

CITY OF CRANSTON

RECOMMENDATIONS TO RESTORE AND MAINTAIN FISCAL STABILITY

July 2002

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Foreword

The fiscal problems of the City of Cranston have received much public scrutiny over the last several months. The Office of the Auditor General has devoted an extensive amount of State resources to assist the City in resolving its fiscal dilemma. The purpose of this report is to provide constructive recommendations to the City and its fiscal oversight board in their efforts to restore fiscal stability in the City. The intent is not to be critical of any individual or administration but to identify issues which we believe are worthy of consideration in putting a responsible fiscal recovery plan in place for the City. We realize that successful implementation of an overall recovery plan requires significant cooperation from many sectors. Some of the recommendations included herein may be difficult to achieve and will require compromise. We hope this report contributes to the discussion and provides guidance to the City during its current fiscal challenges.

I extend my gratitude to all the agencies of State government, Cranston officials, labor organizations and all the individuals who have contributed time and energy to the effort to restore health to Cranston's finances.

Ernest A. Almonte, CPA, CFE
Auditor General

CITY OF CRANSTON

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I. EXECUTIVE SUMMARY

This report results from an extension of our statutory oversight responsibilities with respect to Rhode Island's municipalities. Our initial concern resulted from the City of Cranston's (1) disturbingly late audit reports, (2) chronic under-funding of its police and fire pension plans and proposal to issue pension obligation bonds, (3) warnings of significant deficits highlighted in a RIPEC report issued in September 2000 and (4) serious uncorrected weaknesses in financial controls cited by the City's independent auditors. We provided guidance to the City in a number of areas as the scope of its problems became more apparent and the fiscal 2003 budget was being developed. This report more formally communicates our views as to the underlying causes of the City's problems and our recommendations to restore fiscal stability. We did not perform an audit of the City and we have not performed independent tests of the data provided to us by the City which became the basis for our analyses.

The City addressed prior deficits incurred in the early to mid 1990's by leasing the managerial rights to its sewer fund for 25 years, thereby receiving a \$48 million up front infusion of cash. This transaction created a General Fund surplus that hovered around \$10 million for three successive years. However, underlying financial problems continued to exist, including a growing unfunded police and fire pension plan liability. This coupled with structural deficits caused by unrealistic revenue and expenditure projections, reliance on one-time revenues to balance the budget, and weak financial accounting and reporting controls, caused the erosion of the recently restored fund balance and projections of a general fund cumulative deficit of \$17 million at June 30, 2002.

The City plans to balance the fiscal 2003 budget and eliminate this cumulative general fund deficit by not making the annually required contribution to the City's police and firefighter pension plans and withdrawing \$13.5 million from the plans to meet pension payments during fiscal 2003. These actions and other aspects of the fiscal 2003 budget are projected to create an "operating surplus" which will eliminate the projected general fund cumulative deficit of \$17 million. Earlier consideration was given to issuance of a deficit funding bond to eliminate the general fund cumulative deficit.

Few of the causes of the City's financial condition can be easily remedied. Instead, deliberate actions within an overall framework designed to restore the City to fiscal health must be taken consistently for an extended period. Quick fixes that only provide a temporary illusion of fiscal health should be avoided particularly if the fix exacerbates an existing long-term problem (e.g. severe under-funding of pension obligations) that must ultimately be resolved.

Factors Leading to the City's Current Financial Condition

- ❑ The accumulated General Fund deficit at June 30, 2002 is estimated at \$17 million. The City has failed to adopt balanced budgets reflecting realistic estimates of revenues and expenditures – operating deficits have occurred in the last two fiscal years and an operating deficit of \$11.5 million is projected for fiscal 2002. Operating deficits have occurred in other City funds which have necessitated borrowing from the General Fund and have contributed to the General Fund deficit.
- ❑ Prior to adoption of the fiscal 2003 budget, property tax rates increased in only one of the last five years despite annual increases in the costs of operating the City. Budgets in recent years have been balanced with one-time extraordinary items which avoided tax increases but masked the fact that property tax revenues had not kept pace with increases in the City's operating expenses.

- ❑ Severe cash shortages have necessitated short-term borrowing. The City has issued \$11.6 million in tax anticipation notes due November 2002 to enable it to meet its obligations as they come due.
- ❑ The City pays over \$13 million in current pension costs for 336 police and firefighter retirees from its annual operating budget. The City pays these pensions on a pay-as-you-go basis because it has not made annually required contributions to the City administered pension plans for police and firefighters. An accrued liability for future benefits (active members and retirees) of \$212 million exists as of June 30, 2001 yet assets totaling only \$21 million had been accumulated to pay these future benefits resulting in an unfunded liability of \$191million. These assets were further depleted with the adoption of the fiscal 2003 budget which proposes using \$13.5 million to pay pension benefits in fiscal 2003.
- ❑ Annual audits of the City were not completed timely and were not available to detail previous operating results before adopting new budgets and negotiating contracts with City employees. The City's independent auditors cited serious deficiencies in the City's financial controls as a major contributing factor to these late audit reports (see appendix C and D). The City has not taken prompt corrective action on these audit findings.
- ❑ The City's bond rating has been downgraded to sub-investment grade by two rating agencies. This will significantly diminish the City's ability to convert its bond anticipation notes (\$17.8 million due in November 2002) to permanent financing for various capital projects.
- ❑ On May 14, 2002 the City Council adopted a budget which effectively raised property taxes on homeowners by approximately 11.5% by increasing the tax rate by \$1.79 per thousand and reducing the homestead exemption from 30% to 26%. Sewer fees were also increased by approximately 36% or \$95. All contributions to the City's police and fire pension plans were suspended for 2003. Pension benefits totaling approximately \$13.5 million will be paid in fiscal 2003 from the \$21 million in assets ¹ (actuarial value at June 30, 2001) that had been accumulated in the pension plans. Before considering investment gains or losses, only \$7.5 million will remain in assets accumulated to pay future pension benefits – compared to the City's liability for future benefits estimated at \$212 million at June 30, 2001.

Recommendations to Restore and Maintain Financial Stability in the City

Fiscal Oversight

- ❑ Establish a Financial Review Board to monitor and ensure the City's progress in addressing its financial difficulties. This Board should draw on experience from the business community and serve in an advisory capacity to the City and the State oversight board.

¹ \$21 million is the actuarial value of assets at June 30, 2001 – the current market value of investments held by the plans could differ substantially. Significant market declines have occurred since June 30, 2001.

- ❑ Enhance the resources available to the City Council by establishing an internal audit function and creating a formal audit committee.
- ❑ Obtain a performance audit of all departments to determine if the City is operating efficiently and effectively with the objective of improving operations and achieving cost savings.
- ❑ Prepare a corrective action plan to address all findings and recommendations in the management letter resulting from the City's annual audit.
- ❑ Ensure audits are completed as legally required within six-months of the close of the fiscal year.

Pension Issues

- ❑ Consider the significant risks associated with pension obligation bonds (POB) before proceeding with issuance as a solution to the chronic under funding of the City police and fire pension plans.
- ❑ Address the City's significant unfunded pension liability by making all required contributions to the City's pension plans for police and fire personnel.
- ❑ Determine the feasibility of all police and fire personnel joining the Municipal Employees' Retirement System administered by the State. New hires since 1995 are now members of the State administered Municipal Employees' Retirement System.
- ❑ Review the pension benefits provided to police and fire personnel through the City's pension plans in comparison to those provided by other communities and the State administered pension plans. Through renegotiation of union contracts, align pension benefits with those provided through the State administered Municipal Employees' Retirement System. This would curb the impact of such benefits on the pension plans' unfunded liability.
- ❑ Discontinue additional annuity payments made on behalf of police and fire employees who are members of the Municipal Employees' Retirement System to compensate them for the higher employee contribution rate compared with the City administered plans. Through renegotiation of union contracts, raise the employee contribution rate for police and fire personnel within the City's pension plans to equal the rate paid by those in the State system.

Budgeting Practices

- ❑ Implement improved budget development and management practices.
- ❑ Institute quarterly budget allocations and quarterly reporting at the departmental level.
- ❑ Budget realistic tax collection rates based on actual collection rates for the previous three years.

- ❑ Revise the open enrollment period where employees can make changes in health insurance so that changes can be factored into the annual budget for the next fiscal year.
- ❑ Engage the assistance of the City's Information Technology Department to develop useful computer reports to assist management in reviewing and analyzing information necessary to prepare the annual budget.
- ❑ Prepare five-year budget projections to highlight potential budget imbalances and allow sufficient time to put appropriate plans in place to maintain fiscal health.
- ❑ Create a budget reserve account that would commence after resolution of the City's immediate fiscal problems.
- ❑ Prepare detailed cash flow projections for all funds for the entire fiscal year to better manage cash flow and minimize short-term borrowing.
- ❑ Disburse longevity pay along with regular payroll on a biweekly basis rather than in one lump sum to improve cash flow.
- ❑ Bill and collect all amounts owed for police details promptly to minimize the effect on the City's cash flow.

Cost Reduction Opportunities

- ❑ Negotiate new contracts with employee unions to obtain contract concessions. The City has heeded our advice in this regard. However, if added salary and benefits were promised in future years to obtain concession for fiscal 2003 this will only defer correction of an important component of the City's structural deficit.
- ❑ Compare the City's contract provisions with those offered by similar sized Rhode Island communities. Negotiate all new collective bargaining agreements only after careful consideration of the City's financial condition and ability to pay. Calculate and disclose the fiscal impact of new labor contracts for the full term of the contract to the City Council and make such disclosures a part of the permanent public record. Determine an equitable and uniform co-pay amount for health insurance coverage provided to all City employees.
- ❑ Determine whether cost savings are possible from discontinuing the City's self-insurance program for employee health and other risks and adopting either (1) premium based insurance coverage or (2) coverage obtained through a risk collaborative.
- ❑ Aggressively pursue all potential cost savings identified by Department heads requested to make such an analysis for their departmental budgets.

- ❑ Reconsider the recommendations included in the City/School consolidation report and work cooperatively to implement its cost saving measures.

Other Recommendations

- ❑ Investigate changing sewer user fees from a flat rate to a consumption based rate structure.
- ❑ Implement an internal tracking system for all issues/problems related to the City accounting system. Accumulate and report these issues to the vendor for response and resolution.
- ❑ Perform a city-wide information systems needs analysis.
- ❑ Aggressively pursue the collection of all delinquent taxes.
- ❑ Identify areas where federal and state forfeited property funds could be used to supplement the police department's operating budget. Improve controls over authorization and documentation of expenditures made from federal and state forfeited property funds.
- ❑ Review transaction to acquire a new facility for a public works garage to determine whether costs can be reduced. Refrain from entering into any similar transactions absent extensive cost/benefit analysis.

II. INTRODUCTION

Objectives

The objective of this report is to provide constructive recommendations to the City in its efforts to put a responsible plan in place to address the City's current and long-term fiscal problems.

The information presented in this report was obtained through interviews with various City officials and employees, the City's auditors, financial advisors and consultants, and State officials. We analyzed information contained in the City's audit reports, budget documents and from various sources to support the recommendations included herein. We relied upon the information provided to us and representations made by the City – we did not perform an audit of the City nor did we audit or test the data we analyzed in preparing this report. Information extracted from the audited financial statements performed by the City's independent auditors is identified as such in the body of this report.

We asked the State Department of Education to perform an analysis of the School Department budget and the City's maintenance of effort obligation mandated by state law. The results of the review conducted by the State Department of Education were provided to the City to factor into the development of its fiscal 2003 budget.

The Budget Office and the Bureau of Audits within the State's Department of Administration assisted us in reviewing certain aspects of the City's finances. Recommendations resulting from their work are footnoted to acknowledge their contributions.

This report does not include any observations or recommendations concerning the City's economic development initiatives since we had insufficient time to explore this area. However, efforts to bring new businesses to Cranston and increase the tax base should be an important component of an overall fiscal recovery plan for the City.

City of Cranston - Overview

The City of Cranston is the third largest city in Rhode Island with a population of nearly 80,000. It has a total General Fund operating budget of approximately \$175 million and has more than 2,500 employees. The tables below summarize this data.

Fiscal 2003 General Fund Operating Budget – Summary		
	<u>(millions)</u>	<u>(percent)</u>
Revenue:		
Property Taxes	\$114.5	65%
State Aid	47.4	27%
Departmental	7.0	4%
Other	6.1	4%
Total	<u>\$175.0</u>	<u>100%</u>
Expenditures:		
Schools	\$94.4	54%
Police and Fire	31.0	18%
Other Departments	27.0	15%
Debt Service	22.6	13%
Total	<u>\$175.0</u>	<u>100%</u>

Fiscal 2003 Tax Rate		
Schools	\$18.57	54%
Municipal	\$15.81	46%
Total	\$34.38	100%

Employees	
School	1,782
Police and Fire	398
Other Departments	324
Total	2,504

Chronology of the Auditor General's Recent Involvement in Cranston's Fiscal Crisis

The Office of the Auditor General has statutory oversight authority over municipalities regarding the status of their finances and compliance with audit requirements. It is within this context that the Office of the Auditor General became increasingly involved with Cranston.

Initial meeting

We met with the City on October 17, 2001 to discuss our concerns regarding: late audit reports; a massive unfunded liability in the City's police and fire pension fund; the prediction of significant deficits cited in a RIPEC report²; and numerous deficiencies in financial controls cited in the independent auditor's management letter.

At the time of our meeting in October 2001, the City's audit for the fiscal year ended June 30, 2000 was not complete. We were assured that the fiscal 2000 audit would be completed by the end of November 2001 and that the fiscal 2001 audit would be completed within the required time frame (six-months after the close of the fiscal year - December 31, 2001) or soon thereafter. The City also indicated that operating and cumulative deficits would not be reported in audit reports for fiscal years 2000 and 2001. The City further indicated that corrective action had been taken on many of the deficiencies noted in prior management letters issued by the City's independent auditors.

Deteriorating financial condition

Information about the City's fiscal situation worsened later in October 2001 when the City publicly disclosed that it had (1) incurred deficits for both fiscal 2000 and 2001, (2) learned of the deficits in June 2001, and (3) depleted the City's cumulative surplus to cover these deficits. A projected operating deficit for the fiscal year ending June 30, 2002 was estimated at \$11.5 million.

² RIPEC REPORT

The Rhode Island Public Expenditure Council (RIPEC) a public policy research and education organization, issued a report dated September 25, 2000 on their financial analysis of the City of Cranston. RIPEC prepared a four-year forecast covering fiscal years 2002 through 2005. The forecast showed that the City could face operating deficits in all four years ranging from a low of \$4.2 million in fiscal 2003 to a high of \$7.6 million in fiscal 2005.

The fiscal 2000 audit report was not available until February 2002 – 20 months after the close of the fiscal year and 14 months after the required due date. A draft of the fiscal 2001 audit report was made available in March 2002 – a final audit report was issued in May 2002 (11 months after the close of the fiscal year and five months after the required due date). The management letter prepared by the City's independent auditors indicates that many of the previously reported deficiencies continue to exist.

Proposal to issue pension obligation bonds

Legislation was submitted by the City to the Rhode Island General Assembly to authorize the issuance of pension obligation bonds to fund an estimated \$191 million unfunded liability in the City administered police and fire pension plans. Since this bond issue required legislative approval, we were directed by members of the General Assembly in early 2002 to evaluate the financial prudence of such a bond issue. In the course of this analysis, we gained an enhanced understanding of the scope and severity of the City's financial condition. Based on our review, and the risks associated with bond financing of unfunded pension liabilities, the Auditor General advised against the issuance of pension obligation bonds.

After recommending against pension obligation bonds, we continued to assist the City in its efforts to draft its own voluntary recovery plan, since Cranston remained on the edge of qualifying for State takeover pursuant to Rhode Island General Law Section 45-9-3.

Continuing financial guidance

Based on a preliminary analysis of budgetary data received from the City, we advised City officials that they would need to make cuts of at least \$12 million if they adopted a tax increase between \$2 and \$3 per thousand of assessed property value. We asked the City to prepare various scenarios that would achieve this level of budgetary cuts. However, since salary and benefits represent approximately 75% of the City's operating budget (excluding the School Department) and many of the other scenarios the City presented would significantly curtail City services, it was agreed that concessions in labor benefits would be a necessary part of a fiscal recovery plan. This preliminary budget scenario assumed that the School Department could live within a budget that did not require an increase in local funds over the prior year. This assumption also required concessions in labor benefits.

Analysis of School Department budget

On March 1, 2002 the Cranston School Committee presented its school budget for fiscal 2003 to the Mayor. The proposed budget totaled \$102,637,873 and was an increase of over \$8 million from the prior year's budget. The School Department indicated that the majority of the increase was contractual. The City's severe fiscal crisis ruled out consideration of an increase in funding for the School Department for fiscal 2003. We advised the School Department that as a result of Cranston's fiscal problems, they should review their budget and determine where cuts could be made to assist in reducing the budgetary shortfall that the City was facing for 2003. However, section 16-7-23 of the Rhode Island General Laws, requires the City to fund School operations in an amount not less than its local contribution for schools in the previous fiscal year. Additionally, all required State educational mandates must be met. As a result, we asked the Rhode Island Department of Education (RIDE) to evaluate the School Department portion of the City's budget and propose recommendations for potential savings.

The Rhode Island Department of Education (RIDE) provided the City with a recommended school budget for 2003. The RIDE report, issued on April 5, 2002 stated that the Cranston School Department already manages a lean budget and has done so responsibly for several years. However, in light of the City's fiscal problems, it proposed a balanced budget of \$94,426,786 for the fiscal year ending in 2003, which is \$124,252 lower than the budget that was enacted for fiscal 2002. RIDE's proposed budget would require cuts totaling more than \$7.5 million from a level

service budget; i.e., the same level of services (assuming no changes) provided in fiscal 2002 would cost approximately \$7.5 million more in fiscal 2003. (See Appendix E)

The Commissioner of Education strongly opposed any cuts beyond this level and further stated that several of the proposed cuts involved union contracts and would require the cooperation of various unions especially in the area of health care coverage and salaries. Therefore, this proposed school budget would only be attainable if the identified amount of proposed union concessions were achieved.

In addition, the RIDE report states that the recommendations are meant to apply only to the 2003 budget. They identify the School Department's growing needs, including projected increases in student enrollment, which indicate that the School Department will require increased funding in future years. This should be considered by the City in developing a five-year budget forecast.

Mayor's proposed budget

As required by the City Charter, the Mayor proposed his budget to the City Council on April 1, 2002 which included a \$9.2 million line item identified as City and School concessions. This amount represented a budgetary gap since the union concessions had not been obtained by the City. On April 5, the Mayor presented a proposed fiscal recovery plan to the Auditor General, which identified alternative proposals to bridge the \$9.2 million gap. These proposals were analyzed and based on information provided by the City, they did not appear to resolve the budgetary gap in a manner that corrected the structural deficit.

We believe that the budgetary gap was in fact much higher than the \$9.2 million identified in the Mayor's proposed budget, if all expenses and conservative estimates for revenues were included in the budget. For example, in addition to the \$9.2 million gap, the Mayor's proposed budget included a revenue estimate for State aid to schools that was approximately \$900,000 higher than the amount identified in the Governor's proposed budget. Additionally, there was an approximate \$2.4 million shortfall between the Mayor's proposed contribution to the severely under funded police and fire pension plans and the actuarially determined annual required contribution.

The Mayor's proposed budget for schools was approximately \$8 million lower than the budget proposed by the school committee. The school committee's proposed budget included contractually required increases for which concessions had not yet been obtained. Although the City's dire financial situation necessitated level funding the school budget for 2003, some or all of this difference represented a potential shortfall until concessions were obtained. The budget proposed by RIDE was clear that it was contingent on the School Department's ability to obtain union concessions that would enable the School to assume a level funded budget.

In order to continue to assist the City to identify areas where cuts could be made we then recommended that Department heads analyze their budgets (as included in the Mayor's proposed budget for 2003) and make suggestions for additional cuts. Many did not believe they could offer practical cuts that would attain cost savings, however, we have described one department head's proposal which suggested significant savings as described on page 49.

Recommendation for State takeover

As the date to adopt the budget approached, the City had not yet carved out a fiscally sound plan that would correct the structural deficit without deferring the problem to future years. On April 29, 2002 the Auditor General recommended to the State Director of Administration that a Budget and Review Commission assume control over Cranston's financial operations pursuant to General Law section 45-9-3.

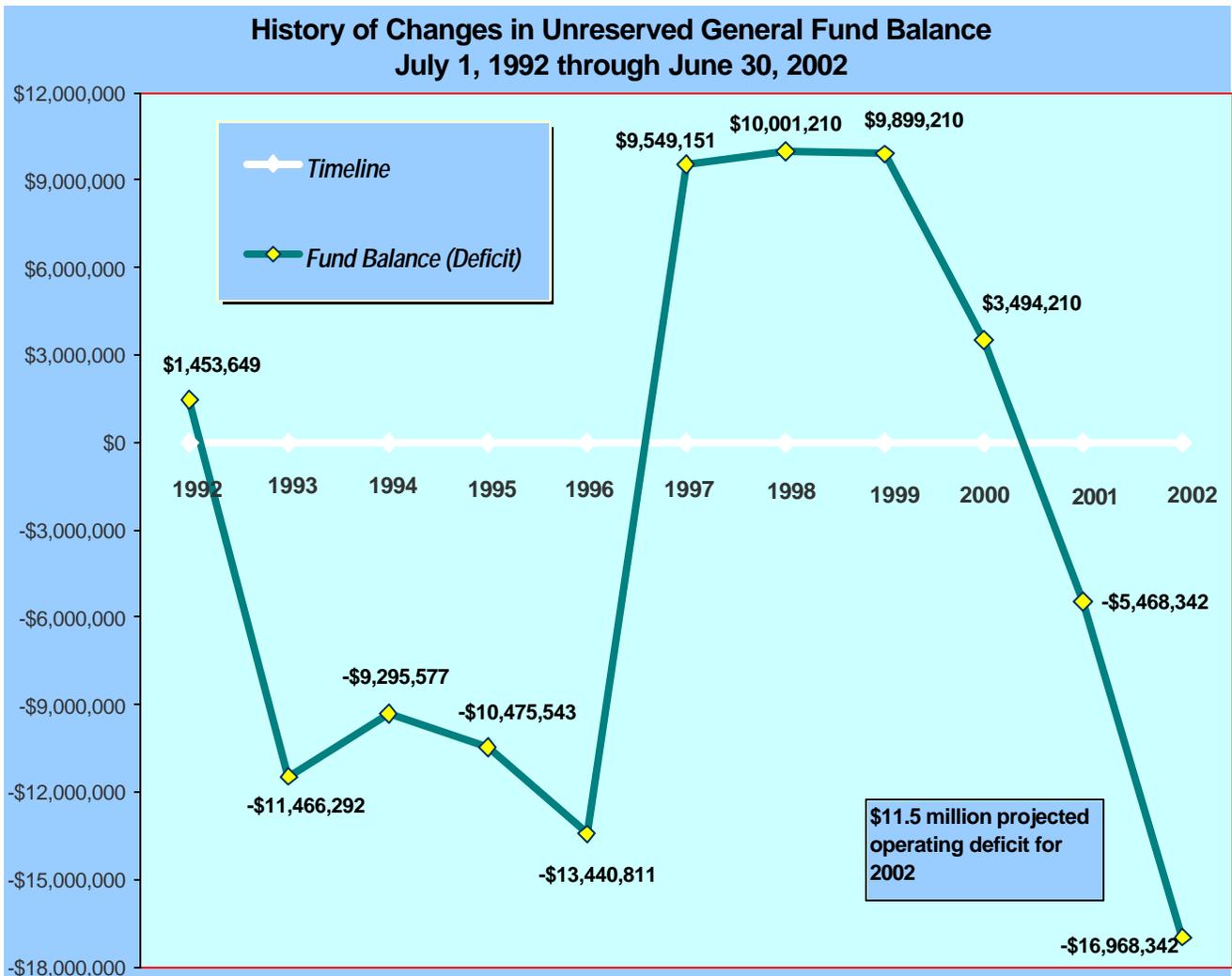
The Director of Administration did not form a Budget and Review Commission but members of his staff advised the City in preparing a budget for 2003 which was adopted by the City Council on May 14, 2002.

III. FACTORS LEADING TO THE CITY'S CURRENT FINANCIAL CONDITION

Overview

The following is a summary status of the City's financial condition and an overview of the factors we believe have contributed to the City's deteriorating financial condition. Few of the causes of the City's financial condition can be easily remedied. Instead, deliberate actions within an overall framework designed to restore the City to fiscal health must be taken consistently for an extended period. Quick fixes that only provide a temporary illusion of fiscal health should be avoided particularly if the fix exacerbates an existing long-term problem (e.g. severe under-funding of pension obligations) that must ultimately be resolved.

The following graph illustrates changes in the City's cumulative unreserved General Fund balance for a ten-year period. It demonstrates that the City addressed its prior deficits (incurred in the early to mid 1990's) by leasing the managerial rights to its sewer fund for 25 years, thereby receiving a \$48 million up front infusion of cash. This transaction created a General Fund surplus that hovered around \$10 million for three successive years. However, underlying financial problems continued to exist, including a growing unfunded police and fire pension plan liability. This coupled with structural deficits caused by unrealistic revenue and expenditure projections, reliance on one-time revenues to balance the budget, and weak financial accounting and reporting controls, caused the erosion of the restored fund balance and projections of even deeper cumulative deficits by June 30, 2002.



GENERAL FUND ACCUMULATED DEFICIT

The City has a projected Unreserved General Fund deficit for the fiscal year ended June 30, 2002 of approximately \$17 million as follows:

<u>History of General Fund Accumulated Deficit</u>		
<i>Unreserved General Fund Balance</i>⁽³⁾ - June 30, 1999	<u>\$ 9,899,210</u>	(1)
Fiscal 2000 - Operating Deficit	(4,940,000)	(1)
Fiscal 2000 - Increase in Reserves ⁽⁴⁾	<u>(1,465,000)</u>	(1)
<i>Unreserved General Fund Balance - June 30, 2000</i>	<u>3,494,210</u>	(1)
Fiscal 2001 - Operating Deficit	(8,756,072)	(1)
Fiscal 2001 - Increase in Reserves	<u>(206,480)</u>	(1)
<i>Unreserved General Fund Deficit - June 30, 2001</i>	<u>(5,468,342)</u>	(1)
Fiscal 2002 – Operating Deficit (<i>Projected</i>)	<u>(11,500,000)</u>	(2)
<i>Unreserved General Fund Deficit - June 30, 2002 (Projected)</i>	<u>\$ (16,968,342)</u>	

1. Source – City of Cranston Audited Financial Statements for fiscal year indicated.
2. Source – City of Cranston
3. Unreserved General Fund balance is the portion of the General Fund balance that is available for appropriation and expenditure in subsequent years.
4. Increases in reserves result from amounts due from other funds that will not be collected within the next fiscal year.

As shown above, the City's unreserved fund balance of nearly \$10 million at June 30, 1999 was erased by operating deficits that increased in amount over the next three fiscal years. The City attributes the fiscal 2002 projected operating deficit to both over-budgeting revenues and under-budgeting of expenditures in a number of key areas.

The most significant causes of the City's accumulated deficit are an ongoing structural budget deficit, failure to make required contributions to its pension plans for police and fire personnel, loans to other funds which had incurred deficits, and over-reliance on extraordinary revenue items to avoid tax increases.

Structural Budget Deficit

The City budget has had an ongoing structural deficit resulting from various budgeting practices as summarized below:

- ❑ Using an unrealistic property tax collection rate (i.e., budgeting a 100% collection rate when actual was closer to 97%).
- ❑ Overestimating investment income – the fiscal 2002 budget may overestimate investment income by as much as \$600,000.
- ❑ Budgeting property tax abatements at \$300,000 per year while actual abatement have been closer to \$1 million in both fiscal 2002 and 2001.

Factors Leading to the City's Current Financial Condition

- ❑ Under-budgeting expenses such as the amount required to make police and fire pension payments and certain contractual salary expenses.
- ❑ Using one-time revenues to balance its budget including proceeds from the lease of the managerial rights to the City sewer system, and an additional amount budgeted in 2002 for extending the sewer contract. The lease of the City's sewer plant was in response to a significant General Fund accumulated deficit in fiscal 1993 which by June 30, 1996 had grown to \$13.4 million. In March 1997, the Council signed a contract to lease the City's wastewater treatment plant to a private operator for 25 years. The plan included an up front lease payment of \$48 million which was used by the City to eliminate the General Fund cumulative deficit, eliminate some sewer related debt, and improve cash flow. This solution to the City's fiscal crisis in the mid-1990's did not resolve the City's structural deficits, since the City continued poor budgeting practices and reliance on one-time revenues.
- ❑ Avoiding property tax increases despite increases in the salaries provided to City employees – the City has negotiated generous contracts with its unions. Personnel costs represent approximately 87% of the School Department budget and 75% of the budget for all other municipal services.

RIPEC highlighted many of the issues contributing to the City's structural deficit. Although this information was available to the City when adopting the budget for the fiscal 2002, the City again adopted a budget with unrealistic assumptions. The City is projecting a budgetary shortfall of at least \$11.5 million by the end of fiscal 2002. This additional shortfall, which adds to the already weakened financial condition of the City, could have been lessened or possibly averted if the City had taken timely action to heed the warnings contained in the RIPEC report.

Deficits in Other Funds

Deficits have also occurred repeatedly in other City funds which have a direct impact on the General Fund. Operating deficits in other funds necessitate borrowing from the General Fund – when the borrowing fund does not have the resources to repay the General Fund, these amounts cannot be considered available to support the operations of the General Fund and must be reserved.

The City is primarily self-insured and records the operations of its Insurance/Risk Management and Health Insurance programs in Internal Service Funds, which are supported by the General Fund. These funds have incurred deficits for a number of years. The City's audited financial statements for fiscal 2001 indicate deficits as follows:

<u>Internal Service Funds</u>	<u>Accumulated Deficit – June 30, 2001</u>
Insurance/Risk Management	(\$2,093,549)
City Hospitalization	(\$ 436,450)
School Hospitalization	<u>(\$2,567,497)</u>
	<u>(\$5,097,496)</u>

These funds have received interfund loans from the General Fund which were either written off or reserved in the General Fund during fiscal 2001 thereby increasing the General Fund unreserved deficit.

The Sewer Enterprise Fund has a \$12 million deficit in retained earnings. The City has indicated that the Sewer Enterprise Fund also owes the General Fund over \$5 million for interfund loans it received. This receivable was written off in the General Fund in fiscal 2000 thereby increasing the General Fund unreserved deficit.

The Council enacted budget for the Sewer Fund increases sewer fees from \$268 to \$363 per household, which the City projects will generate an approximate operating surplus of \$1,450,000 in the sewer fund. This amount will be used to repay the General Fund.

CASH FLOW PROBLEMS

The City has also been facing a severe cash shortage that if left uncorrected, will prevent it from meeting its obligations as they come due. The City has delayed various payments because of insufficient cash and in certain instances has incurred additional interest and late charges due to its inability to make required payments when due. The City's cash flow problems were temporarily addressed through issuance of \$11.6 million in tax anticipation notes in March 2002. The notes are payable in November 2002 from next fiscal year's receipts. The City has the following short-term borrowings that must be repaid or refinanced in the next fiscal year.

SHORT-TERM BORROWING		
	<u>Amount</u>	<u>Due Date</u>
Tax Anticipation Notes	\$11,630,000	November 2002
Bond Anticipation Notes	\$17,798,000	November 2002

The City is moving forward with two significant capital projects which will require permanent funding. The School Department has indicated that the overcrowding situation in the elementary school in western Cranston has reached dangerous limits and they need to build a new school. The City has already received voter approval to issue bonds to build a new school. The School Department is going forward with plans to construct the new school for opening in September of 2003 at an estimated cost of approximately \$8 million. The City is also proceeding at this time with plans to build a new police station.

CHRONIC UNFUNDING OF THE CITY'S PENSION PLANS FOR POLICE AND FIREFIGHTERS

The City Police and Fire Pension Plans had an unfunded accrued liability of \$191 million (as of the July 1, 2001 actuarial valuation date). This results from an accrued liability for future pension benefits of \$212 million less assets of \$21 million (actuarial value) that were accumulated to pay future pension benefits.

The City has not been making its annual required contribution to the City Police and Fire pension plans. The percentage of the actuarially determined annual required contribution made by the City was between 34% and 51% from 1992 through 1999 and increased to 60% in 2000 and 75% in 2001. In reality, the "contribution" to the City's plans represents the amount the City paid out in pension benefits to retired members during those years and does not represent additional funds deposited into the plans to be invested for future pension benefits.

According to the actuary, the City's annual required contribution, if the unfunded pension liability is amortized over 37 years, is approximately \$19 million. Instead of making this required contribution to the plans, the City has adopted a fiscal 2003 budget which makes no annual required contribution to the plans and uses \$13.5 million of the \$21 million of assets held in the plans³ to pay pension benefits during fiscal 2003.

³ \$21 million is the actuarial value of assets at June 30, 2001 – the current market value of investments held by the plans could differ substantially. Significant market declines have occurred since June 30, 2001.

The actuary indicates that pension benefit payments will increase to over \$20 million by 2012, exceed \$25 million by 2019, and exceed \$27 million by 2024. In its response to management comments made by the auditor performing the City's fiscal 2001 audit, the City acknowledged that payments out of the plans to retired police and fire personnel will exceed \$1.2 billion before the pension plans are extinct. This liability, which creates an enormous burden to the City's finances, relates only to 528 employees and retirees. Other City employees are covered by pension plans administered by the State. The City is making required contributions to those plans.

LATE AUDIT REPORTS

Late audit reports have contributed to the City's fiscal crisis by failing to provide timely information regarding the City's financial situation. Annual budgets for the City have been adopted without knowing previous fiscal year operating results. Contracts have been negotiated with the City's unions without audited financial statements documenting the City's deteriorating financial condition.

- ❑ The fiscal 2001 audit was issued in May 2002 -- 11 months after the close of the fiscal year and five months after the legal due date. (A draft audit report was available in March 2002)
- ❑ The fiscal 2000 audit was received in February 2002 almost 20 months after the close of the fiscal year and nearly 14 months after the legal due date.
- ❑ The fiscal 1999 audit was received in March 2001 - 21 months after the close of the fiscal year and 15 months after the legal due date.

The City's independent auditors have pointed to the City's poor controls over financial reporting as one reason for the late reports. The most recent management letter issued by the auditors (which was filed with this office on June 25, 2002) covers the fiscal year ended June 30, 2001. This letter reported seven *material weaknesses* over financial reporting. This is defined as a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the general purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

DOWNGRADE OF CITY'S BOND RATING

Municipal debt ratings represent the rating agencies opinion about the City's long-term ability to meet debt payments and the long-term credit risk associated with its debt. Ratings are assigned based on an evaluation of the City's specific credit characteristics. The ratings show the credit quality of the City's bonds and provide creditors with a simple system to measure the City's ability to meet its financial obligations. A rating can also affect the City's costs associated with issuing debt since additional costs of issuance (e.g., higher interest rate and bond insurance costs) are incurred for debt which has added risk associated with it.

On March 20, 2002, Fitch Ratings, an international rating agency, dropped the City's bond rating to BBB which is the lowest of its investment grade ratings. Fitch also placed this rating on its rating watch negative list for possible downgrade pending a review of the proposed fiscal 2003 budget.

On April 9, 2002 Standard and Poor's, a second international rating agency, dropped Cranston's bond rating to BB, which is non-investment-grade. An obligation rated BB is regarded as having significant speculative characteristics. It faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation. Such a rating limits the City's ability to refinance certain of these obligations as they come due. They further stated that the City was being placed on "CreditWatch" reflecting a pending decision by the State of Rhode Island whether

or not to take over City operations. The rating agency stated that if the State does take over the City's operations and sets a recovery plan in place as it has done successfully in other Rhode Island municipalities, an upgrade is likely. It further stated that if the State does not take over operations and the City fails to develop a multiyear, structurally balanced budget within a reasonable amount of time, a downgrade is likely. A downgrade of even one notch would indicate that the bonds are even more vulnerable to nonpayment and that adverse conditions will likely impair the City's capacity or willingness to meet its financial commitment on the obligations.

Moody's Investor's Services, a third global rating agency, which had previously rated the City's bonds near the lowest of its investment grade ratings, reserved any further action until after the City had adopted its budget for fiscal 2003. On June 6, 2002, after evaluating the City's adopted budget for fiscal 2003, Moody's downgraded the City's bond rating to Ba1, which is below investment grade, and referred to by some as "junk bond" status. Issuers rated Ba offer questionable financial security. Often the ability of these entities to meet obligations may be moderate and not well safeguarded in the future.

It is clear from the actions taken by these bond rating agencies in the past that they will closely watch the steps taken to restore fiscal stability to Cranston. Their evaluation of the seriousness with which this situation is viewed and handled by the State departments and agencies which are given oversight responsibility for Rhode Island cities and towns will impact not only Cranston, but how they will view the fiscal health of all Rhode Island municipalities and the State as a whole.

Further, the City's bond anticipation notes of \$17.8 million due in November 2002 must be refinanced. With the downgrades of the City's bond rating, refinancing these notes will, at a minimum, be more costly. It is unlikely that the City would have sufficient cash to repay bondholders without refinancing.

ANALYSIS OF FISCAL 2003 BUDGET ADOPTED BY CRANSTON CITY COUNCIL ON MAY 14, 2002

The table shown on the page 17 summarizes the significant differences between the fiscal 2003 budget proposed by the Mayor on April 1, 2002 and the budget adopted by the Council on May 14, 2002.

The Mayor's proposed budget was balanced by increasing property tax revenues, level funding the School Department budget, and reducing expenditures by \$9.2 million of unidentified union concessions. The General Fund accumulated deficit was to be eliminated through issuance of deficit funding bonds payable over 5 years.

The fiscal 2003 budget adopted by the Council on May 14, 2002 increases current property tax revenue by \$850,000 more than the Mayor's proposed budget, eliminates all contributions to the City's police and fire pension plans and substitutes \$9.2 million of unspecified union concessions with \$3.2 million of salary and benefit reductions. Debt service on the proposed deficit funding bonds is eliminated. Instead, the cumulative deficit will be reduced by a surplus generated by eliminating contributions to the police and fire pension plans and funding current pension costs from the assets accumulated in the pension plans.

We do not consider the fiscal 2003 budget adopted by the City to be fiscally sound principally because it relies on drawing on the small amount accumulated in the City police and fire pension fund to erase the accumulated General Fund deficit. This action again relies on a one-time fix to alleviate the budget shortfall and adds to a very large existing unfunded pension obligation. Further, insufficient cuts were made in expenditures to better align the growth in expenditures with revenue growth and correct the structural budget deficit.

Moody's Investor's Services cited the following factors on June 6, 2002 when it reviewed the City's fiscal 2003 budget and downgraded the City's bond rating below investment grade:

Factors Leading to the City's Current Financial Condition

- ❑ A significant reduction in General Fund reserve levels that has severely deteriorated the City's financial flexibility and fully eliminated the working capital established from their 1997 deficit reduction plan (a plan which eliminated the deficit and created working capital by using proceeds received from a one-time upfront payment of \$48 million by a private company to lease the City's wastewater treatment facility for 25 years);
- ❑ Longer-term fiscal vulnerabilities stemming from management's need to address deferred pension funding issues;
- ❑ The willingness of the resident base to assume additional tax rate increases;
- ❑ The potential need for supplemental cost control efforts despite the recently approved union concessions which defer fiscal 2003 costs to future years; and
- ❑ The absence of a multi year financial plan with identifiable fiscal initiatives. This creates uncertainty regarding the direction management will pursue to improve overall financial flexibility.

A fuller discussion of the key elements of the City's fiscal 2003 budget follows the table – items are keyed in the table to paragraphs where key changes in the budget are more fully explained:

City of Cranston - Fiscal 2003 Budget

Summary of Changes Between Mayor's Proposed Budget and Council's Enacted Budget

	Revenue					Expenditures				Revenue Over (Under) Expenditures
	Property Tax Revenue	State Aid Schools	State Aid General	Other Revenues	Total Revenue	Municipal Expenditures	School Expenditures	Union Concessions	Total Expenditures	
Mayor's Proposed Budget - April 1, 2002	\$ 113,644,957	\$ 32,342,215	\$ 17,303,787	\$ 9,867,876	\$ 173,158,835	\$ 88,687,570	\$ 93,671,265	\$ (9,200,000)	\$ 173,158,835	\$ -
Changes in Revenue:										
Increase in property taxes	A \$ 857,289				\$ 857,289					
Adjust State aid to State budget (1)	B	\$ (932,948)	\$ (1,313,567)		\$ (2,246,515)					
Sewer fund repayment to General fund	C			\$ 1,450,000	\$ 1,450,000					
Federal Medicaid revenue for schools	D			\$ 1,641,722	\$ 1,641,722					
Other revenue increases				\$ 155,000	\$ 155,000					
Changes in Expenditures:										
Eliminate non-specified union concessions	E							\$ 9,200,000	\$ 9,200,000	
Eliminate contribution to police and fire pension plan	F					\$ (16,600,000)			\$ (16,600,000)	
Deficit reduction	G					\$ 14,950,000			\$ 14,950,000	
Eliminate debt service on deficit funding bonds	G					\$ (3,503,193)			\$ (3,503,193)	
Net increase in School budget	D						\$ 755,521		\$ 755,521	
Other expenditure changes (net) which includes salary and benefit reductions	E					\$ (2,949,529)			\$ (2,949,529)	
Council's Enacted Budget - May 14, 2002	\$ 114,502,246	\$ 31,409,267	\$ 15,990,220	\$ 13,114,598	\$ 175,016,331	\$ 80,584,848	\$ 94,426,786	\$ -	\$ 175,011,634	\$ 4,697

Notes

1 - City Council enacted budget reflects State Aid as included in the governor's budget. State budget for fiscal 2003 as enacted provides Cranston with additional State Aid totaling \$1,248,158 -- \$466,474 for School and \$781,684 for General State Aid.

Notes A - G reference a discussion of the changes between the Mayor's proposed budget and the Council's Enacted Budget

A. Property tax rate raised by \$1.79 and homestead exemption reduced by 4%

The Mayor's proposed fiscal 2003 budget included an increase in the property tax rate of \$3.40 per thousand and eliminated the homestead exemption of 10% on non-owner occupied homes. This would have raised approximately \$10 million in additional property tax revenue.

The Council's enacted budget increased the real estate taxes rate by \$1.79 to \$34.38. It also included elimination of the homestead exemption on non-owner occupied homes. In addition, the Council reduced the homestead exemption on owner-occupied homes by 4% (from 30% to 26%). The City also increased sewer fees by an additional \$95 in an effort to balance its budget.

The following analysis demonstrates the estimated effect of these increases on a City of Cranston homeowner with an assessed value of \$150,000.

ESTIMATED IMPACT OF PROPERTY TAX AND SEWER RATE INCREASES				
	<u>Fiscal 2002</u>	<u>Fiscal 2003</u>	<u>Increase</u>	
			<u>Amount</u>	<u>Percent</u>
<i>Single Family - Owner Occupied</i>				
Assessed value	\$150,000	\$150,000		
Less: Homestead exemption	<u>45,000</u> (30%)	<u>39,000</u> (26%)		
Taxable assessed value	\$105,000	\$111,000		
Tax rate - per thousand (\$1.79 increase in 2003)	<u>\$32.59</u>	<u>\$34.38</u>		
Property taxes assessed	\$3,422	\$3,816	\$394	11.5%
Sewer fee	<u>\$ 268</u>	<u>\$ 363</u>	<u>\$ 95</u>	36%
Combined property tax and sewer fee	\$3,690	\$4,179	\$489	13%
<i>Single Family - Non-Owner Occupied</i>				
Assessed value	\$150,000	\$150,000		
Homestead exemption	<u>15,000</u> (10%)	<u>-</u> (0%)		
Taxable assessed value	\$135,000	\$150,000		
Tax rate - per thousand (\$1.79 increase in 2003)	<u>\$32.59</u>	<u>\$34.38</u>		
Property taxes assessed	\$4,400	\$5,157	\$757	17%
Sewer fee	<u>\$ 268</u>	<u>\$ 363</u>	<u>\$ 95</u>	36%
Combined property tax and sewer fee	\$4,668	\$5,520	\$852	18%

Rhode Island General Laws Section 44-5-2 entitled "Maximum Levy" requires that if a municipality plans to levy a property tax in excess of the five and one-half percent (5.5%) of the prior year, it must obtain certification from the Department of Administration and in some cases also from the Office of the Auditor General (OAG). The Chief of the State Office of Municipal Affairs (OMA) - Department of Administration indicated in an internal memorandum dated May 14, 2002 that the City did not appear to qualify for a waiver of the tax cap requirements for reasons that could be granted by his office. The City did not seek an override to the 5.5% tax cap from the Office of the Auditor General.

Although the above examples demonstrate that a homeowner's real estate taxes required by the City's adopted budget for fiscal 2003 will in effect increase by more than 5.5%, this analysis includes the impact of both the increase in tax rate and the reduction in the homestead exemption. In his May 14 memorandum referenced above, the Chief of the OMA indicated that, in his opinion, the adjustment to the City's homestead exemption had no impact on the 5.5% tax cap statute. Whether the City obtained a legal opinion regarding the requirements of the State tax cap law is not known. However, the OMA memorandum may have been considered by the City in its decision not to request an override to the 5.5% tax cap from our office.

B. State Aid

The Mayor's proposed budget included State Aid amounts that differed from the Governor's proposed budget. The Council enacted budget aligns the State Aid amounts with those included in the State's proposed budget. The State's enacted budget for fiscal 2003 further revises the State Aid amounts resulting in an increase in total State Aid of \$1,248,158 of which \$466,474 is restricted for Schools and \$781,684 is general State Aid.

C. Sewer fees increased to repay General Fund

A proposed \$95 increase in sewer fees will generate additional revenue within the sewer enterprise fund thereby allowing the sewer enterprise fund to repay amounts borrowed from the General Fund.

D. School Department Budget funded at \$94,426,786

RIDE proposed this amount in its report dated April 5, 2002 to provide the City with the minimum amount it could fund the School Department for the fiscal 2003. The budget analysis was performed at the request of the Auditor General in an effort to assist the City reduce the severe budgetary shortfall projected for fiscal 2003. The amount proposed by RIDE was dependent on the School Department's ability to obtain concessions from the labor unions regarding existing contractual obligations. The RIDE proposal would permit the School Department to make over \$7.5 million in cuts from a level service budget – that is a budget that starts with current services as provided for in fiscal 2002 and projects into next year the cost of maintaining the same level of services if nothing changes. (See appendix E.)

The net increase in expenditures for schools between the Mayor's proposed budget and the Council enacted budget would be funded by the net difference between a decrease in anticipated state aid based upon the Governor's budget and an increase from previously unbudgeted federal Medicaid funding.

E. Union Concessions for City Employees including Police and Fire

The Mayor's proposed budget included \$9.2 million of non-specified concessions to be obtained from the City's various bargaining units. The Council enacted a budget which included more modest salary

and benefit reductions totaling approximately \$3.2 million. This necessitated cuts in other areas, principally, elimination of the annual required contribution to the City's severely unfunded police and fire pension plans.

We are not aware of the specific union concessions obtained by the City for fiscal 2003 or whether or not they will achieve the cost reductions targeted. If concessions were achieved by promising increases in salaries and employee benefits in future years it will only defer correcting the structural deficit problems. Future salary increases and benefits will create new demands on the budget in fiscal 2004 and onward that will require revenue increases to fund them, most likely in the form of additional property taxes.

F. The City eliminated its contribution of \$13.5 million to fund the required pay-as-you go amount for the police and fire pension plans and also eliminated the City's contribution of \$3.1 million to fund normal service costs required for these plans.

The City's actuary determined in the most recent actuarial valuation report issued in December of 2001 that the City's annual required contribution to fund the police and fire pension plans is approximately \$19 million. Therefore, the Mayor's proposed budget which provided for \$16.6 million to fund the pay as you go amount (\$13.5 million) and some of the annual required contribution (\$3.1 million) created a budgetary shortfall of approximately \$2.4 million (\$19 million less \$16.6 million).

However, the City enacted budget which eliminates any contribution to the pension fund does not correct the budgetary shortfall of \$2.4 million that existed in the Mayor's proposed budget and in fact totally eliminates any effort to make the annual required contribution in fiscal 2003. The City's fiscal 2003 budget is balanced by funding the City's police and fire pension payments to retirees by using \$13.5 million of the approximate \$21 million in assets⁴ remaining in the severely under funded police and fire pension plans. This approach while being used to balance the budget and avoid deeper expenditure cuts or higher tax increases for the 2003 budget, continues the chronic practice of deferring the correction of problems related to the City's unfunded pension liability to future years.

According to the City's most recent audit report, the actuarial assets of the City's Police and Fire pension plans represented less than 10% of the actuarial liabilities of the plans at June 30, 2001. It further states that significant under funding raises substantial doubt about the plans' ability to continue as going concerns. The independent auditor's indicate that the under-funded situation in the City's Police and Fire pension plans resulted from actual contributions to the plans being less than those required for full funding. The fiscal 2001 management letter cites a material weakness in internal control over financial reporting due to this under-funding situation. The auditors recommended that the City properly budget and fund the pension plans. A similar recommendation was made for fiscal 2000. The City's 2003 budget plan does not implement this recommendation.

The possibility exists that the City will again seek legislative approval to issue pension obligation bonds next year to provide an infusion of cash into the pension plans and trade the pension obligation for bonded debt. Since such a plan is dependent on many factors as described on page 28 of this report, it would be prudent for the City to develop an alternative plan if the risk of issuing POB's continues to outweigh the benefits. Other options and recommendations regarding the City's funding of the police and firefighters pension plans are outlined beginning on page 27.

⁴ \$21 million is the actuarial value of assets at June 30, 2001 – the current market value of investments held by the plans could differ substantially. Significant market declines have occurred since June 30, 2001.

G. City eliminated contribution to debt service originally requested to fund a \$17 million deficit reduction bond over 5 years.

The Mayor's proposed budget included debt service of approximately \$3.5 million on deficit funding bonds to be repaid over five years. The enacted budget eliminates this debt service since the General Fund surplus in fiscal 2003, created primarily through deferring required pension contributions, will be applied to the cumulative deficit.

Need for five-year budget projections

During the time that this office worked to assist the City in its efforts to develop a fiscal recovery plan, we advised the City that in order for the recovery plan to effectively demonstrate sound fiscal management it should include a five-year budget forecast. We believe that a five-year forecast should have been prepared in conjunction with the fiscal 2003 budget to ensure that future costs related to any decisions made to balance the fiscal 2003 budget would not have a detrimental financial effect on future budget years. For example a five-year forecast would have:

- ❑ revealed the financial impact on future budgets of any union concessions received for fiscal 2003 which in turn require additional compensation and benefits and resulting increased property taxes in fiscal 2004 and beyond;
- ❑ demonstrated the financial impact on future budgets of eliminating all of the annual required contribution to the gravely under funded police and fire pension plans, and further depleting the exceedingly inadequate assets of this fund (*The City should include in its 5-year budget projection, alternative solutions to remedy the under funding of these plans since it would not be practical to rely solely on the prospect that issuing pension obligation bonds will prove to be a viable solution next year*);
- ❑ factored in any required increases in City or School services and the related costs, and revenues required to fund them (*for example, increased costs in future school budgets triggered by an increase in student enrollment as expected per the RIDE report*).

IV. RECOMMENDATIONS TO RESTORE AND MAINTAIN FISCAL STABILITY

The City now faces considerable fiscal challenges both short and long-term that must be addressed appropriately so as to eliminate rather than exacerbate these problems. While addressing the immediate deficits and related cash shortages in fiscal year 2002 and 2003 are clear priorities, attention must be given to establishing a fiscal strategy and budgetary practices that resolve the long-term fiscal problems that have existed for some time. We have assembled various recommendations to assist the City in addressing these issues. The recommendations are grouped into five sections:

- ❑ *Fiscal oversight*
- ❑ *Pensions*
- ❑ *Budgeting practices*
- ❑ *Cost reduction opportunities*
- ❑ *Other recommendations*

A. FISCAL OVERSIGHT

ESTABLISH A FINANCIAL REVIEW BOARD

An independent Financial Review Board should be established to (a) monitor the City's progress in addressing its fiscal difficulties, (b) ensure that effective and efficient management practices are in place and operating, and (c) provide guidance regarding any corrective action which may need to be taken. This Financial Review Board would draw on experience from the business community and serve in an advisory capacity to the recently created City and State oversight board.

Structural issues such as the number of Board members, the determination of appointing authorities and the length of time served should be determined by an appropriate deliberative process. We do believe, however, that the City's interests would best be served if the majority of the membership consisted of individuals with professional expertise in the areas of law, banking, finance, and accounting.

The Financial Review Board's duties should include but not be limited to the following functions:

1. analyze all factors contributing to the City's financial condition and propose corrective action to help remedy any such conditions;
2. consult with the City during the preparation of the annual City budget including the School Department's request;
3. verify revenue estimates;
4. monitor expenditures including personnel costs;
5. review the terms of each short-term and long-term borrowing by the City;
6. review all contracts which exceed a predetermined dollar amount and/or have terms greater than one year;
7. review monthly reports that detail the City's current financial condition;

8. consult with the City's auditors during the performance of each annual audit, receive and review the annual audit report, and monitor the City's compliance with developing a corrective action plan for all management recommendations;
9. review the City's operations as necessary and make recommendations where applicable to improve productivity and/or reduce costs; and
10. issue a report semi-annually to the Mayor, City Council, State Auditor General and Director of the Department of Administration on the City's progress in implementing and retaining effective cash management and financial and budgetary controls. In addition, the aforementioned City and State officials should be notified immediately if it appears the City is in danger of incurring additional deficits, budgetary problems, or cash flow problems which will prevent Cranston from meeting its obligations as they come due.

The Financial Review Board should meet monthly, but may convene more frequently should circumstances warrant closer monitoring of the City's financial condition. The Board should also remain in existence for at least five (5) years of balanced budget submissions with no annual operating or cumulative deficits. The Board members should serve without salary or per diem allowance.

RECOMMENDATION

1. Establish an independent Financial Review Board to (a) monitor the City's progress in addressing its fiscal difficulties, (b) ensure that effective and efficient management practices are in place and operating, and (c) provide guidance regarding any corrective action which may need to be taken.

ENHANCE THE FINANCIAL MONITORING RESOURCES AVAILABLE TO THE CITY COUNCIL

The Cranston City Council is the legislative body of the City. The Council has various powers under the City Charter including adopting the annual operating and capital budgets of the City, engaging and contracting for the annual audit of the City, providing advice to the Mayor on the City's bargaining position prior to the start of union negotiations, authorizing labor contracts and authorizing indebtedness of the City (subject to general assembly or voter approval). As such, the City would benefit from the assistance of individuals and committees with financial expertise, which would provide the Council with meaningful information in an effort to assist the Council in fulfilling its duties as effectively and efficiently as possible.

Establish An Audit Committee

The City Council should pass an ordinance establishing an audit committee charged with the following responsibilities:

- ❑ select the independent auditor for the City's financial statement audits;
- ❑ monitor the progress of the financial statement audit;
- ❑ evaluate the results of the financial statement audit;
- ❑ ensure that control weaknesses and legal compliance violations identified in the course of the financial statement audit are promptly and effectively remedied;

- ❑ serve as a direct communication link between the Council and the independent auditors; and
- ❑ monitor the adequacy of the governments internal control structure on an ongoing basis. The internal audit position described below can assist in carrying out this responsibility.

RECOMMENDATION

2. Establish an audit committee to oversee the City's annual audit process from procurement of the auditors to approval of the City's corrective action plan for recommendations resulting from the audit.

Establish An Internal Audit Function

The City Council should also adopt an ordinance to create an Internal Auditor position that would report directly to the Council. This individual should assist the Council in monitoring the design and proper functioning of internal control policies and procedures. In this capacity, the internal auditor functions as an additional level of control and helps to improve the City's overall control environment. The internal auditor should also conduct performance audits, as well as special investigations and studies.

This individual should meet the qualifications and responsibilities as defined in the Government Finance Officers Association Recommended Practices. The Government Finance Officers Association (GFOA) makes the following additional recommendations regarding the internal audit function:

- ❑ The internal audit function should be established formally by charter, enabling resolution, or other appropriate legal means.
- ❑ It is recommended that internal auditors of state and local governments conduct their work in accordance with the professional standards relevant to internal auditing contained in the U.S. General Accounting Office's publication *Government Auditing Standards* (i.e., generally accepted government auditing standards). These standards direct, for example, that internal auditors "report the results of their audits and be accountable to the head or deputy head of the government entity and should be organizationally located outside the staff or line management function of the unit under audit." (Section 3.19)
- ❑ At a minimum, the head of the internal audit function should possess a college degree and appropriate relevant experience. It also is highly desirable that the head of the internal audit function hold some appropriate form of professional certification (e.g., certified internal auditor, certified public accountant, certified information systems auditor).
- ❑ All reports of internal auditors, as well as the annual internal audit work plan, should be made available to the government's audit committee or its equivalent.

RECOMMENDATION

3. The Council should adopt an ordinance to establish the position of Internal Auditor, which would report directly to the City Council.

OBTAIN A PERFORMANCE AUDIT OF THE CITY

The present fiscal crisis in Cranston has made it clear that the City, as a whole, is not operating in the most effective, efficient and economical manner. The City has received annual financial and compliance audits which have resulted in numerous findings and recommendations (see Appendix). The objective of the financial audit is to provide reasonable assurance that the City's financial statements are fairly stated, and report weaknesses in internal control and non-compliance with laws and regulations.

The City should also obtain a performance audit of all City departments including the police department, fire department, public works department and School Department. The objective of a performance audit is to determine if the City is operating efficiently, effectively and economically and to provide recommendations to improve operations and achieve cost savings. The benefits of such an audit will only be realized to the extent City officials are committed to developing a corrective action plan to implement the recommendations contained in the performance audit report.

RECOMMENDATIONS

4. Solicit bids for a qualified firm to conduct a performance audit of all City departments including the School Department.
5. Submit the resulting report to the Financial Oversight Board and the State Auditor General along with the City's corrective action plan to implement the performance audit findings and recommendations.

TAKE PROMPT CORRECTIVE ACTION ON ANNUAL AUDIT FINDINGS AND RECOMMENDATIONS

In February 2002, the City's auditors issued a comprehensive letter to the City which included 9 findings and recommendations highlighting significant deficiencies in the City's internal control (see Appendix). These findings and recommendations resulted from an audit of the City's financial statements for the fiscal year ended June 30, 2000. All the findings reported were considered to be serious weaknesses that warranted the immediate attention of City officials. In the spring of 2002, the City also received the auditor's findings and recommendations resulting from the fiscal 2001 audit which again repeats many of the same recommendations. The City's Finance Director should immediately prepare a comprehensive corrective action plan and timetable addressing all findings and recommendations included in the auditor's management letter for the fiscal year ending June 30, 2001. While the management letter included comments by the City regarding the findings and recommendations, a specific action plan and timetable for implementation should be prepared. This plan should be approved by the Mayor and City Council. This practice should continue for all future management recommendations reported by auditors.

RECOMMENDATIONS

6. Prepare a corrective action plan addressing all findings and recommendations included in the auditor's management letter for the fiscal year ending June 30, 2001. This plan should be approved by the Mayor and City Council. This practice should continue for all future management recommendations reported by auditors.
7. Submit a corrective action plan to the Financial Oversight Board and State Auditor General.

COMPLETE ANNUAL AUDITS TIMELY

The City Charter requires that an annual audit of the City's financial records for the preceding year be made within six months after the close of such fiscal year. In addition, Section 45-10-5 of the Rhode Island General Laws requires that the City submit the report to the State Director of Administration and the Auditor General within six months after the close of the fiscal year. For the past three years, the audit reports have been issued well beyond these deadlines.

<u>Fiscal Year Ended</u>	<u>Due to State</u>	<u>Date Report Submitted To Auditor General</u>
June 30, 1999	December 31, 1999	March 28, 2001
June 30, 2000	December 31, 2000	February 11, 2002
June 30, 2001	December 31, 2001	May 31, 2002

The audit report and the accompanying management letter are essential tools for developing the succeeding year's financial budget. Because the City's audits were not completed timely, the City adopted budgets and negotiated contracts with its employees without full awareness of its weakened financial condition.

RECOMMENDATION

8. Ensure annual audits of the City's financial statements are completed in a timely manner.

B. PENSIONS

OVERVIEW

Pension benefits are provided to City employees and retirees through four separate pension plans:

Summary of Pension Plan Participants – City Employees and Retirees					
	STATE				
	City Administered Police and Fire Plan	Municipal Employees Retirement System – Police and Fire	Municipal Employees Retirement System – General Employees	Employees Retirement System - Teachers	Total
Active employees:					
Police	90	57			147
Fire	102	86			188
General Employees			814		814
Teachers				1,016	1,016
Total active employees	192	143	814	1,016	2,165
Retirees/beneficiaries:					
Police	148	0			148
Fire	188	0			188
General Employees			463		463
Teachers				489	489
Total retiree/beneficiaries	336	0	463	489	1,288
Total employees and retirees/beneficiaries:	528	143	1,277	1,505	3,453

Uncertainty About The City's Police And Firefighters Pension Plans' Ability To Continue As A Going Concern

The City administered pension plans for police and fire personnel cover only 528 active employees and retirees/beneficiaries and are severely underfunded due to the City's failure to make annually required contributions to the plans. The City's auditors have raised doubt about their ability to continue as a going concerns in their report on the City's financial statements. Assets accumulated for future benefits are significantly less than actuarially required amounts. The plans' assets at June 30, 2001 totaled \$21 million⁵. The fiscal 2003 budget proposes no contribution to the plans for 2003 and a withdrawal of \$13.5 million for pension payments. This action worsens the chronic underfunding situation and raises further doubt about the plans' ability to provide future benefits.

The unfunded pension liability of \$191 million associated with the City administered pension plans and the manner in which the City has budgeted and funded these pension benefits has become a major financial issue. The annual contribution required of the City to fund these benefits is more than 10% of the total annual operating budget for the City yet these plans cover only 9% of all active employees. The City has made required contributions on behalf of its employees to the State administered plans.

⁵ \$21 million is the actuarial value of assets at June 30, 2001 – the current market value of investments held by the plans could differ substantially. Significant market declines have occurred since June 30, 2001.

The City sought, but did not obtain, State approval to issue pension obligation bonds to convert the unfunded pension liability to bonded debt and provide a one-time cash contribution to the plans to be invested for the payment of future benefits.

We believe a prudent alternative to issuing pension obligation bonds would be for the City to immediately begin making the annually required contribution to the City pension plans for police and fire personnel. This alone, over time, will allow the City to make progress towards reducing the pension liability. At the same time negotiations should begin with the police and fire unions to transfer active members of the City's pension plans to the State administered Municipal Employees Retirement System (MERS). If such a transfer could be successfully negotiated, then, provided that market conditions were more favorable than existing conditions and the City could support the debt service, issuance of pension obligation bonds as a means to finance the buy-in to the MERS may be worthy of consideration. Under this scenario some of the investment risks (described more fully below) associated with the issuance of pension obligation bonds could be mitigated. Negotiations should also begin regarding some of the specific pension benefit provisions and the method of calculating pensions. As described later in this section, cost of living adjustments and how the base pension amount is determined can have a dramatic impact on individual pension amounts and the liability for future pension benefits.

CONSIDER ALL THE RISKS ASSOCIATED WITH THE ISSUANCE OF PENSION OBLIGATION BONDS

The City has requested for the last two years that the General Assembly pass legislation allowing the City to issue Pension Obligation Bonds (POB's) to fund the City's pension liability totaling approximately \$191 million in its City administered police and fire pension plans. The City proposes to issue POB's and use the proceeds to provide a one-time infusion of cash into the plans thereby erasing the unfunded pension liability. The cash would be invested to provide future benefits to retirees covered by the plans. In essence, bonded debt is substituted for the pension liability. The purported benefit is derived from the assumption that the proceeds of the POB's can be invested and earn a higher return than the interest rate the City is paying on the POB's. Additionally, more funds are available for investment immediately as compared to making periodic contributions to the pension plans.

In an effort to determine the feasibility of issuing pension obligation bonds (POB's) to fund the City's pension liability, we researched and consulted various fiscal advisors with the goal of determining if financing the unfunded pension liability in this manner was fiscally prudent for the City. Although POB's have worked successfully for some local governments, there are substantial risks associated with this method of financing that must be adequately considered.

We sought advice on the risks associated with the issuance of POB's to advise the General Assembly (and the City) of these risks as they considered legislation to allow the City to issue POB's.

Some advisors have advocated that the City first make an effort to fully fund its actuarially determined annual required contribution into the pension plans. This is something the City has failed to do over a period of many years, which has further deepened the problem. See the schedule on page 31 for an historical summary of the City's annual contributions to the pension plans.

The risks and concerns associated with issuing POB's are summarized as follows:

□ *Financial Risk*

Expected savings can be reduced or eliminated if the expected rate of return on the invested bond proceeds is not significantly higher than the interest rate paid on the bonds. Any advantage derived from POB's depends largely upon market conditions. There is a financial risk that the average rate of return on invested bond proceeds will be less than the borrowing cost of the bonds. POB's can guarantee savings for only as long as the actual rate of return

on pension assets stays at least equal to the assumed rate of return. If the actual rate of return is less, additional contributions, over and above pension bond debt service will be required to amortize the resulting increases in the actuarially determined liability. Under-performance may generate a new unfunded liability. (This risk is heightened in light of recent stock market performance.)

❑ *Fluctuations In Long-Term Actuarial Calculation*

Even if POB's are sold, the City could still face an unfunded liability in the future resulting from such factors as changes in benefit levels, experience losses, demographics, or other factors that were not anticipated when the bonds were issued. Adoption of any changes in the pension benefit formula could change calculations dramatically. A pension plan's full funding status is dependent on maintaining targeted assumptions in the future. If other assumptions used in estimating the pension liability (e.g. benefits payable, inflation rates, beneficiary lifespans, etc.) change for the worse, additional contributions, over and above pension bond debt service, will be required to amortize the resulting increases in the actuarially determined liability.

❑ *Bond Rating*

Since the City received bond ratings from two rating agencies that put it in junk bond status, it would need to purchase significant amounts of insurance for an issuance of this size, detracting from any potential savings to be achieved.

❑ *Structure*

Structuring the POB's to take savings up front by deferring principal payments will result in a higher true interest cost on the bonds and, thus, lower potential savings. Higher bond costs will narrow the difference between the bond yield and the retirement plan's assumed rate of return and increase the risk that the retirement plan's actual return could fall below the bond yield.

❑ *Debt Capacity*

Issuance of debt to fund a pension liability will substantially increase the City's overall debt burden and will use up debt capacity that could be used for other purposes.

❑ *Lump Sum Investment of Funds*

One large infusion of cash into the pension fund that is invested all at the same time may expose the fund to increased risk rather than periodic payments on the pension liability over the amortization period. Dollar cost averaging decreases the risk of lump sum investing.

❑ *Other Concerns*

Even if the analysis indicates that financial benefits appear to outweigh the risks, the City should evaluate other issues that may arise if the bonds are issued, such as the:

- loss of flexibility in difficult economic times because of the need to make timely payments of principal and interest in order not to default on the bonds,
- potential misunderstanding by policy makers regarding the possibility that an unfunded liability may reappear in the future, and
- potential pressures for additional benefits by government employees if plans are fully funded and the government's contribution as a percentage of payroll has declined relative to neighboring jurisdictions.

Cranston has chronically under-funded its pension plans as a means of balancing its annual operating budget thereby avoiding tax increases and ignoring the true current cost of providing fire and police protection in the City.

The POB would not resolve the City's fundamental unstable budgetary situation. In fact, without budgetary reform, the POB would inflexibly obligate the City to fund debt service payments that it currently lacks the resources to fund and may need the flexibility to postpone.

We were cautioned by financial consultants that:

- ❑ There is substantial risk that the City could experience "negative arbitrage" if it issued POB's. That is, the assumed investment portfolio return of invested pension assets (currently estimated at 8%) may actually be less than the debt cost (assumed at about 7%⁶) rather than more. We were advised that negative arbitrage in light of current and near term market conditions is likely. Negative arbitrage would negate the intended benefit of the POB's and would actually make fiscal matters far worse.
- ❑ The consensus of respected forecast panels agree that bond yields and expected returns on the US stock market now face a protracted period of low results, driven by the expected low inflation rate the US is expected to enjoy over the next decade. For example, rather than an 8% return on the stock market, the "Survey of Professional Forecasters" (included in the Federal Reserve Bank of Philadelphia, quarterly survey released on February 22, 2002) expects only a 7% return on US stocks over the next ten years. If this forecast were correct, it will result in ten tough years of zero or even negative arbitrage for the POB proposal. This would result since the 7% estimated rate on the POB debt would just "break even" with the likely stock market return. Any insurance premium to insure the issues, estimated at 1%, would push the arbitrage into negative results.
- ❑ In striving to achieve a portfolio return rate that would justify the issuance of the POB's, the City may assume more investment risk than desirable. For example, the consensus estimate of the Blue Chip Financial Forecasts (March 1, 2002 issue) panel foresees the 10-year Treasury note yield ranging up to 5.5% through next year, not much higher than the current yield at 5.1%. This also underscores the dilemma of how to achieve an 8% return on the portfolio, with treasury yields at historical lows and stock market expectations at 7% due to low inflation. With current market conditions and predictions of near term market conditions, actuaries and pension fund consultants may change their return assumption in the near future (perhaps from 8% to 7%). Issuing POB's at 7% when the assumed rate of return assumptions for the pension plan are also 7% may not make any sense at all.
- ❑ A delay would not risk much of an increase in the POB interest rate. Both the "Survey of Professional Forecasters" and the Blue Chip panel look for bond interest rates to stay near current levels over the next few years.
- ❑ These low rates of return expected for the stock market and bonds are driven by the lowered level of expected inflation over the coming decade. This helps explain a further dilemma facing the City of Cranston: It needs to reform its overly generous indexation of benefits. This may well be one of the most important elements of a sustainable fiscal plan for the City. Cranston indexes pension benefits at 4% (actuarial assumption for future salary increases) or even higher if wages of active employees rise faster than 4%. With inflation having been near 2.5% over the past several years and expected to continue at that rate over the coming decade, having a "COLA" of 4+% is simply unsustainable. The return on any investment contemplated by the plan is suppressed

⁶ The debt cost of 7% was estimated prior to the recent downgrades in the City's bond rating below investment grade and therefore could be higher.

by the lower inflation rate; therefore, it becomes nearly impossible to achieve a portfolio return sufficient to pay for indexed benefits without taking very large investment risks.

As a result of the issues cited above, coupled with the City's numerous fiscal problems and viable alternatives to issuing POB's cited in this report, we concluded that the City's proposal to issue POB's is not the appropriate solution to the City's financial problems at this time.

RECOMMENDATION

9. Consider the significant risks associated with pension obligation bonds (POB) before proceeding with issuance of POB's as a solution to the chronic under funding of the City police and fire pension plans.

FUND PENSION LIABILITIES BY MAKING ALL ANNUAL REQUIRED CONTRIBUTIONS

The City has not made its annual required contributions (as calculated by the actuary) to the City's police and fire pension plans for many years. Over the years, the City should have contributed nearly \$92 million⁷ more to the plans based on actuarial studies. The following table is a comparison between the Annual Required Contributions and actual contributions for the last ten years, as shown in the fiscal 2001 audit report:

Annual Required Contributions and Actual Contributions to City Police and Fire Employees Retirement System- 10 years			
Fiscal Year	Annual Required Contributions	Actual Contributions	Percent Funded
2001	\$16,923,974	\$12,610,513	75%
2000	16,923,974	10,149,000	60%
1999	16,030,000	8,241,000	51%
1998	16,940,000	8,438,000	50%
1997	16,940,000	7,183,000	42%
1996	16,940,000	7,344,000	43%
1995	13,733,000	6,134,000	45%
1994	13,733,000	5,671,000	41%
1993	11,479,000	5,041,000	44%

The Annual Required Contribution (ARC) represents the actuary's estimate of the current amount needed to fund future benefits to active and retired members of the plans. The ARC consists of the employer's cost for current benefits (accrued during the year) and amortization of the plan's liability for benefits previously accrued and unfunded. Although an actuarial valuation is obtained to determine the amount that the City should contribute to the pension plans so that assets are available to pay the benefits when needed, the City pays pension benefits on a "pay-as-you-go" basis, i.e., as the benefits become payable (employee retirees). Employees must rely on the City's financial ability to make the payments at that time. For the past five years, the City's contributions have barely been meeting the current benefit payments to pensioners and, in four of those years, the City used employee contributions and investment earnings to help meet pension payroll (see table on next page).

⁷ The Net Pension Obligation represents the cumulative difference between the Annual Required Contributions and the City's actual contributions to the plans. This amount was \$91,677,461 per the June 30, 2001 audit report.

Recommendations To Restore and Maintain Fiscal Stability
Pensions

As a result of not making the Annual Required Contribution to the plans, the City has not made any progress towards reducing the unfunded actuarial accrued liability. Actuarial assets of the plans represent less than ten percent of the actuarial liability. The funded ratio should increase over time until it reaches 100 percent, but the City's funded ratio is only 9.8%. Because the City has been consistently under funding the plans, the unfunded actuarial accrued liability has increased steadily over the years and, as shown in the table on the next page, is approaching \$191 million. The unfunded liability results from failure to make required contributions but the amount is also affected by benefit provisions to plan members that are considered in the actuary's estimate of future pension costs.

Police and Fire Pension Plans – Financial Summary					
	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>
Employer contributions	\$12,610,000	\$10,149,000	\$8,241,000	\$8,438,000	\$7,183,000
Employee contributions	<u>827,000</u>	<u>1,270,000</u>	<u>1,141,000</u>	<u>1,253,000</u>	<u>773,000</u>
Total contributions	\$ 13,437,000	\$11,419,000	\$ 9,382,000	\$ 9,691,000	\$ 7,956,000
Pension benefits paid and other expenses	<u>12,381,000</u>	<u>11,231,000</u>	<u>11,405,000</u>	<u>14,588,000</u>	<u>8,068,000</u>
Balance to net assets	1,056,000	188,000	(2,023,000)	(4,897,000)	(112,000)
Investment earnings	(731,000)	2,870,000	2,751,000	7,266,000	1,915,000
Other revenue	<u>-</u>	<u>-</u>	<u>18,000</u>	<u>243,000</u>	<u>217,000</u>
Increase in net assets	325,000	3,058,000	746,000	2,612,000	2,020,000
Beginning net assets	<u>19,429,000</u>	<u>16,371,000</u>	<u>15,625,000</u>	<u>13,013,000</u>	<u>10,993,000</u>
Ending net assets	<u>\$19,754,000</u>	<u>\$19,429,000</u>	<u>\$16,371,000</u>	<u>\$15,625,000</u>	<u>\$13,013,000</u>

Police and Fire Pension Plans – Status of Unfunded Actuarial Accrued Liability				
Actuarial Valuation	<u>(a)</u> Actuarial Value of Assets	<u>(b)</u> Actuarial Accrued Liability	<u>(b) – (a)</u> Unfunded Actuarial Accrued Liability	<u>(a)/(b)</u> Funded Ratio
July 1, 2001	\$ 20,805,000	\$ 211,799,000	\$ 190,994,000	9.8 %
July 1, 1999	\$ 17,953,000	\$ 187,737,000	\$ 169,784,000	9.6%
July 1, 1998	\$ 17,461,000	\$ 174,057,000	\$ 156,596,000	10.0 %
July 1, 1996	\$ 11,760,000	\$ 158,974,000	\$ 147,214,000	7.4%

The City responded to the growing problem with the City police and fire pension plans by requiring police and fire fighters hired after July 1, 1995 to join the State's Municipal Employees' Retirement System (MERS). Employees with less than five years of service on July 1, 1995 were given the option to join the State's system. As a result, 72 fire fighters and 45 police were transferred to the State plan, along with \$970,000 in employee contributions. However, 192 active members and 336 retired members and beneficiaries remain in the City plans.

The City's unfunded actuarial accrued liability for just these 528 members is steadily growing and currently exceeds \$190 million. The City must fully contribute the Annual Required Contribution to the plans as calculated by the actuary. Due to the severely underfunded status of the plans, no benefit security is extended to plan members because there is the risk that the City may not be in the financial position to pay these benefits in the future. If the City were to fund the ARC, investment earnings on those funds will be available to pay pension benefits and the employer contributions could be reduced. In addition, bond rating agencies will look more favorably towards the City if progress is made towards reducing the unfunded actuarial liability.

RECOMMENDATION

10. Contribute annual required amounts to properly fund the City administered fire and police pension plans.

Additionally, General Law section 45-10-15 requires that any municipality which contributes materially less than 100% of the annual required contribution to its pension plan shall submit to the Auditor General and the Director of the State Department of Administration, management's recommendations for assuring future payments equal to the annual pension cost. We have not received such a plan from the City since they are still seeking approval from the General Assembly to allow the City to issue pension obligation bonds.

RECOMMENDATION

11. Develop and submit management's recommendations for assuring future payments equal to the annual pension cost as required by State law.

EVALUATE PENSION BENEFITS PROVIDED TO FIRE AND POLICE PERSONNEL UNDER THE CITY'S PENSION PLANS

We compared the pension benefits for police officers and fire fighters provided by (1) the City of Cranston Police and Fire Employees Retirement System, (2) other similar Rhode Island cities and towns and (3) the State's Municipal Employees' Retirement System. Based upon the information provided to us by these municipalities and the State system, it appears that in some areas the Cranston police and fire fighters pension benefits exceeded those of the State system and the other Rhode Island cities and towns. The City of Cranston has provided generous pension benefits in the areas of holiday pay, longevity and cost of living adjustments. The Cranston contract also provided two additional benefits that were not addressed in the other union contracts or the Rhode Island General Laws: (1) an additional five percent is added to the pension benefit when the pensioner reaches age 55 and (2) after the completion of ten years of service, any year in which a member completes over six months of service will be credited with a complete year of credited service. Although pensioners receive greater pension benefits from the City pension system, the police and fire fighters contribute eight and nine percent of their salaries, respectively, to the City plans while City employees who are members of the State plans contribute ten percent of salaries. In view of the City's weakened financial condition, we recommended that the City re-evaluate previously negotiated benefits and seek concessions as part of its fiscal recovery plan.

A small change in pension benefits and the method of calculation can have a significant impact on the pension plan liability and ultimately the City's finances over the long-term. The impact on the plans can be illustrated by the pension calculations for two recent retirees promoted two weeks prior to their retirement date. Because of the method used by the City to calculate pensions, the pension benefits increased by approximately \$7,000 per fiscal year due to the promotion. The City pension is calculated based on the individual's rank on the date of retirement; therefore, individuals who retire shortly after a promotion will increase their pension substantially. The base pension

benefit in the City's plans is calculated using a table, which lists the prevailing salaries for each rank. A percentage is taken of the listed salary to calculate the base pension. Longevity and holiday pay are then added to the calculated base pension. In contrast, the State's plan and the plans of some other municipalities base the pension calculation on the actual earnings in the past year or highest year or an average of a number of years. The earnings include longevity and holiday pay. From our estimates⁸, it appears that within seven years, these two retirees could be paid more in pension benefits than they actually earned in their last year of service. Assuming that the two pensioners live to age 75, we calculate the City pension system will pay a total of:

- ❑ \$500,000 to \$600,000 more because of the promotion immediately prior to retirement and
- ❑ \$800,000 to \$900,000 more than the State pension system would pay using its rules.

For all of the pensions reviewed, we compared the actual pension benefits paid by the City's pension system to what the pensioners would have received in benefits if they had been members of the State's MERS. One individual would not have qualified for retirement under the State pension system because he did not meet the minimum twenty years of service, but he did qualify for a City pension because the member had completed more than six months in a year which was credited as a completed year of service. In some instances, the benefits calculated under the State pension rules produced greater pension benefits than the pensions that would be paid under the City's pension system during the first fiscal year. However, by the second fiscal year, all the pensions would be greater under the City plans. The increase in City pensions in the second year can be attributed to such benefits as the five percent increase in pensions at age 55, a higher cost of living increase, recent promotions, and the longevity payments. Under the City plans, an individual receives a portion of the longevity for the months on pension in his first year, but by the second year, the pensioner would receive a complete year of longevity.

The City should begin negotiations with the police and fire unions to transfer additional active members to the State's MERS. The MERS offers a different benefit structure than is currently available to this membership group, which would reduce the unfunded actuarial accrued liability.

RECOMMENDATIONS

12. Review all union contracts to align benefits provided to pensioners similar to those provided by the State MERS.
13. Begin negotiations to transfer additional active members of the City's pension plans to the Municipal Employees' Retirement System for police and firefighters.
14. Obtain a new actuarial valuation to determine the impact on the pension system if employee benefits are changed.
15. Draft legislation that would prohibit increases in benefits unless they can be funded without a significant increase in the contribution rates and without jeopardizing the actuarial soundness of the plan.

⁸ Our comparison of the pension calculations under the City administered pension plans and the State administered pension system is based upon information provided by the City and involves certain assumptions to calculate an estimated pension benefit in the State system using the methodologies employed by that system. The calculation also assumes a 3% cost of living increase in the City system – a higher cost of living increase is possible per the union contract. These estimated calculations are presented only to illustrate the effects of certain actions and methodologies on current and long-term pension amounts.

Changes in actuarial assumptions also impact calculation of the plans' unfunded actuarial accrued liability. The actuarial valuation prepared as of July 1, 2001 includes assumptions for future salary increases to active employees of four percent and cost of living adjustments (COLA) to pensioners of three percent. However, union contracts and city ordinances for the firefighters and police appear to provide pensioners in the plans with COLA benefits that are equal to the active employees' salary increases, but with a three percent minimum provision. The City should clarify with the actuary whether the COLA assumption should be the same as the active employees' salary increases if greater than three percent. By increasing the COLA assumption, the actuarial accrued liability would also increase.

RECOMMENDATION

16. Clarify for future actuarial valuations whether the assumption for cost of living increases should be the same as the assumption for salary increases to active employees when salary increases exceed three percent.

DISCONTINUE THE ADDITIONAL ANNUITY BENEFIT PROVIDED TO CERTAIN POLICE AND FIRE PERSONNEL

Effective July 1, 1995, all newly hired police officers and firefighters (and other police and firefighters who elected membership) are members of the State Municipal Employees Retirement System. Each member contributes 10% of gross salary. Police and firefighters who are members of the City retirement plans contribute 8% and 9% of salary, respectively. To equalize the difference in employee contribution rates, the City provides each police and fire employee in the State pension system with an additional annuity benefit that is funded with an amount equal to the difference in contribution rates (calculation: police 10% vs. 8% = 2%; fire 10% vs. 9% = 1%.) The City Finance Director advised us that the City purchases an annuity from an insurance company and the annuity produces earnings that are invested for the employee.

Approximately 157 police and firefighters are receiving the annuity benefit which is estimated to cost the City more than \$200,000 for fiscal 2003. Through renegotiation of union contracts, the City should raise the employee contribution rate for police and fire personnel within the City's pension plans to equal the rate paid by those in the State system and discontinue this additional annuity benefit. The additional employee contribution into the City's pension plans will help to reduce the unfunded liability.

RECOMMENDATION

17. Negotiate discontinuing additional annuity payments to police and fire members of the State pension system and raising the employee contribution for members of the City's plans to equal the rate paid by those in the State system.

C. BUDGETING PRACTICES

BUDGET MANAGEMENT⁹

Budget Development and Management Process

The Rhode Island State Budget Office performed an analysis of the City's fiscal 2003 Budget dated April 1, 2002; a 3rd quarter review of the fiscal 2002 Budget as Adopted; and an analysis of the last five years (fiscal 1997 through fiscal 2001) municipal budgets. The goals of the exercise were to determine the areas for concern from an historical perspective; to assess current year shortfalls; to test for internal validity of the proposed budget; and, to offer recommendations for budget preparation, management and control measures.

Each City department's budget, with the exception of the School Department, was reviewed in two major areas:

- ❑ *Personnel Costs*
 - Base salaries of full-time employees
 - Part-time, overtime and seasonal wages
 - Employee benefits including, retirement rates, federal old-age requirements, health care rates for the several groups as set by third party administrators and union contracts, life insurance, and severance and pension obligations.
- ❑ *Operating Costs* - prior years' expenditures of individual operating line items were analyzed to establish an understanding of expenditure requirements and trends in the City.

The School Department's budget was considered based on limited information provided with only general state-aid categories reviewed for the purposes of this report.

Areas of Concern from an Historical Perspective

Expenditures of all City departments for all expenditure types were above budgeted amounts by 1.7% in fiscal 1997 and 2.9% in fiscal 1998. In fiscal 1999, expenditures were 8.6% above budget amounts; 8.5% in fiscal 2000 and 11.6% in fiscal 2001. Specific items in several of the departments consistently contribute to the expenditure overages, including pension obligations in the police and fire departments, severance for the City budgeted in the Finance Division; and growth in senior's programs. Most other departments completed the last five fiscal years close to budget, illustrating that some measure of internal control exists in the City.

Various line items in the personnel category of expenditure show inconsistent budget-to-actual relationships over the past several years. These items include extra vacation after 10 years, which has been over budgeted since 1997; incentive pay which has not been budgeted for since 1997; federal old age (FICA) which has been under-budgeted since 2000; and severance pay which was under-budgeted fiscal 1999 and fiscal 2000, and over-budgeted in fiscal 2001. In the police and fire departments, pension obligations, pension fund financing and overtime expenditures have regularly exceeded budgeted amounts and are more fully explained in referenced sections in this document.

On the revenue side, a five-year review of collections illustrates inconsistent expectations in the areas of delinquent tax collections and property tax abatements. Delinquent taxes collected in fiscal 2000 were \$3.1 million in

⁹ Prepared by the State budget Office – Department of Administration – this analysis was performed mostly during the third quarter of the City's fiscal year ending June 30, 2002.

comparison to a budgeted amount of \$1.5 million. In fiscal 2001, delinquent taxes actually collected were \$5.1 million more than the amount budgeted. Property tax abatements have been budgeted at \$300,000 per year while \$963,848 was abated in fiscal 2000 and \$1.0 million in fiscal 2001. Property tax collections, on the other hand, are generally in line with budget amounts and exceeded amounts expected in fiscal 1997, fiscal 1998 and fiscal 2001 by 1%, 6% and 7%, respectively. cursory review shows collection rates above 98% of collection projections (not billings).

Departmental revenues (excluding state-aid for schools) for the past five years have been generally consistent with budget amounts. In all years, discrepancies from budget amounts for state-aid for schools can be explained by state legislative activity adjusting state-aid expectations after City Council approval of the budget. Reliance upon one-time revenues and fund balance transfers in recent years to meet General Fund expenditure requirements has also formed part of Cranston's revenue history.

Current Year Shortfalls

Fiscal Year 2002 revenue collections through the period ending March 20, 2002 (72% of the fiscal year) are 69% of the total expected, foretelling a possible revenue shortfall of at least 3% or \$4 million assuming flat collection of taxes, fees, and penalties for the remainder of the year. The property tax phase-out is over budgeted by \$800,000 in fiscal 2002 based on calculations in the Governor's proposed budget with the City, assuming a \$3,500 exemption level. Based upon the \$4,500 exemption level passed by the House Finance Committee, the projection is within reason. Miscellaneous school revenue is projected to be \$650,000 above the mayor's budgeted amount and school construction aid is expected to be \$300,000 less than the budgeted amount.

In departmental revenues, income in the Finance Division appears overestimated by as much as \$600,000, likely attributable to unrealized investment income. Revenues collected from libraries appear overestimated by \$24,000, though later iterations of the Mayor's budget recognize this and reduce the amount accordingly. Additional revenue sources outlined in the April 1, 2002 version of the proposed budget including Third Party Rescue (\$850,000) and Purchasing (\$40,000) are not in line with historical collection in the General Fund, though they may have existed as interfund transfers in prior years.

The remaining 100 days of the fiscal year and year-end adjustments will determine actual revenue collections. The value estimated for one-time revenues in fiscal 2002 has fluctuated between \$5.8 million and \$5.1 million in two different budget iterations and its unreliability as a budget device remains obvious. A current year forecast based on review of prior year's third quarter collection information would provide a more dependable projection of revenues.

A review of current year expenditures in the personnel category highlight areas of overexpenditure at March 20, 2002 and projections of overexpenditure by year end totaling upwards to \$463,000 (not including approximately \$4 million required for the Fire and Police pension funds). These items include: salaries, which appear short by \$131,000; incentive pay which was budgeted at \$0 but has \$93,308 expended to date; special duty which is expected to be overexpended by \$36,000; federal old age benefit appears under-budgeted by \$183,841; and group life insurance which is projected to end the year \$49,000 overbudget. Playground attendant wages are expected to be \$27,000 over budget by year-end while the shift differential, which apparently is already paid for the year, will show savings of \$35,000.

Operating expenses may end the year in a negative position due to some overexpenditures by March 20, 2002 including 'expense' already \$112,000 overexpended; bank charges of \$77,000 over budgeted amounts; city insurance which is not budgeted, but has \$800,000 expended; and the public works facility lease which appears under-budgeted by at least \$129,000. Without knowledge of purchase timing, expenditure restraints implemented by the City, contract requirements, equipment condition and other factors, a responsible estimate of operating overexpenditures is difficult to assemble.

Validity of Proposed Fiscal 2003 Budget

The most recent iteration of the fiscal 2003 budget was reviewed for its internal validity. It is recognized that on-going negotiations with bargaining units in addition to City Council action and action from the State may change the final form of the budget.

The City has appropriately increased its estimate for delinquent tax collections to \$1.4 million and its estimate for abatements to \$1.05 million to conform to historical experience in these two areas. Values for the Motor Vehicle Tax Phase-Out and State Aid for Schools are above the amounts proposed by the Governor for the City. The fiscal 2002 Supplemental Budget passed by the House Finance Committee identified a \$3,500 level for fiscal 2003 for the Motor Vehicle Tax Phase-Out consistent with the Governor's recommendation. Although state legislative action may adjust these figures, prudent budgetary practices should keep the figures at the published amount until known otherwise. Departmental revenues appear reasonably estimated though the addition of \$40,000 in purchasing revenues and the reduction of \$150,000 in library revenues from the fiscal 2002 levels remain unexplained.

In personnel, federal old age benefit appears to remain under-budgeted in fiscal 2003. A projection for fiscal 2002 year-end shows a projected deficit of \$183,000 and the amount budgeted in fiscal 2003 does not seem to fully accommodate the estimated requirement for this item. Unemployment compensation appears under-budgeted in fiscal 2003. It is similar to the amount budgeted in fiscal 2002 which has already been overexpended by \$40,000 at March 20, 2002. Other items include: police holiday in fiscal 2003 may be under-funded by one day of holiday pay; crossing guard salaries which appear to be budgeted at the fiscal 2004 level as opposed to the fiscal 2003 level based on a cursory understanding of their contract agreement; the City's contribution for retirement continues to be arcane requiring more intense review; and vacant positions in the fire department do not have amounts for hospitalization included. As is noted below, the preparation of a personnel summary would more accurately calculate personnel costs and greatly diminish errors in future budget preparations.

Recommendations for Budget Preparation, Management and Controls

Budget information provided to this office by the City was generally fragmented and lacked the reliable continuity necessary for intelligent budget recommendations. It is recommended that time be spent by the staff in preparing coherent worksheets as described below in the Personnel Summary section, in order to assemble all the information required for responsible budgeting. It is also recommended that once established, these worksheets be regularly updated with useful and accurate information so that they are available in good form for the next year's budget preparation. Also, the budget document itself would be more useful if presented with prior years' *audited* figures as opposed to *actual* figures as it is common for expenditure and revenue adjustments to take place during the audit process thus allowing for greater comparability between years.

RECOMMENDATION

18. Implement improved budget development and management practices.

Track All Changes in the Current Year

All proposed changes to the fiscal 2002 budget, including those resulting from internal adjustments and those originating from outside the City's administration should be documented with dollar amount, source of funds, and a description of the proposed change. A *tracking sheet* listing major areas of the City's operations and budget amounts can capture several change events while providing a tool to accurately add-back unapproved changes if

necessary. A corresponding narrative to each major change more fully describes each item on the tracking sheet. A sample tracking sheet and narrative are included as Appendix B-3.

RECOMMENDATION

19. Utilize a tracking sheet for all proposed changes to the budget in the current year.

Implement Target Budgeting

The City's budget preparation process should begin with realistic revenue and expenditure projections based on the City's experience and acknowledgement of factors that may adjust the projections during the budget year. A policy of target budgeting should be implemented, with department directors providing the finance division with current service requirements and one or two scenarios under which less than 100% of current services are funded. Once reasonable projections are determined, areas for expenditure reduction can be identified, notwithstanding political, bureaucratic or economic constraints on program contraction or elimination. Department directors and executive administrators should not ignore these external constraints when making recommendations for downward expenditure adjustments.

RECOMMENDATION

20. Implement a policy of target budgeting.

Establish a Revenue Estimating Session

Revenue projections would benefit from a more technical process based on historical collection data from year-to-year and an understanding of current economic trends affecting the City and its citizens. It is recommended that the City formalize its process for revenue projections by holding an official revenue estimating session. A revenue estimating session would allow the Mayor's administration and the City Council to agree in advance upon revenue projections to avoid entire budgets built upon uninformed revenue assumptions.

A quarterly review of collections, with a comparison to prior year's quarterly report would provide more accurate figures for the revenue estimating session. Further, this process would highlight potential shortfalls quickly and adjustments could be made if necessary or possible. A quarterly review of revenues will educate the staff to be aware of anomalies in revenue collections due to timing of collections or seasonal influences. Finally, reliance upon one-time revenues to fill revenue or expenditure gaps should be abandoned. Revenues of this sort are not reliable and serve to restrain necessary adjustments to the City's other, more stable revenues.

RECOMMENDATION

21. Formalize the process of revenue projections by establishing a revenue estimating session.

Create and Maintain a Personnel Summary

Budgeting for personnel expenditures would improve if the database that the City already maintains were transferable to an electronic worksheet program with additional information included to form a Personnel Summary. For each division, a full picture of personnel costs should be consolidated, and calculations for federal income taxes, city and individual retirement contributions, life insurance, shift differentials, and health care requirements more accurately computed. Retirement rates especially, are noted to be inconsistent in city documents made available for this review. Retirement contributions, since they vary between divisions and bargaining units, should be itemized in

each division for accuracy. Each individual's expected salary for the year including step increases, longevity or extra vacation should be maintained so that an accurate picture of employed individuals and rates of pay is available throughout the year. Longevity should be calculated with both an historical and prospective view of each eligible candidate.

Amounts expected for overtime, part-time help, special duty or seasonal employees should be displayed and associated tax and benefit requirements itemized. Also, additional payments to employees for non-salary items such as clothing allowance should be kept separate from payroll costs so that quarterly projections can be accurately made. Finally, a count of employees in each division and the status of positions (either filled or unfilled) would assist the City in identifying opportunities for personnel savings from unfilled positions. The employee count per division also yields a value for the cost per employee; a useful tool for managers when isolating factors contributing to personnel expenditure growth. Samples of a Personnel Summary of a City department and a City-wide Personnel Summary are included as Appendices B-1 and B-2.

RECOMMENDATION

22. Create and maintain a personnel summary to improve budgeting for personnel expenditures.

Budget Appropriately for Operating Items

Operating expenditures are generally easier to limit because individual pay or duty assignments are not typically affected. However, the City continues to deliver the same level of services (unless indicated differently) and appropriate amounts must be made available to deliver obligated services and to avoid over-expenditure at year-end.

For example, if the City is to continue to light its streets, then an appropriate amount for electricity, informed by an understanding of state and regional factors affecting the price of electricity needs to be included. It was noted in a review of the City's budgetary process that several important operating items were diminished without explanation or disregarded altogether, in order to reduce budgeted costs for the city. A sampling of these items includes the capital lease on computer equipment, city insurance, fuel in the Building Maintenance division, and bank charges. Another operating expense called 'expenses' appears to be misbudgeted annually, especially in fiscal 2000 when it was overspent by \$150,000. Another observation is an item called 'city hall telephone' which has appeared in a different department every year for the past four years. The item is large enough (about \$200,000) to be assigned to a specific department for tracking purposes.

RECOMMENDATION

23. Analyze current data and prior experience to more accurately project operating expenses.

Institute Quarterly Reporting at the Department Level

The City should require all department directors (including the School Department) to submit a report of the financial status of their departments within 15 days of the close of each quarter. This practice would encourage department directors to hold spending within budget amounts, and would foster appropriate and realistic cost cutting measures if needed. The reports, submitted to the Finance Department, should then be summarized within 30 days of the close of the quarter and a report of the City's financial position submitted to the Mayor and City Council for review and acceptance. The second quarter report (due in mid to late January) would become a useful document for the administration as they prepare the next years' budget document. The third quarter report (due in mid to late April) would assist the City Council as it deliberates on the administration's budget. Finally, the fourth quarter report (due mid to late July) would provide the City's auditors with important information for its year-end review.

RECOMMENDATION

24. Institute a quarterly reporting system at the department level and require department directors to submit quarterly reports on financial status and budget compliance. The Finance Director should summarize the departmental reports and submit an overall summary of the City's financial status and budget compliance, including projections to fiscal year end, to the Mayor and City Council.

Quarterly Allotments

The City should implement a quarterly allotment system. Starting on July 1 of a fiscal year, each department would be allotted one quarter of its enacted budget. Agency specific items which would require more than twenty-five percent of funding to be allotted for a quarter would be approved only by the Finance Director after a written request by the department director. If a department exhausts its allotted financing prior to the end of any quarter, the first flag will be raised to indicate a potential budget problem. Measures to address the problem by either the agency or the Finance Office could be implemented immediately before it becomes a larger issue later in the year.

RECOMMENDATION

25. Implement a quarterly allotment system as a budgetary control mechanism.

Budgeting Collection Rates

The City currently factors in a collection rate percentage when estimating revenues. However, there are no written policies either by ordinance or charter for computing the collection rate. Since accurate revenue projections are essential to maintaining a balanced budget, the City should establish a policy of computing annual tax collection rate percentages by taking the average of actual annual tax collection rate percentages for the three (3) previous fiscal years. This would ensure that the collection rate used in the budget is realistic and reflective of actual prior experience.

RECOMMENDATION

26. Establish a written policy for computing annual tax collection rate percentages for budgetary purposes by taking an average of actual annual tax collection rate percentages for the three (3) previous fiscal years.

BUDGETING FOR HEALTH INSURANCE COSTS

Health insurance is budgeted in February for the year beginning July 1. However, management advised us that employees are allowed to change health plans (Blue Cross vs. United Health Care) and coverage (family vs. single) in July, annually. As a result, there is a risk that the appropriations (based on the February budgeted amounts) will be insufficient to cover the actual cost incurred based on the health coverage selected by employees in July. This condition would contribute to an operating deficit for the fiscal year.

RECOMMENDATION

27. The City should encourage employees to make changes in health insurance coverage earlier so that such changes can be factored into the budget before the budget is voted and appropriations are authorized by the City Council.

BUDGET PREPARATION PROCESS

The City uses a proprietary (licensed) computer program to prepare the annual City budget (excluding the School Department). The vendor provides maintenance and support. We found that the program is suitable for use, but that City finance personnel do not know how to use it to its fullest potential. This impedes an adequate and efficient budget preparation and review process.

The City budget is principally salaries and benefits. The City uses the budget program to prepare the salary and benefit requirements for the budget. The program is table driven. For each bargaining unit, applicable values for salary increases and benefit costs are entered into a table (electronic file). The computer uses the information in the table to generate budget numbers for the salary and benefits of each employee and totals of such information for each department. As a result, the computer performs all the calculations internally and produces final reports. However, the program does not provide certain reports that would be useful for analyzing budget data such as a simple listing of employees by bargaining unit that discloses beginning salary and the amount of increase budgeted for each employee. Such information is necessary because employee compensation consists of many components which each increase based on different considerations. For example, compensation may include regular salary, longevity, step pay, holiday pay and extra vacation pay. A simple listing of employees that discloses the beginning salary, amount of increase and the final amount of each component of compensation would be useful to determine whether such information was calculated correctly. Also, the management could use such a report to generate what if scenarios when negotiating pay increases with bargaining units. This would help management determine whether it could afford the amounts being considered.

We found the following:

- ❑ The City did not subject these reports to adequate analysis to determine that the information generated was correct.
- ❑ We found numerous instances where incorrect information was either budgeted or left out. These errors were not detected by management.
- ❑ The Information Technology (IT) Department was able to design special reports that obtained the information we used to analyze the budget.
- ❑ The Finance department never requested assistance from the IT Department.

RECOMMENDATION

28. Strengthen the budget preparation and review process by utilizing the Information Technology (IT) Department to develop useful computer reports to assist management in reviewing and analyzing information reported in the annual budget request.

PREPARE LONG-TERM BUDGET PROJECTIONS

In addition to improving the preparation of the City's annual budget plan, the City should begin to prepare financial forecasts that go beyond the next fiscal year so that it can adequately plan for the future. Obviously, the ability to accurately forecast revenues and expenditures decreases in future years. However, preparing these forecasts is important to allow the City to address long-term problems today - years before they occur. Such long-term forecasting highlights where current anticipated expenditures are outpacing revenues.

Specifically, the City should, as part of its annual budget process, prepare revenue and expenditure projections for a five-year period. The plan should detail revenues by source and expenditures by category for each of the five years. An appropriate inflation factor (e.g., Consumer Price Index) should be applied to expenditure projections. Debt service and capital expenditures should be separately identified in the plan. The dollar amount of change and percentage increase should be shown between each fiscal year included in the plan. Each year the five-year plan would be updated as part of the annual budget preparation process.

RECOMMENDATION

29. Prepare five-year projections of revenues and expenditures as part of the annual budget.

PREPARE CASH FLOW BUDGETS TO IMPROVE OVERALL CASH MANAGEMENT

The City has experienced a cash shortage and an inability to meet its obligations as they become due. This caused the City to issue \$11,630,000 in tax anticipation notes due November 2002. The City's cash shortage is further confirmed by the fact that bank charges totaling \$108,000 in the current fiscal year (through April 11, 2002) had been expended because the City did not maintain sufficient cash in its bank accounts. Additionally, the City has repeatedly deferred required payments on a capital lease to acquire certain computer equipment thereby incurring additional interest and late charges.

Cash Flow Projections and Analysis

The City's cash flow problems are exacerbated by the fact that it has not adequately prepared and analyzed cash flow projections. The City prepared a brief projection in February 2002 in order to sell its tax anticipation notes in March 2002. No further cash flow projections were prepared by the City until we requested an update and were advised that they do not prepare cash flow projections on a regular basis. Subsequently, the City prepared a cash flow projection covering the period from April 8, 2002 to June 30, 2002. However, both documents lacked sufficient detail to allow analysis.

RECOMMENDATION

30. Prepare a detail cash flow projection for all funds for the entire fiscal year, monitor cash flow daily and analyze spending variances at least weekly. In addition, the City should prepare and retain documentation of cash flow projections and analysis.

Opportunities to Enhance the City's Cash Position

Longevity is paid to eligible employees in a lump sum each July. Longevity pay totaling \$1,823,649 is budgeted for FISCAL 2003 which will be paid in July 2002. The City is obligated to pay longevity as a lump sum by labor agreements and the City Finance Director advised us that the City has enough cash to do so because it is a

peak tax collection due date. However, we believe that it would be better to pay longevity as part of each payroll (26 pay periods) rather than in a lump sum at the beginning of the fiscal year. Funds not paid out in July would be available for other use, including investment.

RECOMMENDATION

31. Seek revision of future labor contracts to pay longevity over twenty-six pay periods rather than in a lump sum annually.

Police officers who work private duty details are paid through the City payroll system. The City is then responsible for billing the entity to obtain reimbursement. The manner in which the City handles reimbursement for police details has a negative impact on the City's cash flow. We found that police details are not billed timely, accounting systems to track these receivables are poor and often incomplete, and receipts representing collection of amounts billed are not deposited timely.

The costs of the details are billed to the entity requesting the services. The department tracks the accounts receivable and payments on an automated internal accounting system that is not linked to the City's accounting system. Only the billings for the hourly fees for the officers are posted to this system. The amounts billed for the use of police cruisers are not posted, but rather, copies of the cruiser bills are maintained in separate folders for each entity. On April 16, 2002, the accounts receivable balance reported by the system was \$151,106. Of this balance, \$32,207 was seven to nineteen months past due. The receivable balance for the cruisers is not included in this amount.

The internal accounting system for Police Detail Outside (PDO) (services performed for private businesses by off-duty police officers) has limited reporting capabilities. We could not obtain a report identifying what was posted as received nor a listing of outstanding receivables as of a prior date. From a report that was generated on July 20, 2001 from the internal system, we estimated the accounts receivable balance at June 30, 2001 as \$199,333. According to City officials, this receivable balance was not included in the City accounting system or in the financial statements. PDO's are only recorded in the accounting system when payment is received. Therefore, at June 30, 2001, the expenses to pay police officers for the details performed were recorded in the accounting system and reported in the financial statements, but the related accounts receivable due from the vendors were not recorded or reported.

Since March 1, 2002, deposits are completed on a weekly basis. However, prior to that time, collections were not deposited in a timely manner. Between July 1 and October 1, 2001, only three deposits totaling \$26,697 were posted to the accounting system, but two significant deposits of \$301,624 and \$170,926 were posted on November 16, 2001 and January 7, 2002, respectively. We were informed that the larger deposits resulted from checks stored in the safe by a prior employee. Copies of the deposited checks indicate dates as far back as June 2001.

All police detail costs should be recorded in one accounting system on a timely basis to ensure full collection. Amounts should be billed timely and all receipts should be deposited timely.

RECOMMENDATION

32. The City should bill and collect all amounts owed for police details immediately to reduce the negative impact on cash flow. Track all amounts owed the City for police details on the City's accounting system. Deposit receipts immediately.

CREATE A BUDGET RESERVE ACCOUNT

It is important that the City also gives attention to plans that would prevent a recurrence of a fiscal crisis of this magnitude. The long-term goal would be to enable the City to achieve sufficient fiscal stability such that it could weather fiscal problems without resorting to deficit financing.

Many governmental entities have created a “rainy day” reserve fund as part of a plan to achieve long-term fiscal stability. For example, the State of Rhode Island has a “rainy day” fund, which is funded by designating 2% of annual general revenues. When the fund reaches an amount that is equal to 3% of General Fund revenues, any excess amounts are used for funding capital items and debt service. The General Laws of the State specify the conditions under which withdrawals from the reserve account can be made.

The City should adopt a similar mechanism and create a budget reserve account. After resolving the current fiscal crisis, a portion of each year’s estimated revenues should be directed to a reserve account until a sufficient balance is achieved. Once the reserve account is fully funded, “excess” contributions to the reserve account could be directed to funding capital items without long-term borrowing, reducing existing bonded debt, and reducing unfunded pension liabilities.

Creation of such reserves is an integral component of a sound financial plan for the City and would demonstrate a commitment to preventing recurrence of a fiscal crisis. Additionally, creation of a “rainy day” fund would enhance the City’s cash position and allow it to fund its temporary cash needs internally without short-term borrowing.

RECOMMENDATION

33. Create a budget reserve account to be funded after the immediate fiscal crisis has been resolved and progress has been made in funding the City’s pension obligations.

D. COST REDUCTION OPPORTUNITIES

LABOR CONTRACT NEGOTIATIONS

Cranston's fiscal problems have grown over the past few years due to recurring structural budgetary deficits. As a result we advised the City that it should take immediate action to correct this condition and develop a fiscal recovery plan commencing with the fiscal 2003 budget. Since it would be imprudent to require the taxpayers to bear the entire burden of the City's fiscal recovery plan we recommended to the City that it also cut expenses to balance the budget. We asked the Commissioner of Education to propose cuts to the School Department's portion of the fiscal 2003 budget that would not violate state education mandates. We provided advice to the City on how to identify cost saving measures for other budgeted municipal expenditures. Approximately 75% of the general fund expenditures for municipal services (excluding school department) as included in the City's original proposed budget for 2003 was for salaries and related fringe benefits. Therefore, we proposed that the City review the salaries and benefits provided to its employees in existing contracts and seek union concessions in an effort to resolve the City's structural deficit.

Benefits provided to Police Officers and Fire Fighters

Salaries and benefits to active and retired police officers and firefighters represented the largest portion (approximately 69%) of total municipal salaries and benefits in Cranston's original proposed budget, excluding the school department. As a result, this represented an area that should be reviewed for potential cost savings. We compared the contractual benefits provided to Cranston's police officers and fire fighters to those of other similar Rhode Island cities and towns. It is difficult to draw conclusion by comparing individual contract provisions in isolation. However, based upon the information provided to us by these municipalities, it appears, that, in many instances, Cranston police and firefighter benefits exceeded those provided by these similar communities. The areas reviewed included holiday pay, sick days, special leave days, life insurance, longevity and cost of living adjustments. In view of the City's weakened financial condition, we recommended that the City re-evaluate previously negotiated salaries and benefits and seek concessions as part of its fiscal recovery plan.

City officials have recently reported publicly that they have obtained some union concessions in an effort to balance the final adopted budget for fiscal 2003. A further discussion of this topic is included in our analysis of the fiscal 2003 budget on page 19 of this report (subsection E). We have not received specific information regarding these concessions or whether they will achieve the savings projected. However, it is important that the City consider the impact of any promised increases in salaries and benefits in future years which it may have agreed to in order to obtain concessions for the fiscal 2003 budget. This assessment needs to be performed to ensure that the City's long-term financial position will benefit from the impact of these revised negotiations.

In addition, we believe that the City must consider in all future negotiations the impact that benefits will have on the City's financial condition including its unfunded pension liability.

Contract Negotiation

Prior to the adoption of the fiscal 2003 budget, the City negotiated three of its most recent labor contracts to cover the period July 1, 2001 to June 30, 2004. In all cases these contracts were negotiated and signed in 2001 without the benefit of audited financial statements for the fiscal year ended June 30, 2000. The audits for both the fiscal years ended June 30, 2000 and 2001, which were released in 2002, after their legally required deadlines, provided evidence of the City's rapidly deteriorating fiscal health. This information clearly would have been of value to the City when negotiating the labor contracts. Although the City did not have the audits available to them when negotiating these contracts, City officials have indicated that they were aware of the structural deficits in the budget,

and had been advised by RIPEC in a report issued in September 2000 of potential deficits commencing as early as 2002. We believe that the City should have given careful consideration to its ability to pay contractual benefits in view of its weakened financial condition. We reviewed the minutes of the City Council meeting, which contained the Council's ratification of the most significant of the three contracts mentioned above. There is no mention as to whether the Council was provided with a fiscal note by the City's Finance Director advising them of the current and long-term financial impact of the provisions of this contract and the City's ability to pay for the provisions in view of its weakened financial condition.

Fiscal notes describing the financial impact of the enactment of an ordinance are required by the City's charter. It is critically important that the fiscal impact of new labor contracts be calculated and disclosed (by fiscal note) for the full term of the contract. Such information should clearly be made available to the Council in its consideration/ratification of the contract and should also be made a part of the permanent public record.

RECOMMENDATIONS

34. Negotiate all new collective bargaining agreements only after careful consideration of the City's financial condition and its ability to pay for current benefits and fund future costs.
35. Calculate and disclose to the City Council the fiscal impact of new labor contracts for the full term of the contract and make such disclosures a part of the permanent public record.

In addition, School Department employees and certain other City employees are required to co-pay the cost of health insurance. However, health insurance is provided at no cost to active and retired police officers and firefighters. We believe that the City should determine an equitable co-pay amount for the cost of health insurance for all City employees and negotiate such concessions in order to obtain savings for the City.

RECOMMENDATION

36. Determine an equitable and uniform co-pay amount for health insurance coverage provided to all City employees.

RE-EVALUATE THE CITY'S SELF INSURANCE PROGRAM FOR HEALTH AND OTHER INSURANCE RISKS

The City of Cranston is self-insured for certain risks subject to certain third party "stop loss" coinsurance. Self-insured risks include general liability, property and casualty, workers' compensation, unemployment and employee health and life insurance claims. The City has established three internal service funds to finance and account for self-insurance costs -- (1) the Cranston City Hospitalization Fund, (2) the Cranston School Hospitalization Fund and (3) the Cranston Insurance and Risk Management Commission Fund.

The Cranston Hospitalization Fund and the Cranston School Hospitalization Fund finances self-insured employee health care claims and accounts for financial contributions and payment of claims and related administrative costs. The City Finance Department administers the Funds. Claim payment services are provided by two compensated administrators (Blue Cross/Blue Shield of Rhode Island and United Health Care of New England). These insurance companies pay the claims and add a service fee and request reimbursement from the City. The City budgets an amount for each full-time employee as an estimate of the amount required to pay claims (provider costs and administrative fee).

The Cranston Insurance and Risk Management Commission Fund finances all other self-insured claims (uninsured risks of loss) of the City, except the School Department. The Fund accounts for financial contributions

*Recommendations To Restore and Maintain Fiscal Stability
Cost Reduction Opportunities*

and payment of claims and administrative costs. The commission reviews and decides claims. The commission is comprised of the director of administration, the city solicitor and certain city council members. The commission retains outside legal counsel.

Claims paid during the last five years are shown below.

<u>Claims Paid – Five Years</u>				
<u>Fiscal Year</u>	<u>Health and Life</u>	<u>Workers' Compensation</u>	<u>Court Judgments and Claims</u>	<u>Total</u>
1997	\$10,564,000	\$ 96,000	\$258,000	\$10,918,000
1998	\$12,499,000	\$ 315,000	\$142,000	\$12,956,000
1999	\$11,061,000	\$ 96,000	\$294,000	\$11,451,000
2000	\$14,287,000	\$ 716,000		\$15,003,000
2001	\$16,603,000	\$ 719,000		\$17,322,000

Source: City of Cranston audit reports

Expenditures for claims and administrative costs have exceeded budget amounts and the internal service funds have experienced deficits during the last three years. The accumulated deficit for the three-year period ended June 30, 2001 is shown below:

<u>Accumulated Deficit in Internal Service Funds – Three Years</u>			
<u>Fiscal Year</u>	<u>Insurance and Risk Management Fund</u>	<u>City and School Hospitalization Funds</u>	<u>Total</u>
1999	(A)	(\$1,376,000)	(\$1,376,000)
2000	(\$ 878,000)	(\$1,672,000)	(\$2,550,000)
2001	(\$2,093,000)	(\$3,004,000)	(\$5,097,000)

Source: City of Cranston audit reports
(A) - Amount not separately reported for fiscal 1999

The accumulated deficits in these internal service funds impact the City's General Fund since cash must be advanced to pay claims and the deficits must be eliminated through increased assessments from the City's departments and agencies. The existence of repeated deficits in these self-insurance internal service funds indicates that the City is not budgeting sufficient amounts to meet actual claims.

The City should reexamine its self-insurance program to determine if it represents the lowest cost alternative for providing health insurance to employees and paying other claims against the City. Budgeting for these costs is more difficult under a self-insured scenario since actual claims paid can vary significantly between years. Further, no opportunity exists to spread risks among a larger pool of participants. By contrast, utilizing premium-based full risk coverage would facilitate budget preparation (premiums would be known and could be accurately budgeted) and would eliminate incurrence of unfunded deficits in the City's self-insurance internal service funds. Ensuring the City has adopted the lowest cost alternative in managing its employee health coverage and payments for other claims would aid the City in overall expense reduction.

The City's School Department provides self-insured health care to its employees through the Cranston Hospitalization Fund. However, the School Department obtains all other types of insurance from the Rhode Island Interlocal Risk Management Trust rather than the self-insured Cranston Insurance and Risk Management Commission Fund. School Department management advised us that the Trust has provided comprehensive insurance coverage at a reasonable cost and that such coverage and cost was better than what the City had provided through the Commission Fund.

The City should reexamine its self-insurance program and investigate whether cost savings are possible through purchasing insurance or through participation in a risk sharing collaborative.

RECOMMENDATION

37. Determine whether cost savings are possible from discontinuing the City's self-insurance program for employee health and other risks and adopting either (1) premium based insurance coverage or (2) coverage obtained through a risk collaborative.

COST SAVING MEASURES

In an effort to assist the City to identify cost saving measures that could be adopted within the fiscal 2003 budget, we asked the Mayor to instruct each department head to identify possible cuts to the amounts included in the Mayor's proposed 2003 budget for their department. Each department head was asked to present three scenarios and the impact each proposed reduction would have on City services.

- Level A - A five percent (5%) reduction to their department's budget
- Level B - A ten percent (10%) reduction to their department's budget
- Level C - A fifteen percent (15%) reduction to their department's budget

Although many department heads did not see significant achievable opportunities for savings, we believe that this tool can be used along with other approaches to accomplish the goal of cost reductions. For example one department head proposed what he considered to be achievable cost savings of approximately \$575,000 in the following divisions:

- ❑ Engineering - \$259,000
- ❑ Department of Public Works – \$54,000
- ❑ Highway Maintenance - \$262,000

RECOMMENDATION

38. Pursue all potential cost saving opportunities identified by department heads.

RE-EXAMINE THE COST SAVING RECOMMENDATIONS RESULTING FROM THE CONSOLIDATION STUDY OF THE CITY

In 1998 the City engaged an international consulting firm to perform an independent analysis of the merits of merging or building closer collaboration among selected administrative support functions within the City and Schools. The objectives of these actions would be to reduce costs, enhance services or both. This project was sponsored jointly by the City Administration, City Council and School Department.

The functions reviewed included finance and purchasing, management information systems, building and ground maintenance, personnel and transportation. The report dated October 1998 projected costs savings from implementation of its recommendations of approximately \$670,000 for the first full year of implementation and \$590,000 per year in recurring savings in subsequent years. It also identifies added potential savings, which could be achieved over a couple of years. In addition to identifying potential cost savings, the consultants suggested a plan of implementation.

The report identified the following principles and challenges to implementation, which were not considered insurmountable:

- ❑ Implementation is reliant on a measure of cooperation and trust between the City and School Department.
- ❑ Proposed staff reductions may be done gradually in line with managed attrition.
- ❑ Some proposals may require changes to the charter although this does not present a major obstacle.
- ❑ Some proposals may require mergers across the City and Schools that will involve combining staff with different union representation status.

The School Department has indicated that it would be willing to assist the City to realize cost savings through joint purchasing. However, school officials have expressed concern regarding other joint operations since they believe their finance, management information systems, and purchasing functions are more effective than those of the City. They do not want to sacrifice any of the economies and efficiencies the School Department now realizes by combining these functions. We agree that neither the City nor the School should experience a significant reduction in the economy, efficiency or effectiveness of its current functions through mergers. However, the City is experiencing a severe fiscal crisis and structural deficits have been identified as a major contributing factor. Recurring deficits can only be corrected through cost savings that are also recurring in nature such as those identified in this report. As a result, the cost saving measures identified in this consolidation report should be re-examined by the City Administration, City Council, and School Department. Since the first recommendation to conduct joint purchasing is estimated to save \$266,000 in recurring savings this could be considered as a first step. In addition, if the City effectively implements the numerous recommendations to improve financial controls made by its independent auditors as well as the recommendations to improve operations made in this report, the School Department may become more receptive to some of the other recommendations that will require the merger of functions.

RECOMMENDATION

39. The City Administration, City Council and School Department should re-examine the recommendations made in the City-School consolidation report and work cooperatively to implement its cost saving measures.

E. OTHER RECOMMENDATIONS

SEWER SYSTEM USER FEES

An annual sewer charge is assessed to all users of the City Sewer System. Section 26 of the Cranston City Code contains the legal statutes governing sewers. Sections 26-69 through 26-71 contain the following provisions:

- ❑ Federal regulations (40 CFR Part 35, Subpart E, Section 35.925-11, 35.935-13 and Appendix B to Subpart E) require that the City enact a system of user charges to assure that each recipient of wastewater treatment services pay its proportionate share of the costs of operation and maintenance costs.
- ❑ All users shall be classified according to the principal wastewater constituents and characteristics for that type of user. The purpose of such classification is to establish a system of user charges and fees, which will ensure an equitable recovery of operation and maintenance cost. The two classifications are industrial and domestic.
- ❑ The City of Cranston ordinances provide for an annual sewer charge.

In accordance with these legal requirements, the City has established a rate structure with thirty rate categories. However, we found that residential and most business properties are assessed a flat rate. Certain business properties pay based on metered sewage flow.

We were advised by the Executive Director of the Narragansett Bay Commission and the chief accountant of the RI Division of Public Utilities that the preferred industry practice is to assess sewer billing rates that are principally based on consumption, i.e., metered flow of water. Consumption based billing rates are preferable because they (1) provide a fairer allocation of cost, and (2) encourage conservation of water.

RECOMMENDATION

40. Investigate changing sewer user fees from a flat rate to a consumption based rate structure.

CITY ACCOUNTING SYSTEM

The City's auditors have made numerous comments about the inadequacies of the current accounting system. Additionally, discussions with the City's Information Technology (IT) Department regarding the accounting system indicated that various problems/issues exist involving:

- ❑ the budget preparation module,
- ❑ starting a new fiscal year – maintaining the old fiscal year while opening a new fiscal year,
- ❑ unsuccessful postings to the general ledger,
- ❑ producing trial balances,
- ❑ voucher duplication, purchase order creation, and
- ❑ the payroll and collections modules.

IT Department personnel indicated that while some problems are attributable to system faults, staff turnover and the lack of ongoing formal training have caused various types of user/operational error within the system. Problems that are determined to originate from the software are reported to the vendor. The vendor has been responsive in addressing these issues.

With consideration of the City's financial situation and the inevitable resources required to implement a new accounting system the City has no practical option but to continue with the existing system and take appropriate steps to ensure that system "problems" are anticipated and corrected promptly. Specifically, the City should consider implementing a personal computer based reporting system to capture and report all occurrences of possible systems problems. These instances could be reviewed and then reported to the vendor for response and resolution.

Future Systems Requirements

The City should consider performing a citywide information systems needs analysis. This needs analysis would be designed to identify gaps between the existing system services and needs which may be required to meet citywide information technology demands. The final product of such a review would be a formal plan that the City could use to help build or restructure the IT infrastructure using emerging technologies that have higher levels of performance and availability, yet are flexible to handle any future operational demands and anticipated growth.

RECOMMENDATIONS

41. Implement an internal tracking system for all system issues/problems. Accumulate and report these instances to the vendor for response and resolution.
42. Perform a citywide information systems needs analysis.

DELINQUENT AUTO TAX REPORT¹⁰

The State Bureau of Audits (Bureau) performed a review of the City of Cranston's Tax Assessor's and Tax Collector's office. This included an analysis of the City's collection of delinquent auto taxes. As part of this analysis they analyzed data files received from the City's tax collector that are provided by the City to the Rhode Island Division of Motor Vehicles. This is done in an effort to prevent delinquent taxpayers from registering their motor vehicles if they have not paid their auto taxes to the City. The Bureau reported the following:

- ❑ The City is considering hiring a collection agency to collect delinquent auto taxes.
- ❑ If a collection agency is hired, the City should only offer delinquent auto taxes that are more than two years old.
- ❑ The charges for these services appear high.
- ❑ The City should use the solicitor's office in an attempt to retrieve the delinquent auto taxes less than two years old.

¹⁰ Based on information accumulated by the State Bureau of Audits – Department of Administration.

- ❑ It appears that much of the data provided by the City to the Rhode Island Division of Motor Vehicles is incomplete. As a consequence, taxpayers may be allowed to register their vehicle even though they may owe delinquent auto taxes to the City.

RECOMMENDATIONS

43. Carefully review the list of delinquent taxpayers provided to the Rhode Island Division of Motor Vehicles to enhance controls that prevent those individuals from registering their vehicles prior to payment of outstanding taxes.
44. Make greater use of the City Solicitor's office in an attempt to retrieve delinquent auto taxes less than two years old.

POLICE DEPARTMENT FEDERAL AND STATE FORFEITED PROPERTY

We reviewed the Cranston Police Department's records related to drug seizure funds with the objective of determining whether such funds could be used as a resource to the department in light of the City's fiscal 2003 budget reductions.

Any local law enforcement agency that directly participates in an investigation or prosecution that results in a federal or state forfeiture may request an equitable share of the net proceeds of the forfeiture from the applicable federal or state agency. The portions are based upon the involvement of each agency. The Cranston Police Department has accumulated about \$250,000 and \$130,000 in federal and state funds, respectively.

The Drug Enforcement Administration – New England Division advised us that these funds could not be disbursed on items of a fixed nature (i.e. salaries, rent, mortgage, electricity, etc.) but may be used for items such as training and capital expenditures that supplement the department's budget. Funds are meant to supplement and not supplant expenditures previously paid with local funds. *A Guide to Equitable Sharing of Federally Forfeited Property for State and Local Law Enforcement Agencies March-1994* issued by the US Department of Justice, sets forth guidelines for permissible and impermissible uses of the local agency's share of federal seized assets. Rhode Island General Law Section 21-28-5.04 (Uniform Controlled Substances Act) discusses permissible uses of state seized assets which generally may be used for local law enforcement and investigating drug violations.

The Police Department should review its fiscal 2003 operating budget and identify areas where the federal and state forfeited property funds could be used to supplement amounts appropriated by the City. As deemed necessary, the City could contact the US Department of Justice prior to disbursing these funds to ensure planned expenditures are consistent with federal guidelines.

We also observed that internal controls regarding authorization of expenditures and adequate supporting documentation for expenditure of these funds could be strengthened. Because of the restrictions on the proper use of these funds, authorization should be limited to those with direct knowledge of the compliance requirements.

RECOMMENDATIONS

45. Identify areas where federal and state forfeited property funds could be used to supplement the police department's operating budget.

46. Improve controls over authorization and requirements for supporting documentation of expenditures made from federal and state forfeited property funds.

PUBLIC WORKS FACILITY

The City conducts public works operations at a facility on Phenix Avenue which is owned by the Public Facilities Management Foundation (hereafter "the Foundation"). The City leases the facility from the Foundation and is required to pay all costs associated with the operation of the facility pursuant to a long-term lease agreement.

We reviewed documents provided to us by officials in the Public Works Department chronicling the move to the current facility (the public works department was previously headquartered on City owned property). We also interviewed the Director of Public Works who held that position throughout the transition to the new facility. Based on the information provided, we have outlined various observations concerning this significant transaction which obligates the City over a fifteen year period.

The Structure of the Transaction

The Public Facilities Management Foundation is a nonprofit corporation created by the City to be the owner of the public works facility on Phenix Avenue. The creation of this entity allowed the Foundation to borrow money for the acquisition of the facility through the issuance of \$5.1 million of tax-exempt debt. The debt service will be paid entirely by the City through lease payments totaling approximately \$7.4 million over a fifteen-year lease term. Annual lease payments range between \$491,000 and \$500,000. At the end of the lease term, the City has the right to acquire title to the facility for one dollar.

The City also provided a financial assistance package valued at approximately \$1 million consisting of grants and low-interest loans to relocate a tenant at the property on Phenix Avenue.

Observations

- ❑ On December 5, 2000, the Foundation acquired the property on Phenix Avenue from a Limited Liability Company for \$3,875,000 with the proceeds from the issuance of the tax-exempt debt. Just prior to that transaction, on the same day, the Limited Liability Company had acquired the property from another party for \$3,400,000 – a difference of \$475,000. The appraisal commissioned by the City is dated after the closing of the land transfer.
- ❑ The Public Works Director recommended the acquisition in October 2000, however, in a memorandum dated September 2000 he advised the Director of Administration that the sole proposal received was not appropriate for the City's needs.
- ❑ In choosing to relocate the Public Works garage to the Phenix Avenue site, the City selected the sole proposal received. Whether other potential alternatives were seriously considered is unclear.
- ❑ The City pays an annual property management fee of more than \$40,000 (for a three-year period subject to renegotiation thereafter) and an annual materials and supplies charge of \$10,000, in addition to the required lease payments. These fees are paid to the same entity that submitted the sole proposal to the City for the acquisition of the facility. The functions performed by the vendor under this agreement could potentially be performed by City personnel at a significant cost savings.

These observations suggest that the City may not have performed sufficient due diligence in embarking on a project of this magnitude. While the City is committed to the lease transaction, the property management fee and supplies charge should be discontinued at the earliest opportunity. Going forward, the City should ensure that sufficient due diligence, including cost/benefit analyses, be performed before entering into any similar large transactions that obligate the City over a period of years.

RECOMMENDATIONS

47. Attempt to reduce costs associated with the operation of the facility. For example, the payment of an annual property management fee should be discontinued
48. Ensure that sufficient due diligence, including cost/benefit analyses, be performed before entering into any similar large transactions that obligate the City over a period of years.

Appendix **A**

Appendix A

CITY OF CRANSTON		
CHANGES IN UNRESERVED FUND BALANCES/RETAINED EARNINGS		
Selected Funds - July 1, 1990 to June 30, 2002		
	General Fund	Enterprise Sewer Fund
	\$	
July 1, 1990 - Unreserved Fund Balance/Retained Earnings (Deficit)	2,465,746	\$ 3,476,216
1991 Operating results	(1,028,582)	(1,134,493)
Depreciation charged to Contributed Capital		1,136,979
June 30, 1991 - Unreserved Fund Balance/Retained Earnings (Deficit)	1,437,164	3,478,702
1992 Operating results	16,485	(1,081,160)
Adjustment to prior years		(318,405)
Depreciation charged to Contributed Capital		1,086,962
Increase in reserve for pretreatment		(379,901)
June 30, 1992 - Unreserved Fund Balance/Retained Earnings (Deficit)	1,453,649	2,786,198
1993 Operating results	(707,237)	(1,717,374)
Increase in Reserve for noncurrent amounts due from other funds	(11,960,000)	
(Increase) in other reserves	(321,228)	
Prior period adjustment	68,524	
Depreciation charged to Contributed Capital		1,115,954
Decrease in reserve for pretreatment		73,501
June 30, 1993 - Accumulated Fund Deficit /Retained Earnings (Deficit)	(11,466,292)	2,258,279
1994 Operating results	(2,433,200)	3,336,484
Decrease in Reserve for noncurrent amounts due from other funds	4,770,000	
Increase in Reserve for tax title property	(166,085)	
Depreciation Charged to Contributed Capital		1,133,637
Increase in reserve for pretreatment		(193,864)
June 30, 1994 - Accumulated Fund Deficit /Retained Earnings (Deficit)	(9,295,577)	6,534,536
1995 Operating Results	(3,775,812)	1,312,485
Decrease in Reserve for noncurrent amounts due from other funds	2,200,000	
Decrease in Reserves for tax title property	265,398	
Decrease in Reserves for other noncurrent assets	130,448	
Depreciation Charged to Contributed Capital		1,144,636
Increase in reserve for pretreatment		(54,834)
Restatement of prior year retained earnings		(1,784,784)
June 30, 1995 - Accumulated Fund Deficit /Retained Earnings (Deficit)	(10,475,543)	7,152,039
1996 Operating Results	(1,477,541)	693,812
Increase in Reserve for noncurrent amounts due from other funds	(1,520,000)	
Decrease in Reserves for tax title property	32,273	
Depreciation Charged to Contributed Capital		1,148,719
Increase in reserve for pretreatment		(25,116)
June 30, 1996 - Accumulated Fund Deficit /Retained Earnings (Deficit)	(13,440,811)	8,969,454

Appendix A (continued)

CITY OF CRANSTON		
CHANGES IN UNRESERVED FUND BALANCES/RETAINED EARNINGS		
Selected Funds - July 1, 1990 to June 30, 2002		
	General Fund	Enterprise Sewer Fund
June 30, 1996 - Accumulated Fund Deficit /Retained Earnings (Deficit)	(13,440,811)	8,969,454
1997 Operating Results (does not include transfer from sewer)	3,520,528	32,600,341
Transfer from sewer fund (broken out of operating results)	13,001,299	
Decrease in Reserve for noncurrent amounts due from other funds	6,510,000	
Increase in Reserves for tax title property	(41,865)	
Depreciation Charged to Contributed Capital		938,195
Increase in reserve for pretreatment		(44,244)
June 30, 1997 - Unreserved Fund Balance/Retained Earnings (Deficit)	9,549,151	42,463,746
1998 Operating Results	475,000	(2,465,000)
Increase in Reserves	(22,941)	
Decrease in Reserve for pretreatment		624,458
Depreciation Charged to Contributed Capital		1,197,000
Restatement of prior year retained earnings		(48,000,000)
Operating Transfer to Capital Projects Fund		(5,075,000)
June 30, 1998 - Unreserved Fund Balance/Retained Earnings (Deficit)	10,001,210	(11,254,796)
1999 Operating Results	35,000	(1,200,000)
Increase in Reserves	(137,000)	
Restatement of prior year retained earnings		(3,695,000)
Depreciation Charged to Contributed Capital		1,197,000
June 30, 1999 - Unreserved Fund Balance/Retained Earnings (Deficit)	9,899,210	(14,952,796)
2000 Operating Results	(4,940,000)	(2,670,000)
Restatement of prior year retained earnings		138,000
Increase in Reserves	(1,465,000)	
Depreciation Charged to Contributed Capital		1,197,000
June 30, 2000 - Unreserved Fund Balance/Retained Earnings (Deficit)	3,494,210	(16,287,796)
2001 Operating Results	(8,756,072)	651,445
Increase in Reserves	(206,480)	
Restatement of prior year retained earnings		2,046,650
Depreciation Charged to Contributed Capital		1,197,000
June 30, 2001 - Unreserved Fund Balance/Retained Earnings (Deficit)	(5,468,342)	(12,392,701)
2002 Operating Results (Projected)	(11,500,000)	
June 30, 2002 – Projected Accumulated Fund Deficit	(16,968,342)	

Source: City of Cranston audited financial statements fiscal years 1991 – 2001 and City's projected operating results for fiscal 2002. Beginning in fiscal 1998, separate fund financial statements were not presented for each enterprise fund. Accordingly, the summary data presented in the table for the Enterprise Sewer Fund after June 30, 1997 is derived from information available within the City of Cranston's audited financial statements. Projected 2002 operating results were not available for the sewer enterprise fund.

Appendix B-1

Appendix B-1

(for illustrative purposes only)

Sample Personnel Supplement for Budget Preparation

Positions	FISCAL 2002 Budget		FISCAL 2003 Budget	
	FTE	Cost	FTE	Cost
Department Head	1.0	60,272		62,458
Senior Clerk	2.0	55,011		57,006
Research Clerk	1.0	31,964		33,124
Principal Clerk	1.0	31,964		33,124
Aide/Technician	1.0	45,795		47,456
Deputy Department Head	2.0	<u>108,338</u>		<u>112,268</u>
Subtotal	8.0	\$333,344	8.0	\$345,436
Extra Vacation		5,443		5,760
Turnover	(1.0)	<u>(\$31,964)</u>	(1.0)	<u>(\$33,124)</u>
Total Salaries	7.0	\$306,823	7.0	\$318,072
Benefits				
Retirement		0		67,000
Medical		40,174		43,425
FICA		26,842		28,950
Group Life		1,200		1,400
Total Salaries and Benefits	7.0	\$375,039	7.0	\$458,847
Cost per Full Time Position		\$53,577		\$65,550

Appendix B-2

Appendix B-2

(for illustrative purposes only)

City of Cranston
General Government Personnel Summary

	FY 2002 (Budgeted)		FY 2003 (Budgeted)		Growth 02 to 03
	Positions	Cost	Positions	Cost	
Salaries					
General Government Employees	166	\$ 6,324,900	168	\$ 6,462,053	2.2%
Division of Maintenance(Highway)	38	\$ 1,260,884	38	\$ 1,215,043	-3.6%
Division of Building Maintenance	27	\$ 857,789	26	\$ 835,105	-2.6%
Parks & Recreation	23	\$ 790,239	22	\$ 769,340	-2.6%
Fire Department	208	\$ 10,801,341	210	\$ 12,457,318	15.3%
Police Department	149	\$ 9,894,264	149	\$ 9,868,264	-0.3%
Public Libraries	32	\$ 1,271,552	32	\$ 1,253,446	-1.4%
Overtime		\$ 1,241,555		\$ 1,412,439	13.8%
Turnover	(12)	\$ (454,946)	(12)	\$ (469,017)	3.1%
Total Salaries	643	\$ 31,987,578	645	\$ 33,803,991	5.7%
Benefits					
Pension Contribution		\$ 1,421,610		\$ 1,339,926	-5.7%
Medical		\$ 4,836,173		\$ 5,724,836	18.4%
Hospitalization Buyback		\$ 340,469		\$ 347,009	1.9%
FICA		\$ 1,069,646		\$ 746,314	-30.2%
Life Insurance		\$ 65,372		\$ 132,960	103.4%
Annuity		\$ 206,984		\$ 207,354	0.2%
Legal Assistance		\$ 25,660		\$ 16,770	-34.6%
Holiday Pay		\$ 1,313,163		\$ 1,431,651	9.0%
Severence		\$ 228,500		\$ 630,000	175.7%
Total Salaries & Benefits	643	\$ 41,495,155	645	\$ 44,380,811	7.0%
Cost per Full Time Position		\$ 64,534		\$ 68,807	6.6%
Temporary & Seasonal	194	\$ 1,267,727	194	\$ 1,394,686	10.0%
Payroll Costs	837	\$ 42,762,882	839	\$ 45,775,497	7.0%

Appendix B-3

Appendix B-3

(for illustrative purposes only)

SAMPLE – BUDGET TRACKING SHEET NARRATIVE

FISCAL 2003 City of Cranston – Safety Services

Item 3 : Add One Position

Amount:	General Revenue:	<u>FISCAL 2003</u> (\$55,000)
	All Funds:	(\$55,000)

Timetable: July 1, 2002

Barriers: Contractual obligations, bargaining units

FTE: One reduction (proposed)

Description: The Fire Department requests the addition of one firefighter in FISCAL 2003 with a total cost \$55,000 including salary and benefits. The Finance Office recommends the elimination of two positions, based on the rate of vacancy experienced in FISCAL 2002. The Mayor's recommendation is for the elimination of one position for a savings of \$55,000 including salary and benefits. The Mayor's recommendation complies with language in the firefighters union contract and accommodates expected salary and benefit requirements in FISCAL 2003.

Revenue Impact: None

NOTE: Each item on the tracking sheet should link to a narrative description. The description should identify the original intent of the department's proposal and any subsequent action by the finance office and/or mayor's office. With the assumption that the finance office and mayor's office may make several iterations of the budget, a separate column with the data of each draft budget should be included. Once the city council acts upon the budget, the final column should be filled in and narrative statements updated to reflect the final form of the budget.

Appendix B-3

(for illustrative purposes only)

SAMPLE – BUDGET TRACKING SHEET

Item No.	Description	Departments' Request	Finance Office Recommend	Mayor's Recommend	Council (Adopted)
	FY 2003 Target Budget	170,000,000	170,000,000	170,000,000	0
	FY 2003 Specific Items				
	Administration				
1	Payroll Adjustments	(10,000)	(10,589)	(10,589)	
2	Operating Adjustments	25,000	(42,000)	(28,656)	
		25,000	(42,000)	(28,656)	0
	Safety Services				
3	Add one position	55,000	(110,000)	(55,000)	
4	Purchase new equipment	150,000	(150,000)	150,000	
		205,000	(260,000)	95,000	0
	Public Works				
5	Overtime	0	90,000	50,000	
6	Utilities	50,000	65,000	65,000	
7	Capital Lease Equipment	0	75,000	75,000	
		50,000	230,000	190,000	0
	... and so on for all city functions.	225,000	275,000	200,000	0
	Subtotal - Specific Items	387,500	60,206	351,050	0
	Citywide Items				
25	Citywide Medical Benefits Adjustment	0	(265,100)	(265,100)	
26	Citywide Retirement	0	(175,000)	(175,000)	
27	Citywide Insurance	0	0	200,000	
	Subtotal - Citywide Items	0	(440,100)	(240,100)	0
	Subtotal - All Items	387,500	(379,895)	110,950	0
	FY 2003 Revised City Total	170,387,500	169,620,106	170,110,950	0

Changes made

Increased BOC 438 to provide additional funding for rotary:

Accounts and Control	100,000
RISAIL - internal shift/no change to total	[80,000]
Registry - OLIS Support - internal shift to 438	[200,000]
Human Resources	10,000
Child Support (state share)	25,500
Child Support (fed share)	[49,500]

Providence Foundation/Traveler's Aid Grant (340,000)

Appendix C

CITY OF CRANSTON, RHODE ISLAND

**LETTER OF OBSERVATIONS AND RECOMMENDATIONS
NOTED DURING OUR AUDIT
YEAR ENDED JUNE 30, 2001**

**CAYER PRESCOTT
CLUNE CHATELLIER**

CERTIFIED PUBLIC ACCOUNTANTS
BUSINESS CONSULTANTS



CERTIFIED PUBLIC ACCOUNTANTS
BUSINESS CONSULTANTS

Providence, Rhode Island

To the Honorable City Council
City of Cranston, Rhode Island

In planning and performing our audit of the financial statements of the City of Cranston, for the year ended June 30, 2001, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control. However, we noted certain matters described in Section I attached hereto involving the internal control and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the City's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.

The memorandum that accompanies this letter summarizes our comments and suggestions into two sections. The conditions contained in Section I are, in our judgment, reportable conditions. Our comments described in Section II represent other opportunities for strengthening internal controls and operating efficiency.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we consider the comments made in regard to Unfunded Pension Liability, Interfund Receivables and Payables, Budgetary Process, Reconciliation Between the City's General Ledger and the School's General Ledger, Accounts Payable, General Ledger Account Analysis, and Tax Overpayments to also be material weaknesses.

We have already discussed these comments and suggestions with City personnel, and we will be pleased to discuss them further at your convenience, to perform any additional study of these matters, or to assist you in implementing the recommendations.

This report is intended solely for the information and use of the City Council, management, and others within the administration and is not intended to be and should not be used by anyone other than those specified parties.

Sincerely,

A handwritten signature in black ink, reading "Cayer Prescott Clune & Chatellier, LLP". The signature is written in a cursive, flowing style with a large initial 'C' and 'P'.

CAYER PRESCOTT CLUNE & CHATELLIER, LLP

April 16, 20.02

SECTION I

REPORTABLE CONDITIONS

UNFUNDED PENSION LIABILITY

According to the most recent actuarial study, dated December 31, 2001, the Police and Fire Pension Trust Funds have an unfunded pension benefit obligation of approximately ~~\$190,993,659~~ at July 1, 2001. The actuaries performed a cost study and recommended that the City should contribute an additional \$15 million each year for the next 37 years, along with the annual employee benefit payments in order to fully fund the unfunded liability. The City did not make an additional contribution for the fiscal year ending June 30, 2001. Since the City did not properly fund the pension in compliance with generally accepted accounting principles, a qualified opinion on the financial statements was issued.

According to the previous actuarial study performed, which was as of July 1, 1999, the unfunded pension benefit obligation was ~~\$169,783,580~~. To amortize it fully over 39 years would have required an additional contribution of \$13.2 million per year. Thus, the contribution to fund the unfunded pension obligation has grown by \$1.8 million in just two years and will continue to grow exponentially unless the City makes adequate contributions.

Recommendation

The City is currently underfunding the Police and Fire Pension Funds by approximately \$15 million per year. We recommend that City properly budget and fund the pension funds.

Management's Response

The City of Cranston is deeply committed to fixing a problem the new administration inherited.

Despite the administration's success in enacting legislation in FY 2001, which would have allowed the City of Cranston to transfer up to 40 individuals from the underfunded **City pension** system to the overfunded State pension system, after seeking a private letter ruling, the Internal Revenue Service will not allow the State of Rhode Island to implement the legislation.

Legislation was passed by the House and Senate to enable the City of Cranston to sell Pension Obligation Bonds, thereby effectively eliminating the unfunded pension liability. Unfortunately, the Governor vetoed the State legislation and the City of Cranston was unable to implement the plan.

The administration again introduced legislation in FY 2002 to eliminate the unfunded pension liability. The measure has had several hearings but has unfortunately not been enacted.

The administration is acutely aware of the seriousness of the unfunded pension liability. The administration's proposed FY 03 budget includes **\$1,400,000** for pension health care expenses. Actuarial studies show that the City of Cranston will pay out over \$1.2 billion before the City of Cranston Police and Fire pension system is extinct. The administration needs the ability to sell Pension Obligation Bonds to properly address the unfunded pension liability.

INTERFUND RECEIVABLES AND PAYABLES

Amounts due to and from other funds were not reconciled at June 30, 2001. The large number of funds that exist within the City and the numerous amounts of inter-fund general ledger accounts further complicate the issue. Furthermore, there is a great deal of uncertainty regarding the validity of many of the interfund accounts. For example, in the general ledger provided by the City at the beginning of the audit, there was an account named "Due to Other Funds," that had a balance of \$8.2 million. An extensive reconciliation of the inter-fund accounts had to then be completed, which resulted in adjustments of over \$9.0 million in the General Fund. In addition, there are many instances where the inter-fund accounts are not being specifically labeled. For example, an account might be labeled "Due to Other Funds" when it should be labeled "Due to General Fund."

Recommendation

We recommend that the City's management reconcile the inter-fund receivable and payable balances on a monthly basis. We would be happy to assist the City in the training of employees in this important function.

Management's Response

The City of Cranston recognizes the need for Inter-fund account analysis. There have been and there will continue to be significant efforts made to reconcile the complex inter-fund system, which this administration inherited with an inconsistent financial management system. The inter-fund receivables and payables are being reconciled in FY 02.

This situation has existed for a while. The current auditor can attest to the complicated process involved with reconciling the inter-funds. The current auditor mentioned the inter-fund analysis as an issue, as far back as 1995. The Finance team worked diligently to identify approximately 60 "Due To" or liability accounts with approximately 60 "Due From" or asset accounts. It is the Finance team that identified the recommended adjustments and then conveyed the information to the auditor.

BUDGETARY PROCESS

During our audit, we discovered several instances where actual expenditures significantly exceeded the adopted budget. For example, the police and fire retirees' health care costs for fiscal year 2001, totaled approximately \$1,000,000. These costs were not budgeted. Also, the workers' compensation medical line item in the Insurance and Risk Management Fund was not budgeted. Total workers' compensation expenditures were approximately \$561,000. In addition, the pension benefits for the police and fire funds were under budgeted by approximately **\$3,100,000**. Another example of expenditures not being budgeted correctly was the police and fire department salaries. These costs were under budgeted by approximately **\$1,025,000**.

On the other hand, the debt service payments that are made from the General Fund, were over budgeted by approximately \$825,000.

The budgeting process is a critical function for the City. Only by recognizing all of the expenditures of the various funds, can the City properly and accurately determine its budget for a fiscal year. By not recognizing all of the expenditures and incorrectly budgeting for other expenditures, the City is more prone to experiencing overall deficits in the future fiscal years.

BUDGETARY PROCESS (Continued)

Recommendation

We recommend that the City accurately budget every line item in the various funds. Accurate budgeting of revenues and expenditures is critical for the financial stability of the City.

Management's Response

The City of Cranston has included ~~\$1.4M~~ in its Proposed FY 03 Operating Budget for retiree health care expenses.

The administration has included costs related to Policemen and Firemen Injured on Duty (IOD) in its Proposed FY 03 Budget.

When the administration submitted its proposed its FY 01 budget, it assumed that Pension Obligation Bond legislation would be passed. The administration did not assume that the Governor would veto the legislation once it was passed by the House and the Senate. Had the governor not vetoed the pension obligation legislation, the approximate \$9500,000 pension fund budget would have been sufficient to meet debt service expenses on the Pension Obligation Bonds.

Regarding the over budgeted salary expenses, this administration inherited a Fire Department that had not had a contract since June 30, 1997 and a Police Department that had not had a contract since June 30, 1998. The city incurred a retroactive one-time Fire Department salary expense of ~~\$627,310.25~~ on September 22, 2000 and a one-time retroactive Police Department salary expense of ~~\$502,015.60~~ on August ~~22, 2000~~.

Regarding the under budgeted debt service expense, the administration wisely refinanced Bond Issue 151 in December of 2000, which created a savings for the City of Cranston.

RECONCILIATION BETWEEN THE CITY'S GENERAL LEDGER AND THE SCHOOL'S GENERAL LEDGER

An important control procedure that needs to be performed is a reconciliation of all of the activity and balances recorded in the Cranston Public Schools' records with the activity recorded on the City's general ledger. Included in this reconciliation must be agreement between the expenditure made by the City's general fund and recorded as revenue by the School as well as any amount owed by the City's general fund and recorded as a receivable by the School. These reconciliations should be performed on a monthly basis to ensure that any discrepancies are discovered and corrected quickly. This reconciliation is the most important reconciliation that needs to occur to ensure that the activities of the School are properly reflected in the City's general fund and its financial statements. As a result of not reconciling the City and School Department inter-fund accounts, the monthly expenditure reports received by the City Council become inaccurate and unreliable.

RECONCILIATION BETWEEN THE CITY'S GENERAL LEDGER AND THE SCHOOL'S GENERAL LEDGER (Continued)

One effect of this reconciliation not being completed was the discrepancy in the amount recorded as the appropriation to the School Department for fiscal year 2001. The School's records reflected an appropriation from the City of \$55,535,987, while the City showed \$54,608,186. This discrepancy was not addressed until we began the process of reconciling the City and School Department inter-fund accounts.

In addition, several other grant funds are maintained by the School Department that the City has on its general ledger, but no reconciliations are completed.

Recommendation

We recommend that the City and the School Department reconcile all inter-fund activity on a monthly basis to ensure they are in agreement.

Management's Response

The City of Cranston never had a disagreement with the School System regarding how much money the City of Cranston would provide the School System. The only disagreement between the City of Cranston and the School System was what should be included in the base for the School System budget.

The City of Cranston's Finance team has a very good working relationship with the School System. Each month, the City of Cranston provides monthly and year to date revenue and expense reports to the School System. If the School System has any discrepancies, the School System must notify the City of Cranston so that the appropriate adjustments can be made.

Regarding the inter-fund accounts, the City of Cranston is in the process of reconciling inter-fund accounts in FY 02. The City of Cranston has identified approximately 60 sets of inter-fund accounts (the "due to" receivable account matches up with the "due from" liability account). The reconciliation consists of comparing the monthly receivable data ("due from") to the corresponding monthly liability data ("due to"). If the amounts are the same, then that particular inter-fund set has been reconciled for that particular month. If the amounts are not the same, then research must be conducted to determine which transaction(s), during the month, made the inter-fund set fall out of balance.

Regarding the School Grant accounts, the City of Cranston must keep the fund and the accounts on its financial management system because all of the bills are paid by the City of Cranston. However, it is the School System and not the City of Cranston that receives the Grant financial details, reports, invoices and other related grant paperwork. The City of Cranston has no choice but to rely on the School System data, which will be used for financial statements.

ACCOUNTS PAYABLE

We discovered during our audit that the computerized general ledger system utilized by the City produced an inaccurate accounts payable report. Upon further examination, it was determined that the system automatically posts open purchase orders to the year in which it was generated instead of posting by the invoice date. This resulted in an exorbitant amount of hours spent by City employees to produce an accurate accounts payable report for all City funds.

Recommendation

We recommend that the City address the flaws within the computerized general ledger system it currently uses as it relates to the accounts payable function. In addition, the Auditing Department should ensure that all expenditures are being posted to the correct fiscal year. Eliminating errors in the accounts payable system will allow City employees to focus on important reconciliations, which, in turn, will improve the overall accuracy of the financial reporting system.

Management's Response

Despite significant efforts made by The City of Cranston's Information Technology Division, computer problems still persist. The City of Cranston agrees with the auditor that the current computerized system does not meet the City of Cranston's needs efficiently. Unfortunately, this is a system ~~the~~ administration has inherited and the administration is bound through contractual agreements into FY 2003.

Thanks to the increased efficiency of the Finance team, numerous compensating controls have been implemented to offset the deficiencies in the Admins system. These controls including developing a manual control log which is used to monitor open vouchers by fund. The control log can be compared to the ~~system-~~generated reports. We have also tightened controls relating to purchase orders. No new purchase orders will be issued after the first week of June. We will also liquidate any unpaid purchase orders by the second week in July. We believe that although these increased internal controls will add significant additional duties to our limited staff, that they will mitigate potential risks that may be associated with the Admins system.

The City of Cranston will continue to work very closely with the system provider, Admins Incorporated, to address system issues. The Finance team and all departments in the City of Cranston will continue to monitor system generated reports and communicate directly with the Information Technology Division for resolution as issues arise.

GENERAL LEDGER ACCOUNT ANALYSIS

The City does not fully analyze the financial activities occurring and recorded in the general ledger during the fiscal year. It is very important that basic analyses of all financial activities of the City be performed periodically (e.g. monthly) to help ensure those activities are fairly and accurately presented in the City's books. For example, the investment activity for the police and fire pension funds was not recorded during the fiscal year. By not recording the investment activity on a monthly basis, management is not able to reconcile the City's accounting records to the external monthly statements provided by the investment advisor.

GENERAL LEDGER ACCOUNT ANALYSIS (Continued)

Additionally, there were many general ledger accounts that could not be explained. For example, there were many funds that contained an account called "Administration and Payroll Expense". Many of these Administration and Payroll accounts consisted of a large balance at the end of the fiscal year. Upon examination of the detail of these accounts, it was discovered that the balances consisted of amounts for purposes other than administration and payroll expenses.

Further, at the end of fiscal 2001, there were numerous general ledger accounts that had no activity in fiscal year 2001. For example, during the audit of the Sewer Fund, an adjustment was made to record the 2001 receivable from the Howard Complex, which is considered to be a major source of revenue.

Another example of account analysis not being completed on a monthly basis is with regards to the General Long-Term Debt Account Group. None of the necessary information needed to complete the audit was gathered until requested. It was also noted that there were some cases where the City did not have all of the supporting documentation for the leases currently in place. Furthermore, the information needed for the accrued sick and vacation liabilities had to be manually computed.

Recommendation

We recommend that all of the various funds within the City be analyzed on a monthly basis. This will help to provide management with accurate financial reports from which informed decisions can be made. The investment activity for the police and fire pension funds should be posted to the general ledger on a monthly basis and compared to the investment advisor's monthly statement for accuracy. We also recommend that additional expense accounts be set-up to better describe the expenses of the funds. Miscellaneous expense accounts should only be used for small immaterial balances. Further, all information relating to the City's long-term liabilities should be maintained on a monthly basis. Accrued compensated absences information should be maintained in a computerized spreadsheet to prevent mathematical and other errors.

Management's Response

The City of Cranston recognizes the need for analysis of all financial activities. Also, the City of Cranston understands that monthly or quarterly reconciliation between the department's sub ledgers and the general ledger needs to be performed.

In FY 02, the City of Cranston has been conducting proper reconciliations. A team of 7 individuals meets periodically to discuss the end of month performance in the following key areas: Cash & Investments, Accounts Receivable & Taxes, Accounts Payable, Inter-funds, Accrued Expenses, Fixed Assets and Notes/Bonds Payable. The purpose of the meetings is to share information and to make sure data is properly reconciled between/among appropriate areas. For example, investment activity is being properly reconciled and recorded.

Management's Response (Continued)

The Investment Commission meets quarterly with its consultant, Paine Webber. The investment commission members receive a quarterly report and the commission members plus the consultant closely review the report during the quarterly meetings. The City of Cranston is conducting monthly reconciliations of the Paine Webber reports and making appropriate adjustments to the General Ledger.

The City of Cranston financial management system has approximately 1700 accounts (approximately 1250 Balance Sheet accounts and approximately 450 Income Statement accounts). The City of Cranston is well aware of the fact that each of these accounts needs to be reviewed and reconciled. It is a major task, which the City of Cranston will continue to address. The City of Cranston looks to consolidate and eliminate accounts wherever possible. In FY 03, all Fund 102 accounts will be eliminated.

The City of Cranston's financial management system does not calculate accrued sick and vacation liabilities. The City of Cranston has no other option but to perform this calculation manually. The administration is determined to work through or around the system as necessary.

TAX OVERPAYMENTS

During our audit of the various taxes collected for real estate, motor **vehicles and sewer, we** discovered that the overpayments made by taxpayers for their tax assessment billings **are not** being refunded or credited to their next billing. We have not computed the total overpayments for all of the various taxes, but the sewer overpayments alone are approximately \$100,000.

Recommendation

We recommend that the City develop procedures to ensure that taxpayers are refunded any overpayment or that the overpayment is credited to the next billing.

Management's Response

The City of Cranston has approximately 130,000 tax receivable records. The system should automatically credit an account if an overpayment is made. However, the City of Cranston does not issue refunds unless requested by the individual. This safety procedure has been implemented to ensure that refunds are provided to the correct individual. The City of Cranston Treasurer has been and will continue to monitor the aging report on a monthly basis.

SECTION II

*OTHER INTERNAL CONTROL
PROCEDURES*

FIXED ASSETS

The procedure of tagging the City's fixed assets is currently not being followed by all of the departments within the City. Furthermore, not all of the necessary paperwork for keeping track of the fixed assets is being completed. For example, there was one instance where two assets had the same tag number on the fixed asset listing. In addition, there were also several instances where fixed assets from the fixed asset listing could not be physically located. Upon further investigation, it was determined that majority of these fixed assets had been sold or scrapped prior to the end of the fiscal year. It is crucial that all fixed assets that are sold or scrapped be removed from the fixed asset listing. In addition, there were several fixed assets that could not be physically located within the Fire Department due to the fact that they had been transferred from one station to another. In these cases, the necessary paperwork for transferring a fixed asset was not completed. An important element of sound financial management is the safeguarding of the municipal's fixed assets. By not adhering to proper procedures, safeguarding the assets becomes more difficult.

This issue takes on even greater importance with the implementation of Governmental Accounting Standards Board Statement 34, which is discussed in a separate management comment. GASB 34 mandates that infrastructure assets such as roads and sidewalks, be capitalized and all general fixed assets, including infrastructure assets be depreciated. Based on our observations, virtually no work has been performed in this area to address the implementation of GASB 34, which is effective for the fiscal year beginning July 1, 2001.

Recommendation

We recommend that the City personnel affix the required identification tags to all fixed assets and reconcile additions and deletions to the detail fixed asset reports on a monthly basis. All of the necessary paperwork regarding additions, deletions, and transfers should be completed in a timely fashion and the fixed asset listing should be updated accordingly to ensure an accurate listing.

Further, we recommend that City officials assign responsibility of implementation of GASB 34, specifically as it relates to fixed assets, to an individual with the training and ability to accomplish this task as quickly as possible.

Management's Response

The City of Cranston has been working to update its fixed asset records and to inform division and department heads of their fixed asset responsibilities. The Purchasing Division has been addressing this task and the Internal City Auditor will supervise. A report has been prepared which lists the City of Cranston's fixed assets. This report will be sent to each of the respective department/division heads for updating. The report will be reconciled by the Purchasing Division with the actual purchases made by the respective department/division heads.

CASH FLOW MANAGEMENT

We believe that the City's cash management and control activities are weak. This situation, of course, stems in large part from the operating deficits sustained by the City. An example is a lease payment for the computer system in the amount of \$349,910 was due on March 1, 2001. The bill was not paid until August 2001, causing the City to incur an additional \$18,000 in interest. In addition, the City's bank charges related to the poor management of cash increased significantly from \$14,500 for fiscal year 2000 to \$82,700 for fiscal year 2001.

CASH FLOW MANAGEMENT (Continued)

Recommendation

We understand that the City has developed a plan of action to gain better control of the cash flow situation. We recommend that the City continue to closely monitor cash management.

Management's Response

The Finance Department has been developing cash flow reports for the last few months and will develop the cash flow reports on a bi-weekly basis.

Regarding the delay in the lease payment of \$348,810, the auditor is incorrect to state that the delay was due to cash flow. The former Director of Administration decided not to pay the invoice in FY 01. The company that received the late payment was well aware of the City of Cranston's plan and provided the City of Cranston with a revised bill that was paid on August 1, 2001. In FY 2002, the city made two payments to bring its obligations current.

Regarding the auditors comment regarding bank charges, please note the following 2 comments:

1. The City of Cranston did not award its banking contract to Fleet Bank. It awarded its banking contract to Bank Boston on December 15, 1998. When Bank Boston was purchased by Fleet Bank, things changed and expenses increased. The City of Cranston had several meetings with Fleet Bank personnel to try to find a way to reduce the monthly bank charges. Unfortunately, the City of Cranston did not have many options other than leaving more money with Fleet Bank, possibly lowering some of the bank charges, but leaving less money with Financial Investors Trust, the holding financial institution for the City of Cranston. The City of Cranston worked with Fleet Bank to minimize expenses. For example, the city reduced the number of accounts it had 'swept' on a daily basis because the service fees for certain accounts was no longer cost effective.
2. The City of Cranston generated over \$990,000 in interest income in FY 2001.

COMMUNITY DEVELOPMENT DEPARTMENT

During our audit of the Community Development Department, we discovered that the computerized accounts receivable system the department is using does not appear to be adequate for its current needs as the data produced by the system is not always reliable. For example, there was one residential loan of approximately \$15,000 that had been paid off, but which continued to be shown as outstanding on the accounts receivable listing. In addition, a \$17,000 balance was being shown as outstanding on a property that was foreclosed in February, 2001. It is essential for the department to have a reliable computerized system to aid in the process of accurate reporting.

COMMUNITY DEVELOPMENT DEPARTMENT (Continued)

Recommendation

We recommend that the necessary changes be made to the computerized system to ensure accurate reporting. If the preceding is not a viable option, the department should look into the option of purchasing a new system. We would be happy to assist the department in the process of finding a system that is both accurate and cost efficient in nature.

Management's Response

The City of Cranston has recognized this issue and will take the necessary corrective action to implement manual controls to reconcile the system-generated amount to the amounts outstanding in the loan file. Please note that the City of Cranston is mandated to use a program provided by the Department of Housing and Urban Development.

PROBATE FUNDS

During our audit, we discovered that the City of Cranston has custody of several probate accounts totaling approximately \$14,000. Upon further examination, it was discovered that the City Clerk's Office has custody of these accounts with the City Clerk having signature authority. There was also no knowledge of these accounts by the City's Finance Director. Per the City's policies the Finance Director should have knowledge of and control over all City finances.

Recommendation

We recommend that the custody of the probate accounts be kept within the Finance Department of the City. We also recommend that the authorized signature be changed to the Finance Director.

Management's Response

The City of Cranston has recognized this issue and will take the necessary corrective action.

DEPOSIT CASH RECEIPTS ON A TIMELY BASIS

We discovered during our audit that not all of the departments submit their deposits to the Tax Collector's Office on a timely basis. It was also noted that the City Treasurer is not aware of the controls that exist as the deposits are transferred from one department to another. As a result, not only is there a risk of loss from burglary, misplacement or misappropriation, but also the cash is not available for expenditure or investment.

DEPOSIT CASH RECEIPTS ON A TIMELY BASIS (Continued)

Recommendation

We recommend that deposits be made on a timely basis both to improve cash flow and to reduce the risk of loss. We also recommend that a written policy be established regarding the timely deposits of all funds of the City, including departmental receipts.

Management's Response

The City of Cranston Treasurer has and will continue to work hard with the division and department heads to ensure timely deposits.

Regarding the control issue, the City of Cranston has recognized this issue and will take the necessary corrective action.

CITY COUNCIL MINUTES

During our audit, we discovered that there were some cases in which the minutes to the City Council meetings had not been signed prior to being available for public use. It is imperative that all minutes be signed by the appropriate individual to ensure that they have been properly recorded and approved.

Recommendation

We recommend that the minutes from all of the City Council meetings be signed before being available for public use.

Management's Response

The City of Cranston has recognized this issue and will take the necessary corrective action.

PAYROLL

While examining the internal controls over the payroll function, we found that 10 of the 60 employees selected did not have an I-9 form in their file. The federal government mandates that an I-9 form be obtained for every employee hired after November 1986. There were also two employees that did not have a W-4 form in their file. This could result in incorrect withholdings from an employee's paycheck.

Recommendation

We recommend that the City of Cranston obtain an I-9 form for all employees hired after November 1986 and that the City obtain and keep on file an up-to-date W-4 form for all active employees.

PA YROL L (Continued)

Management's Response

The City of Cranston has recognized this issue and will take the necessary corrective action.

BASIC FINANCIAL STATEMENTS

As we have briefly discussed during previous meetings, the Governmental Accounting Standards Board has recently issued a new standard governing the form and content of your basic financial statements. Specifically, Statement 34 requires the City to include expanded information in the following areas:

- Management's Discussion and Analysis – Intended to provide the narrative introduction and overview that users need to interpret the basic financial statements and the City's financial activities.
- Government – Wide Financial Statements – Financial statements that are prepared using the same measurement focus rather than several different measurement focuses for the entire reporting entity.
- Fund Financial Statements – Governmental funds will require a Balance Sheet and a Statement of Revenues, Expenditures, and Changes in Fund Balances, each emphasizing the newly determined "major" funds. Proprietary funds will require the same three statements as were required before implementation of the Standard; however, the statements will emphasize only "major" enterprise funds rather than both enterprise and internal service funds. Fiduciary fund types are changing drastically upon implementation of the Standard. All fiduciary fund types will use the same financial statement format as those currently used for the pension plans.
- Capital Asset Reporting - Infrastructure assets will be required to be capitalized and all general fixed assets, including infrastructure assets will be required to be depreciated.

The date by which the City must adopt the financial statement provisions of the Standard is June 30, 2002, and is based on the revenues recognized in the City's June 30, 2000 financial statements. The date by which the City must adopt the infrastructure and depreciation provisions of the Standard is June 30, 2006. We were involved with the Town of Warren's early implementation for the June ~~30, 2000~~ fiscal year, the first government in Rhode Island to adopt the Standard.

Currently, City officials have not adequately addressed the implementation of GASB 34. For successful implementation, many phases of the implementation process should have already been completed. The City is very late in addressing virtually all aspects of GASB 34.

BASIC FINANCIAL STATEMENTS (Continued)

Recommendation

We recommend that the City consider implementing the necessary expanded disclosures as soon as possible. We believe that the changes required by the Standard will make the City's financial statements more informative and useful to readers. We would be pleased to discuss this implementation in greater detail and assist with your transition.

Further, we recommend that City officials appoint an individual to spearhead the implementation of GASB 34. A great deal of work remains to be done in this area.

Management's Response

Steps have already been taken by the City of Cranston to address the new accounting and reporting model – GASB 34. The Finance Director and the Controller have been exposed to the new standards from following and attending related seminars, discussions, and plans of action.

The City of Cranston has recognized this issue and will take the necessary corrective action.

Appendix **D**



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**AUDITORS' REPORT ON COMPLIANCE AND ON INTERNAL CONTROL
OVER FINANCIAL REPORTING IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS**

The City Council and School Committee
City of Cranston, Rhode Island:

We have audited the general purpose financial statements of the City of Cranston, Rhode Island, as of and for the year ended June ~~30, 2000~~, and have issued our report thereon dated December ~~31, 2001~~. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the City's general purpose financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the City's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the general purpose financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we considered to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the City's ability to record, process, summarize and report financial data consistent with the assertions of management in the general purpose financial statements. Reportable conditions are described in the accompanying schedule of current year findings and questioned costs (Exhibit IV) as ~~items 00-1 through 00-09~~.





The City Council and School Committee
City of Cranston, Rhode Island

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the general purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items 00-1 through 00-09 to be material weaknesses.

This report is intended solely for the information and use of the Mayor, City Council, School Committee, other elected officials, management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

January 14, 2002

CITY OF CRANSTON, RHODE ISLAND

Schedule of Current Year Findings and Questioned Costs

Year ended June ~~30, 2000~~

(2) **Relating to Financial Statements Findings Reported in Accordance with *Government Auditing Standards***

Status of Prior Year Comments

The June 30, 2000 audit revealed that there has been no substantial attention paid to the comments provided to City **officials** in previous years. Although nearly all of these comments were identified as material weaknesses none have been adequately addressed. Such a situation exposes the City to financial risks and delays in financial reporting until appropriate corrective action is taken.

The City Council and Mayor must devote adequate personnel and other resources to addressing these issues to mitigate risks that may impact the City including the delay or loss of state and federal assistance. The lack of proper action on the part of the City to the comments and recommendations in the previous years' management letters has resulted in a significant delay in the issuance of the June 30, 2000 financial statements.

At the urging of KPMG, the Finance Department has initiated steps to help minimize future delays in financial reporting and improve the data being reported. However, these efforts will not produce measurable results without adequate **staffing** and reliable automated systems. Currently, the lack of effective automated and manual financial systems exposes the City to risk that data being reported is neither accurate nor reliable.

With regard to Cranston Public Schools, many significant improvements have been made from the 1999 audit to the 2000 audit. The implementation of a new computer system adequate skilled staffing and proper and timely monitoring of the School's activities has resulted in an operation that can produce timely and accurate financial reports. Unfortunately, the delays encountered by the City have precluded the issuance of the School's financial statements.

All of the comments presented below are considered material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the general purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. The Comments, many of which were included in the 1998 and 1999 management letters, are as follows:

00-1: Responsibility for Financial Reporting

The City's finance personnel are responsible for performing the accounting and reporting of all City activities. This includes the preparation of the City's annual financial statements – the City's independent auditors cannot prepare the City's financial statements and remain independent. The belief that the financial statements belong to the auditor is not correct. In reality, the auditor is

CITY OF CRANSTON, RHODE ISLAND

Schedule of Current Year Findings and Questioned Costs

Year ended June 30, ~~2000~~

responsible for auditing the City prepared financial statements and rendering an opinion on those financial statements.

Accordingly, the auditor cannot complete an audit until the City has fully discharged its responsibility, including the preparation of the financial statements. Thus, delays in the preparation of the financial statements result in delays in the completion of the audit.

To address this comment, the City must ensure it has adequate resources to carry out its responsibilities. Management, including the Mayor and the City Council, must take some action. A **first** step would be to determine whether the number and skill level of the current personnel are adequate to carry out the required accounting and reporting functions and, if necessary, make appropriate changes.

A similar comment was included in the 1998 and 1999 management letters.

Management Response:

It was never this Administration's belief that the financial statements belong to the auditor. In fact, the task of preparing the City's financial statements was specifically assigned to the new internal auditor, which the City hired in January of 2001.

We are deeply troubled by the auditor's assertion, which seems to indicate that the City of Cranston has failed to carry out its responsibility of preparing the financial statements. We strongly believe that those financial statements were first prepared by us, and then submitted to the auditor for his review and audit, as evidenced by the electronic **email** sent on November **6, 2001** to KPMG.

In concert with KPMG, a plan of action was put together by the Finance Department for the purpose of arriving at a conclusion of the audit process. The preparation of the financial statements was at the tail end of that plan, and was contingent upon other steps being completed first. In fact, at the urging of KPMG, we were instructed not to record or post any more journal entries until they approved such entries.

For the reasons stated above, we don't agree with the auditor's comment that the delays in the preparation of the financial statements cause the delays in the completion of the audit.

00-2: General Ledger

The City's current computerized general ledger system does not appear to be adequate for its current needs and the data produced by the system is not always reliable. For example, during the audit of fiscal 2000, it was discovered that the system had been producing and the City had been using an accounts payable report that was found to be erroneous. Additionally, as noted in prior audits, the

CITY OF CRANSTON, RHODE ISLAND

Schedule of Current Year Findings and Questioned Costs

Year ended June 30, ~~2000~~

system allows users to enter 'One-sided' entries into the system, a critical flaw that can severely impact the integrity of the City Financial accounting and reporting ability.

Additionally, the City's ledger still contains several funds that are unnecessary and that contain activities that are not readily determinable. The existence of funds and the fact that they are not monitored on a regular basis can create a situation where errors could occur and not be detected in a timely fashion.

A similar comment was included in the 1998 and 1999 management letters.

Management Response:

Despite significant efforts made by The City of Cranston's Information Technology Division, computer problems still persist. The City of Cranston agrees with the auditor that the current computerized system is not an easy one to deal with and has been shown to contain many flaws. Unfortunately, this is a system the Mayor O'Leary administration has inherited, and the administration is bound through contractual agreements into FY 2003.

Thanks to the increased efficiency of the Finance team some improvements have been made. Numerous compensating controls have been put in place by management for the sole purpose of mitigating potential risk that may be associated with the system.

The City of Cranston will continue to work very closely with the system provider, Admins Incorporated of Boston, Massachusetts, to address system issues. The Finance team and all departments in the City of Cranston will continue to monitor system-generated reports and communicate directly with the Information Technology Division for resolution as issues arise.

Although the system may allow for 'One-sided' entries, no such entries have been made since FY 1999. The 'One-sided' entries made in FY 1999 were only entries completed at the request of Admins Incorporated.

00-3: Departmental Reconciliations

An important control procedure that needs to be performed is reconciling all activity recorded in the City's general ledger to the detail records maintained within the various City departments. Ideally, such a procedure should be performed monthly, but quarterly reconciliations may be adequate.

Performing such reconciliations helps ensure that all activity is being properly reported and helps reduce the risk of errors. Although all departments need to be reconciled, the major department where such a reconciliation is critical is the Cranston Public Schools.

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This absence of proper reconciliation controls results in general ledger information that is not supported by the records of the Cranston Public Schools. The City and School should consider eliminating the duplicate accounting records by accounting for certain activities on only one set of books. A reasonable compromise would be for the School to maintain the detail accounting activities on its books and the City to maintain a 'control' account on its books. Such an arrangement would simplify the reconciliation process while allowing the City to effectively monitor and control school finances.

Other major reconciliations that need attention include cash accounts and receivable accounts, including water and taxes receivable.

The City Council needs to address this situation in order to help minimize the potential for unauthorized or inappropriate transactions and to help ensure the activities of the various City departments, including the School department are properly reflected on the City's general ledger.

A similar comment was included in the 1998 and 1999 management letters.

Management Response:

Concerning City of Cranston reconciliations with the School System, communication between the City of Cranston and the School has considerably improved in terms of exchanging and sharing financial data. Since November of 2000, the City of Cranston has been providing the School System with monthly and year to date Revenue & Expenditure reports and with a monthly and year to date Balance Sheet. Regular meetings frequently occur to discuss various issues affecting one party or the other. The School System and the City of Cranston have already come to an agreement whereby exclusively the School will maintain Funds 420 thru 423. Management has already put in place a system whereby the School System's activities within the General Fund are closely monitored and reconciled almost on a daily basis.

Concerning internal City of Cranston reconciliations, since the beginning of FY 2002, the City of Cranston has been conducting proper reconciliations. A team of 7 individuals meets periodically to discuss the end of month performance in the following key areas: Cash & Investments, Accounts Receivable & Taxes, Accounts Payable, Inter-funds, Accrued Expenses, Fixed Assets and Notes/Bonds Payable. The purpose of the meetings is to share information and to make sure data is properly reconciled between/among appropriate areas.

00-4: General Ledger Account Analysis

The City does not fully analyze the financial activities occurring and recorded in the general ledger during the fiscal year.

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It is extremely important that basic analyses of all financial activities of the City be performed periodically (e.g., monthly) to help ensure those activities are fairly and accurately presented in the City's books. Such analyses should include receivables from and payables to the School. Additionally, there are many accounts on the general ledger that could not be explained. Further, at the end of fiscal 2000, there were nearly 100 general ledger accounts that had no activity in fiscal 2000.

As with the 1999 financial statements, the lack of periodic analyses has unnecessarily delayed the issuance of the City's 2000 financial statements.

Because reconciliations were not performed on a timely basis in fiscal 2000, the City required the help of an outside consultant to reconcile the activity in its major bank account.

A similar comment was included in the 1998 and 1999 management letters.

Management Response:

The City of Cranston recognizes the need for analysis of all financial activities. Also, the City of Cranston understands that a monthly or quarterly reconciliation between the department's sub ledgers and the general ledger needs to be performed.

The following was a reply used for ~~00-4~~ but it is certainly appropriate for 00-5: Since the beginning of FY 2002, the City of Cranston has been conducting proper reconciliations. A team of 7 individuals meets periodically to discuss the end of month performance in the following key areas: Cash & Investments, Accounts Receivable & Taxes, Accounts Payable, Inter-funds, Accrued Expenses, Fixed Assets and Notes/Bonds Payable. The purpose of the meetings is to share information and to make sure data is properly reconciled between/among appropriate areas.

00-5: Controls Over Financial Reporting

Management of the City is responsible for the preparation of the City's financial statements and preparing the financial statements for the City would not be a difficult task if departmental reconciliations and general ledger account analyses are done monthly.

Unfortunately, the internal controls that should be in place to allow for the timely preparation of the financial statements are also the same controls that the Mayor, City Council and City management should rely on to ensure the integrity of the data they receive and use for making decisions.

Without these controls, the obvious and most often criticized result is a delay in the preparation of the financial statements. However, City management should be more focused on ensuring controls are in place so that data is more reliable and decisions are made based on reliable data.

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Management Response:

This issue is a combination of 00-1: Responsibility for Financial Reporting, 00-2: General Ledger 00-3: Departmental Reconciliations and ~~004~~: General Ledger Account Analysis.

There are 3 pieces to the 00-5:

1. Who is responsible for preparing financial statements?
2. Does the city have a good financial management system?
3. Does the city reconcile and analyze the data in the financial system?

The City of Cranston's response to question 1 was provided with the reply to 00-1. The City of Cranston's response to question 2 was provided with the reply to 00-2. The City of Cranston's response to question 3 was provided with the reply to 00-3 and ~~004~~.

00-6: Interfund Account Receivables and Payables

For the last three years, the City's inter-fund receivable and payable accounts have been significantly out of balance. These accounts represent loans between various funds of the City and accordingly amounts receivable in one fund must be offset with payable amounts in other funds. At June 30, 1998, the year end accounts were out of balance by \$818,000. In the general ledger provided to **KPMG** by the City, the accounts were out of balance by \$1.6 million at June 30, 1999 and were out of balance even more at June ~~30,2000~~.

In addition to the out-of-balance condition, the inter-fund accounting is further complicated by the large number of funds that exist and the number of extraneous inter-fund general ledger accounts. Finally, many inter-fund accounts are not properly labeled or classified as such. – many being labeled "Accrued Interest".

An analysis of all inter-fund accounts needs to be performed immediately in order to ensure that all amounts borrowed and lent agree and are collectible by the receiving fund. Without such an analysis, the City may ultimately need to write-off uncollectible amounts thus impacting the existing equity amounts.

For June ~~30,2000~~, the collectibility of over \$10 million of inter-fund receivables was questioned.

A similar comment was included in the 1998 and 1999 management letters.

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The City of Cranston recognizes the need for Inter-fund account analysis. There have been and there will continue to be significant efforts made to reconcile the complex interfund system which this administration inherited with an inconsistent financial management system.

It isn't for the last three years that the City of Cranston's inter-fund receivables and payables have been out of balance. This situation has existed long before that, as reported by the predecessor auditors who performed the City's audit 6 or 7 years ago, in a meeting attended by KPMG on November ~~8, 2001~~.

Further, according to the City of Cranston records, at June ~~30, 2000~~, the inter-fund accounts were out of balance by approximately \$550,000 which would represent a reduction of over \$1 million from the June ~~30, 1999~~ imbalance.

00-7: Retirement System

The funded status of the Police and Fire Retirement Plans continues to deteriorate. The City's inability to develop a plan to adequately deal with this situation has resulted in a going concern paragraph being included in the audit opinion for fiscal 2000. Left unaddressed, this situation can result in significant costs to the City's general fund and ultimately its taxpayers.

A similar comment was included in the 1998 and 1999 management letters.

Management Response:

The City of Cranston is deeply committed to fixing a problem the new administration inherited.

The administration was successful in enacting legislation in FY 2000 which would have allowed the City of Cranston to possibly transfer up to 40 individuals from the under funded City pension system to the over funded State pension system. Unfortunately, the Internal Revenue Service may not allow the State of Rhode Island approved legislation to be implemented.

The administration was successful in enacting legislation in FY 2001, which would have allowed the City of Cranston to sell Pension Obligation Bonds, thereby effectively eliminating the unfunded pension liability. Unfortunately, the Governor vetoed the State of Rhode Island approved legislation.

The administration is acutely aware of the seriousness of the unfunded pension liability. Actuarial studies show that the City of Cranston will pay out over \$1.2 billion before the city police and fire pension system is extinct. The administration needs the ability to sell Pension Obligation Bonds to properly address the unfunded pension liability. The administration modified the FY 2001 Pension

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Obligation Bond legislation, reviewed the Governor's veto message, inserted additional controls and submitted a FY 2002 Pension Obligation Bond bill.

00-S: Actuarial Valuation for Self-Insured Liabilities

After repeated management letter comments, the City had, as of December 20, 2001, still not obtained an actuarial valuation for its self insured health claims or other self insured liabilities. Obtaining an actuarial valuation is the most common method for assessing the extent of the liability the City has incurred relative to its self insured risks. Without such a valuation, the amount of the liability cannot be effectively estimated.

A similar comment was included in the 1998 and 1999 management letters.

Management Response:

Buck Consultants completed the requested actuarial valuation for the City of Cranston's self-insured health claims and or other liabilities on December 21, 2001.

00-9: Reconciliation Between the City's General Ledger and the School's General Ledger

An important control procedure that needs to be performed before the School's financial statements can be issued is a reconciliation of all of the activity and balances recorded in the Cranston Public Schools' records with the activity recorded on the City's general ledger. Ideally, such a procedure should be performed monthly, but quarterly reconciliations may be adequate. Included in this reconciliation must be agreement between the expenditure made by the City's general fund and recorded as revenue by the School as well as any amount owed by the City's general fund and recorded as a receivable by the School.

This reconciliation is the most important reconciliation that needs to occur to ensure that the activities of the School are properly reflected in the City's general fund and its financial statements.

In addition, several other grant funds are maintained by the School Department that the City has on its general ledger, but no reconciliations are done. As recommended in the past, the duplicate accounting should either be reconciled or be eliminated and all activity could be accounted for on only one set of book. A compromise would be for the School to maintain the detail accounting activities on its books and the City to maintain a 'control' account on its books.

As recommended in the past, the City Council and School Committee need to address this situation in order to ensure that all activities between the School and the City are properly tracked and accounted for in a timely fashion.

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A similar comment was included in the 1998 and 1999 management letters.

Management Responses:Response from Cranston Public Schools

Cranston Public Schools has and continues to reconcile financial data posted on its general ledger system for both the operating budget and grant programs as compared to similar transactions posted on the City's financial system on a monthly basis. This is accomplished via the review of detail transaction reports received from the City's Finance Office each month. Upon review of the transaction reports any and all discrepancies are brought to the attention of the City Finance Office personnel by the School Business Office so that corrections can be made prior to the receipt of the subsequent month reports.

Furthermore, it is the policy of the School Business Office to verify that all School District revenue and expenditure transactions for both the operating budget and grant programs are communicated to the City Finance Office prior to the close of a given fiscal year. Also, a memo identifying both year-end account receivables and payables is sent to the City Finance Office by the School Business Office so that the amounts can be posted to their accounting system.

In conclusion, the School Business Office however has no control over how or if School related financial information is properly accounted for by the City. What has been and continues to be our policy is to point out discrepancies and request correction.

Response from City Management

Concerning the comments made in paragraphs 1 and 2, the administration already responded with its reply to Comment 00-3: Departmental Reconciliations.

Concerning the comments made in paragraph 3, it is the City of Cranston that pays the bills, manages the cash flow and maintains the accounting entries for the School System. The city does not have the detail the School System has. The School System needs to contact the City of Cranston if there is an issue with the monthly reconciliations the School System receives.

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00-10: New Reporting Model

For fiscal 2002, the City is faced with complying with a new accounting and reporting standard – GASB No. 34. The complexities of this standard must be fully understood by the Mayor, City Council and City management. Without a complete understanding of the new standard, the City will have an extremely difficult time preparing its financial statements and explaining those financial statements to the rating agencies. Additionally, a lack of planning for and attention to the implementation of the standard will unnecessarily delay the issuance of future financial statements.

Management Response:

Steps have already been taken by City Management to address the new accounting and reporting model – GASB 34. The Finance Director, the Controller and City Auditor have been exposed to the new standards from following and attending related seminars, discussions, and plans of action.

Last Spring when the City of Cranston issued a **RFP** in search of new auditors, specific provisions relative to GASB 34 were included to ensure that the City of Cranston's new auditors are on top of this issue. This partly led the City of Cranston choosing to hire the **firm** Cayer Prescott Clune Chatellier, which has performed an audit using GASB 34 guidelines. **Internal** discussions have taken place involving many heads of department. With the collaboration of the new auditor, we expect to be ready to be in compliance with the new standards.

(3) Findings and Questioned Cost Relating to Federal Awards

None to report.

Appendix **E**



State of Rhode Island and Providence Plantations
DEPARTMENT OF EDUCATION
Shepard Building
255 Westminster Street
Providence, Rhode Island 02903-3400

Peter ~~McWalters~~
Commissioner

April 5, 2002

Mr. Ernest A. Almonte, CPA, CFE
Auditor General
1145 Main Street
Pawtucket, RI 02860

Dear Mr. Almonte,

Thank you for inviting us to assist your office in addressing the current financial problems facing the city of Cranston. As you requested in your letter dated March 20, 2002, I convened a team of education finance and legal specialists to help review the Cranston School Department budget and to recommend a course of action that would not dismantle Cranston's schools.

Attached for your review is a report outlining our findings and recommendations. Specifically, we propose for the Cranston School Department a Fiscal Year 2003 balanced budget of **\$94,426,786** which is \$124,252 lower than the FY 2002 enacted budget and represents cuts totaling more than \$7.5 million from a *level services budget*.

Please know that we do not make this recommendation lightly. We are deeply troubled that this municipal fiscal crisis is jeopardizing the School Department's efforts toward implementing real education reform. We strongly oppose any cuts beyond our recommended level. The Cranston School Department already manages a lean budget and has done so responsibly for several years. Over the next few months they will also be feeling increasing state and federal pressure to improve student performance in their low performing schools. Education reform is challenging for any district. It will be daunting for Cranston in this fiscal environment. Additional cuts would make their task impossible. Indeed, we believe that reductions below our recommended level would destroy what is otherwise a relatively healthy and improving school system and squander past city and state investments in reform.

Thank you again for inviting us to participate in this process. We will continue to be available to assist in any way you see appropriate.

Sincerely,

Peter ~~McWalters~~
Commissioner

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