# *City of Tucson Independent Audit and Performance Commission*

April 9, 2013

Subject: Report to Mayor and Council: Commission Comments on City of Tucson's Comprehensive Annual Financial Report (CAFR) for Fiscal Year Ending June 30, 2012

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, 2012.

The Commission presents the following highlights from our recent review:

<u>Financial Performance and Concerns</u>

- The City's net worth (total net assets, i.e. assets minus liabilities) increased by 4.9% ($108 million).
- The General Fund's net worth increased 1.6% or ($1.7 million) over last fiscal year.
- Given its reliance on various tax revenues that may not provide sufficient operational funding, including the ongoing decline in State-shared revenues, and given the high subsidization of such services as mass transit and the convention center, among others, the General Fund continues to not be structurally balanced. Please note that the IAPC plans to continue its review of mass transit's 5-year financial forecast/model, as the data becomes available.
- As in previous years, significant multi-million dollar net assets deficits remain in such programs as Self Insurance and Environmental Services (due to long-term landfill closure and post-closure costs). It should be noted, though, that Management continues to identify strategies to reduce these deficit fund balances. Similarly, while Golf continues to run an operating deficit, management continues to work on strategies to reduce this. The IAPC would like to thank Mayor & Council for implementing, via Ordinance 11050, the Commission's June 30, 2011 CAFR Report recommendation regarding the treatment of Golf's accumulated cash deficits as a long-term loan from the General Fund, and reflecting within the General Fund the loan amount as a nonspendable portion of its Fund Balance.
- Future unfunded liabilities (e.g. pension – see comments below) will erode the City's net worth, and potentially undermine its bond ratings and financial sustainability. This is compounded by a trend of increased employee wage and benefit cost.
- Similarly, unmet capital needs and deferred maintenance on the City's decaying long-term capital assets – in what is traditionally known as Property, Plant, and Equipment – will also have a deleterious long-term effect on City services and operating costs.
- The City's 5-year financial sustainability model should include a timeline of key milestones needed to achieve the Mayor & Council's reserve policies (e.g. the 10% target of the "stabilization fund" and the 7% target of the General Fund's "unassigned/contingency" fund).

<u>Audit and Auditor Matters</u>

- Since our last CAFR memo to you a year ago, the Commission is pleased to note that its recommendation to periodically change audit firms, as a best-practice, was implemented.
- Similarly, the Commission is pleased to note that the Mayor and Council met with the auditors, and we encourage you to continue this practice, ideally both pre- and post-audit, in order to both identify to the auditors areas of significant audit concern that you might like the auditors to more

closely examine during their audit, and then to have the benefit of a full debriefing with the auditors post-audit.

- You will note in the Management Letter from the auditors their finding of one significant deficiency relating to streetcar capital expenditure invoices (cumulative $8 million in value) that were not properly accrued. However it should also be noted that this was a one-time occurrence and that management corrected this error prior to the completion of the CAFR and the audit.
- As noted by the auditors in their report to management, new accounting pronouncements from the Governmental Accounting Standards Board in the next several upcoming fiscal years will require that the City's Basic Financial Statements include the statement of all pension related assets and liabilities (including currently unfunded pension liabilities), rather than simply noting these in a supplemental disclosure. The net effect of this incorporation of these pension items will inevitably be a significant erosion of the City's net worth. It is yet unknown how this net worth erosion will precisely affect the City's bond ratings.
- For public transparency, accountability, and performance management purposes, the Commission recommends adding the following items to the City's Finance Department website:
    - The addition of a table of 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 key financial or operating ratios, 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.
- The Commission enjoyed the "then and now" photos of important Tucson landmarks scattered throughout this year's CAFR, and expressed gratitude that this walk down memory lane did not include childhood photos of Mayor and Council nor City Management.

Respectfully Submitted,

Michael McDonald
IAPC Chair

Attachment:
Questions from Commission Members Regarding the CAFR and Responses from City Staff

c: Richard Miranda, City Manager
Liz R. Miller, Deputy City Manager
Kelly Gottschalk, Assistant City Manager/CFO
Albert Elias, Assistant City Manager
Silvia Amparano, Interim Finance Director
Mike Mason, Accounting Administrator

# Independent Audit and Performance Commission
# Review of the Fiscal Year 2012 Comprehensive Annual Financial Report (CAFR)
# Commission Questions and Staff Responses

1. The General Fund:
   a. Unassigned Fund Balance decreased by $2.4 million and the Assigned Fund Balance increased by $4.1 million. Please explain the relationship between these two changes?
   **The assigned fund balance is funded to address various budget requirements for fiscal year 2013 in case revenues do not meet budget projections. The assigned fund balance will provide funding:**
      - **To prevent COPs debt restructuring,**
      - **Provide funding for various technology enhancements, such as the new Human Resource/ Payroll system implementation, vehicle replacement, and outsourcing for the City's ERP IT support**

   b. What makes up the *Other Purposes* under both *Committed* and *Assigned Fund Balance?*
   **General Fund:**
   **Committed:** **Property management of Interim Greyhound Station-$270,192, Civano (Remaining balance for this development, working with Mayor & Council to spend)-$274,376**
   **Assigned:** **Imprest Cash-$353,108**
   **Open Space Donations-$49,837**

   **Mass Transit:**
   **Committed:** **Gadsen Settlement (Streetcar)-$249,224**
   **Cash with Fiscal Agent (property management)-$1,275**
   **Assigned:** **Imprest cash-$259,200**

   **HURF:**
   **Committed:** **Developer In-Lieu Fees-$2,499,055**
   **Native Plant Preservation-$176,095**
   **Warehouse District-$178,484**
   **Assigned:** **Fog Seal (streets)-$336,416**
   **Remaining fund balance (similar to unassigned in General Fund)-$9,390,557**

   **Civic Contribution:**
   **Assigned:** **$289,178 (Remaining fund balance)**

   **ParkWise:**
   **Assigned:** **$105,317(Remaining fund balance)**

   **Convention Center:**
   **Assigned:** **Imprest Cash-$29,365**

2. Golf Enterprise Fund:
   The CAFR continues to report the payable between the General Fund and the Golf Fund as an interfund balance/transfer. Interfund balances/transfers are defined in the CAFR as "necessary to cover short term timing differences between cash outflows and inflows or cash flow issues for specific funds." With the Golf cash shortages continuing to increase

(up to $8.4 million per the City's December 31, 2012 monthly financial report), what is the reasoning for treating the financial agreement as a non-long term loan between the funds?
**The Mayor & Council approved various options to address the continuing deficits in the Golf Enterprise Fund for staff to review. Several options were presented that included outsourcing the golf course operations, selling properties, repurposing courses into parks, and reducing to smaller par 3 courses. Depending on the decisions made, the accounting impacts can vary. So for fiscal year 2012, the accounting for the cash shortages remained the same as previous fiscal years. For fiscal year 2013, an ordinance will be presented to Mayor & Council for approval that will require the establishment of a non-current asset/liability for the General fund and the Golf Enterprise fund. This will result in a non-current liability for the Golf Enterprise fund and a non-current asset and a non-spendable fund balance category for the General Fund.**

3. Self-Insurance Fund:
    a. Mayor & Council presentation indicates that the "10 year surcharge" will be "restored" in 2014. Please provide background information on the surcharge and why it was stopped?
    **Mayor & Council decided not to fund the surcharge in FY2013 as a budget balancing measure. The annual surcharge is $2.5M for all funds of which the General fund is $1.6M.**
    b. The inclusion of involuntary tort payments as a property tax component began in 2011. Will this be a permanent addition to the property tax and how is the assessment calculated?
    **Mayor & Council approved including the involuntary tort liability in the property tax levy as a policy in 2010. Staff will continue to pursue the inclusion of the involuntary tort payments in the property tax. The policy is to include payments over $20,000 in the property tax levy. The City submits documentation required by state law to Arizona Attorney General's Office to allow the City to include the previous FY tort judgment payouts within its following FY property tax levy. (Example: FY 2012 payments are included in the FY 2014 tax levy).**

4. Pension Funds:
    In June 2012 GASB issued two new standards intended to improve the accounting and financial reporting of pensions by state and local government effective for Tucson's FY 2014. With standards dealing with long-term pension obligations, projections, and discount rates, what impacts are anticipated in the City's reporting, future actuarial valuations, and resulting employer contribution rates to the various pension plans?
    **GASB 67, Financial Reporting for Pension Plans, and GASB 68, Accounting and Financial Reporting for Pensions, establish requirements to calculate a pension and net pension liability and add additional disclosures for the net pension liability and other pension information. The total pension liability is the portion of the actuarial present value of the projected benefits payments that is attributed to past periods of plan member service based on actuary assumptions outlined in the GASBs. The net pension liability is calculated using the pension liability less the net position (assets) of the pension trust fund. The start date for these GASBs is FY 2014 and FY 2015.**

    **The City is planning to implement both GASBs in FY 2014. The impact of these GASBs has not been fully determined. An actuary report will be prepared using the requirements of these GASBs based on FY 2013 pension data to start this analysis.**

    **For fiscal year 2012, the estimated unfunded liability is $344 million. This will provide an idea of the projected net pension liability. In addition to this liability, the**

**City's portion of the PSPRS net pension liability must be recorded as well. Our portion of this liability has not been determined. These liabilities will impact the entity-wide and proprietary fund statements.**

5. Financial Planning: The presentation to Mayor & Council concludes with a listing of significant financial concerns.
    a. What are the strategies to tackle these difficult issues?
    b. How are these concerns and variables handled in the City's *Five Year Financial Model*? Can the IAPC schedule a presentation in the future?

    **An item will be scheduled on a future IAPC meeting agenda for staff to present the Five Year Financial Model.**

    **<u>Financial Concerns listed on the 2/5/13 CAFR power point presentation</u>**

    - **General Fund not structurally balanced - Modest revenue increases vs. higher expenditures**
    - **Continued Deficits - Action Plans are being developed to address the fund deficits**
    - **Unmet reserve policies - Fund Balance as % of Revenues**
        - **Stabilization Fund = 5.5% (Mayor & Council Policy = 10%)**
        - **Unassigned = 2.1% (Mayor & Council Policy = 7%)**
    - **Increasing Employee Costs - Pension options are being discussed with Mayor & Council; Benefits-Human Resources is exploring options of reducing employer costs; Compensations-Human Resources is working on a compensation plan to address but ultimately Mayor & Council will decide to fund**
    - **Future unfunded Liabilities - Net OPEB Obligation is $7M. Changing the cap on the retiree medical from 75% to a flat subsidy will help this liability going forward. There is no plan to fund this at this time.**
    - **Pension Obligations - GASB 67 and 68 will mandate that the City record the future pension liability. An actuary will provide the amount to be recorded.**
    - **Impact Fees - Changes in legislation will reduce the amount of impact fees the City is allowed to collect from development. The City will have to pursue other funding sources for infrastructure improvements.**
    - **Unmet Capital Needs - Total $1.2 billion Funding sources will have to be identified.**
    - **Deferred Maintenance - A plan to maintain the City's assets should be developed and funded. The list of city-wide unfunded facility repairs (excluding enterprise funds) was over $80M.**

**<u>Long Term Strategies listed in the Budget power point presentation on 3/5/13</u>**

- **Manage unsustainable mass transit system funding support increases**
    - **Transit Task Force and TDOT are evaluating efficiency and effectiveness options (e.g., fare policy, comprehensive operational analysis)**
- **Establish sustainable constant employer contribution rate to Tucson Supplemental Retirement System (TSRS)**
- **Adopt a redesigned compensation plan to sustain and adequately compensate our workforce**
- **Decrease accumulated net asset deficits (e.g., Self-Insurance, Golf)**
- **Immediately focus on resolutions for FY 2015 issues (e.g., DROP accrued vacation/sick payouts, funding for grant-funded police officers, streetcar/PCWIN operating and maintenance)**
- **Look at reducing pensionable pay categories (e.g., shift differential, sick leave sell back)**
- **Institute vehicle, technology, equipment, and facilities replacement funding reserves**

- **Develop master plan for "managed competition/outsourcing" to provide more effective services; identify logical functions (e.g., maintenance) and level of service needs**
- **Reduce reliance on one-time funding resources; attain structurally balanced budget**
- **Operationalize Mayor & Council goals and priorities and Plan Tucson goals and policies through the annual budget process to strive for:**
    - **strategic public and private investments for long-term economic, social, and environmental sustainability**
    - **stabilized local economy with opportunities for diversified economic growth supported by high-level, high-quality public infrastructure, facilities and services**

6. In the CAFR Power Point to Mayor & Council, there was a Deficit Fund Balances or Net Assets chart. For comparison purposes, could you provide a similar chart for last fiscal year's deficit amounts?
   **Funds with deficit Fund Balances or Net Assets from previous fiscal years:**

| | Fiscal Year 2012 | Fiscal Year 2011 | Fiscal Year 2010 | Fiscal Year 2009 |
|---|---|---|---|---|
| Environmental Services | ($3,479,259) | ($7,698,880) | ($12,306,243) | ($61,933,785) |
| Self-Insurance | ($20,955,597) | ($25,254,597) | ($28,015,945) | ($17,608,330) |
| General Services | ($2,615,292) | ($2,200,359) | ($3,591,526) | |
| Other Federal Grants | ($2,392) | ($2,392) | | |
| GO Bond & Interest | ($417,749) | | | |
| S&H Bond & Interest | ($896) | | | |
| H.U.R.F. | | | | ($3,275,980) |
| ParkWise | | | | ($1,396,049) |
| Special Assessment Construction | | | | ($528,205) |

7. Relating to page 11, under **Governmental Activities**, first and second bullets: What is the *new* enterprise fund?
   **The new enterprise fund is the Non-Public Housing Asset Management Fund. This fund is used to manage a variety of properties that do not fall under the Public Housing Authority (managed by a third party for the City).**

8. Relating to page 20, what are the plans for reducing the deficiency of $32,272,424?
   **This amount is the difference between revenues and expenditures. The more pertinent amount is the Changes in fund balance amount, ($30,274,015). Normally, the City would want the fund balance to increase, but it could be planned for the fund balance to decrease. Although revenues are in a positive trend, controlling expenditures is a challenge. A main reason for the decrease is the Capital Improvement fund that expended COPs proceeds that were issued in prior years.**

9. Relating to page 29, **Government-wide and Fund Financial Statements**, second paragraph: I assume that a restricted net asset is under the same constraints of the restricted fund that it is under.
   **Normally that is correct, but there are situations where a restricted asset within a restricted fund can have a greater restriction.**

10. Relating to page 31, 3. **Internal Service Funds**, concerning facilities and fleet maintenance services: Are *all* buildings and facilities, as well as *all* fleet units covered under Internal Service Funds, or are there certain departments, facilities and/or fleet units that are under the general fund or some other fund?
    **The Fleet Service ISF has all vehicles, except fire apparatus equipment. Buildings and facilities are under general government and not the ISF.**

11. Relating to page 37, under **Committed To**: What is the Stabilization Fund of $22,836,507 used for and who can use it? When was the last time this fund was audited?
    **The stabilization fund is a category of fund balance that was established in conjunction with GASB and the City's financial policies. The committed fund balance is the City's "rainy day fund" or savings account to meet emergency situations. It requires Mayor & Council approval to be used. This is part of the general fund and is audited as part of our annual audit.**

12. Relating to page 37, under **Assigned To:** What are Management Contingencies of $17,653,330, and who is authorized to approve the expenditure of these funds? When was the last time this fund was audited?
    **This assigned fund balance is established is accordance with the City's financial policies, which gives the CFO the authority to establish. The management contingencies included having funds available for vehicle replacements and technology improvements and to avoid a COPs debt restructuring.**

13. Relating to page 57, **Note 1- LANDFILLS (continued):** What was the closure/post closure cost for F.Y. 2012? Is the number planned or is it an end-of-the-year actual? What are we doing at those landfills whose capacities are at 100%?
    **The landfill liability is a calculation accomplished by the Environmental Services department, in accordance with GASB, based on criteria that is outlined in the note at the end of a fiscal year. For those landfills that are closed, costs are incurred to ensure they are closed and for any remediation issues.**

14. Relating to page 128, Taxable Sales by Category, Activity – Utilities: 2011 the number was $2,119,852,518 and in 2012 the number was $941,807,810. Why the decrease of 65+%?
    **The calculation of the base amount in fiscal year 2012 was changed because there are various tax rates calculated using the same base. In previous years an average rate was used, which resulted is using a calculated revenue base. The reason for the change was to make the reporting and calculation of this amount more consistent from year to year.**