CALENDAR ITEM

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REVIEW OF THE CITY OF REDONDO BEACH COST ALLOCATION PLAN AND INTERNAL SERVICE FUND ALLOCATION METHODOLOGY

INTRODUCTION:

The City of Redondo Beach (City) is a trustee of sovereign tide and submerged lands granted by the Legislature pursuant to Chapter 57, Statutes of 1915 and as amended by Chapter 1555, Statutes of 1971.

The Commission has the statutory responsibility to oversee the management of public trust lands and assets by legislative grantees who manage these lands, in trust, on behalf of the State. (Pub. Resources Code, § 6301, et seq.; *State of California ex rel. State Lands Commission v. County of Orange* (1982) 134 Cal App. 3d 20, 23).

BACKGROUND:

Several Redondo Beach residents have alleged that the City is misusing tidelands funds by abusing Internal Service Fund (ISF) transfers.

ISFs are used in governmental accounting to allocate overhead costs of goods or services to other city departments on a cost-reimbursement basis. Generally accepted accounting principles do not require the use of ISFs but many local governments use them to achieve a higher level of operating efficiency than would be available if the same activities were performed by multiple units within the organization. ISFs are set up to take advantage of economies of scale and to accurately identify costs of specific governmental services. Examples of ISF charges include Human Resources, Information Technology, Insurance, and City Council functions.

The specific concern is that the City is over-allocating overhead costs to the Tidelands Fund instead of billing the City's General Fund. At the June 19th Commission meeting, staff was directed to analyze the City's Cost Allocation Plan and whether the City has adopted an ISF allocation method that is appropriate and reasonable.

STAFF ANALYSIS:

ISF Allocation Methodology/Cost Allocation Plan

The City uses ISF allocations to determine the true cost of departmental operations and the same cost allocation methodology is used for all departments, not solely for the Tidelands Fund. Starting in 2012, the City's ISFs are reviewed annually and the individual audits are placed in the City's Comprehensive Annual Financial Statement (CAFR) and the mid-year budget.

The City has seven ISF funds: Self-Insurance Program Fund, Vehicle Replacement Fund, Building Occupancy Fund, Information Technology Fund, Emergency Communications Fund, Major Facilities Repair Fund, and a City Facility Sewer Fee. Although a separate ISF is commonly established for each service activity, the City's ISFs have multiple categories within each fund. Allocations for the categories within each fund are charged to departments at a rate that is intended to fully recuperate the full cost of the service.

Because the objective of ISFs is to recover the total cost of services through user charges, the relationship between the cost of the service and the charged price of the service is important. The City uses certain statistics to determine the cost allocation amount to user departments. For example, the City's Information Technology Fund has three expenses that will need to be considered when determining cost allocation: personnel, maintenance and operation, and internal service fund/overhead allocations that directly support the information technology function. The statistics used to determine the allocation amount to each user are the number of computers and computer related equipment and the number of telephones and telecom-related equipment. The statistics used by the City to allocate costs are reasonable and are supported with a nexus to the cost being allocated. Further, in 2008 the City commissioned an audit of the ISF allocation methodology. The audit also concluded that the methods used for allocating costs to the ISF were generally reasonable. The audit was completed and released in 2010.

The allegations raised earlier this year point to significant increases in the City's ISF cost allocations to the Harbor Enterprise Fund over the past decade. Since fiscal year 2005-2006, there has been a 27% increase in total ISF cost allocations to the Harbor Enterprise Fund. The ISF cost allocations to the Tidelands Fund, which is one of the two funds within the Harbor Enterprise Fund, increased only 2% during that same time. The substantial amount of the Harbor Enterprise Fund's cost allocation increase was due to the increase of cost allocations in the Uplands Fund, which is for land adjacent to the granted lands that the City holds as a municipality and is outside the scope of the Commission's jurisdiction.

Based on this review, it appears that the City's allocation method for its ISFs is appropriate and reasonable.

Additional Items Addressed

1. Self-Insurance Fund

Self-Insurance is the term often used to describe a government's retention of risk or loss rather than transferring that risk to an independent third party through the purchase of an insurance policy. The types of self-insurance activities vary from government to government and almost any type of potential liability could be self-insured.

The self-insurance fund is the City's largest ISF and it is administered by a third-party agent, Adminsure. The City's Self-Insurance Program Fund accounts for the cost of providing liability and property insurance, worker's compensation insurance and unemployment insurance. Unemployment insurance is billed as a personnel expense and is not an ISF allocation. Each category is charged to departments at a rate that fully recuperates the annual cost of the insurance. The allocated costs also include personnel costs for managing the program, contracts and professional services, and overhead allocations that directly support the insurance function.

Allocation for the City's liability and property insurance is calculated using the number of claims paid for the structure occupied or activity performed. Such a claims-based approach is a common method for allocating self-insurance costs. The current value and the square footage of the structure occupied are also used to allocate liability costs. Allocation for workers' compensation insurance is determined based on claims paid for each department's specific employees and also on full-time and part-time salaries. For both workers' compensation and liability and property insurance the total charge by the ISF to other funds is based on an actuarial method or historical cost information that is adjusted over a reasonable period of time. This method is commonly used by governmental entities with the goal to ensure that the ISF revenues and expenses are approximately equal.

In the past the City adjusted the amount necessary for the reserve level of the self-insurance fund resulting in a surplus. That surplus was not returned to the various funds on an equitable basis. Commission staff has concerns about this practice. In the future, if a surplus should arise, staff recommends that the Tidelands Fund receive a proportional share of the surplus fund.

Based on this review, it appears that the City's allocation method for its self-insurance fund is appropriate and reasonable. Staff believes that the City should proportionally reimburse the Tidelands Fund if there is a surplus in the future.

2. Comparison of Allocation Methods

Due to the concerns raised by the public, staff compared the City's three largest ISFs with ISFs for other grantees with similarly sized harbors. However, making direct comparisons are difficult and not an effective way to evaluate the methodology of a grantee's allocation of ISFs because of the different accounting methods utilized and the uniqueness of each grant.

As mentioned, a direct comparison of ISFs between grantees is not an effective evaluation tool because of the variation of each grantees use of ISFs. Governments are not required to use ISFs to account for the financing of good and services. Some governments have many ISFs; others use few or none. Moreover, the same function that is accounted for in an ISF in one government may be accounted for differently in another government. For example, one grantee's operating costs of a data processing department may not be accounted for with an ISF but the costs associated with the service are still paid out of the grantee's trust fund. Whereas another grantee may account for the entire cost of data processing in an ISF solely for data processing or in an ISF that has multiple other categories of services. These inconsistencies impact the comparability of the financial reports between grantees.

Staff compared the City's ISF cost allocation with two other similarly sized southern California harbors: Santa Barbara Harbor and Dana Point Harbor. The City of Santa Barbara manages its legislative grant that encompasses the harbor and Stearns Wharf. Dana Point Harbor is comprised of three areas: a landside area along Dana Point Harbor Drive; the Island area; and two marinas consisting of docks, commercial fishing slips, federal anchorage areas, and tall ship docks, as well as youth and group docks, a fishing pier, fuel dock, sport fishing dock, and bait barge. Compared to Santa Barbara's and Dana Point's ISFs, the City of Redondo Beach's three largest ISFs (self-insurance, overhead, and vehicle replacement funds), as a percentage of gross revenue, are within a range of four percent. Such a close range between the City's cost allocation for its ISF and other similarly sized grantees does not appear unreasonable.

3. Limitations of the OMB A-87 Guidelines

The allegations also discuss the limitations of the OMB A-87 guidelines, which are the cost accounting principles and standards used for determining the costs of the City's ISFs. The allegation states that OMB A-87 was designed for federal grants where no off-setting tax revenues are involved. Although the majority of State and Federal grants under OMB A-87 guidelines do not have the ability to generate tax revenue, the City's land generates money from City imposed local taxes, including taxes imposed within legislatively granted tide and submerged lands. These local taxes are imposed on both uplands and granted lands and are not considered tidelands revenue that must be used solely for trust purposes. The State cannot mandate that a local tax be used for Statewide or non-local purposes. Therefore, the City does not need to devote local tax revenue collected on granted tide and submerged lands to reimburse for ISF allocations.

Conclusion

The ISF allocation methodology used by the City appears to be appropriate and reasonable. In addition, given the ISF audit of the cost allocation methodology released in 2010, the relatively small increase in the Tideland's Fund ISFs over the past eight years, and the similar comparison with other legislative tideland grants, staff believes that the evidence available does not represent misallocation or maladministration of the City's ISF cost allocations, and does not warrant further action by the Commission. Staff does recommend working with the City to ensure that an equitable portion of any future surplus from the City's self-insurance fund is deposited back in the Tidelands Fund.

OTHER PERTINENT FACTS:

1. The public concerns regarded an alleged misuse of ISFs within the Harbor Enterprise Fund, which is comprised of both the City's Tidelands Fund and City's Uplands Fund. The Uplands Fund is for revenues and expenditures for land adjacent to the tideland grant that is owned by the City as a municipality. Because this Upland Fund does not account for any public trust land within the City's grant it is outside the scope of the Commission's review of tidelands trust matters.

2. ISF financial reports are presented in a more complicated format than the appropriated budget reports. To fully understand ISF allocations, an understanding of accounting terminology is required. It is difficult to analyze the

allocation amounts on financial statements without having a comprehensive knowledge of the underlying transactions. Due to the complexity of ISF reporting and the additional effort to analyze, ISFs generally do not always receive the same level of scrutiny as other budgets. To remedy this issue, the City has hired a third party, Adminsure, to manage their self-insurance fund, which is their largest ISF. The City also hires a third party accounting firm to audit the financial statements of their ISF accounts regularly, see number five and six below for further information. In February 2014, the City announced its intent to engage OpenGov as a financial transparency vendor that will enable the City to share financial data with the public. In addition, the City's Treasurer's Office intends to hire a full time internal auditor to review various City operational functions.

3. In 2004, Commission staff received a complaint alleging a number of illegal activities by the City, including the misuse of ISFs. In response, Commission staff conducted a financial review investigation of the City's granted tide and submerged lands trust fund accounts. The scope of the Commission's review included an analysis of revenues and expenditures for a five-year period ending June 20, 2004. As part of the investigation, staff reviewed the City's method for determining ISF cost allocations and found no evidence that funds were being transferred illegally.

4. The Commission staff's findings were presented to the Commission on June 26, 2006, and December 14, 2006. The Commission staff found that the evidence uncovered at that time did not warrant further action by the Commission relating to the specific allegations. However, the review did lead staff to uncover several separate areas within the financial management of the City's granted tide and submerged lands that needed attention. To rectify these issues, the Commission and City entered into an agreement entitled the "Agreement Regarding the Harbor Center Project and Kincaid's Restaurant Lease" (Agreement). The Agreement, which was amended by the Commission on December 2, 2013, addresses the Harbor Center Project, a hotel, retail and parking complex project on lands acquired by the City using tideland trust funds, and a lease with Kincaid's restaurant, which is located on the Redondo Beach Pier. The agreement set out a framework to address outstanding issues that were not necessarily in violation of the grant, but required further attention.

5. In 2008, the issue of ISF allocations was again raised by citizen members of the Redondo Beach Harbor Commission and the Budget and Finance Commission. The City Council called for a joint public meeting of the Redondo Beach City Council, the Harbor Commission, and the Budget and Finance Commission to

review concerns over a newly applied ISF methodology for fiscal year 2007-2008, performed by a newly contracted financial consulting company, MGT of America (MGT). MGT prepared a cost allocation plan that was inconsistent with that of prior years, resulting in a miscalculation in departmental ISF and overhead charges. In 2009, City staff and MGT were found by the City Council to have erred, and the incorrect methodology was rolled back and the original methodology was reapplied. In response to the error, the City Clerk recommended more transparency and suggested the City have external auditors review calculations and the method for the ISFs. An Audit Committee, made up of two members of City Council, the elected City Clerk, and the Chairpersons of the Harbor Commission and the Budget and Finance Commission, was formed.

6. In 2009, the Audit Committee elected to select an independent firm to review the ISF and enterprise funds for fiscal year 2007-2008, the application of the ISF cost allocation methodology. The report, completed in 2010, reviewed the cost allocation plan as a whole and determined whether it results in a fair and equitable allocation of costs to all funds, departments and divisions, as appropriate, including the Tidelands Fund. With the exception of a few suggestions, the review found the cost allocation plan for fiscal year 2007-2008 resulted in a fair and equitable allocation of costs, and that the allocation methodology used to allocate the costs was reasonable. In 2012, the audit committee recommended that individual audits of the ISF and enterprise funds be included with the annual CAFR audit procedures. The ISF audits procedures continue to this day.

7. At the April 23, 2014, Commission meeting, several Redondo Beach residents raised concerns about the City's management of its granted tide and submerged lands and alleged that the City is misusing tidelands funds. Upon hearing the concerns, the Chair directed staff to report to the Commission at its June 19, 2014, meeting on the feasibility of conducting an audit of the City's use of tideland funds, with an emphasis on the City's use of ISF transfers. At the June Commission meeting, staff proposed four alternatives to address the alleged misuse of tidelands revenue. Staff was directed to pursue alternative two, consisting of an analysis of the City's Cost Allocation Plan, and whether the City has adopted an ISF allocation method that is appropriate and reasonable. The review was to be performed without the redirection of Commission audit staff from auditing revenue generating leases.

8. During the review process, Commission staff interviewed several City staff members including the City Treasurer, City Auditor, Finance Director, and Risk

Manager. In addition, staff analyzed several documents including: The 2008 Cost Allocation Plan Procedures Audit, 2012 and 2013 Internal Service Fund Audit, 2012 and 2013 Enterprise Fund Audit, Fiscal Year 2012-2013 Cost Allocation Plan, ISF Administrative Policy/Procedures, and several administrative reports submitted by the City.

9. The staff recommends that the Commission find that directing staff to work with the City to determine a way to allocate any future self-insurance surplus equitably back to the Tidelands Fund and to continue to review the City's annual financial statements including the ISF cost allocations to the Tidelands Fund does not have a potential for resulting in either a direct or a reasonably foreseeable indirect physical change in the environment, and is, therefore, not a project in accordance with the California Environmental Quality Act (CEQA).

   Authority: Public Resources Code section 21065 and California Code of Regulations, Title 14, sections 15060, subdivision (c)(3), and 15378.

RECOMMENDED ACTION:
It is recommended that the Commission:

CEQA FINDING:

Find that directing staff to work with the City to determine a way to allocate any future self-insurance surplus equitably back to the tidelands fund and to continue to review the City's annual financial statements including ISF cost allocations to the Tidelands Fund is not subject to the requirements of CEQA pursuant to California Code of Regulations, Title 14, section 15060, subdivision (c)(3), because the subject activity is not a project as defined by Public Resources Code section 21065 and California Code of Regulations, Title 14, section 15378.

AUTHORIZATION:

Direct staff to work with the City to determine a way to allocate any future self-insurance surplus equitably back to the Tidelands Fund and to continue to review the City's annual financial statements including the ISF cost allocations to the Tidelands Fund.