California State Auditor

BUREAU OF STATE AUDITS

City of Richmond:

Poor Spending Decisions and Weak Monitoring of Its Finances Caused Its Financial Decline and Hinder Its Ability to Recover

December 2004
2004-117

The first five copies of each California State Auditor report are free. Additional copies are $3 each, payable by check or money order. You can obtain reports by contacting the Bureau of State Audits at the following address:

California State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814
(916) 445-0255 or TTY (916) 445-0033

OR

This report is also available on the World Wide Web
http://www.bsa.ca.gov/bsa/

The California State Auditor is pleased to announce the availability of an on-line subscription service. For information on how to subscribe, please contact the Information Technology Unit at (916) 445-0255, ext. 456, or visit our Web site at www.bsa.ca.gov/bsa

Alternate format reports available upon request.

CALIFORNIA STATE AUDITOR

ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

December 7, 2004

2004-117

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning our review of the city of Richmond (city) with a focus on the factors that contributed to its financial crisis. This report concludes that the city drained its financial assets and jeopardized its financial stability because it failed to control spending while its revenues decreased. Between 1998 and 2003, the city entered into agreements with its six employee unions that significantly increased salaries and improved retirement benefits. Unreasonable budget estimates in fiscal years 2002–03 and 2003–04, some of which were intentional, and ineffective budget monitoring masked Richmond's overspending and the city did not take timely action to reduce its costs.

In March 2004 the city introduced a corrective action plan to rectify the city's deficit and build long-term financial health. Since that time, the city has taken steps to reduce its costs by renegotiating certain benefits in its labor agreements and increase its revenues by placing a half-cent sales tax increase on the November 2004 ballot that voters approved. Although the city is moving in the right direction, it is too soon to tell whether the actions the city has already taken and plans to take in the future will be sufficient to restore its financial health.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

CONTENTS

SUMMARY

Audit Highlights . . .

Our review found that the city of Richmond's (city) financial health deteriorated because it:

- ☑ ***Significantly increased employee salaries and retirement benefits without ensuring it would have adequate funds to pay for them.***
- ☑ ***Agreed to increase some salaries to exceed those of other cities without knowing what the amounts would be and without limiting the increases.***
- ☑ ***Underestimated how much it would spend out of its general fund, sometimes intentionally, and delayed making spending reductions.***
- ☑ ***Relied on inaccurate reports to monitor and adjust the budget.***

Since March 2004 the city has taken steps to improve its financial health and how it monitors its finances.

RESULTS IN BRIEF

In reviewing its midyear progress for fiscal year 2003–04, the city of Richmond (city) announced in March 2004 that during the previous fiscal year, several funds had greater outflows than inflows and some funds had large negative cash amounts. Most significantly, during fiscal year 2002–03, expenditures exceeded revenues by $14.5 million in the city's general fund—its main operating fund—and the fund had an $8.3 million negative cash amount as of June 30, 2003.

The imbalance between the city's inflows and outflows was largely caused by its failure to control spending. Although the city expected to increase revenues to make up for the increased spending, its expectations for swift revenue increases were overly optimistic and did not materialize. Personnel costs represent the largest portion of the city's spending and contributed significantly to the city's increased costs, the result of salary increases ranging from 16 percent to 27 percent for most employees between 2000 and 2003. The city also enhanced its employees' retirement benefits, thereby increasing its obligation to the retirement system; in some cases, retirement benefit costs exceed 30 percent of what it pays employees in salaries. The city council believed that the increases were necessary to be competitive with other cities and to attract and retain qualified employees. However, it agreed to increase some salaries to exceed those of other cities without knowing what the amounts would be and without setting limits on the increases. Additionally, the city council enhanced retirement benefits, knowing that the benefits would be a significant expense and without having set aside funds to prepare for the increases.

Although the intent of the city council's decisions was to improve services to the public, the effect appears to have backfired. In fact, because the city's costs increased rapidly while its revenues did not, the city has laid off 250 of its staff since March 2003, drastically cut funds to some of its programs, and diminished its reserves. To improve its financial outlook, the city's revenues must not only align but also exceed its expenditures to make up for past deficits and rebuild its resources, a direction the city has been heading with recent revenue increases and cost reductions.

The city's budget preparation and monitoring processes were disjointed and therefore did not identify that the city council's decisions would cause a deficit in fiscal years 2002–03 and 2003–04. Consequently, the city council did not make decisions to reduce spending until after the city had spent more money than it could afford. The city's budget process failed in part because the city significantly underestimated what it would spend on personnel, bond payments, and insurance during fiscal year 2002–03. Additionally, the city deliberately underbudgeted certain expenditures to balance its fiscal year 2003–04 budget.

The finance department's quarterly and midyear reports, which it provides to the city council to monitor the budget, should have indicated what the budgets did not: that the city's outflows would exceed its inflows. However, the reports from the finance department for fiscal year 2002–03 did not disclose that information. Instead, the updated spending estimates the finance department reported to the city council incorrectly showed that the city could afford the increases using reserve funds. The department's calculations of the city's general-fund reserves were incorrect, mostly because they did not include all outflows, such as transfers from the general fund to other funds. The quarterly and midyear reports also did not show other indicators of the city's financial troubles, such as the cash position of the city's individual funds and losses in other funds, including its workers' compensation and general insurance funds. As a result, the city council was not fully aware of the city's serious financial predicament until the city released its audited financial statements. The financial statements disclosed losses and negative cash amounts nearly one year after the end of the 2002–03 fiscal year, at which point the city began taking corrective action. Although the city has taken steps to improve its monitoring procedures, to some extent the problems continued throughout fiscal year 2003–04.

Since the city discovered its financial deterioration, it has taken steps to improve its financial health and how it monitors the finances of the city. Specifically, in March 2004, the city published a corrective action plan to eliminate negative cash amounts and reduce costs by June 30, 2004, while the city implemented longer term solutions, such as increasing the sales tax and renegotiating certain benefits with its six employee unions. Additionally, in September 2004, the interim city manager issued an assessment that enumerated specific tasks needed to strenghten the city's fiscal and organizational structure. The tasks in this assessment include having departments submit monthly reviews of their budgets and ensuring the city completes its financial statements by the end of the calendar year. However, it is too soon to tell whether the actions the city has already taken and plans to take in the future will be sufficient to restore its financial health.

RECOMMENDATIONS

To ensure that the city has sufficient funds to meet its operating costs and does not spend more than it can afford, Richmond should do the following:

- When negotiating agreements with its employee unions, consistently analyze salary and benefit increases to determine the long- and short-term effects the increases will have on the city's budget.

- Cease raising salaries based on amounts outside the city's control. If the city chooses to continue to base its salaries on those of other cities, it should ensure that its agreements with employee unions include limits to the amounts the city will raise the salaries.

To reestablish the value of the budget as an essential planning tool, Richmond should budget for all likely expenditures and not knowingly adopt budgets that reflect inaccurate estimates of expenditures or revenues. If the city needs to reduce expenditures to balance the budget, it should promptly take cost-cutting measures.

To improve the quality of the financial information that the city council uses to make budget changes during the year, the city's finance department should take the following steps:

- Monitor the amount of reserves the city has during the year, using a method that includes all inflows and outflows.

- Include information on the status of other city funds, not just the general fund, in its quarterly and midyear reports.

AGENCY COMMENTS

The city is in general agreement with the recommendations and facts in the report. ■

Blank page inserted for reproduction purposes only.

INTRODUCTION

BACKGROUND

Incorporated in 1905, the city of Richmond (city), in western Contra Costa County, had a population of 101,400 as of 2003, according to estimates from the California Department of Finance. Located 16 miles northeast of and directly across the bay from San Francisco, the city boasts 32 total miles of shoreline and a central Bay Area location situated near major metropolitan cities. The California Constitution and the provisions of the city charter charge the city with making and enforcing all regulations and ordinances regarding municipal affairs and to maintain a city police force and fire department, among other duties. The city is authorized to levy and collect taxes and assessments and charge fees for services that it provides to residents and businesses.

A nine-member, publicly elected city council governs the city.[1] The city council establishes comprehensive goals and objectives for the city, provides leadership in establishing policies for the conduct of city business, and formulates priorities for allocating city resources. To carry out its policies, the city council appoints a city manager who is responsible for directing departments, providing day-to-day leadership in policy development and implementation, and directing administrative functions, including overseeing the annual budget process. Figure 1 on the following page shows Richmond's organizational structure. The city's fiscal year runs from July 1 through June 30. For fiscal year 2004–05, the city council adopted a budget that included general-fund operating revenues and expenditures totaling $96.9 million, and the city had 672 employees, including 161 sworn police officers and 83 full-time firefighters.

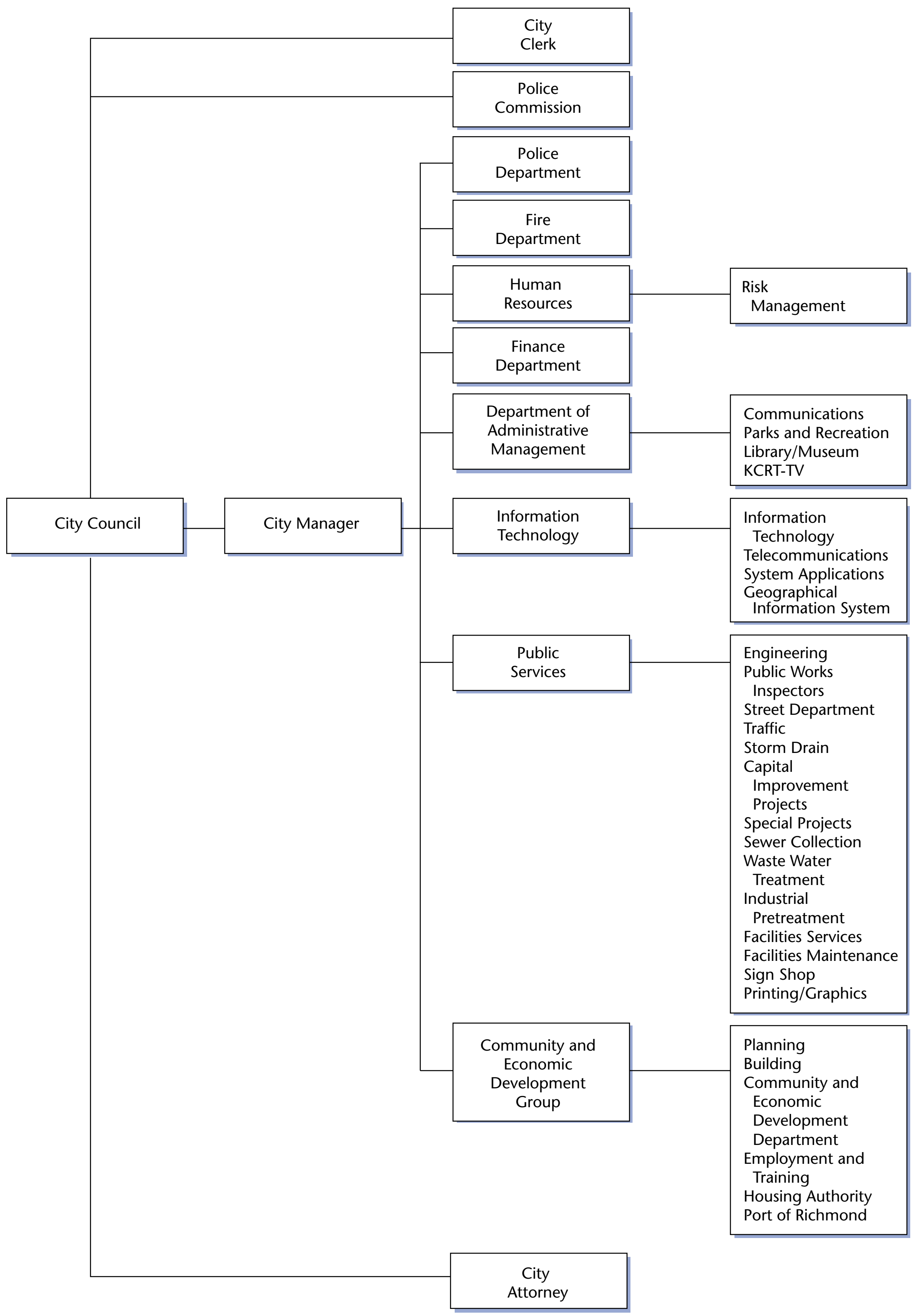
In March 2004, during its midyear review of fiscal year 2003–04, the city announced it had spent $14.5 million more than it took in to the general fund during fiscal year 2002–03 and that if the city did not take corrective action, spending would exceed revenue by $6 million in fiscal year 2003–04. Facing these significant operating deficits, the city also announced it needed $35.2 million in cash to cover negative cash amounts in the general fund and in other funds. The city attributed its financial situation to its inability to

---

[1] As a result of a measure passed in November 2004, beginning with the November 2008 election, the number of council members will be reduced to seven.

FIGURE 1

Richmond's Organizational Structure



Source: City of Richmond.

control personnel costs, a slowdown in the economy, and the loss of certain city revenues to the State, such as the portion of the vehicle license fee that the State promises to repay in 2006. When making those announcements, the city introduced a plan of action to rectify the city's current deficits and build long-term financial health. The plan contained a number of one-time corrections to infuse the general fund with cash, such as accelerating the repayment of loans it made to the Richmond Redevelopment Agency, as well as more permanent actions, such as laying off city employees. The Appendix shows the components of the city's corrective action plan and the status of those components as of November 12, 2004.

Because of the city's reduced operating reserves and lack of cash and other liquid assets, in March 2004, the city's credit rating was downgraded to Ba3, which limits its ability to obtain short-term financing notes to help remedy cash shortfalls. To allow the notes to be adequately secured and marketable at reasonable interest rates, in July 2004, the Legislature authorized the Contra Costa County auditor to transfer a portion of the city's property tax revenues directly to the notes' trustees to pay principal and interest on the notes. Part of the Legislature's intent was for Richmond to continue to explore innovative cost-cutting measures, including a charter amendment to reduce the size of the city council. The city has not yet issued short-term financing notes. According to Richmond's deputy finance director, the city will likely issue notes before December 31, 2004.

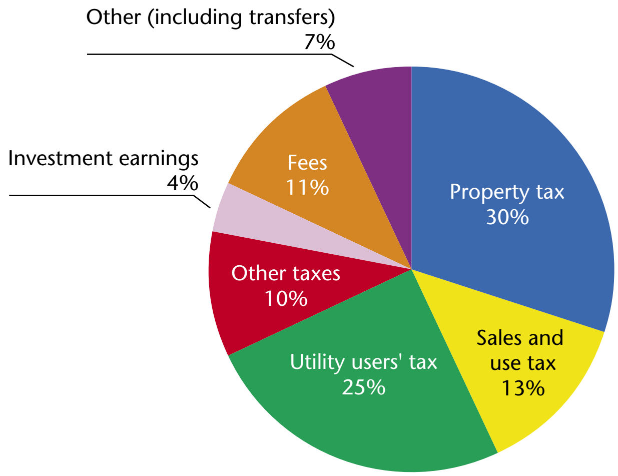
ECONOMICS OF RICHMOND

Richmond obtains revenue to operate the city from a variety of sources. However, as Figure 2 on the following page shows, Richmond's revenue mix is largely made up of a utility users' tax and property taxes. The city imposes the utility users' tax on consumers and businesses for the use of utilities such as telephone, natural gas, and electricity. Property taxes, a significant source of revenue for any city, are based on the assessed value of properties. Richmond projects that it will collect \$27.8 million from the utility users' tax and \$28.4 million from property taxes in fiscal year 2004–05.

Like other cities throughout the State, Richmond spends a significant portion of its budget on personnel costs, including salaries and benefits. In addition, the city spends 5 percent of its general fund paying principal and interest on bonds it has issued. As Figure 3 on the following page shows, the city spends its revenues in a variety of areas. As in other California cities, the largest portion of Richmond's budget (49 percent) goes toward public safety, which includes police services. Because of its crime rate, however, Richmond's need for public safety spending may be greater than that of other cities in the State. Overall, Richmond's crime index, which is calculated using several factors such as population and the number of various crimes, is significantly higher than the statewide crime rate.

FIGURE 2

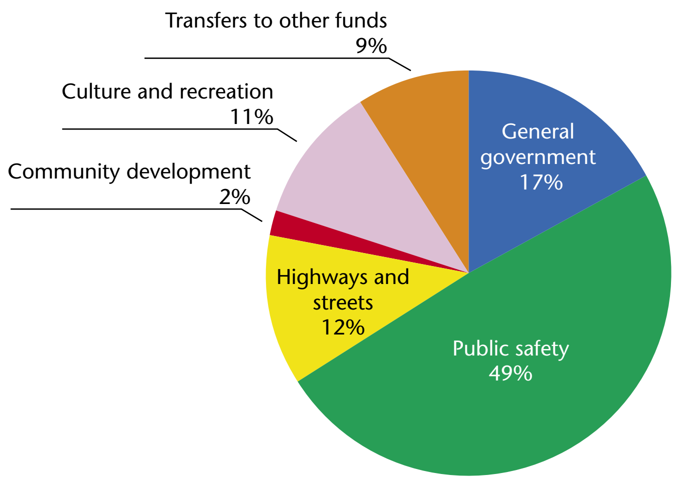
Inflows of Richmond's General Fund
Fiscal Year 2002–03



Source: City of Richmond's audited financial statements, fiscal year 2002–03.

FIGURE 3

Outflows of Richmond's General Fund
Fiscal Year 2002–03



Source: City of Richmond's audited financial statements, fiscal year 2002–03.

Richmond provides some services that have not always been self-supporting. An example of a non-self-supporting service is the city's employment and training program, which trains unemployed workers in Richmond and helps them find jobs. Although the current interim city manager has set a goal for the employment and training program to be financially independent of the city's general fund, the program drew from the general fund in fiscal year 2002–03. In fact, the employment and training program spent $400,000 more than it took in during fiscal year 2002–03. Additionally, Richmond's municipal sewer operated at a loss of almost $2.7 million during fiscal year 2001–02. Although the sewer fund began generating a surplus in fiscal year 2002–03, the city expects it will take two to three years to erase the deficit in the sewer fund. Moreover, because both the sewer fund and the employment and training program fund ended fiscal years 2001–02 and 2002–03 with negative cash amounts, the city looked to the general fund to cover those cash shortages.

RICHMOND'S BUDGET PROCESS

The city starts preparing its budget five months before the beginning of the new fiscal year, typically in February, with the finance department distributing instructions that the city's various departments follow when creating their budgets. Once departments submit their budgets, the finance department reviews and compiles the information into a comprehensive draft budget document. After the draft budget document is complete and before the end of April, members of the city management team—the city manager, assistant city manager, finance director, and department directors—review and discuss the draft before they approve it and submit it to the city council in May. At the May city council meeting, the department directors hold a work session to inform the city council about the budget. Based on the city council's comments, the finance department may subsequently revise the draft budget. Finally, the city council adopts the budget by a formal resolution before the start of the fiscal year on July 1, and the budget then serves as the city's operational plan for the ensuing fiscal year. The city updates the budget throughout the year as needed but generally makes most adjustments during the quarterly and midyear reviews.

STAFF TURNOVER AND LAYOFFS AFFECT THE WORK ENVIRONMENT AT THE CITY

In recent years, leadership within the city government has changed in several ways. For example, the city manager retired during fiscal year 2003–04. Since that time, the city has had three interim city managers. Additionally, the finance department has had significant turnover in management staff, and the city has tried to save money by removing directors and managers in other departments, such as the recreation and parks department. When the city council discovered that the city was operating in a deficit, it took steps to lay off 250 city employees. Consequently, city staff are spread more thinly than they were previously, forcing management to prioritize tasks. Moreover, with fewer resources, city leaders are left to strike a balance between vital services, such as police and fire protection, and other services it elects to provide, such as employment and training. Although he is convinced that the personnel cuts were necessary, the current interim city manager concedes they have negatively affected morale because a reduced workforce is expected to keep up with a growing workload. Thus, although the financial situation of the city is precarious, it is not the only challenge the city faces.

SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee (audit committee) requested that the Bureau of State Audits conduct an audit of the financial records and accounting systems of the city of Richmond, focusing on the factors that contributed to the city's financial crisis. Specifically, the audit committee asked us to do the following:

- Determine the extent to which items such as the city's accounting and budgeting practices, revenue shortfalls, and increases in expenditures contributed to the deficit.

- Determine if the financial statements disclosed the impending financial crisis, and if so, examine any corrective action taken by city officials.

- Review the corrective action plan that the city issued in response to its financial crisis, and determine the extent to which the city will correct the problems.

To understand the extent to which the city's budget process contributed to the financial crisis, we reviewed the city's budget preparation procedures and determined whether the city followed its procedures during fiscal year 2002–03. We also calculated variances between the original budget and actual numbers for fiscal year 2002–03. For large variances, we reviewed the original budget estimates and assessed them for reasonableness. We also determined if the finance department accurately input its budget amounts into the accounting system—a procedure that could help prevent departments from spending beyond their budgets—and found that the finance department correctly input original budget amounts. We focused on fiscal year 2002–03 because the city's financial health significantly deteriorated that year and because year-end financial statements for fiscal year 2003–04 prepared by the finance department were not available.

To evaluate if the city council had accurate and timely information, we reviewed the quarterly and midyear reports that the finance department provided to the city council for fiscal years 2001–02 through 2003–04. Our review included determining if the information was complete and accurate and if the finance department submitted the reports promptly. We also interviewed city staff, the mayor, and the former interim city manager to obtain their perspectives on the information that the city's finance department provided in the past. Finally, we reviewed the audited financial statements for fiscal years 2000–01, 2001–02, and 2002–03 to determine if they disclosed the city's financial condition and if the city issued the financial statements within a reasonable amount of time after the end of the applicable fiscal year.

Because the city had a significant cash deficit at the end of fiscal year 2002–03 that the finance department was not aware of, we evaluated the city's process for reconciling its pooled cash account and reviewed its monthly reconciliations for fiscal years 2002–03 and 2003–04 to determine if the reconciliation process is adequate to monitor the city's pooled cash account.

To understand how the changes in the city's revenues affected its fiscal condition, we determined if the city had significant unplanned changes to its revenues during fiscal years 2002–03 and 2003–04 and found it did not. We also examined the extent to which changes to revenues, imposed by the State, affected the city. Because the city informed the public that personnel costs had increased more than any other city expenditure and thus had the biggest effect on the city's financial health, we reviewed the agreements that the city has with its six employee unions. In view of the information available when the city council entered into those agreements, we assessed whether the city council acted appropriately.

To determine if the city is following its corrective action plan, we interviewed management staff in the finance department and reviewed documentation that supported their assertions. However, the city's fiscal year 2003–04 financial statements prepared by the city's finance department were not available for our review; therefore, we could not evaluate the overall success of the city's corrective action plan. ■

CHAPTER 1

The City of Richmond's Failure to Control Costs Has Damaged Its Financial Health, Reduced Public Services, and Created Challenges for Its Future Fiscal Stability

CHAPTER SUMMARY

The cost of operating the city of Richmond (city) has grown significantly in recent years. Agreements the city made with its six employee unions, some of which took effect as early as 1998, to raise salaries by 16 percent or more between fiscal years 2000–01 and 2002–03 and the city's July 2002 decision to enhance retirement benefits contributed significantly to the higher operating costs. With 85 percent of the city's budget composed of personnel costs, salary increases significantly affect the city's finances. Therefore, we believe the city should have assessed whether it could afford salary increases before it agreed to them. Instead, the city council entered into some of the salary agreements without knowing what they would cost the city.

The city council agreed to base its salaries for public safety employees (police officers and firefighters) on the salaries that certain other cities in the Bay Area would be paying at future points in time. However, Richmond did not know the exact amounts the other cities would be paying and did not limit how much it would raise salaries. Although the city council intended to keep Richmond's salaries competitive, it failed to recognize that some of the other cities can better afford to pay higher salaries than Richmond. The increased salaries have had a significant effect on the city's current expenditures, and its enhanced retirement benefits drastically increased payments the city must make to the retirement system both now and in the foreseeable future. In some cases, payments to the retirement system exceed 30 percent of its employees' salaries and will likely increase in the next few years. Although the city council was informed of the impending increases in retirement contribution rates, it did not take steps to set money aside to stabilize its costs when funds were available or require its employees to pay into the retirement system.

The city planned to increase its revenues to pay for the added costs; however, its expectations of obtaining additional revenue sources in time to meet the increased expenditures were unreasonable. Moreover, the new source of revenue the city acquired in fiscal year 2002–03 did not provide enough funds to cover reductions in other revenue sources, such as the sales tax and funding from the State, much less increase city revenues to cover the 17 percent increase in expenditures since fiscal year 2000–01. With increased spending and decreased revenues, the city had to reduce the services it provides to the public. For example, the city reduced the staff in its police and fire departments and cut funding to public libraries. Even with those reductions, the city's budget for fiscal year 2004–05 projects that, beginning in fiscal year 2005–06, revenues for the general fund will again be insufficient to cover the cost of operating the city. Richmond is currently working on ways to increase its revenues to reduce the imbalance between inflows and outflows. However, to recover from past years' deficits, rebuild its reserves, and improve its financial outlook, the city must ensure that its revenues exceed its expenditures.

HIGH-COST AGREEMENTS WITH EMPLOYEE UNIONS FORCED PERSONNEL LAYOFFS AND CUTS TO VITAL PUBLIC SERVICES

By agreeing to large increases in employee salaries and benefits, Richmond shrank its financial assets and jeopardized its financial stability to the extent that major cuts were required in city services, including fire and police protection. Between 1998 and 2003, the city council agreed to certain employee salary increases with no knowledge of their costs. Moreover, the city council ignored warnings that enhancing retirement benefits would cost more than the city could afford. During 2001, the California Public Employees' Retirement System (CalPERS) allowed Richmond to use excess retirement plan earnings to pay the employer's share of benefits. However, the city did not use that one-time source of funds to establish a rate stabilization reserve. With 39 fewer police officers than the city had planned to have and the rotating closure of three of its 11 fire stations, the cost of the city's agreements with its employee unions is negatively affecting services to the residents of Richmond.

Richmond Significantly Increased Employee Salaries

The city provided a number of salary increases between 1998 and 2003, raising its salary costs for some public safety classifications by more than 20 percent since 2000, as Table 1 shows. Some of the increases occurred during fiscal year 2002–03, when the city's revenues were not sufficient to cover its expenditures. Currently, Richmond has agreements with six unions—four unions representing public safety employees, one representing general employees, and one representing management employees. The agreements provided for several salary increases.

TABLE 1

Sample of Richmond Salary Increases Between 2000 and 2003

Union	Position	2000 Lowest Base Salary	2003 Lowest Base Salary	Difference	Percentage Increase
Representing public safety employees					
Richmond Police Officers Association	Police Officer	$4,513	$5,441	$ 928	21%
Richmond Police Management Association	Police Captain	7,420	8,571	1,151	16
International Association of Firefighters	Firefighter	4,026	5,117	1,091	27
Richmond Fire Management Association	Fire Marshal	7,210	8,874	1,664	23
Representing non-public safety employees					
Richmond General Employees	Buyer	3,715	4,391	676	18
Richmond Management Association	Chief of Redevelopment Projects	6,185	7,309	1,124	18

Source: City of Richmond's 2000 and 2003 salary schedules.

Richmond entered into salary agreements with four of its employee unions between 1998 and 2002 without knowing what the amounts of some of the increases would be or the impact the increases would have on the city's budget. Specifically, in 1998, the city agreed to raise salaries for members of its police unions effective July 2000 and July 2001, and for members of its two firefighter unions effective January 2001 and January 2002. Without specifying salary amounts or percentage increases, the city agreed to make the compensation package for each union the fourth highest in a survey of 12 Bay Area cities. (For a sample of cities used in the survey and their

Some Cities Richmond Included in Survey of Salaries for Public Safety Employees

City	Per-Capita Income as of 2000
Richmond	$19,788
Palo Alto	56,257
Mountain View	39,693
San Mateo	36,176
Fremont	31,411
Alameda	30,982
Berkeley	30,477
South San Francisco	23,562
Vallejo	20,415
Hayward	19,695

Source: U.S. Census Bureau.

respective per-capita incomes, see the text box.) The compensation packages included salaries and other compensation the city provides, such as the retirement costs it pays on behalf of the employees. In June and July 2002, the city made the compensation packages for public safety employees even more competitive with the other cities surveyed by agreeing to salary increases that placed the compensation packages at the third highest as of July 2002 and the second highest as of January 2003. Thus, the 2003 salary levels were to be based on the compensation that the second-highest-paying city would decide to pay, an amount that Richmond would not know until the survey was completed, seven months after the date of the agreement. Although the city council had to officially approve each salary increase after the survey was completed, the agreements it had already entered into with the unions made it unlikely the council would not approve the increase. Therefore, in essence, Richmond's city leaders relinquished control of public safety employees' salaries to the decisions of leaders in other cities.

Because the economies of some of the surveyed cities may be better than Richmond's, those cities may be able to afford higher salaries than Richmond can pay, a reality that the city must consider when trying to offer competitive salaries. For example, one of the cities to which Richmond compares itself is Berkeley, which not only has a greater per-capita income but also has much larger total revenues than Richmond does. In fact, all the other cities, with the exception of two, have per-capita incomes significantly greater than Richmond.

Certain other cities in the Bay Area agreed with their employees to make salary adjustments using salary surveys; however, the agreements we reviewed typically had safety nets to ensure that the cities did not give salary increases they could not afford. For example, one city agreed to increase salaries based on the average salary of 12 comparable cities, but the increase could not exceed 3 percent. Because Richmond did not have a similar provision in its agreements, it gave up the ability to control salary costs.

Generally, city governments in California spend a large amount of their budgets on personnel costs. According to the city, personnel costs—salaries and benefits—are roughly 85 percent of its budget. Decisions to increase expenditures in this area, if not well thought out, could cause extensive damage to the city's financial health. In the future, before agreeing to salary increases, the city should know what the full cost of the agreement will be; otherwise, the city risks spending more than it can afford.

Improved Retirement Benefits Have Dramatically Increased Richmond's Current and Long-Term Obligation to the Retirement System

To attract and retain employees, the city council approved enhanced retirement benefits for all city employees during 2002. Ironically, the result was exactly the opposite of what the city intended: Steep retirement costs have been partly to blame for Richmond's major personnel layoffs. To increase what it will pay retirees in the future, the city must pay more into the retirement system now. Moreover, the city will continue to pay at least a portion of the employees' share of payments into the retirement system for most employees until July 2005. As city staff warned the city council as early as 2001, retirement costs have strained the city's resources. Further, those costs will continue to increase in the future, making it more difficult for the city to balance its budget and maintain essential public services.

Retirement costs will continue to increase in the future, making it more difficult for the city to balance its budget and maintain essential public services.

The city contracts with CalPERS to assist it in providing benefits. CalPERS is an institutional investor that invests its assets and those it holds in trust for others, such as a city's retirement funds. Using actuarial valuations, CalPERS sets Richmond's contribution rates, expressed as percentages of payroll, to cover the accumulated cost of the plan's benefits, which were previously earned by active and retired members but not yet collected or paid. The actuarial valuations are based on a set of actuarial assumptions, such as plan earnings, life expectancy, and inflation rates, as well as the employer's schedule of benefits and membership data. To avoid placing the complete burden of retirement costs on the employers, the plan is structured so that each employee pays a percentage of his or her wages to the retirement system. Known as the employee's contribution, the percentage is set in law.

Table 2 shows that in 2001 the city did not have to pay an employer's contribution. CalPERS attributes this to its excellent investment performance. Throughout that year, the city paid the employees' contributions but did not adequately prepare for likely future increases to its contribution rates by setting aside funds it normally would have paid to the retirement system. In October 2001, CalPERS notified Richmond that its retirement contribution rates for fiscal year 2002–03 would increase to 2.5 percent of salaries for public safety personnel and remain at zero for its general employees. Additionally, although CalPERS did not provide the specific rates until October 2002, the city received advance warning in June 2002 that it would have a second, more substantial increase in the retirement contribution rates beginning in fiscal year 2003–04. According to the Government Finance Officers Association (GFOA), a professional association of state and local finance officers dedicated to the sound management of government financial resources, city governments should have policies to guide the creation, maintenance, and use of resources for financial stabilization purposes. However, Richmond did not have a policy to set aside funds to respond to CalPERS' increases, as do some other California cities. Consequently, the city did not have funds to lessen the impact of the rising contribution rates imposed by the retirement system.

TABLE 2

Allocation of Contributions to CalPERS 2001 Through 2004

	Employees' Share		Richmond's Share				Total Share Paid by Richmond	
Plan	Prior to 2003	2003 to Current	2001	2002	2003	2004*	2001	2004
Public safety employees	9.0%	9.0%	0.0%	2.5%	21.1%	22.2%	9.0%	31.2%
General employees	7.0	8.0	0.0	0.0	8.3	9.5	7.0	17.5

Source: CalPERS.

Note: Contribution rates are expressed as percentages of payroll.

* Rates for 2004 reflect reductions from restructuring that is described more fully on page 20.

Between 1998 and 2003, the city's retirement benefits provided 2 percent of the final year's salary for each year of service for general employees retiring at age 55; public safety personnel received 2 percent at age 50. Under this plan, for example, a person who served the city for 25 years as a general employee would receive 50 percent (2 percent times 25) of his or her final compensation on retiring at age 55. In June and July 2002, aware that increases in the employer's contribution were imminent, the city council awarded enhanced retirement benefits of 3 percent at age 55 to members of the four unions representing public safety employees and 2.7 percent at age 55 to members of the unions representing general employees and management. In our example, with the enhanced benefit, the 55-year-old retiree who was a member of the general employees' union would receive 67.5 percent (2.7 percent times 25) of his or her final compensation. Additionally, the city council agreed to further enhance the retirement benefit to its police force to 3 percent at age 50 effective October 2002, three months after the initial enhanced benefits went into effect. Like other local agencies in California, Richmond sets its retirement benefits for its public safety employees to match the levels that the State gives its firefighters and patrol officers. However, Richmond gives its general and management employees significantly more than the 2 percent at age 55 that the State gives its general and industrial employees.

Richmond's dramatically enhanced retirement benefits, combined with a downturn in CalPERS' investment earnings, also caused dramatic increases to the city's contribution rate to CalPERS. Table 2 shows that the city's rates jumped to 22 percent of salaries for public safety personnel and nearly 10 percent of salaries for general employees in 2004. During this period, although the public safety employees' share remained at 9 percent, the general employees' share increased, and the city elected to continue paying those costs, which it estimates at approximately $5 million per year.[2] City staff warned the city council in May 2001 that having city employees share in the retirement plan costs was necessary because the city could not afford to pay the increased employer's contribution as well as the employees' share. The contribution rate increases ultimately affect the city's general-fund assets by requiring the city to contribute more money to cover the future retirement costs of its employees.

[2] The portion the city pays on behalf of its public safety personnel is included as compensation in the survey it uses to set salaries for those employees. Therefore, if the city continues to set the salaries for public safety employees to be the second highest in the survey of 12 cities, it would have to raise salaries for this group of employees by the amount of any decrease in these payments.

City staff warned the city council in May 2001 that the city could not afford to pay the increased employer's contributions for retirement benefits as well as the employees' share.

The city may be limited in its ability to change the benefits offered under its retirement plans. Therefore, reducing the amount the city will pay its current employees at retirement is not a likely option. Richmond's agreement with each of its employee unions to enhance retirement benefits is much like a contract in that it gives the parties to that agreement enforceable contract rights. In the context of retirement benefits, the courts have stated that the pension rights of public employees are an integral portion of "contemplated compensation" and that employees have a vested right to pension benefits in effect during their employment. Related to that, both the federal and state constitutions prevent a vested contract right from being impaired. The courts have also established that pension rights are not necessarily unchangeable; however, in making any changes to those rights during the time that an employee is working for the city, the city would have to make reasonable modifications, replacing a benefit that is taken away with an equivalent benefit. This requirement would not likely cause the city to save money. Although the city has a limited ability to alter the benefits for existing employees, it may have other options it could explore, such as offering different retirement benefits to employees it hires in the future. These changes would likely require approval from the six employee unions.

Because the city is facing financial difficulties, it has been able to take advantage of two restructuring opportunities to defer a portion of its contributions to CalPERS. The retirement system's policy allows local agencies to request a rate restructuring of the unfunded future retirement liability for a period of up to 30 years. As local agencies began experiencing financial difficulties during fiscal year 2003–04, CalPERS adopted another one-time policy that allowed agencies facing severe budget crises in fiscal year 2004–05 to restructure their contributions by paying less in fiscal year 2004–05 and more in subsequent years beginning in fiscal year 2007–08. Although the city projects that this restructuring will save it a total of $5.7 million over the three-year period from fiscal year 2004–05 through fiscal year 2006–07, the solution is temporary and does not address the effects of increasing salaries and benefits on Richmond's future retirement liability.

Facing Rising Personnel Costs, Richmond Laid Off 250 Employees and Reduced Public Services

The city's decisions to increase salaries and enhance benefits have backfired. The city offered improved compensation packages to make them competitive with those offered by other cities and to attract and retain highly qualified candidates, thus improving city services. Instead, the increased salaries and benefits led the city to spend more than it could afford. As a result, the city ended up having to cut its workforce. In March 2003, the city estimated it would spend $3.7 million more than it took in for fiscal year 2002–03. To close the gap, the city implemented a rightsizing plan that resulted in the layoff of 42 employees. In fiscal year 2003–04, the city made additional staff cuts for a total of 250 layoffs and drastically cut funds to some of its programs. For example, according to the interim city manager, the recent budget reductions resulted in 26 percent cuts in library service hours and 60 percent cuts in staffing. Additionally, the budget for library materials was reduced by 90 percent, resulting in spending per child dropping from $3.27 to 34 cents.

In the middle of fiscal year 2003–04, the city cut the fire department's budget by $2.9 million, which resulted in the elimination of 30 positions and the rotating closure of three of its 11 fire stations.

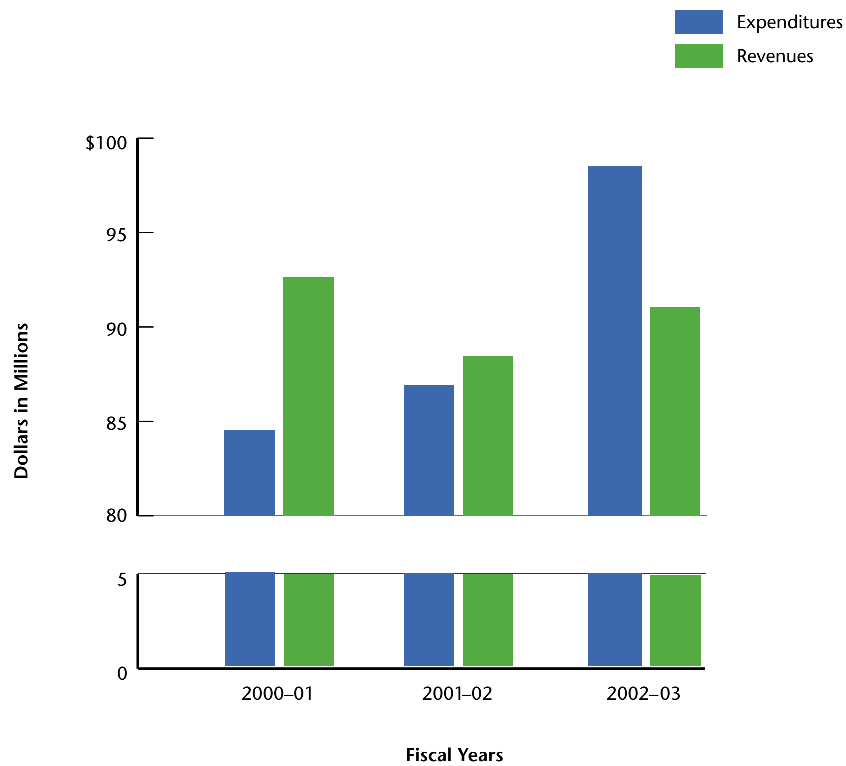
The city also froze 18 vacant police officer positions to achieve a $1.8 million reduction to the police department's budget in fiscal year 2003–04; in fiscal year 2004–05, the city froze 21 more vacant police officer positions to achieve an additional savings of $2.1 million. The city made similar reductions to the fire department's budget. In the middle of fiscal year 2003–04, the city cut the fire department's budget by $2.9 million, which resulted in the elimination of 30 positions and the rotating closure of three of its 11 fire stations. These disruptions to city services are potentially harmful to the residents of Richmond. With fewer staff filling crucial public safety positions, the citizens of Richmond may be exposed to longer wait times for nonemergency calls. Moreover, closing fire stations on a rotating basis could increase wait times when mere minutes can be vitally important.

RICHMOND'S REVENUE DECREASED WHILE ITS EXPENDITURES INCREASED

As the city was increasing its expenditures, its revenues were not increasing at a comparative rate. Consequently, as Figure 4 on the following page shows, Richmond started spending more money out of its general fund than it was receiving in revenue, beginning in fiscal year 2002–03. Although the city increased its revenues in some areas, its expectations for revenue increases were unrealistic, and they proved inadequate to cover the city's increased spending. Further complicating the situation were reductions in revenues from the sales tax and state funding that the city experienced.

FIGURE 4

Richmond's General Fund Revenues and Expenditures
Fiscal Years 2000–01 Through 2002–03



Source: City of Richmond's audited financial statements, fiscal years 2000–01, 2001–02, and 2002–03.

Between fiscal years 2000–01 and 2002–03, the city's total revenue decreased by almost 2 percent and total expenditures increased by nearly 17 percent. As discussed earlier in the chapter, the city raised employees' salaries and enhanced retirement benefits. To pay those increased costs, the city counted on increased revenues. In November 2002, the city tried to increase revenues by introducing a measure to raise the utility users' tax from 8 percent to 10 percent. Voters approved the tax increase, which was to provide additional funds to help preserve vital city services—including police and fire protection, emergency medical and library services, recreation, and local street maintenance—and for other general governmental purposes. The finance department estimated that the increase in the utility users' tax would generate $5.4 million annually in additional revenue. In fiscal year 2002–03, for the first six months the city could collect the increased tax, Richmond received $2.3 million more from its utility users' tax than it did in the prior year;

however, the city's overall revenue decreased compared with fiscal year 2000–01. Increases in some revenues, including that gained from the utility users' tax, were offset by decreases in other revenues, such as a $2 million decrease in the sales tax and a reduction in the vehicle license fee in fiscal year 2002–03. The State promises to pay back the reduction in the vehicle license fee in August 2006, adding $1.8 million to Richmond's general fund, according to the city's estimates.

The city's expectation that it would achieve adequate revenue increases in time to pay for its increased costs was unreasonable because significant revenue increases, such as an increase to the sales tax, often require voter approval.

By the time Richmond adopted its fiscal year 2003–04 budget, the city announced that to operate within the budget and to maintain current programs required increased revenues. The city's expectation that it would achieve adequate revenue increases in time to pay its increased costs was unreasonable because, as illustrated later in the chapter, significant revenue increases such as an increase to the sales tax, often require voter approval, making it impossible for the city to collect the new revenue immediately.

Richmond also believes that the State's shifting of property tax revenues to the Educational Revenue Augmentation Fund (ERAF), which began in 1993, has caused the city to lose revenues. In response to its severe budget deficits of the early 1990s, the State set up the ERAF to help pay its obligation to schools from kindergarten through grade 14. In doing so, the State directed each county auditor to establish a fund and annually transfer to the fund property taxes that otherwise would be allocated to cities, counties, and special districts. About half the losses that local governments incurred from the property tax shift were offset in 1993 by a half-cent increase in the sales tax that went to cities and counties for local public safety, but most of the funds from the sales tax increase have gone to the counties. Richmond estimates that it will lose almost $6 million to the State in fiscal year 2004–05 as a result of the ERAF. Although correct, the city's argument that it lost revenues to the State does not excuse the city for spending more than it can afford because Richmond's decisions to increase its expenditures in fiscal year 2002–03 came nine years after the revenue reductions began.

RICHMOND MUST DECREASE EXPENDITURES OR INCREASE REVENUES TO IMPROVE ITS FINANCIAL HEALTH

The city's budget for fiscal year 2004–05 shows that without $6 million in one-time revenues, the city's spending would exceed its revenues. Specifically, the Richmond Redevelopment

Agency (redevelopment agency) is making payments on a loan the city made to it from the general fund more than 20 years ago. In 2003, the redevelopment agency used a portion of its revenue bonds to repay approximately $18 million of prior city obligations, leaving an outstanding balance of about $6.4 million. Originally, the redevelopment agency and the city planned for the remaining balance to be repaid in two $3 million installments (plus interest), one in fiscal year 2004–05 and the other in fiscal year 2005–06. However, because of the city's difficult financial condition, the redevelopment agency paid the entire balance on October 28, 2004. The city plans to use those funds for the city's normal operating expenses in fiscal year 2004–05. Because the one-time revenue source will not exist in future years and the city expects certain costs to increase, the city projects that expenditures will exceed revenues in its general fund by $6.6 million in fiscal year 2005–06, assuming that the city receives no new revenues. Therefore, to improve its financial outlook, the city must either decrease its expenditures or find ways to raise its revenues.

The only way Richmond can improve its financial condition is by ensuring its revenues not only meet but also exceed its expenditures so it can rebuild its reserves.

In fact, the only way Richmond can improve its financial condition is by ensuring that its revenues not only meet but exceed its expenditures so it can eliminate the negative fund balance in its general fund, which was $4.4 million as of June 30, 2003, and then rebuild its reserve funds (reserves). Governments often maintain reserves to cover economic uncertainties or assist with cash flows. Reserves typically act as a holding account to provide resources for periods of uncertainty or to help cover unexpected costs, such as damage from a natural disaster. The GFOA recommends that a government maintain unrestricted reserves—that is, current and available financial resources—of 5 percent to 15 percent of the general-fund budget for annual operations. Richmond has a policy to maintain reserves at 5 percent of the general-fund expenditure budget. However, it has not always enforced this policy and has sometimes used its reserves to pay for ongoing expenses. By not following its policy, the city risks not only being short on funds but also setting a precedent that will make it more difficult to increase its reserves in the future. For example, the city acknowledged that it used its reserves to help support ongoing programs and activities. This is an unsound practice because it leaves no money either to continue the programs or to replenish the reserves. The city is currently working on a plan to accumulate money over time to fund a contingency reserve to use for items such as infrastructure failures. Similarly, the city may pursue a benefit stabilization reserve to help absorb major increases in health care and retirement costs.

The city recently started researching other sources of revenue. Between April and June 2004, the finance department contracted with outside experts to review the city's revenues. That prompted various departments to take individual actions to propose new revenues. For instance, the police department has proposed taking full control of the city's vehicle towing needs rather than using local tow companies. The police department estimates this would generate several million dollars per year in additional revenue for the city. The fire department has also proposed new sources of revenue: a tax on 911 emergency calls and a charge for any 911 emergency calls that are false alarms.

To increase revenues, the city opted to place a half-cent increase in the sales tax on the November 2004 ballot that voters approved.

In addition, the city contracted with a firm to provide a legal review of the potential use of special districts, assessments, and tax increases to raise revenues. The city also opted to place a half-cent increase in the sales tax on the November 2004 ballot that voters approved. The city estimates the increased tax will generate roughly $6 million in revenues annually. Richmond is also considering other options for future voter initiatives to increase revenues, such as a special library tax, revision of the business license tax, and formation of landscape and lighting districts.

The finance department also coordinated a citywide fee review and compiled the city's master fee schedule, which consisted of increasing many fees based on the employment cost index, increasing selected fees based on the costs of providing the services, and adopting new fees for services the city already provides but for which it is not compensated. On January 13, 2004, in accordance with the municipal code, the city council adopted the resolution to establish a master fee schedule that updates the fees that city departments assess for services to reflect the actual costs associated with providing the services.

In fiscal year 2003–04, the city set out a plan that identified areas where expenditures could be reduced, in addition to the significant layoffs the city instituted. For example, the city negotiated with the employee unions to have employees pay their share of pension contributions to CalPERS, which the city currently pays. The city estimates that having employees pay their share of retirement costs could save Richmond $5 million a year. In November 2004 the city reached agreements with five of its six employee unions and is imposing conditions on the sixth. As a result, members of all unions will pay the entire amount of the employees' contribution by July 1, 2005. The city also planned to explore combining utility accounts for all city facilities to qualify for large-user discount rates; however, according to the deputy finance director, the city does not yet have a plan in place to aggregate the accounts.

Although the city is making efforts to increase its revenues and reduce its expenditures to eliminate the budget deficits it faces, other changes in state funding will also affect the city's financial outlook. For instance, beginning in fiscal year 2004–05, the State plans to retain a portion of the city's sales tax revenues and replace it with property tax revenues, which the state had previously diverted to ERAF. This shift in revenue sources is supposed to have no impact on the amount of money the city receives. However, the frequency with which the city receives revenues will change because cities receive sales taxes monthly and property taxes twice annually. Consequently, at various times throughout a year, the city may have access to less money than it otherwise would have, which could require the city to obtain short-term financing and incur the associated costs.

RECOMMENDATIONS

To ensure that the city has sufficient funds to meet its operating costs and does not spend more than it can afford, Richmond should do the following:

- When negotiating agreements with its employee unions, consistently analyze salary and benefit increases to determine the long- and short-term effects the increases will have on the city's budget.

- Cease raising salaries based on amounts outside the city's control. If the city chooses to continue to base its salaries on those of other cities, it should ensure that its agreements with employee unions include limits on the amounts the city will raise the salaries.

- Evaluate other options the city may have to reduce its retirement costs, such as offering different retirement benefits to employees it hires in the future.

- Continue exploring ways to reduce the city's expenditures as outlined in its March 2004 corrective action plan, including having the employees share in the added cost of enhancing retirement benefits.

The city should establish a policy to set funds aside for fluctuations in its contributions to the retirement system. This policy should specify the conditions under which the city contributes to the stabilization fund and when it may use the funds.

To meet the challenges of a budget deficit, the city should first consider reducing its expenditures, which is more immediate than increasing its revenues. If the city creates a new revenue source to eliminate the deficit, it should match the increases to the period in which they will likely occur.

To ensure that the city does not operate outside its means and that it has funds available for contingencies, the city should take the following steps:

- Establish a policy that delineates how the city may use one-time revenues and discourages using them to fund ongoing operations.

- Reevaluate and reestablish its policy for building and maintaining reserves for specific purposes, such as contingencies and economic uncertainties. The policy should indicate when it is appropriate to use the reserves. Once it has established a reserves policy, the city should follow it and continue with its plans to fund the reserve within five years. ■

Blank page inserted for reproduction purposes only.

CHAPTER 2

The City of Richmond Made Unreasonable Budget Estimates and Did Not Monitor Its Budget Effectively

CHAPTER SUMMARY

Unreasonable budget estimates and ineffective budget monitoring by the city of Richmond (city) masked the city's overspending and the city did not take timely action to reduce costs. In its budgets for fiscal years 2002–03 and 2003–04, the city underestimated certain expenditures, including personnel costs, the costs for workers' compensation insurance and general liability insurance, and the general fund's share of debt payments. Because of these inaccuracies, the adopted budgets did not expose the city's overspending. Although it was aware that some of the estimates were inaccurate in the proposed fiscal year 2003–04 budget, the city council adopted the budget anyway, intending to adjust it later. However, the reports the city's finance department prepared and the city council relied on to monitor and adjust the budget were fraught with errors and lacked some important information. The reports included overly optimistic revenue projections that did not materialize and indicated erroneously that the city had unspent reserve funds (reserves) from earlier years on which it could draw. In addition, the finance department's reports did not contain information on the amount of cash in each of the city's funds.

Not fully notified that the city lacked adequate resources to cover its expenses, the city council did not take adequate actions to curb the city's spending and, in fact, increased spending in some areas. Because the city's budget-monitoring process failed to disclose the overspending, the city's bleak financial position was not revealed until the city's audited financial statements for fiscal year 2002–03 were issued in March 2004. Although the city has taken steps to improve its monitoring procedures, to some extent the problems continued throughout fiscal year 2003–04. Without timely, accurate, and complete reports, the city council remains vulnerable to the same type of spending mistakes that created its present fiscal predicament.

RICHMOND'S POOR BUDGETING CONTRIBUTED TO UNEXPECTED REDUCTIONS TO SEVERAL FUND BALANCES

Although the city adopted seemingly balanced budgets for fiscal years 2002–03 and 2003–04, the budgets were flawed because they contained inaccurate estimates of the city's personnel costs, costs for workers' compensation insurance and general liability insurance, and bond payments. The city council was aware of some of the underestimates when it adopted the budget for fiscal year 2003–04. Further, as Table 3 shows, the city used its general fund for expenditures and transfers to other funds that deviated significantly from the city's original budget estimates for fiscal year 2002–03. Consequently, the city spent more of its general fund than it took in, and the city estimated in the middle of fiscal year 2003–04 that, without corrective action, the city would overspend again. Because the city had not maintained reserves according to its policy, the city's general fund did not have the assets to pay for its spending deficits. Therefore, at the end of fiscal year 2002–03, the liabilities of the general fund exceeded its unreserved assets by $4.4 million.

TABLE 3

Budgeted and Actual Inflows and Outflows of Richmond's General Fund Fiscal Year 2002–03

	Original Budget Amounts	Actual Amounts	Variance From Budget Favorable/ (Unfavorable)
Inflows			
Revenues	$91,102,623	$91,050,944	$ (51,679)
Transfers in	3,328,449	1,169,088	(2,159,361)
Outflows			
Expenditures	91,780,405	98,493,953	(6,713,548)
Transfers out	4,120,908	8,199,828	(4,078,920)

Source: City of Richmond's audited financial statements, fiscal year 2002–03.

According to the Governmental Accounting Standards Board, an organization dedicated to improving the standard of governmental accounting and financial reporting, many believe the budget is the most significant financial document produced by a government unit. Richmond shares this belief, stating in its policies that the budget is an essential component of the city's financial planning and management. As an expression of the city council's financial intent for the upcoming fiscal year, the budget indicates the amount of revenue the city expects to receive and the expenditures it plans to make with its financial resources. Additionally, the budget is an essential planning tool that reflects the city's choices among available spending options in providing its citizens with public services, including police and fire protection.

Richmond Adopted an Imperfect Budget Without Acting to Reduce Its Costs for Fiscal Year 2003–04

To balance its budget for fiscal year 2003–04, the city intentionally underestimated some of its expenditures and delayed immediate reductions to its costs. Specifically, when the city council adopted the budget for fiscal year 2003–04 on July 1, 2003, the city council and the city manager then in office discussed that the budget's spending estimates were not adequate to sustain the city's programs at their current levels and that making significant spending reductions or increasing revenues was necessary. To help balance the budget, the city included only 80 percent of what the fire department expected to spend. However, rather than taking immediate action, such as laying off public safety personnel, the city council passed the imperfect budget and planned to revisit the budget six months later. The city council and the city manager then in office agreed to keep all fire stations and libraries open and to work diligently to control expenses and maximize city revenues. In an effort to control personnel costs, the city began to reduce its spending in December 2003. However, those cost-cutting measures came too late because in fiscal year 2002–03, before the city council adopted the budget, the city had already spent significantly more than it had. As discussed later in the chapter, the city was unaware it had already overspent because it relied on faulty reporting, which showed the city had reserves.

Richmond Did Not Budget Enough for Its Personnel Costs

As discussed in Chapter 1, the city's revenues have not increased to the same degree as its expenditures, which rose significantly due to increases in salaries and employee benefit costs. To understand why the city's expenditures exceeded its budget, we examined how the city's spending estimates in the original budget for fiscal year 2002–03, the year in which the city first experienced significant spending deficits, compared with its actual spending. We found that although most of the city's departments spent close to the amounts in the original

In fiscal year 2002–03, the fire and police departments exceeded their original budgets by roughly $6.8 million because the city did not adequately budget for certain components of employee costs.

budget during fiscal year 2002–03, some large departments had expenditures that greatly exceeded their original budget allocations. For example, the city originally allocated a total of $45.6 million for its fire and police departments, or approximately 50 percent of the general-fund budget. However, those departments spent $52.4 million, exceeding their original budgets by roughly $6.8 million.

The imbalance between actual spending and the original budget for fiscal year 2002–03 occurred because the city did not adequately budget for certain components of employee costs for the fire and police departments. When we reviewed the salary and benefit costs for units within the fire department, we discovered that personnel costs for its operations and emergency service units accounted for approximately $2.9 million, or 97 percent, of the $3 million difference between the original budget and actual expenditures. Our review of personnel costs for the police department disclosed that two administrative units accounted for approximately $2.3 million, or 59 percent, of the $3.8 million discrepancy. Discoveries the finance department made during fiscal year 2003–04 point to a flaw in the city's process for estimating its personnel costs and may explain why the budgets for personnel costs were not accurate during fiscal year 2002–03.

Like the fire and police departments, other city departments did not budget adequately for personnel costs in fiscal year 2003–04. For example, in the middle of fiscal year 2003–04, the finance department discovered that the city's public works division did not budget adequately for all its staff positions, and the finance department had not caught the omission before the budget was approved. The oversight illustrates a larger problem with Richmond's budgeting process. Overall, in fiscal year 2003–04, the city found that it did not budget for at least 24 positions, 12 of which were public works positions totaling nearly $768,000. Although it is likely that the city did not budget for all positions when it prepared the budget for fiscal year 2002–03, we could not verify that conclusion because limited documentation exists. Before the fall of fiscal year 2003–04, the city did not have a fundamental control in place to compare the number of paid employees to the number of budgeted positions. Without adequate controls to assist it in identifying the number of budgeted employees versus actual paid employees, the city may incorrectly calculate its personnel costs.

The city's finance department realized it lacked the necessary control function and made changes to its process to ensure that the city adequately budgets for all positions. Specifically, beginning with the development of the fiscal year 2004–05 budget, the finance department centralized the process by taking charge of estimating the city's personnel costs, rather than giving the departments the responsibility. In fiscal year 2004–05, the department also implemented a position control listing, which was started in concept in fiscal year 2003–04. Using the position control listing on a monthly basis, the finance department compares the actual number of paid employees to the number of budgeted employees. This process should ensure that the city's budget reflects all approved or filled positions. The interim city manager recognizes the importance of the process and recommends the city use a position control listing as part of its budgeting process. Because the finance department implemented that mechanism in fiscal year 2004–05, it is too early to determine how effective the process is in practice.

Richmond Did Not Budget Enough for Workers' Compensation Insurance and General Liability Insurance

The city used a flawed system to budget for its workers' compensation insurance and general liability insurance funds (insurance funds), which pay for activities ranging from employee claims resulting from industrial injuries to general claims against the city for damages. Consequently, the two funds have liabilities greater than their assets (negative fund balances). Table 4 shows that the city significantly underestimated its expenditures and overestimated its revenues when it budgeted for its insurance funds in fiscal year 2002–03.

TABLE 4

Budgeted and Actual Inflows and Outflows of Richmond's Insurance Funds Fiscal Year 2002–03

	Original Budget Amounts	Actual Amounts	Variance From Budget Favorable/ (Unfavorable)
Inflows			
Revenues	$6,924,224	$ 3,588,622	$(3,335,602)
Transfers in	1,000,000	3,000,000	2,000,000
Outflows			
Expenditures	7,924,224	11,027,473	(3,103,249)

Source: City of Richmond's audited financial statements, fiscal year 2002–03.

Richmond self-insures and self-administers a portion of its workers' compensation insurance and its general liability insurance. Therefore, the city established the insurance funds to accumulate assets for claim settlements associated with losses, up to a predetermined limit. Additionally, the city purchases excess insurance coverage from various commercial insurance carriers to assist it in meeting its insurance needs. The city centralizes services for workers' compensation insurance and general liability insurance into its risk management division and uses the insurance funds to accumulate and allocate the cost of providing those services among the city departments on a cost reimbursement basis. It does this by estimating the costs for the year during the budget process.

Because the city, in past budgets, did not fully cover expenditures from the insurance funds, the funds' liabilities have grown. For example, the audited financial statements for fiscal year 2001–02 show negative fund balances totaling $6.4 million, which the city's audited financial statements show increased to $10.9 million by the end of fiscal year 2002–03. Most of the negative fund balances are related to accrued claims liabilities. Annual actuarial studies, an important tool, consist of a review of the estimated value of claims incurred, asset reserve levels, and payout patterns over the life of prior and current claims. After reviewing and analyzing this data, the actuary projects the city's estimated total insurance costs based on its actual claims experience. According to the manager of the risk management division (risk manager), the city was budgeting only for the cash expenditures that it expected to make that year, not the total insurance costs, which would include the payments it would likely make in future years. Moreover, during the fiscal year, the city further reduced the already underbudgeted expenditure amounts. Specifically, at the beginning of fiscal year 2002–03, the city estimated cash expenditures for risk management at $7.9 million, but in its third-quarter report, the city's finance department reduced that amount to $3.5 million without explaining why.

Calculation of Total Cost of Claims for Workers' Compensation Insurance and General Liability Insurance

Total cash payments	+	Accrued claims
(estimated amount in claims to be paid during the fiscal year)		(estimated amount of claims that will be paid at future dates but are attributable to the current or prior year)

Budgeting less than what is needed to pay the total cost of workers' compensation insurance and general liability insurance may be a way for the city to create the appearance of reduced expenditures in the general fund and the insurance funds. Although accrued liabilities and the related expenses do not have an immediate cash impact, not funding the total amount could result in cash shortages as claims arise and require the city to tap into the general fund to pay some claims. For example, because the city did not adequately fund the total cost of insurance in the past by increasing the amount of revenue it planned to collect from other departments and thus build sufficient assets, the city had to transfer $3 million from the general fund to the insurance funds in fiscal year 2002–03.

According to the risk manager, the city has made significant changes to improve how it budgets for its insurance costs. Specifically, the city is now budgeting for the total cost of claims rather than just the cash cost, and it no longer uses a flat-rate approach to allocate its workers' compensation insurance costs to city departments. The flat-rate approach did not take into account the hazards of specific job classifications. For example, because firefighting is a high-risk occupation, the average cost of claims for firefighters injured on the job is expected to be greater than the average cost of claims for injured clerical staff. However, we were unable to determine the adequacy of the city's budgeting process for insurance costs because fiscal year 2004–05 does not end until June 30, 2005. To address the existing negative fund balance, the city has developed a plan to increase the insurance funds' assets to more closely match its liabilities. According to the interim city manager, Richmond plans to adopt a seven-year goal to build sufficient assets to pay for the majority of costs related to its insurance funds.

Richmond Did Not Reasonably Budget for Bond Payments

For fiscal year 2001–02, the city allocated nothing in its adopted budget for making bond payments from the general fund, yet it actually transferred more than $2.3 million from the general fund to make bond payments.

Although fully aware of how much its bond payments would be for fiscal years 2001–02 and 2002–03, the city did not adequately budget the amounts it would have to transfer from the general fund for those payments. If the city had included the transfers in its budget, the city council would have noticed earlier that an imbalance existed between the general fund's inflows and outflows and could have corrected the imbalance by decreasing spending. Bond payments, which include principal and interest on bonds sold by the city, have set payments that the city tracks on schedules. However, the deputy finance director told us that because he did not work at the city when it prepared the budget for fiscal year 2002–03, he was unsure if the city used the payment schedules. Because the budgeted transfers for bond payments were significantly different from the actual payments, it appears that the city did not use its schedules. For example, for fiscal year 2001–02, the city allocated nothing in its adopted budget for making bond payments from the general fund, yet it actually transferred more than $2.3 million from the general fund to make bond payments. Similarly, the budget for fiscal year 2002–03 allowed for a transfer of $4.1 million from the general fund to another fund to help pay bonds, $1 million less than the $5.1 million the deputy finance director told us was needed to pay general debt. When the city does not properly reflect in its budget the amounts transferred from the general fund to other funds, it is not accounting for all its outflows and may incorrectly report a balanced budget. Based on the fiscal year 2004–05 budget, the city used the debt payment schedules when it budgeted for transfers out of the general fund to cover bond payments.

When the city does not properly reflect in its budget the amount transferred from the general fund to other funds, it is not accounting for all its outflows and may incorrectly report a balanced budget.

RICHMOND'S BUDGET MONITORING WAS INCONSISTENT AND FLAWED

Inaccuracies in Richmond's original budgets highlighted the importance of the city's process of monitoring and adjusting the budget throughout the year. The primary tools the city uses in this process are the quarterly and midyear reports prepared by the finance department. However, during fiscal year 2002–03, the quarterly and midyear reports that the city council received did not accurately represent the city's financial position. At times, the city council adjusted its budgeted spending upward, relying on the information it had, when the city could not afford additional costs. Moreover, the reports did not indicate that corrective actions were necessary because they did not disclose cash and operating deficits in the city's general fund or in the city's other funds.

The city council must have accurate and timely financial information so it can approve the budget and track the progress of the city's financial position. The Government Finance Officers Association (GFOA) recommends that a government periodically review budget-to-actual revenues, expenditures, cash flows, and fund balances during the budget period. Regular monitoring of budgetary performance provides an early warning of potential problems and gives decision makers time to consider actions that may be needed if major deviations in budget-to-actual results become evident.

Past Quarterly Reports Did Not Accurately Reflect the City's Financial Position

The finance department projected in its July 2003 report that the city would have $2.2 million in general-fund reserves as of June 30; however, the fund actually had a $4.4 million deficit.

The finance department's midyear and quarterly reports for fiscal year 2002–03 stated that the city was spending more from its general fund than it was taking in for the year, indicating that the fund had an operating deficit for the year. However, the reports misrepresented the amount of the surpluses from prior years that the city held in reserve in its general fund. Specifically, based on accounting information through May 2003, the finance department projected in its July 2003 report that the city would have $2.2 million in general-fund reserves as of June 30, 2003. Actually, as the city's audited financial statements for fiscal year 2002–03 reported, the fund had a $4.4 million deficit. That difference affected the fiscal year 2003–04 budget because the city made no allowances in the budget for a deficit.

The finance department calculated the city's reserves in most of its quarterly and midyear reports using the same process for fiscal year 2002–03: It began with the estimated ending reserve balance from the prior year, subtracted the budgeted use of reserves, and added or subtracted increases and decreases to its budgeted inflow and outflows. However, the department overestimated the general fund's inflows and failed to include certain fund outflows. The finance department overestimated the general fund's inflows because it would increase revenue projections to match the increasing expenses and add any surplus revenues from the projections to the reserve balance. However, in total, the revenue estimates for the general fund shown in the original budget were very close to the actual total revenue; therefore, it may not have been necessary for the city to adjust its estimates for individual sources of revenue. By the end of fiscal year 2002–03, the city lowered its revenue estimates to reflect the amount it actually earned; however, it had already incurred the increases in expenditures.

The finance department drastically underestimated the general fund's outflows because it did not include the more than $8 million that the finance department transferred from the general fund to other funds during fiscal year 2002–03 to pay for insurance costs and bond payments. Because the finance department used an outflows amount that excluded the transfers to calculate its reserves, the department overstated the general fund's reserves. Management staff in the finance department agreed with us that the previous finance staff did not adequately monitor the reserve balance.

Not only did the fiscal year 2002–03 midyear and quarterly reports include inaccurate reserve calculations for the general fund, but also the reports did not disclose the losses some individual funds were experiencing. The city's insurance funds have experienced growing losses over the past few years, as discussed earlier in the chapter, but the reports did not mention the losses. Moreover, the finance department further reduced the insurance funds' revenues by reducing the amount the general fund would spend for risk management. Thus, the finance department attempted to balance the general fund's budget by shifting shortfalls of the general fund to the insurance funds that were not monitored. Ultimately, as mentioned earlier in the chapter, the city had to transfer general-fund assets to cover the losses of the insurance funds. If the reports had contained more information regarding the insurance funds' balances, the city council might have noticed that the insurance funds had a deficit and required money from the general fund.

The quarterly and midyear reports that the finance department presented to the city council did not disclose that several funds had negative cash amounts.

Another indicator of financial troubles that the finance department did not include in its quarterly and midyear reports was the cash position of the city's individual funds. At the end of fiscal year 2002–03, several of the city's funds had large cash deficits, as described later in this chapter. The reports that the finance department presented to the city council compared budgeted amounts to actual amounts for revenues and expenditures, which appeared in line with the projections for a given point in time. However, the reports did not disclose the funds that had negative cash amounts. When the finance department provides the city council with budget-to-actual comparisons in isolation, it gives the city council members an incomplete view of the city's financial health, which could create false perceptions that the city is operating as intended at various times. Moreover, if the finance department does not include information on negative cash amounts in its reports, it is not providing the members of the city council with details that could affect their decisions or raise questions about the city's financial health.

If the city council members had taken training in public finance, they might have been better prepared to ask questions about inconsistencies in the finance department's reports. However, city council members are not required to have public finance training. Although training is available through outside sources, such as the League of California Cities, members are not required to participate. This puts city council members at a disadvantage when presented with financial information. If city council members do not fully understand information that city management staff present to them in reports or during council sessions, they could fail to recognize discrepancies and make decisions based on inaccurate information.

The first-quarter report for fiscal year 2003–04 attempted to address the shortcomings of the flawed budget and the increased costs caused by severance and accumulated vacation payments to employees the city had laid off. However, like its predecessors, the report did not provide a complete picture of the city's financial problems. It was not until March 2004, when the audited financial statements were nearing completion, that the finance department described in the midyear report for fiscal year 2003–04 the full impact of the city's financial problems. Although the midyear report for fiscal year 2003–04 was more informative than that for the prior year, the finance department's third-quarter report provided information only on the general fund. According to the finance department, it did not include information on the city's other funds because the postings to its accounting system were not up-to-date.

It was not until March 2004 that the finance department described the full impact of the city's financial problems in a report to the city council.

Richmond Is Attempting to Improve Its Financial Monitoring

The finance department has realized the shortcomings of its reporting process and is taking steps to improve. Richmond's deputy finance director told us that the city is monitoring its deficits monthly and will calculate its reserves at the end of the fiscal year. Additionally, the finance director told us that future reports to the city council would include information regarding the city's cash balances, particularly those for funds with deficits.

Richmond's interim city manager has also stressed the importance of the city's following its budget review policy to achieve and maintain financial stability as part of his September 2004 assessment of the fiscal and organizational stabilization needs of the city. Therefore, he has started to require departments to submit monthly reviews of their budgets. According to the deputy finance director, the finance department suspended the monthly review process during fiscal years 2002–03 and 2003–04 and had switched to using quarterly reports because key finance and budget staff had been laid off. Resuming the monthly review process, as well as improving quarterly and midyear reports, should give the finance department and the city council more timely and accurate information than they have previously received.

Richmond Did Not Monitor the Cash Position of Its Funds

Like many other local governments, the city maintains a large portion of its cash in a pooled cash account. Many of the city's funds, including the general fund, operate out of the pooled cash account. In March 2004, Richmond announced that at the end of June 2003, several of the city's funds had negative cash amounts. A fund with a negative cash amount has used its portion of the pooled cash account and has tapped other funds' portions of the account. As of June 2003, the general fund had an $8.3 million negative cash amount, and 11 other funds had negative cash amounts totaling $21 million. Despite having funds with negative cash amounts, the city was not overdrawn at its banks because, with positive cash balances in 16 funds totaling $41.7 million, the city's total cash was still positive. The funds with negative cash amounts were using the surplus cash of those 16 funds. Although several of the city's funds also had negative cash amounts in fiscal year 2001–02, it appears that Richmond did not make an effort, such as formulating a corrective action plan, to ensure that those funds did not continue to have negative cash amounts.

Because all the city's funds, other than the general fund, have limitations on their use, each fund with a negative cash amount would look to the general fund to cover the cash shortage.

Usually, governments account for borrowing between funds. However, Richmond's finance director told us that the city's accounting system allows a fund with a negative cash amount to borrow cash from another fund without recording an entry to identify the other fund or funds from which it borrowed. Because all the city's funds, other than the general fund, have limitations on their use, a fund with a negative cash amount would look to the general fund to cover any cash shortage. Therefore, it is important that the city monitor all its funds' shares of the pooled cash account. However, Richmond did not have an adequate process to monitor each fund's share of the pooled cash account until May 2004. Prior to that time, the city's finance department reconciled the total pooled cash on its general ledger to the bank statement for each month. We reviewed the procedures and reconciliations it prepared during fiscal year 2002–03 and found that the reconciliations were not adequate to monitor the cash position of the city's funds for two reasons: The procedures did not require staff to reconcile each fund's share of cash to the pooled cash account, and the city did not consistently reconcile its pooled cash account within a reasonable amount of time after the end of the month.

The finance department's procedures require staff to reconcile the total pooled cash to the bank statement. However, by looking at the total pooled cash, which is a combination of positive and negative cash amounts, the staff would not see negative cash amounts in individual funds. The finance director told us that most cities usually rely on their accounting software to deal with each fund's portion of the pooled cash account. While his comments have merit and we agree that the city can use its accounting system to keep track of each fund's share of the pooled cash, the city did not extract the information from the system until May 2004, when the finance department created reports of cash balances of the individual funds to show each fund's claim on the pooled cash account. These reports clearly show funds with negative cash amounts. By reviewing this information frequently, the finance department will know when certain funds are low in cash and can notify the city council.

The city did not consistently reconcile its pooled cash account within a reasonable amount of time after the end of the month.

The second reason we do not believe that the finance department's cash reconciliations were adequate to monitor the cash position of the city's funds is that the city did not consistently reconcile its pooled cash account within a reasonable amount of time after the end of the month. By delaying those reconciliations, the finance department minimized any assurance that its reconciliation process provided. Specifically, during fiscal year 2002–03, it appeared that the city waited until near the end of the fiscal year to complete its reconciliations. Moreover, the city did not complete and review its reconciliations promptly during fiscal year 2003–04, with some reconciliations as much as seven months late. Unless the finance department promptly and frequently reviews the cash position of its funds, it will lack a complete picture of the city's current financial health and may deprive the city of time to react to low cash balances and the necessary information to make appropriate management decisions.

LATE AUDITED FINANCIAL STATEMENTS IMPAIRED THE CITY COUNCIL'S ABILITY TO PROTECT RICHMOND'S FINANCIAL HEALTH

For fiscal years 2001–02 and 2002–03, the city's audited financial statements disclosed its weakened financial condition: The cash balances of several funds were declining and deficits existed. However, the city did not have audited financial statements for fiscal year 2001–02 until 10 months into the next fiscal year, and audited financial statements for fiscal year 2002–03 were not completed until more than eight months after the end of the fiscal year. Lacking timely financial statements, neither city staff nor the city council had the information regarding deficits they needed to make the appropriate management decisions to improve Richmond's financial condition.

The GFOA recommends that government agencies issue financial statements within 120 days after the end of the fiscal year, but the GFOA also recognizes that under certain circumstances a city might have difficulty meeting the deadline. In fact, cities that complete their financial statements within six months after the end of their fiscal years are still eligible for GFOA's certificate of achievement for excellence in financial reporting. According to the finance department, the city's financial statements were delayed in fiscal year 2001–02 because it implemented a change in reporting standards. According to the city's independent auditor, the city's financial statements were also delayed for that fiscal year because the city did not provide the information required to perform the audit in a timely manner. For fiscal year 2002–03, the city's financial statements were delayed because the finance department did not engage an auditor until six months after the fiscal year ended and the city lost several important staff. As noted earlier in the chapter, because the city's quarterly and midyear reports did not disclose the city's financial condition, the city council was forced to rely on the late financial statements. If the city does not ensure that its financial statements are promptly completed, it will not be able to make appropriate management and budgeting decisions, and it will not be able to warn the city council of financial difficulties that might lie ahead.

According to the finance department, it is taking steps to improve the timeliness of the city's audited financial statements. For example, the finance department has developed a timeline for its year-end closing that department staff are required to follow. In addition, as laid out in his September 2004 assessment of actions needed to stabilize the city's fiscal structure, the interim city manager is planning to implement a policy requiring the city to issue its financial statements by the end of the calendar year. Although this policy falls short of the GFOA's recommended 120 days, it still meets the GFOA's six-month requirement.

RECOMMENDATIONS

To reestablish the value of the budget as an essential planning tool, Richmond should take the following steps:

- Budget for all likely expenditures and not knowingly adopt budgets that reflect inaccurate estimates of expenditures or revenues. If the city needs to reduce expenditures to balance the budget, it should promptly take cost-cutting measures.

- Continue using its new centralized process to budget for personnel and periodically comparing the positions on its position control listing to its current staff.

- When budgeting for the city's insurance costs, the city should follow its plan to ensure that it budgets for the total costs of the insurance, rather than just the cash cost. Additionally, the city should follow its plan to rebuild its insurance funds' assets.

- The city should continue using the payment information in its bond payment schedules when budgeting for bond payments.

To improve the quality of the financial information that the city council uses to make budget changes during the year, the city's finance department should take the following steps:

- Monitor the amount of reserves that the city has during the year, using a method that includes all inflows and outflows.

- Include information on the status of other city funds, not just the general fund, in its quarterly and midyear reports.

- Perform prompt reconciliations of its pooled cash account.

- Regularly review the report on the cash balances of city funds that the department created in May 2004 and share this information with the city council in its updates.

To ensure that the city council is prepared to ask questions related to the information the finance department provides, the city should consider adopting a policy requiring city council members to periodically receive training related to public finance.

To ensure that the city council has adequate time to respond to financial information presented in the audited financial statements, it should adopt, as a policy, the interim city manager's recommendation to issue statements by the end of the calendar year.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

Date: December 7, 2004

Staff: Nancy C. Woodward, CPA, Audit Principal
Peter A. Foggiato, III
Fernando Valenzuela
Katrina Williams

APPENDIX

The City of Richmond's Progress in Implementing Its Corrective Action Plan

The city of Richmond (city) recognizes that it faces challenging financial hurdles in both the short term and the long term. The city believes its corrective action plan of March 2004, shown in Table A, addresses these hurdles and provides a framework for the difficult decisions the city council faces. Although it has developed one-time corrections to address the current deficit and cash shortfall, its solvency depends on its ability to make ongoing structural changes involving significant and difficult program cuts and citywide restructuring.

TABLE A

Richmond's Progress in Implementing Its Corrective Action Plan as of November 12, 2004

Corrective Action	City's Progress
One-Time Corrections	
Convert $13 million of bond proceeds, which the Richmond Redevelopment Agency (redevelopment agency) paid to the city in the fall of 2003, to working capital to fund normal operations of the general fund. Additionally, accelerate the repayment of the redevelopment agency's remaining $6 million debt to the city so it is repaid in fiscal year 2003–04.	**Implemented**. The city converted the bond proceeds to working capital in May 2004. As discussed in Chapter 1, the redevelopment agency paid the remaining debt to the general fund on October 28, 2004.
Convert approximately $2 million in series 2001A bond proceeds to working capital to offset amounts the general fund previously advanced to pay for capital costs.	**Implemented**. The city requested nearly $2 million in funds from the fiscal agent since March 2004.
Reimburse the general fund for eligible pension costs of $1.2 million that it paid.	**In progress**. According to the city, it hired actuaries to determine the amount of pension override funds available to reimburse the general fund for eligible pension costs.
Immediately collect $1 million that the Richmond housing authority owes the city in sewer service charges that are past due.	**Not implemented.** According to the city, the amount owed to the city is $601,000 and will be paid by November 1, 2005.
Determine if the city used the general fund to pay capital expenditures that could be reimbursed using bond proceeds from the wastewater enterprise fund.	**Implemented.** According to the city, it has determined that it did not use the general fund to pay capital expenditures.
Collect $875,000 as cost reimbursement from one vendor for the city's wastewater treatment plant by June 30, 2004.	**Implemented.** The city received a payment of $875,000 from the vendor in April 2004.

continued on next page

Corrective Action	City's Progress
One-Time Corrections cont.	
Improve the cash position of the general fund with reimbursements from grants and bonds as follows: • Receive $1.2 million in reimbursements from the U.S. Department of Housing and Urban Development for the Community Development Block Grant Fund by June 30, 2004, thus erasing the deficit in the fund. • Receive about $1.5 million in reimbursements for its employment and training program by June 30, 2004. • Research other expenditures for which grants or bond proceeds are supposed to pay reimbursements, immediately process the reimbursement requests, and pursue payment on an expedited basis.	**In progress.** According to the city, it is currently working to improve the cash position of the general fund as described in the corrective action plan, and the city plans to keep all reimbursements from grants and bonds current. We asked the city to tell us how much of the $2.7 million in reimbursements it received; however, the city did not provide us with information to support the actions it has taken.
Personnel Cost Reductions	
Decrease personnel costs by considering the following alternatives: • Lay off city employees. • Have employees pay their share of pension contributions to the California Public Employees' Retirement System. • Institute unpaid furloughs. • Institute salary reductions.	**Implemented.** The city has laid off 250 employees since March 2003, as discussed in Chapter 1. Also as discussed in Chapter 1 as a result of negotiations with the employees' unions, employees will pay their entire share of retirement contributions by July 1, 2005.
Other Actions Considered	
Examine whether any of the $4.4 million that the general fund transferred to other funds to make bond payments could be or should be paid or reimbursed by other funds' bond proceeds or grants.	**Implemented.** The city determined that none of the $4.4 million of general-fund transfers to other funds to make bond payments should be paid by the other funds' bond proceeds or grants.
Evaluate whether grants from state and federal governments are likely to be received and in what time frame. Additionally, downsize or defer expenditures to match expected dates and amounts of grant receipts.	**In progress**. As part of the city's preparation for the annual audit for fiscal year 2003-04, the deputy finance director told us that all state and federal grant receivables will be analyzed to determine the collectibility as of June 30, 2004.
Aggregate utility accounts for all city facilities to qualify for large-user discount rates.	**Not implemented**. According to the city, it currently does not have a plan in place to aggregate utility accounts for city facilities.
Examine development and capital projects to determine which projects could be deferred.	**Not implemented**. According to the city, it has not deferred capital projects.
Examine fees, charges, rates, and franchises for the Development Services Department to ensure that it is recovering actual costs from applicants. Also, reduce services to the extent that there are no offsetting revenues, and adjust pricing to recover the actual productive time of staff.	**Implemented**. The city has examined and restructured the fees and rates it charges, as described in Chapter 1.
Open discussions with major property holders regarding possible prepayment of future years' property taxes in exchange for prompt-payment discount, which would require legislative authorization.	**Not implemented**. The city does not plan to move forward on this item.
Review inventory of surplus properties and evaluate whether any small surplus parcels can be sold quickly for cash.	**In progress**. In May 2004, the city council authorized staff, under the direction of the city manager, to pursue disposition and sale of surplus properties. City staff have identified the city's surplus properties and prepared criteria for selecting proposals for the sale of surplus properties.

Corrective Action	City's Progress
Other Actions Considered cont.	
Explore asset transfer financing, which the city describes as essentially borrowing on a long-term basis to cover operating deficits.	**Not implemented**. The city does not plan to move forward on this item.
Evaluate whether state or federal grants could be redirected for use in capital projects.	**Not implemented.** The city does not plan to move forward on this item.
Identify unspent bond proceeds, evaluate contract commitments against those proceeds, and explore (with bondholder consent) redirection of the use of proceeds.	**In progress**. Although the city has identified bond proceeds, it has not explored the redirection of the use of proceeds. We asked the city if it planned to do so, but the city did not reply.
Borrow through what is commonly known as a tax and revenue anticipation note to cover the intrayear cash-flow shortfall of $13.8 million.	**In progress**. The Legislature acted to help Richmond obtain short-term financing as described in the Introduction. According to the deputy finance director, the city will probably issue a note by December 31, 2004.
Long-Term Structural Changes	
Examine liability insurance costs ($5.7 million of the fiscal year 2003-04 budget) and workers' compensation insurance costs ($2.3 million between July 2003 and March 2004) to evaluate if increased efficiencies and better pricing are available. Engage an insurance broker-evaluator to work on a contingent basis and earn a fee only if and to the extent the city saves money.	**In progress**. According to the city, it has taken several steps to decrease its costs, including outsourcing the administration of its workers' compensation claims to a vendor it selected through a competitive process. Additionally, the risk management division has been developing and implementing a major upgrade to the city's claims-tracking software to improve the quality of data and allow for better tracking of the city's overall cost of risk.
Evaluate whether underused assets (such as the port) could be sold, leased, or developed without requiring significant expenditures by the city. Consider private enterprise lease, franchise, or development financing of large parcels that could generate long-term revenues, such as ground rent and increased property taxes. State-enabling legislation might be needed to authorize or speed up this process.	**Not implemented.** The city has no plans to implement this action.
Consider debt restructuring by doing the following: • Evaluating 22 bond issues for interest-rate savings, considering capital markets demands. • Consider replacing reserve funds with sureties. • Consider extending maturities to lower annual payments.	**Not implemented.** The city has no plans to implement this action.
Explore additional revenue sources, including landscaping and lighting assessment districts, a library tax, increased users' fees of various types, and increased general or special taxes.	**In progress**. The city has taken steps to increase its revenues, as described in Chapter 1, including a half-cent sales and use tax increase to provide additional funds for the city's general governmental purposes, such as police and fire protection, emergency medical and library services, recreation, local street maintenance, and other general governmental services.
Pursue grants from the Economic Development Administration and elsewhere.	**Not implemented**. The city has no plans to implement this action.

Blank page inserted for reproduction purposes only.

Agency's comments provided as text only.

City of Richmond
Finance Department
1401 Marina Way South
Richmond, CA 94804

November 24, 2004

Elaine M. Howle, State Auditor*
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814

RE: Draft Report 2004-117
<u>City of Richmond</u>

We appreciate the opportunity to respond to the draft report. We have the following observations to the draft.

<u>Summary</u> <u>(page 1 - page 6)</u>
The summary does not acknowledge the accomplishments and corrective actions taken to date. Among the accomplishments are:

- The City has gone through a series of three layoffs that have resulted in the reduction in the work force of approximately 250 positions.
- The City has entered into a tentative agreement with all six of its employee organizations to reduce the benefits for safety employee by 9% and by 8% for non safety employees. As of November 24, 2004, five of the six agreements have been ratified by the employees.
- The City Manager prepared an initial assessment of the fiscal and organizational stabilization needs of the City that contained 170 recommendations to improve the organization, operation and financial well being of the City. Included in this report were 64 recommendations dealing with the fiscal issues of the City, such as the requirement that each department submit monthly financial status reports to the Council and the requirement that the City complete its financial statements by the end of the calendar year. This report was presented at the City Council meeting of September 14, 2004 and was approved without modification by a unanimous vote of the Council.
- On November 18, 2004, the City Finance Committee approved a report that was prepared by the City Manager and the Finance Director that recommended the reorganizing of the Finance Department, establishing clear reporting channels that will improve efficiency, accountability, communications and establishing needed internal controls. Other organizational and operational recommendations in this report that will be acted on by the City Council during the November 30, 2004 meeting include:
    - The establishment and strengthening of a Budget function that reports directly to the Finance Director,

* California State Auditor's comments begin on page 55.

- The transfer of the inactive Auditing function from the Finance Department,
- The re-establishment of a Purchasing function,
- The establishment of a Cash Management Section,
- The review and strengthening of the Accounts Payable function,
- The identification of an Accounts Receivable function,
- The addition of six staff positions,
- The establishment of an independent Internal Audit function that will report directly to the City Council and will perform financial and operations audits. The foundation of the Internal Audit function has four cornerstones: 1) Governmental Auditing Standards, 2) Independence, 3) Peer Review, and 4) a Professional Audit Advisory Committee. The proposal includes staffing the function with four individuals.
- The adoption of the Governmental Auditing Standards as recommended by the Government Finance Officers Association that were prepared by the United States General Accounting Office as the basis for the proper functioning of this program.
- The establishment of a Professional Audit Advisory Committee, consisting of three (3) professional members, one representative from the City Council and one representative from the City Manager's Office whose responsibilities would be to:
    - Advise the City on the selection of the City's independent auditors and the resolution of audit findings from both the independent and internal auditors.
    - Monitor the independent audit function of the City of Richmond including the selection of the independent auditor and the resolution of audit findings.
    - Monitor reports of the Internal Auditors.
    - Review the annual internal audit work plan.
    - Review the resolutions of internal audit findings, and
    - Provide written annual reports to the City Manager and Council on how effectively and efficiently the auditors perform their duties and discharge their responsibilities.
- The adoption of a policy that the annual financial audit, for each preceding fiscal year, is to be completed by the end of the calendar year.
- A provision for the Internal Audit Unit to review and recast the City's credit card policy and cancel all unnecessary credit cards.
- A provision for the Internal Audit function to perform an audit of the Accounts Payable function to audit the City's records and identify any discounts that may be due the City.

- A requirement that a cash receipts audit be performed consisting of cash counts, physical control and receipt site record keeping reviews, an examination of the accountability and reconciliation procedures that will ensure that all cash receipts are properly accounted for, deposited and recorded in the finance system on a timely basis.
- The adoption of a policy that one-time reserves will not be used as a source of funding for continuing programs and activities.
- A requirement that a position control accounting procedure be developed and utilized by all agencies, authorities and departments in the City as part of the budgetary and appropriations process.

- It is also important to take into account the significance of the fact that, on November 2, 2004, the voters of the City of Richmond approved a general one-half cent sales tax measure which should provide for additional stability with regards to the City's finances. ●
- The City Council also approved a Land Disposition Agreement with Upstream to sell City-owned property located at Point Molate to Upstream for $50 million with the potential to generate another $350 million, in the next twenty years. Even if this development proposal cannot move forward, Upstream will pay the City a potential $15 million in non-refundable deposits in the next five years. ●

As noted, the summary is notable for its silence on the progress being made. We have provided by separate cover -- a video tape of the November 18, 2004 Finance Committee meeting in which future revenue efforts are discussed as well as the independent Internal Auditor, summaries of the negotiated and imposed labor agreements, and the **Finance Department Reorganization, Accountability and Work Improvement Plan** dated November 18, 2004 (Finance Committee) and November 30, 2004 (City Council). ●

Report Title
There seems to be a disconnect between the report title and the report. The title does not acknowledge the City is on the road to recovery, or that previous State takeaways also contributed to the City's financial condition and ability to recover. ●

Draft Report (page 26 and page 27)
The State, in efforts to balance past State budget deficiencies, has shifted a cumulative **$55,516,514** in City of Richmond property tax revenues through the ERAF shift. The shift has only partially been offset by other sources for a net takeaway of **$45,703,733** through fiscal year 2003-2004. While the City has to accept responsibility for its own actions, actions by the State have contributed to the City's ability to provide services to the Citizens of Richmond. We request the above information be included in the report. ●

Overall
The City is in general agreement with the recommendations and facts in the report and we thank the State Auditor for the opportunity to respond to the draft.

(Signed by: Patrick Samsell)

Patrick Samsell
Finance Director

November 22, 2004

Elaine M. Howle, State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814

Attn: Tanya Elkins

RE: Supplementary Material to City of Richmond
Response To Draft Report 2004-117

Enclosed are a video tape of the City of Richmond City Council Finance, Administrative Services and Economic Development Standing Committee meeting of November 18, 2004 which discusses:

- future revenue options,
- the establishment of an independent internal audit function,
- discussion of the finance department reorganization,
- monthly and quarterly financial reports, and
- cash balances of funds.

Resolutions for the labor unions outlining the terms and conditions of the three year labor agreements and the impact on fire union 188 members to not ratifying the negotiated three year agreements is also enclosed.

In addition, included is the 390 page **Finance Department Reorganization, Accountability and Work Improvement Plan** consisting of: ♦

- Recommended actions, discussions of those actions , and draft ordinances breaking out the duties and responsibilities of an independent internal auditor (page 1 through page 43),
- Monthly reports of operations summarized (page 45 through page 50) and detailed (page 51 through page 387), and
- Quarterly cash balance by fund report (page 388 through page 390).

The City Council is scheduled to act on the recommendations on November 30, 2004.

Also included is a one page table showing the City's cumulative ERAF loss through FY 2004 totaling **$55,516,514** and netting **$45,703,733**. While not the immediate cause of the City's fiscal problems, the State's takeaway of City property tax revenues do contribute to the City's ability to respond to fiscal challenges and do support our claims that the total ERAF takeaway and the net should be included in the report.

We appreciate the opportunity to respond to the draft report and hope the State Auditor will acknowledge the efforts undertaken by the City which go beyond the recommendations in the draft report.

(Signed by: Patrick Samsell)

Patrick Samsell, Finance Director

♦ We have not included attachments in the report; however, they are available for review at the California State Auditor's office.

Blank page inserted for reproduction purposes only.

COMMENTS

California State Auditor's Comments on the Response From the City of Richmond

To provide clarity and perspective, we are commenting on the response to our audit report from the city of Richmond (city). The numbers below correspond with the numbers we have placed in the margin of the city's response.

The city inaccurately asserts that the Summary does not acknowledge the accomplishments and corrective actions the city has taken to date. Specifically, we note in our Summary that the city has worked to increase revenues and reduce costs and has taken steps to improve its monitoring. Additionally, during the agency response period, we added a paragraph to the Summary that refers to the city's attempts to improve its financial health with its March 2004 corrective action plan. The paragraph also refers to the city manager's directive that requires departments to submit monthly reviews of their budgets and that requires the city to complete its financial statements by the end of the calendar year. We provided a draft of this paragraph to the city during the agency response period. Since the Summary is a synopsis of the entire report, certain of the details the city cites are discussed only in the individual chapters.

The city may have overlooked the third paragraph of the Summary, in which we mention that the city has laid off 250 of its staff since March 2003.

Based on the documentation the city provided, we have updated our report and the Appendix to recognize the ratification of the agreements, which occurred after we sent our draft report to the city. These changes are on page 2 of the Summary, page 25 of the report, and page 46 of the Appendix.

We agree that the city's proposed reorganization of the finance department, its proposed establishment of an internal audit function, and its proposed establishment of a professional audit advisory committee are indications of the city's attempts to implement a viable operating framework. However, as of the November 24 date of the city's response, this proposal was to be presented to the city council for action on November 30, 2004.

Consequently, we did not include this in our report as corrective action that the city has taken. Furthermore, these actions in and of themselves will not necessarily improve the city's financial health and our recommendations are focused on the information the city needs to generate and the actions it needs to take to improve its financial health.

In Chapter 1 we discuss the city's explorations of additional revenues increases and expenditure reductions. We discuss the November 2004 voter approval of the half-cent sales tax increase on page 25 of the report.

Although agreeing to sell property located at Point Molate may be considered progress, the city's revenue estimates only represent potential revenues. As noted in the city's response, there is a possibility that the development proposal may not move forward. Therefore, it is premature to assess the effect of this action on the city's financial position.

We disagree with the city's assessment that the report title is disconnected from the report contents. The city's suggested inclusions mischaracterize the contents of our report by overstating the city's progress, which cannot be reliably measured until the fiscal year 2003–04 financial statements are completed. Additionally, the city's abrupt financial decline is primarily the result of the city's poor decisions, not takeaways of city revenues by the State, as the city indicates. Therefore, we have not revised our title.

We discuss the effects of the State's diversion of local government property taxes to the Educational Revenue Augmentation Fund on page 23 of the report. However, as we also mention, in light of the fact that this revenue shift is of longstanding, it cannot excuse the city for spending more than it can afford.

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press