City of Tucson Independent Audit and Performance Commission

March 7, 2012

Subject: Report to Mayor and Council: Commission comments on City of Tucson's Comprehensive Annual Financial Report (CAFR) for Fiscal Year ending June 30, 2011.

Honorable Mayor and Council:

Members of the City's Independent Audit and Performance Commission (IAPC) have recently reviewed and discussed the City's Comprehensive Annual Financial Report (CAFR) for the fiscal year ending June 30, 2011.

In order to properly and effectively discharge your fiduciary responsibility as the primary stewards of the City's resources, both to ensure optimal benefit or "return on investment" to the community, as well as to ensure an effective internal control environment in which to prevent or mitigate various types of risk, the Commission recommends that Mayor and Council similarly review and discuss the City's CAFR, including the *Management's Discussion and Analysis* and *Notes to Basic Financial Statements* sections. Attached you will find some of the Commission's questions regarding information in the CAFR, as well as staff's answers to those (see Attachment B).

In order to assist you in your own review, the Commission presents the following highlights from our recent review:

<u>Financial and Operational Strengths</u>

- While total revenue for the City (Governmental Activities and Business-type Activities combined) fell by 1.2% from last year, the fund balance (or net assets) of the General Fund increased $13.6 million (or 30%) from last year, due primarily to lower General Fund expenses.
- Total net assets (or assets *less* liabilities) increased $103.5 million (or 5%) from last year, with unrestricted cash increasing 31% for 51 days-in-cash to cover daily operating expenses vs. 39 days-in-operating-cash last year. It should be noted, however, that this increase in cash was primarily not in the General Fund but rather in Business-type funds.
- The debt-ratio (total liabilities as a % of total assets) was 39.6% last year and increased slightly to 39.8%.
- Bond ratings from the City's three rating agencies remained unchanged for all of the City's bond instruments.

<u>Financial and Operational Risks</u>

- There are some notable *unrestricted net asset* <u>deficits</u>. It should be noted that these deficits are the result of previous years' annual operating deficits. Please note those instances below where the Fund or Department has taken demonstrable steps (or not) to decrease their accumulated unrestricted net asset deficits.

- -$49.8 million Self Insurance. It should be noted, however, that this unrestricted net asset deficit in the Self Insurance Fund is expected to continue to decrease as a result of the implemented rate structure which is based on covering expected new claims and a surcharge to recover past years deficits. Additionally it should be noted that Self Insurance did not have an operating deficit this fiscal year, and its operating activities provided positive cashflow.
- -$29.6 million Environmental Services. It should be noted, however, this unrestricted net asset deficit is expected to decline in coming years as a result of periodic rate increases for residential customers and landfill service fees. Additionally it should be noted that Environmental Services did not have an operating deficit this fiscal year, and its operating activities provided positive cashflow.
- -$7.3 million Golf. It should be noted that in addition to its unrestricted net asset deficit, Golf also had both an operating deficit of $1.3 million this fiscal year and required cash from outside its operations (i.e. the General Fund) to finance those operations. See additional information in the Recommendation below and Attachment A regarding Golf's accumulated deficits and cash subsidization by the General Fund. At this time, the IAPC does not have evidence that a turn-around plan to deal with the chronic and increasing Golf Fund deficits has yet been developed.

- Notable annual operating deficits , and arguably "under-investments" in capital assets or improvements:
  - The Convention Center Fund ended the fiscal year with a $5.8 million deficit before transfers. This deficit is covered by the annual transfer of funds from the General Fund. The FY 2011 transfer was substantially the same as the FY 2010 transfer. It is important to note that this deficit does not reflect any of the unmet capital needs required at the Center.
- The Stabilization Fund balance of $22.8 million *and* the Unassigned Fund balance of $11.1 million is $37.1 million or 52% below their respective combined target amounts of 10% and 7% of revenue as set by Mayor and Council policy.
- The funded ratio for the Tucson Supplemental Retirement System decreased from 71% at June 30, 2010 to 67% at June 30, 2011. Each of the funding ratios for the Police and Fire retirement systems decreased from 66% to 63%.
- The General Fund subsidy of Mass Transit increased $12.2 million or 41%.
- Given the Police Department's recent investigation in to the parking meter theft, as well as public concerns about the management of ParkWise in general, it is feasible that management may note a significant control deficiency in ParkWise in the management letter or single audit report.

<u>Recommendations</u>

For transparency , accountability, performance management, and optimal environment for strong internal controls and risk management, the Commission recommends the following to Mayor and Council:

1. That the General Fund formally record the coverage of Golf's cash deficits as a long term loan. Additional information regarding this recommendation is provided on Attachment A.
2. Request that management include the following supplemental information in next fiscal year's CAFR and/or on the City's website:
   - The addition of a table in the Notes to Basic Financial Statements of significant City-wide operational expenses, such as total personnel costs.
   - The addition of the 5-year financial model, including the anticipated dates and fiscal requirements needed to achieve the % of revenue stabilization fund targets.
   - The addition of the length of the affordability periods of the City's various low-income housing partnerships described in Note 16.
   - The addition of key financial or operating ratios in to the CAFR itself, as such ratios not only have performance monitoring value but also financial forecasting value as well. Such ratios enable benchmarking comparisons to other municipalities or other organizations in other sectors of the economy, regardless of the economic size of those entities. A variety of key financial and operating ratios have been previously developed by staff, but not consistently utilized by either the management or governance functions of the City, as an aid in their monitoring and forecasting of the financial performance of the City.
3. Ensure an environment of optimal internal controls to prevent, mitigate, and manage various types of risk, including:
   - The Mayor and Council meeting face-to-face with the City's external audit firm at least annually to identify specific areas of enterprise risk for audit focus and/or specific areas for financial and operational performance assessment.
   - Periodic change of external lead auditors and entire audit firms, per best-practice standards.
   - Review of the City's Comprehensive Financial Policies every three years.
4. Provide robust, dynamic, and ongoing communications to the public regarding the financial performance of the City and its various departments and Enterprise funds, including both return-on-taxpayer -"investment" or "ROI" type information regarding the efficiency and value of City services vis-à-vis other municipalities, or even marketplace alternatives (where applicable), as well as highlights of the City's risk management strategies and results.

Respectfully Submitted,

Michael McDonald
IAPC Chair

Attachments:
A - General Fund Coverage of Golf Fund's Cash Deficit
B - February 2012 CAFR Questions from the IAPC to Staff – Fiscal Year 2011

Attachment A:

General Fund Coverage of Golf Fund's Cash Deficit

The table below identifies the Golf Fund's increasing cash deficit over the last six fiscal years. The Golf Fund cash deficit has been covered by utilizing General Fund cash.

Golf Enterprise Fund

Year Ending June 30,	Income (Loss)	June 30 Cash Deficit Covered by Year End Transfer from General Fund
2006	**($770,737)**	**$1,535,914**
2007	**($784,994)**	**$3,250,328**
2008	**($1,462,699)**	**$4,501.338**
2009	**($1,972,337)**	**$5,498,095**
2010	**($1,624,347)**	**$6.345,267**
2011	**($1,449,182)**	**$6,880,543**

Currently, financial statements within the CAFR do not report the cash coverage as a formal loan, but rather as a short term interfund payable/receivable between the General Fund and Golf Fund. Because it covers Golf's cash deficits on a day-to-day basis, the General Fund has millions less in funds available to meet potential other General Fund needs. The City's Monthly Financial report for January 31, 2012 shows the interfund payable has increased to $8.2 million. While the Golf Fund is charged interest on the "loaned" funds ($24,345 in interest charges for FY 2011), with the ongoing annual losses in Golf, the interest merely increases the amount of General Fund cash required to cover Golf's deficits.

Recommendation: The IAPC recommends that the General Fund formally record the coverage of Golf's cash deficits as a long term loan. The Commission recognizes that formalizing the loan will reduce the General Fund's Unassigned Fund Balance and increase its Nonspendable or Committed Fund Balance's, both by the loan amount. It is, however an accurate reflection of the unavailability of those funds to meet other General Fund needs pending repayment of the loan. This recommendation is made with the following considerations in mind:

Transparency: The extent of the General Fund cash support of the Golf Fund, and contingent exposure to loss, should be clearly evident in financial statements.

Conservative Presentation and Risk: As the amount of Golf's cash deficit increases, the probability of repayment within the next several years is significantly reduced. Repayment, when it occurs, is likely to be many years in the future.

Attachment B:

February 2012 CAFR Questions from the IAPC to Staff – Fiscal Year 2011

1. Page 9. Business type activities "*Unrestricted net assets increased due to rate increases in the Water Utility and the Environmental Services funds. These rate increases resulted in combined operating revenue increases of $14.6 million while combined expenses increased only $3.7 million.*" Sounds like increases were not needed. Perhaps additional explanation of how the increases will be utilized would beneficial here.

   The rate increases were approved through the normal process. The increase of Net Assets for the Water Utility will ensure adequate resources to meet debt service coverage ratio and improve the cash position of the Water Utility Fund. The increase in the Net Assets for the Environment Services is used to provide resources to cover the landfill liability, which is the reason for their negative Net Asset balance, and cover the costs to construct new landfill cells. Also see Question 13.

2. Page 13. Bond ratings for GO and Street & Highway Junior lien from Moody's for FY 2010 were lower than reported in the 2010 CAFR. Why the change?

   An error in the FY 2010 was identified when we were updating the FY 2011 data.

3. Page 38. What is the current status of the $1.7 million receivable from Rio Nuevo?

   This final outcome for this receivable is part of the continuing negotiations between the City and the District.

4. Where in the CAFR are the $12.7 million in General Fund's fund balance Assigned for Management Contingencies discussed or detailed? If not in the CAFR, what makes up that balance?

   This amount was established to provide a contingency against potential revenue shortfalls to cover the curtailment of furloughs and to avoid the restructuring of COPs debt service in FY 2012.

5. Page 57. The estimated remaining life for the Los Reales landfill has remained at 60 years for at least the last three years although capacity used has increased from 82% to 86%? Why?

   The capacity percentage relates to the current active cell. Currently, the plan is to establish another cell over an existing inactive cell once this cell is fully utilized. There are also plans to construct a new cell in the next couple of years.

6. Page 59. *"The City's policy ….. Is to contribute 75% of the cost of retiree medical insurance premiums prior to Medicare eligibility (age 65). Effective January 1, 2011, the employer contribution will change to a flat rate."* We mean "for those retiring after December 31, 2010", right?

   Employees who retired after December 31, 2010 and who were not in the End of Service or DROP programs, received a flat dollar contribution toward the medical premium. Employees who entered the End of Service program by December 31, 2010 were required to separate employment from the City no later than December 31, 2011.

Employees who entered the DROP program by December 31, 2010 are required to separate employment from the City no later than December 31, 2015 and are eligible to receive the City's 75% subsidy toward the medical premium.

7. Page 91. What comprises the $8.2 million in Fleet Services' transfers out?

   The Fleet Service inventory should only include Fire vehicles under 1 ton. Their inventory contained several vehicles that were over 1 ton, which were moved to the Governmental inventory. This transfer represents the value of the assets that were moved.

8. How much does the Golf Course Fund pay the General Fund under the Administrative Service Charge? If not paid, what is the calculated amount?

   The Golf Course fund is not charged the Administrative Service Charge. The calculated amount based on the last cost plan was $378,983. The revised cost plan has not been finalized at this time.

9. Please complete the following table for the Golf Course Fund:
   Year Ending June 30,
   Income (Loss) June 30 Cash Deficit Covered by Year End Transfer from General Fund
   2006 ($ 770,737) $1,535,914
   2007 ($ 784,994) $3,250,323
   2008 ($1,462,699) $4,501,338
   2009 ($1,972,337) $5,498,095
   2010 ($1,624,347) $6,345,267
   2011 ($1,449,182) $6,880,543

10. How does the City receive an unqualified opinion from the auditors with the occurrence of such cash-control and loss risk issues like at ParkWise? Do the auditors just see that as de minimis? Or was it outside the timeframe of the audit and not considered a significant subsequent event?

    Although the control deficiency resulted in a loss of cash/revenue the financial statements themselves are correctly presented. In order to issue a qualified opinion on the financial statements we would be required to identify a material audit adjustment that the City should post to properly state the financial statements, and/or not obtain sufficient audit evidence to support that the amounts presented are materially correct. We will be evaluating this matter with respect to reporting a control deficiency in our related reports on internal control. Control deficiency matters are included in either a management letter or the Government Auditing Standards report on internal control issued upon the completion of the audit procedures for Federal programs. These reports are typically issued by the end of February.

11. What is the City's total payroll cost (salaries and ERE), and from which various financial statements in the CAFR do I glean or stitch-together the cumulative amount?

    The total payroll cost for FY 2011 $430.3 million. Expenditures in the CAFR are primarily reported by function (except Proprietary funds), so categories such as personnel, contractual services, etc. do not show. This changed in FY 2002 due to GASB 34.

12. Why the change in presentation on the Statement of Net Assets on pg 15, which eliminated last year's "Housing Partnership" column of assets and liabilities?

    The Housing Partnerships were reported as component units in the CAFR. There are Governmental Accounting Standard Board (GASB) pronouncements that provide criteria to determine if an entity should be reported as a component unit. The criteria is based on the ability to the City to control and access the financial resources of the entity. After discussions the Housing personnel, the determination was made that the Partnerships no longer met the GASB criteria.

13. On pg 15 again, what is the $26.9M deficit position of the Business-Type Activities unrestricted net assets? A transfer to Governmental Activities? Or were those funds plowed-back into Business-Type Activities (e.g. capital purchase)?

    Page 29 of the CAFR provides the following explanation of Net Assets: "The Statement of Net Assets reports the assets and liabilities of the primary government. The net asset section of this statement represents the residual amount of assets less their associated liabilities. The net asset section is divided into three categories. The first category is *Invested in Capital Assets, Net of Related Debt,* which includes all capital assets, net of accumulated depreciation, less any debt outstanding associated with the assets. Capital assets cannot readily be sold and converted into cash. The second category is *Restricted Net Assets,* which includes those assets, net of their related debt, that have a constraint placed on their use. The constraints are either: 1) externally imposed by creditors, such as through debt covenants, grantors, contributors, or laws and regulations of other governments, or 2) imposed by law through constitutional provisions or enabling legislation. The final section is *Unrestricted Net Assets,* and this represents net assets that generally can be used for any purpose. However, they are not necessarily in a spendable form, such as cash. Once all the capital related and restricted items are considered, the remaining net assets are negative primarily because of the Landfill Long-term liability in the Environmental Services Fund.

14. On pg 32, what does this sentence mean, "The City does not currently employ an indirect cost allocation system?" Does it just mean an IT system itself, as my understanding is that you do utilize an indirect cost allocation policy/plan, which is reviewed and amended as needed periodically?

    An indirect cost allocation system (similar to our direct full cost plan that computes the Administrative Service Charges) is used to allocate indirect costs (costs not directly chargeable to a specific function/program) to other programs. This is also used to charge indirect costs to federal grants to recover the cost of maintaining the grants. Currently we do not prepare an indirect cost allocation plan.

15. In the 5 Year General Fund Financial Model that the City is using for sustainability purposes, when are the 10% Stabilization Fund goal and the 7% Unassigned goal likely, as the current fund data on pg 38 shows that where only 58% and 38% of the way there currently and the audited statement notes don't give any specific timeframe and/or idea what it will take to achieve those goals? Also, why are both these Stabilization and Unassigned goals stated as a % of revenue, rather than a % of expenses, as a "% of revenue" metric is more about revenue diversification than about expense sustainability and the notes about these reserves indicate that the intent is sustainability not diversification per se?

    On page 38, the note states that “it will take several years to reach our goals”. Currently, our fund balance has increased primarily through significant expenditure cuts. Revenues are increasing, but at a very slow rate. With slow revenue increases, it will take time to increase fund balance while also dealing with pension and benefit increases, eliminating furloughs, and covering are debt service requirements. Governmental Finance Officer Association best practices provide various ways to establish fund balance goals, of which, a percentage of revenues and expenditures are some of the options. Our previous goal was based on a percentage of expenditures, but was changed since rating agencies use the percentage of revenues in their analysis and revenues represent the starting point to determine the level of expenditures that can be sustained.

16. Why is there a $3.7M deficit in Fleet Services (pg 91), when the Commission previously understood that Fleet was profitable and self-funding? In the same vein, what is the source and use of the $995k transfers in to Fleet?

    The Fleet Service fund is basically self funding. The operating loss is occurring because their rates do not cover the depreciation expense. The fund is maintaining it’s ability to cover short term requirements as demonstrated by the positive unrestricted fund balance, which consists mainly of cash. The $995,000 transfer was provided by the general fund to purchase vehicles in FY 2012.

17. The Council took a lot of heat when the Coronado Apartments for affordable senior living downtown went out of its affordability period recently. When is the end (month/year) of each of the affordability periods listed in Notes E - I on pgs 63-64? Putting these end dates in next year's CAFR might be judicious for Council transparency and tracking purposes.

    The Partnerships are a little different situation, but we will add the beginning dates because the ending dates can vary depending on future decisions made by the City.

18. I note this in passing... Note 16 on pgs 65-66 regarding the potential risk in the relationship between the City and Rio Nuevo give a measure of legitimacy/credence to Kevin Oberg's contention that perhaps the Commission has some valid fiduciary role/responsibility to weigh in to this circus.

    There is potential risk to the City so the disclosure was necessary for informational purposes.

19. In the CAFR's Statistical Section, why are there none of the financial or operating ratios or trend graphs that Joyce Garland and others have worked on over the years (yes I know...my old "dashboard" or key performance metrics soap-box)? Wouldn't it make sense for next year's CAFR to include some of the ratios/graphs

that management finds most useful/pertinent to manage risk, ensure sustainability, and communicate compellingly to the Council and other financial statement users?

Statistical Section information is established by GASB standards. These standards allow for additional information as long as it fits within the categories allowed. The standard format and information allows for comparability between other government entities. CAFRs produced by other government entities tend to follow the prescribed format and content laid out by GASB standards. There are other products that can be produced, such as a Popular CAFR that allows more flexibility and creativity in the information and presentation. In other words it allows for more freedom to use graphs and analytical data. Unfortunately, we do not have the resources to produce both a CAFR and a Popular CAFR.