Residents' Discovery of Major Undisclosed Changes to the Proposed 2020-2021 City Budget

A draft 2020-2021 budget was presented to the Finance Commission on May 26, 2020, by the then-acting Finance Director Karen Aceves. The commission voted 5-0 to recommend that the City Council approve the draft budget, and a presentation of the draft budget to the City Council was scheduled to occur at a City Council meeting on June 3, 2020.

However, the draft budget in the City Council agenda packet, posted online on May 29, 2021, was different from the budget originally presented to the Finance Commission 3 days earlier. Changes totaling approximately \$14 million had been made to revenue and expenditure line items. The gross sum of changes made by Staff over the course of 3 days was an amount equal to 28% of the City's total \$51 million revenue budget. Further, significant changes had also been made to various general fund reserve balances and special revenue fund balances. The breadth of the changes was neither disclosed nor explained in the agenda report for the June 3, 2020, City Council budget presentation.¹

The June 3, 2020 City Council meeting was continued, and, in the following days and weeks, irregularities in the draft budget and other concerns and questions about the City's financial reporting were brought to the attention of City residents and leadership, largely through two reports, one authored by Sheila Rossi and FAHC member, Stephen Rossi, and the other by a former City Finance Director.

B. The Dispute Over the Adoption of a Resolution of Continuing Appropriations

At this point, the City Council requested that the new draft budget be reviewed by the Finance Commission. On its review of the new draft budget, the Finance Commission voted 4-1 to recommend that the City Council adopt a resolution of continuing appropriations, with review of the draft 2020-2021 budget postponed until completion of delayed 2018-2019 Comprehensive Annual Financial Report ("CAFR").²

Later, during a Special Meeting held on June 24, 2020, Staff presented the City Council with the Finance Commission's recent recommendation to delay review of the 2020-2021 budget. The first item on the agenda included a Staff report recommending that the City Council approve Finance Commission's proposal. However, citing a supposed \$3.5 million revenue shortfall expected due to the Covid pandemic³, Staff (led by Ms. Aceves and the then-acting City Manager, Ms. Stephanie DeWolfe), along with Councilmembers Ms. Khubesrian and Ms. Mahmud, spoke against the Staff's recommendation, instead suggesting the City Council adopt the new draft budget.⁴

After stating the report's characterization that the Finance Commission had "originally approved [the budget] unanimously" was a "misdirection" on the part of Staff, then-sitting City Councilmember Schneider commented further, "Let me remind you what the item on the agenda is. It says, 'Approve a Resolution to Continue Appropriations of the FY 19/20 Budget...That is the Staff recommendation, and now they're arguing against it.'"⁵ Following the City Attorney's conclusion that adopting a new budget that evening would be a violation of the Brown Act, the City Council adopted the recommended resolution of continuing appropriations.

C. Councilmember Khubesrian's Emails Utilizing False Identities and Intimidation to Quell Resident, Former Employee, and City Official Questions Regarding the Budget

By way of additional background color leading to the formation of the FAHC, when the resolution of continuing appropriations was before the City Council for consideration, then-sitting City Councilmember Khubesrian not only dismissed residents who had raised questions regarding the budget, characterizing them as complainers "criticizing without looking for solutions,"⁶ but also submitted public comments via email under false identities. These emails advocated for adoption of the controversial draft budget; expressing support for the then-acting City Manager's and Finance Director's performance in connection with the 2020-2021 budget process; and making allegations of improprieties against the former City Finance Director who authored one of the critical reports.⁷ Furthermore, Ms. Khubesrian used these same false identities (also via emails) to pressure her colleague, Councilmember Cacciotti to stop asking questions about the City's financials and claimed additional improprieties against yet another resident who had previously been critical of both Ms. Khubesrian and the 2020-2021 budget process.⁸ After these inappropriate actions were discovered and exposed by a resident, Ms. Khubesrian admitted authoring the pseudonymous emails and resigned her position in mid-August 2020. The public fallout that followed these discoveries weighed heavily in the City Council's decision to form the FAHC.

D. Formation of the FAHC to Assist Finance Department Staff and Make Recommendations

On September 2, 2020, the FAHC was formed as an advisory committee to provide recommendations to, and consultation with, the City Finance Department on operational matters to promote the timeliness, accuracy, and transparency of the City's financial reporting as well as to form a recommendation, based on the FAHC's review, regarding whether a forensic audit would be warranted. The FAHC's scope of work was limited to the following items:⁹

- (i) Ensuring the completion of the delayed fiscal year 2018-2019 Comprehensive Annual Financial Report ("CAFR");
- (ii) Ensuring the timely completion of the fiscal year 2019-2020 CAFR;
- (iii) Management and oversight of the fiscal year 2020-2021 budget;
- (iv) Updating the City's financial policies and procedures;
- (v) Making a recommendation to the Finance Commission regarding the frequency and timing of financial reporting; and
- (vi) Assess the necessity of, or scope of any additional audits, depending on the summation of the [FAHC's] work, up to and including a forensic audit where the situation warrants additional review.

II. SUMMARY OF RESULTS OF OPERATIONAL CHANGES

As of the date of this summary report, the FAHC was comprised of six members – one Finance Commission member and five residents with various backgrounds in accounting, audit, business operations, finance, municipal finance, and restructuring – plus two City Council liaisons.¹⁰ From the date of the FAHC's inception until approximately July 2021, the FAHC assisted Finance Department Staff in accomplishing the following. More detail on each of these items can be found in **Exhibit A** to this report.

- (i) On October 26, 2020, the City Council voted 4-1 to receive the final 2018/19 Comprehensive Annual Financial Report ("CAFR"), ahead of the November 3, 2020 election¹¹;

- (ii) On July 21, 2021, the City Council voted to receive the final 2019/20 Annual Comprehensive Financial Report (“ACFR”)¹²;
- (iii) On April 27, 2021, the City Council voted 5-0 to receive the Annual Budget for 2020/21;
- (iv) Completed researching and make recommendations (through Staff) regarding best practices for financial policies and procedures; and
- (v) Completed researching and make recommendations (through Staff) regarding best practices for monthly and quarterly reporting.

From approximately July 2021 until the date of this report, the FAHC focus has been the final remaining item included in the FAHC’s scope, as directed by the City Council:

- (vi) Assess the necessity of, or scope of any additional audits, depending on the summation of the [FAHC’s] work, up to and including a forensic audit where the situation warrants additional review.

The remainder of this report, and the accompanying exhibits and endnotes (which are an integral part of the FAHC’s recommendations), provides highlights of the FAHC’s discussions and deliberations on whether conducting a forensic audit is recommended. With the delivery of this report, the FAHC’s work has been completed.

III. RECOMMENDATION REGARDING A FORENSIC AUDIT

Before providing a recommendation as to whether a forensic audit is warranted at this time, it was the determination of the FAHC members that both Staff and the casual reader be presented with the following information:

- What is the purpose of a forensic audit?
- What are the red flags that indicate a forensic audit is warranted?
- A discussion of the relevant findings by the FAHC.

A. What is the Purpose of a Forensic Audit?

A forensic audit differs significantly from a regularly scheduled, annual audit like the CAFR. There are numerous whitepapers that explain in detail the scope and procedures contained within a typical forensic audit, however, a more simplified description can be found on Investopedia, “Forensic audits cover a wide range of investigative activities. A forensic audit is often conducted to prosecute a party for fraud, embezzlement, or other financial crimes.”¹³

Further, according to the American Journal of Business Education (“AJBE”), “Forensic accountants and auditors share some goals similar to traditional accountants and auditors. They have different roles, knowledge and skills. Forensic accountant investigations include identification of fraud. This is different from Certified Public Accountant (CPA) investigations that are not responsible for identifying fraud.”¹⁴

B. What are the Red Flags that Indicate a Forensic Audit is Warranted?

The red flags highlighted by the AJBE include, but are not limited to, the following...”

- Weak internal control processes; and
- Management style that pressured employees to take actions beyond financial statement management to manipulation to outright misrepresentation which is fraud.

The AJBE goes on to state, “Personnel-related practices allowing financial statement misrepresentation include low employee morale that is possibly due to inadequate compensation, high turnover and inexperienced

managers...An organization that loses financial records may have lost their financial records on purpose to hide fraud. Fraud is easier to commit when there is no strong accounting information system.”¹⁵

Further, Investopedia highlights how fraud can manifest in actual practice¹⁶:

- Conflicts of Interest: “when a fraudster uses their influence for personal gains to the [City’s] detriment.”
- Extortion: “the wrongful use of actual or threatened force, violence, or intimidation...”
- Asset Misappropriation: which can include, but is not limited to, activities such as embezzlement, providing contracts/not charging fees to third-parties due to personal relationships, and misuse of Staff time or other City resources,
- Financial Statement Fraud: “The goal of presenting fraudulent numbers may be to...ensure that C-level executives continue to receive bonuses, or cope with the pressure to perform.”

C. Findings of the FAHC

For the reader’s convenience, the relevant FAHC findings have been categorized according to the potential red flags indicating the possibility or threat of fraud outlined previously in this report.

1. **Management failures in managing and hiring Finance Department personnel led to high staff turnover and new, relatively inexperienced and, in some cases, unqualified staff.**

Finding 1.1 A Finance Department reorganization led to a significant reduction in Finance Department staffing levels: On November 7, 2018, then-acting City Manager, Ms. Stephanie DeWolfe initiated the reorganization of the Finance Department.¹⁷ This reorganization ultimately resulted in a 44% reduction in department staffing levels, from a historical level of 9 staff members to 5. The reductions included the elimination of two senior accounting clerk positions and the outsourcing of business licenses and payroll functions. *Potential Red Flags: Low employee morale, high turnover, inexperienced managers, weak internal controls, and incomplete financial reporting.*

Finding 1.2 The reorganized Finance Department had inexperienced leadership. Departed staff were replaced with new, underqualified or inexperienced staff members. Although then City Manager DeWolfe had received the recommendation to hire strong leadership for the Finance Director position,¹⁸ the acting Finance Director did not have any management experience in finance department operations. It is important that City employment policies and job descriptions for all positions within the Finance Department, especially that of the Finance Director, adhere to appropriate educational or equivalent experience requirements during recruitment. *Potential Red Flags: Low employee morale, high turnover, inexperienced managers, weak internal controls, and incomplete financial reporting.*

2. **The Finance Department reorganization and the procurement of the Citygate Report were undertaken in circumstances that give rise to questions about a possible lack of transparency, possible attempt to cover-up alleged asset misappropriation, and potential existence of a conflict of interest by City Manager DeWolfe.**

Finding 2.1 Questionable circumstances surrounded the timing of, and the process undertaken, to engage Citygate: Of note, one of the main items used by Ms. DeWolfe to support the Finance Department reorganization, was a report (the “Citygate Report”) provided by Citygate Associates, LLC (“Citygate”).¹⁹ According to the staff report to the City Council recommending hiring Citygate, an organizational assessment report was needed to prepare for the retirement of the finance director who had been on leave of absence. The report was

initiated by City Manager DeWolfe while the City was actively recruiting for a new finance director. The stated purpose of the report was to provide an “organizational review” and “best practices” in a confidential report to be used as a “resource and management tool” for the new finance director. However, in the two years that followed the report, the City had completed only 1 of the 43 items that the report recommended be implemented within the first 12 months. Further, the FAHC finds that the existence of allegations by Lauren Rubin going back to March 2018, approximately a month before City Manager DeWolfe entered into a contract with Citygate, and other circumstances, raise concerns which should be discussed:

DeWolfe Engages Citygate for an Organizational Review of the Finance Department: Starting in March 2018, Lauren Rubin, a member of the Finance Department staff, sent then-Human Resources Manager Miriam Lee Ko and Karen Aceves messages regarding “financial irregularities and mishandling of a substantial amount of government and public monies,”²⁰ however no response was received by Rubin. Approximately one month later, on April 19, 2018, a consulting contract between Citygate and the City of South Pasadena was signed by Ms. DeWolfe, including a not-to-exceed contract total of \$69,420.00. The proposal had been presented to, and approved by, the City Council the prior evening on April 18, 2018.²¹ A review of the City Clerk files on the City’s website did not find any evidence of a competitive bidding process as per the City’s typical procedures. Further, it was not disclosed, either in the presentation to the City Council by Staff nor in the contract with Citygate itself, that the Senior Consultant who would be performing the organizational review was former Pasadena Finance Director, Mr. Andrew Green. Mr. Green had previously worked with Ms. DeWolfe in the City of Pasadena for three years (2009-2012)²², but later departed the City of Pasadena in January 2015 amidst an investigation into the embezzlement of \$6.4 million from a city fund overseen by Mr. Green.²³

Questionable Circumstances Regarding the Rubin Case and Citygate: The Citygate report became a central piece in the subsequent wrongful termination lawsuit by Lauren Rubin claiming that DeWolfe commissioned the Citygate report, through her personal relationship with Green and without any competitive bidding process, in an attempt to invent cause to terminate Rubin and hide Rubin’s claims of financial improprieties from the City Council.²⁴ Rubin was terminated by the City in November 2018, three months after Citygate issued the final, August 16, 2018 report. It is unclear to the members of the FAHC whether the prior messages alleging “financial irregularities and mishandling...of...monies,” sent by Rubin to Ko and Aceves, were ever disclosed to the City Council prior to the commissioning of the Citygate report, the dismissal of Rubin by the City, or the filing of Rubin’s legal claim.

Per Ms. DeWolfe’s LinkedIn profile, since June 2021, approximately 2 months after a final settlement was reached in the Rubin case and nine months after DeWolfe’s separation from her position as City Manager of South Pasadena, Citygate hired Ms. DeWolfe as a Management & Leadership Consultant.

Potential Red Flags: Conflict of interest, management style that pressured employees to take actions beyond financial statement management to manipulation to outright misrepresentation which is fraud, potential asset misappropriation...providing contracts to third-parties due to personal relationships, misuse of Staff time or other City resources, and specific claims of financial irregularities made by Rubin.

Finding 2.2 **The City Council appeared to have used, extensively and inappropriately, closed session City Manager performance reviews to conduct other business unrelated to the City Manager:** For reference, the position of the City Manager reports to the South Pasadena City Council, and periodic performance evaluations of the City Manager are conducted by the City Council in closed session. A summary analysis, based on a review of the City Council closed

session agendas from January 2018 through August 2020, of the various dates these closed session performance evaluations occurred is included in the chart below:

	Date of Closed Session	Days Since Last Eval	Total Days in Grouping	# of Evals in Grouping	Avg Months per Eval
1	February 21, 2018	N/A	N/A	1.0	N/A
2	July 18, 2018	147			
3	August 15, 2018	28			
4	October 17, 2018	63	203.0	6.0	1.13
5	December 19, 2018	63			
6	January 16, 2019	28			
7	February 6, 2019	21			
8	August 21, 2019	196			
9	September 11, 2019	21	28.0	3.0	0.31
10	September 18, 2019	7			
11	January 15, 2020	119	63.0	2.0	1.05
12	March 18, 2020	63			
TOTAL DATA SET:			756.0	12.0	2.10

Most cities and companies provide at least one performance review annually. Some private companies even perform regular reviews on a quarterly basis. Therefore, the existence of 12 performance reviews over an approximate 2-year span (or one performance review every 2.1 months on average) seems unusual in the absence of a performance improvement plan. However, upon closer inspection of the dates in question, it is clear that there was no regular cadence to the closed session performance reviews. Rather these reviews come in three main spurts with large gaps between each grouping, including one grouping which contained three separate closed session performance reviews within the same 28-day period.

Potential Red Flags: Conflicts of interest, weak internal control processes, potential Brown Act violations

3. The Finance Department did not have, and did not follow, important internal controls, policies, and processes.

Finding 3.1 The Finance Department failed to reconcile bank accounts timely. While it is best practice to reconcile bank accounts and close monthly financials within 30 days of each month end, the Finance Department was as much as twelve (12) months behind in reconciling the City’s bank accounts and closing monthly financials, directly leading to the delay in starting/completing the 2018/19 CAFR. *Potential Red Flags: Weak internal control processes*

Finding 3.2 The City lacked controls or procedures to alert management to the Department’s unreconciled accounts. The City’s failure to have “procedures in place to ensure that all relevant accounts are reconciled” at year end was a “material weakness” finding by the auditor in the 2018/19 CAFR audit letter. (As outlined in more detail in Exhibit A of this report, in conjunction with the delivery of the 2018-2019 CAFR, the City’s outside audit firm, RAMS, highlighted several “material weaknesses” in the City’s internal control processes that negatively affected the timely delivery of financial reporting. These included, but were not limited to, monthly bank reconciliations being as much as 12 months delayed; an inability to properly review numerous financial statement accounts and a failure to maintain an adequate

year end closing process; and (noted as a “significant deficiency”) the failure of the Finance Department to maintain an updated accounting policies and procedures manual for Staff to reference. RAMS also noted that the root cause of these issues was the City’s inability to maintain adequate Staffing levels in the Finance Department. *Potential Red Flags: Weak internal control processes*

Finding 3.3 The Finance Department failed to prepare forward looking projections of the City’s cash position nor was the Monthly Liquidity Report certified by the City

Treasurer as required by the City’s Investment Policy. The City’s Investment Policy (as voted on by the City Council each year) requires the City Treasurer to certify “as to the availability of cash to meet the City’s expenditures over the next six months.... based on cash flow projections provided by the Finance Department.” As of the date this FAHC was created, the City Treasurer’s monthly report was the only interim financial report regularly presented directly to the City Council. The City’s Investment Policy required the City Treasurer to certify the City’s liquidity position based on the forward-looking projections of the Finance Department.

Had the City Treasurer report and certification highlighted the Finance Department’s failure to provide the forward-looking statements, the City Council would have been directly alerted to the issue. The City Council would have been on notice as to the issues within the Finance Department, potentially as much as a year prior to the contentious budget discussions that occurred in June 2020. *Potential Red Flags: Weak internal control processes*

4. The City did not comply with its own purchasing policy.

Finding 4.1 The prior City Manager used her authority to undermine the spirit of the City’s purchasing policy requiring City Council approvals of major contracts. City purchasing policies include various provisions outlining authority levels required by the total size of expenditure. These policies state, among other things, that any contract, amendment, or follow-on contract, that results in a cumulative possible expenditure more than \$25,000.00 requires approval by the City Council.²⁵ Included in the sample selections reviewed by RAMS as part of the 2018-2019 CAFR, approximately 18 contracts (provided to the FAHC directly by RAMS) were found to be in potential violation of the City’s purchasing policies, including at least 2 contracts that, on their surface, should have gone to the City Council for approval. Both were executed by then-acting City Manager DeWolfe and then-acting City Attorney Highsmith (contracted through Colantuono, Highsmith, and Whatley).²⁶ *Potential Red Flags: Weak internal control processes, asset misappropriation*

5. The City did not have policies or procedures for administering its legal liability reserve.

Finding 5.1 The City did not have a policy or practice of accruing an actual reserve against its legal liability. Based on the FAHC’s review of the October 26, 2020, City Council meeting and follow up discussions with staff, the City did not maintain a legal liability reserve and had no policies or procedures for doing so. First, the \$500,000 “reserve” amount which appeared on the City’s balance sheet remained constant over years, without any accounting entries of expenditures or accruals to reflect activity in the liability. Second, as elicited by FAHC member Rossi in the question-and-answer session with the auditor representative at the October 26, 2020, City Council meeting, the account was for all practical purposes an inactive placeholder account within the larger general reserve and there was no true legal liability reserve accrual maintained within the City’s balance sheet. Third, there was no method of review utilized by the City to determine the City’s true, outstanding legal liability to be reflected in the annual audit and financial statements as required by GASB. Instead the City relied exclusively on the City Attorney’s general, but inaccurate, belief that all litigation claims are covered by the City’s

insurance risk pool and therefore not required to accrue for properly. *Potential Red Flags: Weak internal control processes, conflict of interest, asset misappropriation, financial statement fraud*

Finding 5.2 Official representations that the litigation liability reserve was an actual accrual for anticipated liability expenses were based on inaccurate statements made by City Attorney Highsmith and Councilmember Mahmud with no internal review process by the Finance Department, Finance Committee, City Manager, City Council, or the City's outside audit firm, resulting in the filing of a potentially inaccurate 2018-2019 CAFR. At the October 26, 2020 council meeting, City Attorney Highsmith and Councilmember Mahmud represented that the annual designation of a legal liability reserve was a reserve against reasonably anticipated legal expenses, and 100% of all litigation expenses beyond the policy's deductible would be covered by the City's insurance pool making further discussion on the topic unnecessary. However, during the same council meeting,²⁷ the City's outside auditor affirmed: 1) there was no actual accrual in the City's financials for litigation expenses; 2) despite the CAFR being conducted for the period ending June 30, 2019, given the date the CAFR was being *delivered* to the City Council, October 26, 2020, a review of all existing, pending, or threatened litigation outstanding at any time from June 30, 2019 through effectively September 30, 2020 would be necessary in order for the CAFR to be correct²⁸; and 3) the auditors' sole source of information regarding potential litigation claims against the City was a letter provided by then-acting City Attorney, Ms. Theresa Highsmith, a partner at Colantuono, Highsmith, and Whatley. The representations by City Attorney Highsmith are further in direct contradiction to notification previously received by the City's insurance provider, and available to the City Attorney prior to the October 26, 2020 council meeting and finalization of the 2018-2019 CAFR as outlined in Finding 5.3 below. As such, no oversight or review of the City Attorney's methodologies, analysis, or conclusions was conducted by any member of City Staff, Finance Commission, or the City Council prior to a vote to receive the CAFR. The City Council voted 4-1 to receive and file the 2018-2019 CAFR on October 26, 2020. *Potential Red Flags: Weak internal control processes, conflict of interest, asset misappropriation, financial statement fraud*

Finding 5.3 The City filed and received the 2018-2019 audit report containing a legal liability estimate without adequate due diligence. Even if most claims against the City are covered by the City's risk pool coverage, the City is still required, for both the purpose of presenting accurate financial reports as well as ensuring proper accountability for, and execution of, the City's fiduciary responsibilities, to accurately estimate the amount of reserve needed for claim liabilities and for legal expenditures exceeding its annual legal expense budget. In the context of the City Council adoption of the 2018-2019 CAFR on October 26, 2020, it should be noted, that per emails provided to this FAHC and included as Exhibit B to this report, both City staff and Colantuono, Highsmith, and Whatley were made aware, at least 5 months prior to the October 26, 2020 Council meeting, that the City had been notified by its insurance company that at least one ongoing litigation may not be covered under the policy ("Case 2"). On May 27, 2020, City staff attempted to raise an alarm to the City Council that additional funds would be required to cover potential litigation costs, stating, "We need to go to Council for sure, can we discuss ASAP." Upon a review of subsequent City Council meeting agendas, this topic was never brought before the City Council. FAHC finds this course of action does not demonstrate a good faith effort to accurately reserve against the City's liability position or accurately present the City's financial position and performance to the public. FAHC recommends that the City determine its estimated legal liability position in accordance with GASB, as required by local and State regulation, and after a full review of a fulsome economic risk analysis of all existing, pending, or threatened litigation outstanding for the relevant time-period, prepared by the City Attorney and reviewed by the Finance Department, Finance Commission, City Manager, and the City Council prior to inclusion in any City budget or CAFR.

As of the October 26, 2020 City Council meeting, "Case 2" was still being tried on behalf of the City by litigators employed by Colantuono, Highsmith, and Whatley. Notification of potential non-coverage by the City's insurance company appears to be in direct contradiction to the information provided by then-acting City Attorney Highsmith, in writing to the City's outside auditors, and directly to the City Council during open session, and may have negatively impacted the accuracy of the financial information included in the 2018-2019 CAFR. *Potential Red Flags: Weak internal control processes, conflict of interest, asset misappropriation, financial statement fraud*

Finding 5.4 The City's potentially inadequate due diligence or policies regarding litigation risk assessment and risk management led to approximately \$600,000 of litigation and settlement costs born by taxpayers. Below is an example of a litigation issue with potential inadequate risk management. On May 20, 2022, the *SouthPasadenan* reported that the Hanscom Drive sewer litigation (referred to by the City as "Case 2") had been settled for \$200,000. This settlement was in regard to a two-day sewer overflow that occurred on January 11th and January 12th, 2018.²⁹ Included in the settlement agreement is the City's first public acknowledgement that the sewer blockage (found by work crews on January 12, 2018) actually resided in the City's mainline sewer system. In January 2018, the resident initially requested approximately \$40,000 to pay for environmental remediation of the soil as well as replacement of damaged personal property from the overflow caused by a blockage in the City's sewer mainline. The City decided not to accept the request. The resident hired a lawyer in early 2018. In October 2019, the resident again made a settlement offer to the City through then Mayor Khubesian for \$80,000 to cover the environmental remediation, replacement of damaged personal property, and incurred legal costs through that date. The settlement offer was not accepted by the city. Litigation continued until a final settlement offer was executed in mid-May 2022. Based on the legal billings presented in open session City council meetings plus third-party expert costs including but not limited to engineering, soil testing, Transtech inspections, and the final settlement cost itself, the City spent approximately \$600,000 in hard costs regarding Case 2, not including soft costs associated with City staff and Council time as well. Please see below for additional detail on legal billings and timeline of key events:

	12 Mos Actual FY2015-2016	12 Mos Actual FY2016-2017	6 Mos Actual FY2017-2018	12 Mos Annual'd FY2017-2018	12 Mos Actual FY2018-2019	12 Mos Actual FY2019-2020	12 Mos Actual FY2020-2021	11 Mos Actual FY2021-2022	5 Year Total	Check
General Services	193,569.00	241,457.00	47,661.44	95,322.88	105,763.72	99,376.28	107,083.94	100,008.30	507,555.12	-
LITIGATION (UNIDENTIFIED)										
Case 2 (SMITH)					5,263.50	114,175.53	156,648.38	116,341.18	116,341.18	-
Case 1 (Fox)					14,775.50	1,963.00	-	-	16,738.50	-
Case (Benzoni)			16,921.31	33,842.62	21,944.32	-	-	-	55,786.94	-
Other Identified Litigation Cases			22,089.81	44,179.62	44,337.65	75,029.06	51,649.01	3,610.35	218,805.69	-
Transportation (710 issues)	21,604.00	2,515.00	2,396.50	4,793.00	1,527.50	8,941.00	12,208.57	857.50	28,327.57	-
Labor & Employment	9,354.00	8,461.00	11,727.00	23,454.00	34,352.50	52,509.19	33,527.00	50,892.00	194,734.69	-
Special Projects			18,256.00	36,512.00	80,950.57	96,759.87	116,843.80	158,185.58	489,251.82	-
Tax & Assessment			1,611.50	3,223.00	11,280.00	5,724.50	4,336.50	318.50	24,882.50	-
Water & Utilities			1,457.00	2,914.00	7,520.00	5,694.50	10,734.50	16,377.50	43,240.50	-
COVID-19						10,392.00	8,042.00		18,434.00	-
Gardena V RWQCB			1,871.00	3,742.00	3,681.50	8,346.15	2,608.00	144.50	18,522.15	-
Miscellaneous	1,998.00	1,033.00			1,903.50	600.00	(415.10)	33,639.44	35,727.84	-
Subtotal	226,525.00	253,466.00	123,991.56	247,983.12	333,300.26	479,511.08	503,266.60	515,931.33	2,079,992.39	-
% Growth YoY	N/A	11.9%		-2.2%	34.4%	43.9%	5.0%	2.5%		
Subtotal - Litigation (All)			39,011.12	78,022.24	86,320.97	191,167.59	208,297.39	155,508.01	719,316.20	-
Subtotal - Litigation (Identified as Smith Case)					5,263.50	114,175.53	156,648.38	35,556.48	311,643.89	-
Case 2 (Smith) as % of total Litigation Expense by Period (as Identified in Billings)					6.1%	59.7%	75.2%	22.9%	43.3%	
Subtotal - Litigation (Identified Smith plus Pro Forma for Undesignated Billings)					5,263.50	114,175.53	156,648.38	116,948.55	393,035.96	
Case 2 (Smith) as % of total Litigation Expense by Period (Pro Forma for Undesignated Billings)					6.1%	59.7%	75.2%	75.2%	54.6%	

CITY CASE 2 LITIGATION EXPENSE DETAIL BASED ON KEY TIMELINE OF EVENTS

Key Items and Dates	DATE	# OF MONTHS	\$ Expenses	Cumulative \$'s	Cumulative %
Original \$40K Claim from Resident for Property Remediation and Replacement Costs	Jan-18	N/A	-	-	0.0%
Initial \$80K Settlement Offer from Resident and Date of City Press Conference	Oct-19	21.27	11,825.86	11,825.86	2.0%
First Mediation	Jun-20	8.13	107,613.17	119,439.03	20.1%
Judge Kralik Rules Against City in SLAPP Case	Jan-21	7.13	61,681.42	181,120.45	30.5%
Mandatory Settlement Conference	Jun-21	5.03	94,966.96	276,087.41	46.6%
City Files Appeals Brief in SLAPP Litigation	Nov-21	5.10	71,011.40	347,098.81	58.5%
First Formal Offer of Settlement From the City to Resident	Dec-21			347,098.81	58.5%
Settlement Executed Between City and Resident	May-22	6.03	45,937.15	393,035.96	66.3%
Plus: Agreed \$200K Settlement Cost for City (Not included in billings numbers above)	May-22		200,000.00	593,035.96	100.0%
Cumulative Total Expense (Excluding Third Party Fees ie. Transtech, engineers, etc)		52.70	593,035.96		

Total Cost to the City Since Losing the SLAPP Judgement	Jan-21	411,915.51
Total Cost to the City Since First Mediation Date	Jun-20	473,596.93
Total Cost to the City Since \$80K Settlement Proposal Made by Resident	Oct-19	581,210.10
Total Cost to the City Since Original \$40K Claim Made by Resident	Jan-18	593,035.96

Approximately \$600,000 of litigation costs came after the resident's initial request of \$40,000.00. The City Attorney at that time, Highsmith, is employed directly by Colantuono, Highsmith, and Whatley, the firm hired to litigate Case 2. As noted by the California League of Cities white paper on City Attorney ethics³⁰, there is a potential conflict of interest for a partner in a law firm, serving as a contract city attorney, to advise a city council on litigation work conducted by other members of the same law firm. *Potential Red Flags: Weak internal control processes, conflict of interest, asset misappropriation*

6. The City decreased its financial transparency by reducing the detail and frequency of its financial reporting to Council.

Finding 6.1 The City discontinued its semi-annual report on expenses for attorneys, consultants, and lobbyists. Historically, and to track total expenditures more readily for each group by category, a consolidated summary of expenses spent during the year on attorneys, consultants, and lobbyists was provided twice a year to the City Council. Without the provided consolidation, it is difficult to track total expenses by category as expenses can be distributed across multiple departments and Fund accounts making it impossible for the City Council to trace the impact of litigation, staffing, or outsourcing decisions – and thereby significantly reducing the ability for oversight from both the City Council and residents. While this report was historically provided twice per year, at the time the FAHC was created, the last issuance of such a report was in February 2018. Please note that these legacy reports had been available online via the Finance Department website until sometime in mid to late 2020. They have since been removed. *Potential Red Flags: Weak internal control processes, conflict of interest, asset misappropriation, financial statement fraud*

Finding 6.2 The City reduced the detail provided in its Legal Billing Disclosures amidst resident concerns regarding conflicts of interest regarding the City Attorney's employment by Colantuono, Highsmith, and Whatley As far back as the 1990's (the oldest available files archived in the City's online document database) legal expenses included in the warrant register presented, and approved for payment by the City Council were summarized by matter with each matter assigned a specific identifier (either a matter name or case number).³¹ Starting with the legal expenses billed for the month of July 2021 by Colantuono, Highsmith, and Whatley (the firm which employs the City's contract City Attorney among providing other legal services), and presented to the City Council for inclusion in the warrant register to be approved on October 6, 2021,³² these identifiers have been removed.

	FY 2017-2018								FY 2018-2019								FY 2019-2020										
	1/3/18	1/17/18	2/7/18	5/2/18	6/6/18	8/15/18	9/19/18	11/7/18	1/16/19	2/6/19	3/6/19	4/17/19	5/15/19	7/17/19	8/21/19	10/2/19	11/6/19	12/4/19	12/18/19	1/14/20	2/5/20	3/18/20	4/15/20	6/3/20	6/17/20		
General Services	9,597.37	9,599.59	9,570.85	18,893.63	19,261.47	19,215.82	9,500.00	19,326.25	9,587.20	9,620.64	9,601.54	9,650.80	9,560.32	9,560.32	10,077.72	10,095.12	10,141.62	10,075.40	10,067.28	10,065.78	10,085.78	10,088.77	4,194.95	5,449.00			
LITIGATION (UNIDENTIFIED)																											
Case 2 (SMITH)																											
Case 1 (Foa)																											
Case (Benzon)	141.00	10,300.26	3,413.05	3,067.00	16,332.74	5,470.58	141.00		2,096.50	141.00	1,081.00	1,848.00	107.00	2,312.40	4,249.96	17,594.25	21,735.52	7,311.70	8,161.68	10,671.09	17,607.18	13,543.50	10,588.25				
Other Identified Litigation Cases	6,721.78	5,384.93	4,714.00	5,269.50	3,607.50	4,840.85	21,854.30	7,000.50	6,785.50	1,997.50	4,253.50	1,433.50	305.50	1,081.00													
Transportation (710 issues)	660.50	91.00	634.50	1,010.50	211.50	235.00	164.50	352.50	47.00	517.00																	
Labor & Employment	493.50	1,998.00	5,757.50	3,478.00	5,146.50	12,290.50	1,679.50	3,266.00	3,078.50	5,898.50	1,034.00	1,959.00	2,209.00	1,292.50	4,624.50	3,438.00	3,887.50	16,047.93	4,064.00	1,077.50	12,746.76	1,483.00	1,638.50				
Special Projects	2,238.50	1,683.50	10,799.00	3,335.00	5,494.50	13,330.83	8,711.00	22,624.86	1,808.50	15,294.57	4,812.00	9,874.31	2,694.86	3,034.08	3,471.00	2,940.00	3,120.06	3,568.56									
Tax & Assessment	1,443.50			188.00	1,527.50	9,318.00	624.50																				
Water & Utilities	493.50	235.00	282.00	446.50	1,136.00	164.50	493.50	399.50	282.00	564.00	869.50	611.00	752.00	70.50	441.00												
COVID-19																											
Gardena V RWQCB	415.00	292.50	449.00	714.50	438.50	732.00	555.50	70.50	120.00	987.00	94.00	684.00	1,950.50	1,039.00	814.25	468.45	1,127.45	198.50	2,064.00	204.50	65.00	181.00	253.50				
Miscellaneous																											
Subtotal	22,194.65	29,584.38	35,619.90	36,602.63	55,956.21	64,421.58	43,898.30	63,486.61	18,918.20	39,273.71	21,936.01	25,409.61	27,581.50	25,471.40	24,466.59	45,864.82	60,279.20	42,732.59	35,730.47	50,312.37	68,301.19	54,357.05	44,413.00				
% Growth Yot																											

	FY 2020-2021								FY 2021-2022									
	7/1/20	7/15/20	8/5/20	11/18/20	12/16/20	3/2/21	4/7/21	4/28/21	7/1/21	7/21/21	10/6/21	10/20/21	11/10/21	1/12/22	2/1/22	3/28/22	4/20/22	6/4/22
General Services	6,455.50								10,000.00	10,000.00	10,006.80	10,000.00	10,000.00	6,918.50				
LITIGATION (UNIDENTIFIED)																		
Case 2 (SMITH)	1,627.35					38,430.39	30,843.22		8,928.28									
Case 1 (Foa)																		
Case (Benzon)																		
Other Identified Litigation Cases	7,134.50					1,568.00	1,592.50		2,552.75									
Transportation (710 issues)																		
Labor & Employment	860.50					318.50	1,200.50		686.00	2,156.00	2,523.50			3,062.50			10,596.50	
Special Projects	8,645.50					7,261.50	13,641.00		36,815.50		15,884.50			15,190.50			20,560.50	
Tax & Assessment	1,273.50					24.50					220.50							
Water & Utilities	1,273.50					122.50	2,499.00		196.00		1,739.50			2,118.50			1,984.50	
COVID-19	3,544.50					117.50	156.00											
Gardena V RWQCB	82.00					1,176.00	318.50											
Miscellaneous						191.58			12,029.50	305.56				218.56			534.55	
Subtotal	29,623.35					64,359.19	55,684.72		71,208.03	26,518.98	34,996.80			37,508.56			73,035.00	

It should be noted that, while discussion by the City Council during the October 6th meeting concluded that the shift in billing practice was to mitigate any potential "advantage" that an

opposing council could gain by seeing the amount of billings incurred by the City on any particular case, this change in billing practices occurred just one month after various residents raised concerns to the City Council, via public comments, regarding what was perceived to be excessive litigation costs, specifically citing the billings by Colantuono, Highsmith, and Whatley associated with the ongoing “Case 2” litigation.³³ That South Pasadena City Attorney, Andrew Jared, who recommended the change in the decades-long billings practice, is a contract City Attorney employed directly by Colantuono, Highsmith, and Whatley presents a conflict of interest vis a vis the recommendation to Council. *Potential Red Flags: Weak internal control processes, conflict of interest, asset misappropriation, financial statement fraud*

Finding 6.3 **If the City had maintained the frequency and detail of legal expense reporting, the disclosures would have alerted the public to large fluctuations in legal expenses from year to year.** The 2018-2019 CAFR filed with the City Council on October 26, 2020, estimated legal liabilities of the City, outside of its budgeted legal expenses, at \$500,000. On March 12, 2021, less than 5 months after the 2018-2019 CAFR was presented to the City Council, the *SouthPasadenan* reported³⁴ that the City’s then-proposed 2020-2021 City budget included a litigation budget of “\$1.15 million for 2021, nearly four times as much as for 2020...” The article also quotes then-acting Interim Assistant City Manager, Elaine Aguilar, as stating the “\$1.15 million figures does not include potential costs for the still pending litigation over a sewer leak on Hanscom Dr. [Case 2]” FAHC recommends that increased financial reporting of highly fluctuating, cumulatively large legal expenses is an important step toward greater financial transparency, including an immediate return to providing semi-annual reports on expenses for all lawyers, consultants, and lobbyists. *Potential Red Flags: Weak internal control processes, conflict of interest, asset misappropriation, financial statement fraud*

IV. **RECOMMENDATION REGARDING A FORENSIC AUDIT**

It was not within the scope of the FAHC to make any conclusions as to whether any inappropriate activities *had* occurred or the intentions behind any individual activities described in this report. The FAHC has not made, nor does it infer, any such conclusions. Rather, it was the task of the FAHC to investigate whether red flags existed that would indicate inappropriate activities *may* have occurred. It is the opinion of the FAHC that the red flags discussed throughout this report do, on their surface, warrant a further review by specialists via a forensic audit. However, given the number of years that have transpired since the bulk of these actions took place, the significant financial cost associated with such an endeavor, and the prior removal/resignation of many then-acting City officials potentially involved, such a step may not be practical for the City at this time. The FAHC instead recommends the City take the additional actions outlined below to help ensure similar activities are not tolerated or allowed to exist in the future. This conclusion was based, in no small part, upon the assumption that City Staff, the Finance Commission, and the City Council will continue to implement the many recommendations provided in both this report and previously provided throughout the FAHC’s work. In the event the City does not follow through on the recommendations provided in the next 12 months, it is the belief of the FAHC that a forensic audit, designed to look into the numerous findings discussed in this report, is not only warranted, but necessary.

It is further recommended that City Staff:

- Review and prepare an analysis to the Finance Commission and City Council regarding the viability of instituting a new, independent internal auditor position within the City of South Pasadena. As discussed elsewhere in this report, the existing City policies and procedures, had they been properly followed, would have helped prevent or eliminate many of the FAHC’s findings. However, as the position of City Manager is the only City Staff member reporting directly to the City Council who is also under the Council’s direct and sole supervision, a potential for conflict of interest is created. An Internal Auditor, hired by, reporting to, and having compensation determined directly by the City Council, would act

independently of the City Manager and Finance Departments, helping to ensure ongoing compliance with stated City codes, policies, and procedures without fear of intimidation or retaliation by the City Manager. This internal auditor could support the City Council in their responsibility for oversight by providing institutional knowledge and an additional level of security regarding stewardship of funds for the citizens of South Pasadena;

- In order to comply with best practices for contract attorneys as described by the League of California Cities and the City of South Pasadena’s own code of ethics requiring the elimination of even the “appearance” of a conflict of interest, it is recommended the City codify as policy that the City cannot retain one law firm to provide both (i) contract City Attorney services, and (ii) litigation services;
- Immediately proceed with an RFP for a new contract City Attorney law firm (as already motioned by Councilmember Zneimer and seconded by Councilmember Cacciotti in open session during the September 1, 2021 council meeting) to be acted upon, and any awards determined, by the newly constituted City Council after the November 2022 elections;
- Determine its estimated legal liability position in accordance with GASB, as required by local and State regulation, and after a full review of a fulsome economic risk analysis of all existing, pending, or threatened litigation outstanding for the relevant time-period, prepared by the City Attorney and reviewed by the Finance Department, Finance Commission, City Manager, and the City Council prior to inclusion in any City budget or CAFR;
- Increase financial reporting of highly fluctuating, cumulatively large legal expenses, including an immediate return to providing semi-annual reports on expenses for all lawyers, consultants, and lobbyists; and
- Provide a quarterly update to the Finance Commission to update both that body and, in turn through Finance Commission and City Council Liaison reports, the City Council as to Staff’s progress on implementing the recommended actions.

The opinion is based on the FAHC’s work on the operational matters described above; its review of documents and other information provided by Staff during the FAHC’s work; agenda reports, presentations, and discussions at open meetings of the Finance Commission and City Council; and other related, publicly accessible materials – many of which have been cited throughout this report in support of the FAHC’s findings and recommendations.

The FAHC did not consider, and did not have access to, City Council closed session materials, or other information protected from disclosure to the public by the attorney-client or other privileges. Nevertheless, the FAHC believes that the current members of the City Council, in consultation with current City senior management, should conduct its own assessment of the necessity for and scope of any additional audits (including a forensic audit if deemed warranted), using relevant materials that may be outside the scope of the FAHC’s work or protected from public disclosure.

For the purpose of transparency to Staff, the City Council, and City residents, much of the FAHC’s discussions regarding the final scope item, to “Assess whether it is advisable for staff to recommend a forensic audit be conducted for the period of July 2019 through the current period [September 2020],” can be found in publicly available emails and Zoom meeting video recordings (for the final two meetings of the FAHC). Videos can be found on the City’s YouTube channel (<https://youtu.be/EBod1BSaoQY> and <https://www.youtube.com/watch?v=qkCj65Qcc-E>).

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EXHIBIT A

COMPREHENSIVE ANNUAL FINANCIAL REPORT (“CAFR”) FOR FISCAL YEAR 2018-2019

On September 24, 2020, a draft Comprehensive Annual Financial Report (“CAFR”) for fiscal year 2018-2019 was presented to the Finance Commission for review, discussion, and a recommendation to City Council.

During its initial review of the draft 2018-2019 CAFR, the commission discovered discrepancies between the draft 2018-2019 CAFR and the 2018-2019 budget adopted by City Council on June 6, 2018.³⁵ The commission further observed discrepancies between the 2018-2019 budget adopted by City Council and the 2018-2019 budget document posted on the City’s website.³⁶

In other words, there were three different 2018-2019 budget documents, two of which were different from the budget document actually adopted by the City Council in 2018. The commission could not find evidence that the changes had been disclosed to or approved by the City Council.

In its initial meeting on October 13, 2020, the FAHC reviewed, discussed, and provided feedback to staff on the draft CAFR, on the variances identified by the Finance Commission, and on the adverse findings made by the City’s auditor in connection with the draft 2018-2019 CAFR. Among others, the auditor’s findings included:

- Non-Compliance with Budget Policy: While reviewing the DRAFT 2018/19 CAFR, members of the FAHC realized that the 2018/19 Budget referred to in the DRAFT CAFR was not consistent with the 2018/19 Budget approved by the City Council. Similar to the 2020/21 Budget variances described elsewhere in this report, subsequent to approval of the 2018/19 Budget by the City Council, errors within the Budget appear to have been discovered by members of the Finance Department and “corrected” without any notification to, review, or approval by the Finance Commission or City Council. As noted by RAMS and included in the 2018/19 CAFR Management Letter, this was in violation of stated City Financial Policy.
- Non-Compliance with City Purchasing Policy: City purchasing policies include various provisions outlining authority levels required by the total size of expenditure. These policies state, among other things, that any contract, amendment, or follow-on contract, that results in a cumulative possible expenditure in excess of \$25,000.00 requires approval by the City Council³⁷. Included in the sample selections reviewed by RAMS as part of the 2018/19 CAFR, approximately eighteen (18) contracts were found to be in potential violation of the City’s purchasing policies, including at least two contracts that, on their surface, should have gone to the City Council for approval. Both were executed by then-acting City Manager DeWolfe and then-acting City Attorney Highsmith (contracted through Colantuono, Highsmith, and Whatley).
- Bank Reconciliations Not Prepared Timely: RAMS found that bank reconciliations had not been prepared, reviewed or approved in a timely manner, describing the cause as: “The City did not have controls in place to ensure bank reconciliations were performed in timely manner [i.e., monthly].” The auditor considered this deficiency to be a “material weakness.”³⁸
- Year-End Closing Process: RAMS found that “many accounts were not properly reviewed and/or reconciled at year-end in preparation for the [2018-2019] audit.” The auditor described the cause as: “The City did not maintain the appropriate staffing levels to allow for the proper year-end closing process.” The auditor considered this deficiency to be a material weakness.

- Accounting Procedures and Policies Manual: RAMS found that the Finance Department did not have “an updated accounting procedures and policies manual readily available for reference.” The auditor considered this deficiency a “significant deficiency.”³⁹

A revised draft 2018-2019 CAFR was presented to the Finance Commission on October 15, 2020, with current staff disclosing and explaining the revisions made to the draft initially presented to the commission on September 24, 2020, in response to feedback received from the commission and from the FAHC. The commission voted to receive and file the 2018-2019 CAFR.

The 2018-2019 CAFR was presented to the City Council on October 26, 2020. The agenda report discussed and explained the variances identified by the Finance Commission and their review by the Finance Commission and by the FAHC. The City Council voted 4-1 to receive and file the 2018-2019 CAFR.⁴⁰

In the FAHC’s view, a primary cause of the financial reporting crisis that led to the formation of the FAHC was insufficient staffing in the Finance Department. In addition to the “high turnover at the management level in the Finance Department” cited by the City’s auditor, an ill-conceived 2018 reorganization of the Finance Department, promoted by the then-acting City Manager, reduced department staff from a historical nine (9) to five (5), and outsourced business licenses and payroll functions.

Exacerbating the reduction in staff was the replacement of legacy staff with new staff who did not have institutional knowledge, and the hiring of a Finance Director who lacked the experience necessary to lead the department.

These conditions, compounded by a lack of controls (and the failure to follow existing controls), led to a delay in month-end bank reconciliations -- by as much as twelve (12) months -- which in turn led to a delay in the year-end closing process, which in turn led to a delay in commencing the audit process for the 2018-2019 CAFR.

The City’s former City Manager retired suddenly effective September 12, 2020, immediately subsequent a September 11, 2020 Special Agenda Closed Session performance evaluation with the City Council. The City’s former Finance Director left on an unspecified indefinite family leave in August 2020, and resigned on October 6, 2020, prior to returning from leave and one week after the formation of this FAHC was announced.⁴¹ The committee credits the interim Assistant City Manager hired to lead the Finance Department and current department staff for their transparency and responsiveness to feedback from the Finance Commission and the FAHC, and for bringing the fiscal year 2018-2019 CAFR to completion.

ANNUAL COMPREHENSIVE FINANCIAL REPORT (“ACFR”) FOR FISCAL YEAR 2019-2020

Finance Department staff regularly updated the FAHC and the Finance Commission on the progress of the audit necessary to complete the Annual Comprehensive Financial Report (“ACFR”) for fiscal year 2019-2020, noting completion of tasks on the year-end audit schedule.

To assist staff with preparation for the 2019-2020 audit, the FAHC reviewed City Council agenda materials for the 2019-2020 fiscal year (July 1, 2019, through June 30, 2020) to identify City Council action that had the effect of adjusting or modifying the budget, such as authorizing contracts or contract amendments, or increasing contract amounts. The FAHC members assembled the relevant agendas, agenda reports, and minutes for use by staff in connection with the audit and completion of the 2019-2020 ACFR.

A draft 2019-2020 ACFR was presented to the Finance Commission on July 14, 2021, and to the City Council on July 21, 2021. Both bodies voted to receive and file the report.

ANNUAL BUDGET FOR FISCAL YEAR 2020-2021

A new, draft fiscal year 2020-2021 budget was presented to the Finance Commission on March 4, 2021, and to the City Council on April 27, 2021. The commission voted unanimously to recommend approval of the 2020-2021 budget, and the Council voted unanimously to adopt the budget.

With the 2018-2019 CAFR having been completed, year-end fund balances and fiscal year 2018-2019 revenue and expenditures reported in the 2020-2021 budget were tied to actual, audited numbers. Additionally, fiscal year 2019-2020 revenue and expenditures were tied to pre-audit, actual numbers.

UPDATING FINANCIAL POLICIES AND PROCEDURES

As part of the FAHC review, recommendations were made to Staff regarding updated financial policies in 2021-2022 budget including: mid-year budget update, quarterly reports, GASB 10 / risk management accounting (revenues and expenditures are now accounted for through insurance internal service fund, instead of through general fund via transfer). The FAHC also discussed purchasing policies, the lack of a current policies and procedures manual, reviewed existing City policies as provided by staff, and also reviewed other the policies of other "case study" cities with the City of Irvine providing a model as to best practices. The City has since retained a consultant to draft an updated policies and procedures manual tailored to the City of South Pasadena based on the prior mentioned recommendations and reviews.