CITY COUNCIL STANDING COMMITTEE

Budget & Finance

Thursday, July 15, 2010 – 5:30 p.m.

1st Fl. Council Conference Room – City Hall

Present: Chair, Councilor Steven Curcuru; Vice Chair, Councilor Paul McGeary, Councilor Jacqueline Hardy
Absent: None
Also Present: Kenny Costa; Jeffrey Towne; Chris Rogers, Rogers & Sullivan; Jim Duggan; Tom Markham

The meeting was called to order at 5:32 p.m.

1. ***Continued Business***

A) COM2010-027: Sullivan & Rogers – Independent Auditors' Report (Reports on file in City Clerk's Office) (Continued from 07/01/2010)

Chris Rogers, Partner, Sullivan & Rogers, Independent Auditors, of the firm who conducted the independent audit of the financials of the City, spoke to the "Reports on Internal Control over Financial Reporting and Compliance and Federal Award Programs; the Management Letter; and the Financial Statements (all documentation on file in City Clerks & City Auditor's Office).

High Level Financial Summary:

Mr. Rogers noted it was Sullivan & Rogers' first year as outside auditors for the City. Financial statements were issued in time in order for the recap. From that standpoint, it was a success. However, there was a lot of room for improvement. There were some prior period adjustments to the financial statement numbers; significant restatements and reclassifications as it related to the General and Enterprise Funds primarily. Some examples of those restatements relate to the recording of Workers Compensation liability; the recording of a landfill post closure care liability that had never been recorded. Capital Assets were misstated in the past, unbilled AR for the water and sewer funds had never been recorded in the past. Principal subsidies related to MWPAT debt was recorded this year. Capital leases, some accounts receivables, Title V betterments that the CFO had gone through and identified that hadn't been on the books before were recorded this year. There were material maladjustments to prior financial statements.

Councilor Curcuru asked how long these items had been outstanding as not having been recorded.

Mr. Rogers replied since they weren't on in the prior period, they've never been on the books. There'd be no reason to take them off had they existed beforehand.

Councilor Hardy stated these were common practices that should have been done before which Mr. Rogers affirmed noting pages 63-65 went into the details.

Councilor McGeary restated the situation by saying it starts the City on a clean slate which Mr. Rogers affirmed.

Mr. Rogers continued that in FY09 was the first year the City had to implement GASB (Governmental Accounting Standards Board) 45 which is the other post-employment benefits obligation liability. An actuarial was performed as of January 1, 2008, and as of that date, the City's total actuarial liability totals were about $148 million. From a financial statement standpoint, you don't have to put that entire liability on your full accrual financial statements. But you do have to put a liability on for the difference between what you physically paid out for retiree health insurance compared to the annual required contribution that was calculated as part of your actuarial valuation. The difference was $7.3 million. Based on the actuarial, if you are funding your future benefits like you were a pension system, you should be

contributing $11 million per year. Currently you're paying about $4.5 million for the pay-as-you-go retiree health care costs.
Councilor Curcuru asked if the rules were going to be changing soon.
Mr. Rogers explained if this new statement, which he believed it would, in two or three years when the GASB goes through, the City will have to put the full liability on the full accrual financial statement which will flip everyone upside down and will put everyone in a deficit. It doesn't mean that you necessarily have to fund it. There won't be a federal mandate to fund it, but there is a lot of discussion of how these items are going to affect the financial statements and what the impact from a credit agency standpoint will be. That won't be determined until that statement is finalized.
Mr. Towne stated a lot of people said they wouldn't have to get serious about funding the pension liability at one point in time also. Now they're at the stage where they have to keep with their schedule or the City will be in trouble some day. With the hit that they took, they dropped significant portions of their item which is why the legislation is moving forward, and will be passed soon. A lot thought that there wasn't much to pension liability. Now they're talking about actuarials and its process. That's why you have to fund more on the balance sheet and show the liability. Realistically, maybe they won't have to fund it right away, but at some point it will show a huge deficit already for pension and OPEB.
Councilor Curcuru asked when they will start making the changes; would they do it in small increments over the next few years.
Mr. Towne didn't know how they'd afford any of it; with the Charter School; with the schools capital improvements-those numbers are astronomical just for roof repairs, HVAC repairs/upgrades of systems alone will be enormous on the school side, not including the City side which will probably have similar numbers that they need to be sure they take care of. He reminded the Committee how he had said previously it would take 18-24 months to fix things and manage them. Now they're at the stage where they're going to start managing this year and putting out all the deficit fires. Now that Mr. Costa is on board as well as Mr. Markham; the financial team is fully in place. Both Mr. Costa and Mr. Markham are already making changes and with Sullivan & Rogers in place, that too, will be a help. It was a tough report, but it is exactly what the City needed.
Mr. Rogers continued that every year that difference between the required contributions will grow and grow until that statement passes, then the whole liability goes on the books. The bottom line is everyone is aware that this liability exists.
Councilor McGeary asked if they weren't currently under health care like they are under pension they haven't been given a date certain to fully fund it. This is just a disclosure.
Mr. Towne stated this is disclosure. Cities and towns haven't focused on what is the liability for all the people who are on pensions and have left the City's employment that you're still paying benefits for. That is a real liability for the City. Every time they talk about early incentive programs for retirements, it doesn't help because you're still paying all the benefits; and it's only a small incremental salary savings for a short period of time until they catch up. Then we're worse off.
Councilor Curcuru noted the trend is to hire non-benefited people.
Mr. Towne responded its hiring part time people more than putting full time people back. They're all doing that but at some point in time you can't put a part-time police officer on the street or a part-time paramedic or firefighter – that's why the Mayor is trying to put a couple of those people back.
Mr. Rogers spoke of the opinion which is the only two pages in the document where there was an unqualified opinion on the financial statements probably for the first time. It is the best opinion available. In prior years you had adverse opinions because the City didn't have your infrastructure fixed assets on. That is cleaned up. Moving forward hopefully you'll receive more unqualified opinions.
Councilor Hardy expressed her thanks to the financial team on this accomplishment.
Mr. Rogers continued that looking at the fund financial statements, at the end of the year $1.2 million in total fund balance in the General Fund which is segregated into three components; reservation for encumbrances of about $317,000.00; a reserve for stabilization of about $1.5 million; and an undesignated fund deficit of about $616,000.00 (all described on page 18), snow and ice and a culmination of a lot of other things. Moving forward, this number designated on financial statements is

no reflection of free cash. Free cash is a State calculation, not a financial statement calculation. This is your true undesignated portion of what's in your General Fund on a gap basis. When rating agencies are looking at it, these are the reserves that they are looking at. There was a positive undesignated fund balance in the prior year, but it didn't include the workers compensation liability. A healthy undesignated fund balance is at least $4 million; 5% of the number; that is the minimum to say "healthy".
Mr. Towne stated he would feel great in two or three years if they could get to this number. They spoke last year of a two to three year plan to get there. $1.5 million in tax titles, $1 million each year after that to get there, and he included stabilization.
Mr. Duggan stated that would continue to grow as their bottom line grows further, so that $4 million would continue to grow also. You want it to reflect 5% of your total budget.
Mr. Rogers stated one of the things you want to look at in terms of fiscal policy is to maintain 5% whatever the year's budget is, it's going to jump every year because usually budgets don't go down; 5% is a good comfort level. Five percent of your overall budget - if something major occurred, this would be eaten up very quickly. Even if you're hovering at 1-2%, it doesn't take long for it to go away. He talks to bond rating agencies, and they always look at undesignated fund balance, in stabilization, are your infrastructure self-supporting or is the General Fund subsidizing that operation. As long as it's self supporting there's some comfort there. He believed the City was in good shape.
Mr. Towne stated they picked up general liability insurance for City water and sewer. They don't charge that off to water and sewer, but they should. They have to insure their buildings, their pump stations. This year they did the indirect cost break back to the General Fund for FY11. They calculated out a percentage of his department, the Auditor's department, etc. They're recapturing about $125,000.00 from each fund back into the General Fund to offset all the collection reports. They were charging a portion of Mr. Hale's salary; now they're doing more than that. Of that $616,000.00 negative General Fund item, they raised $830,000.00 as deficit appropriations in FY10 to offset that to bring them back to zero. They purposely intended in FY10 that it be at zero, maybe even $200,000.00 above zero. Then FY10 operations would be reflected in adding or subtracting from that. They purposely tried to budget more revenues in FY10 than appropriations to take care of that negative amount. If FY10 works out in the way they budgeted, they should start with zero, depending on the rest of FY10 operations turn out to be. In about a month, they'll tell them what it all implies. It isn't as if they didn't do anything on the $616,000.00 – they purposely put a plan together through the Administration to the City Council when they voted the FY10 budget knowing that that deficit would be there knowing that most of it would be snow and ice.
Councilor Hardy asked if they are better able to do financial forecasting now.
Mr. Towne stated yes. Mr. Costa's department is working hard in his department to work on month end closing procedures. They won't be perfect next month but a lot better off; and by the end of next year, their offices will be balancing everything monthly on the General Ledger. They really need to have those closing procedures done regularly to be able to predict the revenues, and liability. They should be able to, with some certainty; they'll have a much better chance at making rock solid recommendations. He reiterated that he has now been with the City two years, Mr. Markham a year, and Mr. Costa while new, they have his solid background to rely on; it will be easier especially by April just before they go into the budget season. Each month they'll take up a different topic for B&F on fiscal strengthening.
Mr. Rogers noted in non-major funds, fund deficits on page 37 lists all the deficits that exist that were not going to be financed to be a long term debt. The largest one out there was the school lunch deficit, about $191,000.00. It is a required disclosure to make a list of all fund deficits. Regarding Enterprise Funds on Pgs. 22-24, they're full accrual reports. The statements from the CFO and City Auditor will not look like the financials. What's maintained on the books for the City on a cash basis of accounting, this is full accrual, where you accrue your receivables and long-term debts including capital assets, etc. Total net assets are about $2.8 million for waterways; for sewer enterprise were about $93.5 million; there was an unrestricted component of $2.8 million; and on the water enterprise the unrestricted net assets totaled about $3.6 million. The Enterprise Funds, on a full accrual basis are self supporting which is what you want. There were so many changes made to financial statements, especially on the sewer enterprise; over

the next 2-3 years when you get more financial information, the trends will mean a lot more. If you compared this to last year, it would not show trends. The biggest change is the presentation of the sewer betterments and the reserves and the receivables. That is all now with the sewer enterprise funds. It gives a more accurate picture of what the Sewer Enterprise does. A portion of the debt is funded from the General Fund, but they come in as transfers.
Councilor McGeary asked how the CSO debt shifts affect the accounting of the sewer fund; where does it fit in the big picture
Mr. Towne stated the CSO debt shift is a financing mechanism that is not an asset change. It will show up in how they fund the debt; how they pay for the debt; but not where the debt lays.
Mr. Rogers noted the internal service fund exists because it was self insured retiree health insurance through FY08. FY09 is the first year you didn't have it. So all that fund is doing is paying run-off claims; $300,000.00 approximately in FY09. There was about $430,000.00 left in FY09. Based on their review of subsequent activity, there aren't many claims left. It looks that when it runs out, you'll have some money remaining in that trust fund. Pension trusts have total net assets of about $52 million. The funded schedule, the last actuarial evaluation done January 1, 2008, showed a funding ratio of 55.8% which is an increase from January 1, 2006.
Councilor McGeary asked that to fully fund our pension liability we should have $100 million in there.
Mr. Rogers agreed. You will have to see what the 01/01/10 actuarial looks like which he cautioned probably "won't be pretty". No one can afford to do this; this is why all that legislation is out there. From a high level point of view, those are the most significant items to point out in your financial statements.
Mr. Costa stated he's now going through all this, what makes up the details; going through the numbers. He's looking at some of the policies they should implement like on reserves and create some policies.
Councilor McGeary asked on page 9 total revenues are $112 million and total expenses are $118 million. Where does the $6 million come from; how do you pay that $118 million.
Mr. Rogers stated that one of the things you could be using is reserves, especially like in the sewer funds. There's also depreciation. There are a lot of non-cash activities that are occurring that don't show up as revenues which offset expenses. He gave the example of OPEB, a non-cash item which is an expense effect and bottom line effect as the same time as depreciation.
Mr. Towne noted they had depreciation of about $3,122,000.00 of assets.
Councilor McGeary expressed confusion on the concept of net assets asking how this figures into the fiscal health of the City; if he's a bond rating agency, what would it tell him.
Mr. Rogers stated with the full accrual financial statements they're not really looking at them except for the enterprise funds because they're self-supporting that live based on billings which they look at more like a business. They're looking at it as a cash basis.
Councilor Curcuru asked how they could be self sufficient.
Mr. Rogers stated by your maintaining a healthy fund balance and not getting close to zero, then there isn't concern. If there were years of losses, that would be concern.
Mr. Towne stated if you are absorbing a lot of expenses in the General Fund and not showing in the enterprise funds; that could have the opposite affect to show they're doing better than they really are.
Councilor Curcuru asked if you're better off having more enterprise accounts in the City or less or does it matter.
Mr. Rogers stated do you want to raise it to the tax levy or do you want to have a separate user charge. It is what is the most reasonable, cost effective method to operate the activity.
Mr. Towne noted there are certain criteria that make up an enterprise fund.
Councilors Hardy and Curcuru suggested ambulance and trash as an example.
Mr. Rogers stated those are types of activities that could be and **Mr. Towne** stated there'll be expenditures out. All the fixed assets are on the general fixed asset fund. If they do things like that they have to do it years in advance. They can't do something like that quickly.
Councilor McGeary if the general fund were subsidizing the water or sewer, their bond rating be inflated but would also deflate the City's because you have less money to "play" with on the City side.

Councilor Curcuru asked about the water and sewer rates in FY09 where the consumption was overestimated for multiple years. It made the fund balance in a steady decline. It always underestimated the rate based on overestimating consumption.
Councilor McGeary asked on page 10 on governmental activities at the top of the page for Mr. Rogers' explanation.
Mr. Rogers stated it is a narrative on the top of Page 11. Next year there will be an explanation of why those changes happened (related to the previous net asset question by Councilor McGeary). He spoke of what and what isn't an expense in this instance. The $5.8 million change in net assets for governmental activities is primarily the result of implementation of GASB 45. You took on another $7 million liability in the governmental activities column. That's a direct hit on this column.
Councilor McGeary asked how good an AA rating on bonds was.
Mr. Towne stated it's mediocre. A solid rating would be much better. If there is an AA with a negative rating, meaning, you're going in the wrong direction. They've been able to contain it this past year. He believed they would see a serious improvement at the end of this fiscal year going the other way. Because the rating structure is changing, we may get a boost from that. If we stayed the same and didn't improve the structure, he believed they would still improve this year with the results of the operations by decreasing our capital; having good revenue; not spending full amount on appropriations. The ship is slowly turning around and gaining momentum in the right direction. He's hopeful the negative outlook will cease which would be a huge plus and be able to look towards fund balance management policies, cash management policies. There are a lot of debt payments in July, some in August which requires they start the year by spending about $20 million in two months. It was set up poorly many years ago which is self-perpetuating. Realistically, they should come due in September and March. The old debt payments can't be switched; but going forward they can arrange it that way with new debt.
Councilor McGeary asked if they should consider changing the date of the fiscal year. There was discussion amongst Mr. Towne, Mr. Rogers and Mr. Costa who noted that Mass General Law prohibits changing the fiscal year and that it must run July 1 to June 30.
Mr. Towne stated there's a lot of data if you're not an accountant to look at and absorb. Mr. Costa should be able to come in and just do an audit. Mr. Rogers had to pull much of the information by tapping into a lot of people and the investigation was difficult. It was a fact finding process the first year. The way that it should work is Mr. Costa and he simply gives Mr. Rogers all he needs at the start to perform his audit.
Mr. Costa stated he's already started work on that for the next audit to commence in September.
Mr. Rogers stated it will be realistic this year and in better shape.
Mr. Towne agreed and while he felt it wouldn't be perfect, there would be substantial improvement.
Mr. Rogers reviewed Reports on Internal Control over Financial Reporting and Compliance and Federal Awards Programs. This document includes two reports: Report on Internal Controls over Financial Reporting and Compliance which is required by government auditing standards. It doesn't provide an opinion. They have to report on any instances of material weakness in internal control or on compliance on other matters. The second report is a report on compliance on major Federal awards programs and are where they do provide an opinion on the City's compliance on major Federal programs. They identify any significant deficiencies or material weaknesses in internal control over compliance related to those Federal award programs. By definition, major Federal award programs means over $300,000.00 received for Federal Grants. CDBG, SPED, Title I, ARA, School Nutrition. He noted page 11 where they identify their findings. There were 15 material weaknesses related to internal control over financial reporting and 2 related to non-compliance. Material weakness is a deficiency in the internal control structure where there is more than a remote likelihood of a material misstatement to your financial statements could occur. Significant deficiency is also a control deficiency where there's more than a remote likelihood that is more than inconsequential to the financial statements. The significant deficiency piece is more than inconsequential. It is, he admitted, a little ambiguous. Those definitions actually change next year. Everything reported here are material weaknesses. This is on financial reporting over your financial statements. Just because something didn't happen, say there's no controls and somehow that number was

correct, if there were no controls he would report it as a material weakness because the controls aren't there to prevent it. Anytime an auditor comes in and makes a gap adjustment to a financial statement provided to them and that adjustment was not communicated by the client, it is an automatic material weakness in this report. It happens all the time. If you're not aware of it, you don't have a control on it. Half of these relate to purely accounting. They weren't recorded on the General Ledger (GL). He gave the example of parking tickets. It's not like you weren't collecting the money but there wasn't a receivable on the books; and there was no reconciliation between a control account on the GL and the detailed reports.
Councilor Curcuru asked if they're doing anything with the General Ledger.
Mr. Costa stated he's just cleaning up the GL now.
Mr. Rogers stated it's literally just putting it on the GL and recording it correctly.
Mr. Towne stated he manages the receivables in terms of trying to go after and do the collections. They still don't book the monthly transactions to the receivables. It's literally just cash receipts. They don't book the abatements. They book the amounts they collect and hit the revenue account. Should they get into that level of it, absolutely. He took over a list that dates back to 1900. They talked about what and what not to book. They also have to prioritize what they are looking at. Parking tickets were not a priority.
Mr. Rogers stated when he walks into a situation like this; it's a high risk audit for them. The review of the General Ledger – this is what has to be done. If this isn't done, he could still be writing the material weaknesses. If you don't have procedures to review the general ledger, you're done. How can you validate one number in the GL, and have no review process. As soon as you have that type of issue, materiality drops, then there's material weakness after material weakness. If this had happened, he guaranteed 75% don't exist because that's happening. That's an enormous piece of internal auditing.
Mr. Towne stated you started over with his tenure; Mr. Costa's coming on board last month, along with Mr. Markham on the school side now in place for a year. It was so tough they didn't have revenue and expense reports for two years in Unifund. You have to focus on that before you can even focus on booking a balance sheet item. You couldn't even check that out. That's the '05, '06 and '07 timeframes.
Mr. Duggan stated these practices weren't in place long before Unifund.
Mr. Towne stated they balanced the General Ledger when Data National was here. They didn't like it because it didn't have a solid receivable package; and they wanted to switch because of that. There were things for Mr. Rogers to pull all that he had to, there were things that unless they said don't forget we have to look at Title V, etc., there was nothing on the balance sheet. They could only tell them what they believed. He was looking at things that weren't even complete sets of information. Next year will be better and even better two years from now.
Mr. Rogers summarized that the weaknesses 09-1 through 09-13 primarily are accounting related. You are going to take out most of what's reported there. 09-14 and 09-15 on page 17 and 18 relate to risk assessment monitoring program and a documentation of financial policies procedures. If he didn't have all these other material weaknesses, he would not have those two items as material weaknesses. But because there's so may financial related issues and the controls surrounding the financial reporting process is so bad, risk assessment and monitoring is a material weakness. It's the same with documentation of policies and procedures. There's always usually a procedure; whether they're documented is another thing.
Councilor Curcuru asked if a lot of communities hade these polices and procedures in place.
Mr. Rogers responded that more are starting to come around.
Mr. Towne stated that when he got here there was a large binder that incredibly outdated. They now document, improve upon it, and test it out.
Councilor Curcuru stated they must have these in place just in case if one of their financial team is suddenly not in place.
Mr. Rogers stated there has to be a collective concerted effort of all department heads. Further, there were first 15 were material weaknesses which by review the GL, they'll be taken care of. He explained

CFDA stands for the Catalog of Federal Domestic Assistance, a listing of all federal grants and are coded to look up what are the requirements. Its how the federal government tracks how they give out money. He stated that if there is any type of material noncompliance, grants, regulations, etc., they have to report it here. 09-16 and 0917 relate to school grants – Title I distributions in Special Education. When they were doing the major federal award program audit, they found instances of non-compliance which questioned costs that were material to financial statements taken as a whole. For instance, looking at the special education federal program; there was an internal control problem which showed documentation was not maintained the approximately $600,000.00 charged to payroll expense; he couldn't substantiate because the documentation could not be maintained in accordance with federal regulation under A133 and A187. As relates to that specific grant there is a non-compliance issue and a question cost of $600,000.00. This was part of people not signing their time cards. From an audit standpoint, the $600,000.00 is now an internal control issue and a non-compliance issue because a question of costs. It has to be reported as material non-compliance in this report.
Councilor McGeary asked what is non-material.
Mr. Rogers stated if financial reports were not filed in a timely manner; request for funds. It would not cause a question costs.
Councilor Curcuru noted they have responses from the individuals involved. Were the responses satisfactory.
Mr. Rogers noted a great deal was put behind the responses. What they're saying he can't substantiate anything. If they did it, then it's fine.
Mr. Markham agreed. By in large the responses were about what their improvement would be throughout the course of FY10. It's not unreasonable that some of these findings would be in place for FY10. It speaks to the lack of polices and procedures on the school side as well. Using 09-16 as an example, the issue of time sheets seems small but it's very big. The employee who's paid under the federal program, they didn't sign it; there wasn't even a line for them to sign it. He believed the employees were performing the duties as required. They didn't have procedure in place for them to sign the form. The grant manager didn't even know that the form had to be corrected to have this sort of thing on it. The employee has to acknowledge that they're paid under a grant. They're controls. He didn't realize there wasn't a grants procedure. There will be similar findings in FY10.
Mr. Roger stated that isn't the first time he's written this many findings on a school department. Cities and towns don't necessarily have grant administrators who understand all the requirements. It's important to understand that this is not abnormal in Massachusetts. It's a resource. Even if you have many administrators A137 and A187 - they'll never understand it all.

The following was a housekeeping item. The Committee thought that this had been done before by them; therefore, this motion was made and then the City Council will vote on the matter at their July 20, 2010 meeting.

MOTION: On motion by Councilor Hardy seconded by Councilor McGeary, the Budget & Finance Committee voted 3 in favor, 0 opposed to recommended to the City Council to authorize the City Auditor's Department to create a new Department 472 within the Publics Works section and all the personal services, ordinary services required to account for the transfer of the school custodial and maintenance department facilities to the City side, formerly Department 368.

Mr. Rogers will return to attend the July 29, 2010 meeting to continue the discussion. That meeting will convene at 5:30 p.m.

2. ***Memo from City Auditor regarding accounts having expenditures which exceed their authorization***

No Report for the July 15, 2010 Meeting was made available from the City Auditor's Office under this heading or any action taken by the Committee.

A motion was made, seconded and voted unanimously to adjourn the meeting at 6:47 p.m.

Respectfully submitted,

Dana C. Jorgensson
Clerk of Committees