CITY OF RICHMOND

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

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.

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City of Richmond's response as of June 2005[1]

In March 2004, during its midyear review of fiscal year 2003–04, the city of Richmond (city) announced it had spent $14.5 million more than it took in to the general fund during fiscal year 2002–03 and that it needed $35.2 million in cash to cover negative cash amounts in the general fund and in other funds.

The Joint Legislative Audit Committee requested that the Bureau of State Audits conduct an audit of the financial records and accounting systems of the city, focusing on the factors that contributed to the city's financial crisis. We found the following:

Finding #1: 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, the city 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. In fact the city raised salaries by 16 percent to 27 percent for most employees between fiscal years 2000–01 and 2002–03 and in some cases, retirement benefit costs exceed 30 percent of what it pays employees in salaries. Between 1998 and 2003, 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, the city did not know the exact amounts the other cities would be paying and did not limit how much it would raise salaries. Moreover, the enhanced retirement benefits the city council approved drastically increased payments the city

[1] We did not receive the city's one-year response that was due December 7, 2005. Therefore, we are presenting the city's reported progress in implementing our recommendations as of its six-month response.

must make to the retirement system both now and in the foreseeable future. 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. 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 ensure that the city has sufficient funds to meet its operating costs and does not spend more than it can afford, we recommended that Richmond 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.

We also recommended that the city 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.

City's Action: Partial corrective action taken.

According to the city, it negotiated three-year contracts with five of its six unions, which did the following:

- Set wages at the current level with one 3 percent wage increase for public safety employees over the three-year life of the contracts, and one 2.5 percent wage increase for miscellaneous employees over the three-year life of the contracts.
- Phased in over a six-month period having the employees pay the employee's share of retirement contributions, including most public safety employees.
- Capped medical rates and required employees opting to stay in higher-costing plans to pay the difference.

The city also reported that none of the agreements use a city salary survey to set compensation. Although it stated in its initial response that it was in general agreement with the recommendation, the city did not indicate in its six-month response whether it developed a policy to set funds aside for fluctuations in its share of contributions to its employee retirement system.

Finding #2: The city's revenue decreased while its expenditures increased.

Between fiscal years 2000–01 and 2002–03, Richmond's total revenue decreased by almost 2 percent and total expenditures increased by nearly 17 percent. Consequently, the city started spending more money out of its general fund than it was receiving in revenue, beginning in fiscal year 2002–03. By the time the city 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 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.

We recommended that 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.

City's Action: Corrective action taken.

As discussed in its response to finding #1, the city indicated that it has taken steps to reduce its employee expenditures. Additionally, the city reported that it has taken a very conservative approach to budgeting and using its new revenue source, Measure Q, which was a 0.5 percent sales tax increase. According to the city, it is using a zero based budgeting approach for using the new revenues and will restore service levels as the revenues become measurable and available.

Finding #3: The city sometimes used one-time revenues and its reserves to pay for ongoing expenses.

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 city has accelerated the repayment of the remaining $6 million balance of a loan it made to the Richmond Redevelopment Agency. The redevelopment agency paid the entire balance on October 28, 2004, and 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.

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. 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. 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.

The city is currently working on ways to increase its revenues and decrease its expenditures. For example, Richmond opted to place a half-cent increase in the sales tax on the November 2004 ballot that the voters approved. Additionally, in November 2004, the city reached agreements with five of its six employee unions and is imposing conditions on the sixth that result in members of all unions paying the entire share of the employees' retirement contribution by July 1, 2005.

We recommended that 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.

City's Action: Pending.

The city did not include in its response whether it established a policy delineating how it may use one-time revenues or a policy related to maintaining reserves. ➲ However, in its initial response, the city stated that a proposal to adopt a policy that one-time revenues will not be used as a source of funding for continuing programs and activities would be presented to the city council for action at its meeting on November 30, 2004.

Finding #4: The city 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 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.

We recommended that the city 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.

City's Action: Corrective action taken.

The city reported that it plans to continue budgeting using conservative estimates. Additionally, the city council adopted a policy to set aside $2 million in each of the next five years into a reserve for contingencies to cover unexpected events.

Finding #5: The city did not budget enough for its personnel costs, its workers' compensation insurance and general liability insurance costs, and bond payments.

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. Because of these inaccuracies, the adopted budgets did not expose the city's overspending. 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.

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

- 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.

- Continue using the payment information in its bond payment schedules when budgeting for bond payments.

City's Action: Partial corrective action taken.

According to the city, it continues to use its process to better budget for salaries by comparing the positions on its position control list to its current staff. Additionally, the city reported that in the fiscal year 2004–05 budget, it set the contribution rates for its general liability and workers compensation insurance to cover the projected actuarial contributions for the cost incurred plus a contribution toward the unfunded liability of prior years' costs. The city's goal is to fully fund the unfunded liability over a 10-year period. Finally, the city indicated in its 60-day response that it would use the payment information in the bond payment schedules to develop its budget for fiscal year 2004–05.

Finding #6: The city's budget monitoring was inconsistent and flawed.

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. Although the city has taken steps to improve its monitoring procedures, to some extent the problems continued throughout fiscal year 2003–04.

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. 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.

To improve the quality of the financial information that the city council uses to make budget changes during the year, we recommended that the city's finance department 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.

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

City's Action: Corrective action taken.

In its 60-day response, the city indicated that it prepares monthly financial reports and presents them to the city council. The reports cover all operations and all funds. The city also reported that the issue of periodic financial training for council members has been referred to city council's rules committee for consideration.

Finding #7: The city 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, the city announced that at the end of June 2003, several of the city's funds had negative cash amounts. 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, the city 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. These 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.

In May 2004 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.

We recommended that the city's finance department perform prompt reconciliations of its pooled cash account. We also recommended that the finance department 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.

City's Action: Corrective action taken.

In its 60-day response, the city indicated that it prepares monthly financial reports and presents them to the city council. According to the city, each quarterly report will include an update of cash balances for each fund.

Finding #8: Late audited financial statements impaired the city council's ability to protect the city'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. 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.

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

City's Action: Pending.

The city reported that the city council is considering the issuance of a policy establishing a goal of issuing its annual financial report by each calendar year end. According to the city, it will take time to make the goal a reality.