Chapter Two

STAFF REPORT
ON

TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK

ACCOUNTING PRACTICES AND FINANCIAL REPORTING

August 26, 1977

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OF THE CITY OF NEW YORK

REPORT ON

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INTRODUCTION

Pursuant to the Securities and Exchange Commission's formal order of investigation, we have inquired into the accounting practices, systems and procedures employed by the City of New York prior to June 1975. As a result of that inquiry we believe that one of the fundamental factors underlying the City's financial difficulties was the use of budgetary, accounting and financing practices which enabled it to borrow funds from the public which could not be supported by its sources of revenue.

The results of our investigation indicate that New York City's accounting and reporting practices effectively served to obfuscate the City's real revenues, costs and financial position and that substantial weaknesses in the City's system of internal accounting control caused published financial information to be inherently unreliable. Both of these factors directly affected the materials used in connection with the sale of its securities. "Notices of Sale" were prepared in connection with the issuance of many of its debt obligations. A "Report of Essential Facts" was appended to the Notices which contained summary financial data indicating a balanced budget. This information was based on accounting principles employed by the City and was essentially a product of its defective system of internal accounting control.

Our analysis is based upon material obtained from a variety of sources, including the Comptroller General of the United States, the Office of the New York State Comptroller, the City of New York, the American Institute of Certified Public Accountants ("AICPA"), the Municipal Finance Officers Association of the United States and Canada ("Municipal Finance Officers Association"), various independent public accounting firms, testimony before the staff of the Commission's New York Regional Office as well as publications on file in various public libraries.

The staff has reviewed audit reports dealing with the City prepared by the Office of the New York State Comptroller and various independent public accounting firms; municipal accounting guidelines and other material prepared or issued by the Comptroller General of the United States, the Office of the New York State Comptroller, the AICPA, the Municipal Finance Officers Association, and others; public documents prepared by the City of New York, including statutory reports, press releases, proceedings of the City Council and various studies; nonpublic memoranda and other material obtained both pursuant to subpoena and voluntarily from the City and its Counsel; and other material, including legislative background materials, textbooks, professional journals, magazines, and newspapers.

I. NEW YORK CITY ACCOUNTING PRACTICES

A. Introduction

Many of the major problems inherent in New York City's accounting practices were succinctly summarized by City Comptroller Goldin:

> "Whereas a prudent and conservative accounting system would allow the budgeting and spending only of revenues actually to be received during the fiscal year, New York City's system allowed the accrual each year of many millions of general fund revenues which would not be collected until the following year—if, indeed they were collectible at all. Real estate taxes were budgeted as if 100 percent of the tax levy would be collected, even though it was as certain as sunrise that a portion would still be outstanding at year's end.
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> "Since spending was keyed to the level of accrued revenues rather than revenues actually received, the result was heavy short-term borrowing.
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> "On the expense side, New York City maintained a cash basis for payables, carefully preserving the fiction that incurred expenses did not exist until the bills were paid. Payroll costs, for example, were not provided for in the year incurred but rather in the year in which paychecks were distributed—a system which resulted, not surprisingly, in teachers receiving much of their earnings for the latter part of the fiscal year out of borrowings against receivables in the following year." 1/

In the course of our inquiry we sought to determine the extent to which New York City's accounting practices obscured the City's true fiscal condition and enabled the City to ostensibly

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1/ Unpublished document drafted by Harrison J. Goldin sometime subsequent to the formation of MAC; Harrison J. Goldin Exhibit 99 for identification ("Goldin Exhibit 99").

balance its budgets and prolong the precarious state of its finances until the Municipal Assistance Corporation ("MAC") enabling legislation and its mandated reforms in 1975.

Foremost among the critics of the City's accounting practices has been the MAC itself. On August 29, 1975, MAC published a document which exposed the cumulative effect of certain accounting practices utilized by New York City, indicating a deficit at June 30, 1975 of almost $2.6 billion. The MAC analysis of the City's fiscal condition cautioned that "other audits and further examination of City records may require modification" of this deficit figure. 1/

It was subsequently disclosed in the Fall of 1976 that in addition to this initial $2.6 billion deficit, the City had accrued pension liabilities and other charges which increased the deficit estimate to an amount in excess of $5 billion.

Although the accounting practices reviewed may not all have had a direct impact on the fiscal crisis, they did

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1/ Municipal Assistance Corporation, August 29, 1975 press release.

clearly affect the City's ability to provide "complete and accurate financial information in proper form and on a timely basis." 1/

City Comptroller Harrison Goldin, in testimony before the staff stated that beginning in the fall of 1974:

> "We were working intensively on developing a whole new formulation, one that would reform completely the City's accounting budgetary control and management information systems, one that would retranslate the way in which the principles had developed historically into approaches that would conform not with the historic legislatively mandated and sanctioned and customary accounting principles but with those that more closely approximated the principles articulated by the M.F.O.A. [Municipal Finance Officers Association]." 2/

Unfortunately, that "new formulation" of the City's information systems was begun too late to be of use during its fiscal crisis.

1/ National Committee on Governmental Accounting, Governmental Accounting, Auditing, and Financial Reporting (Chicago: MFOA, 1968) P 1. [Hereinafter referred to as "National Committee, Governmental Accounting."] The National Committee noted that, despite its unique character, this is the purpose of governmental accounting, as it is for accounting for other types of economic activities.

2/ Testimony of Harrison J. Goldin (26 August 1976) at pp. 134-35.

In order to put the relationship between the City's accounting practices and the massive deficit disclosed by MAC in proper perspective, we have reviewed the City's methods of revenue and expense recognition, fund accounting, capitalization of expenses, and other matters. This analysis includes a review of:

1) The basis of accounting, or the manner in which revenues and expenses were recorded in given fiscal years;

2) "Fund" accounting, or the format of the accounting system; and

3) The nature and amount of expenses financed through the capital budget.

Background material, including a brief history of municipal accounting and an overview of generally accepted accounting principles ("GAAP") applicable to municipalities, is included in Appendix A.

B. Basis of Accounting Utilized by New York City

In its investigation the staff found that the basis of accounting utilized by New York City substantially deviated from the basis of accounting regarded as generally accepted. These accounting methods were a substantial factor in the failure to set forth the huge cumulative General Fund deficit which existed as of June 30, 1975.

The accounting practices of New York City permitted the City to distort its financial position by overstating its assets and understating its liabilities and further failed to disclose a material cumulative operating deficit. The City's accounting methods recorded cash due in later years as a receivable (and as revenue) in a current fiscal year, but did not record liabilities of the same current year until a later year, when the cash was actually disbursed. Thus the recognition of revenues was advanced while the recognition of expenses was postponed, distorting both the City's financial position and its concept of a balanced budget.

A December 29, 1975 Arthur Andersen & Co. report sharply criticized this practice stating:

> "The basic policy is to account for expenditures on a cash basis and revenue on an accrual basis, whether earned or not. This approach can be very distortive of financial position and has probably contributed to the present fiscal crisis. The accruing of unearned or unbillable revenue is not an acceptable accounting practice and could be manipulated to reflect a better financial

> picture than actually exists. It seems particularly anomalous when combined with cash basis expense accounting, where liabilities are understated." 1/

Indeed, the City went beyond this by increasing from year to year the amounts of revenues and expenses so recorded. As the City from year to year increased its recognition of accrued revenues, it also increased from year to year its delay in the recognition of such expenses as pension fund payments and payroll. Thus, the imbalance increased, being expanded to new categories of revenues and expenses, in addition to the increased dollar amounts applicable to revenue and expense categories not newly introduced in a given year.

Our inquiry has included the City's treatment of revenues which were budgeted to be received from its three primary sources: (a) revenues from taxes of various types which the City recorded in its General Fund, (b) revenues from the State and Federal governments under various State and Federal aid programs, and (c) revenues from real estate taxes. We have also reviewed the City's method of recording expenses for personal services

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1/ Arthur Andersen & Co., Report for the Secretary of the Treasury Regarding Information Relating to the Financing Requirements under the New York City Seasonal Financing Act of 1975, 29 December 1975 [Hereinafter referred to as "Arthur Andersen & Co., Report for the Secretary"].

and have briefly described certain other items such as reserve account transactions. The following pages relate the effects of what Comptroller Goldin has called "this least conservative of all possible accounting systems." 1/

1. General Fund Revenues 2/

The City receives tax revenue from a variety of sources such as the City sales tax, personal and corporate income taxes and stock transfer tax 3/, and, during the fiscal year, generally records revenue as it receives cash in payment of these taxes. Prior to 1975, however, at the end of a fiscal year, an estimate was made of certain tax revenue which would be received in cash in the following fiscal year and which was deemed applicable to the current fiscal year. The City then recorded this estimated revenue in the current fiscal year and to meet its cash needs, issued Revenue Anticipation Notes ("RANs").

1/ Goldin Exhibit 99, p. 4.

2/ The "General Fund" in the City accounting system differs substantially from the GAAP concept.

3/ For a complete list of taxes paid into the City's General Fund, see part 2-E of the Annual Report of the Comptroller of the City of New York for the Fiscal year 1974-1975.

Revenue recorded in this manner was commonly referred to as the "June accrual." According to MAC, this practice resulted in $358 million of the cumulative deficit. 1/

The issuance of RANs in anticipation of the receipt of estimated revenue was permitted by a New York State Statute passed in 1965. Prior to 1965, the City was precluded from borrowing against taxes and fees unless they were due and payable during the fiscal year. 2/ The City issued no RANs at all in some years during the 1950's and early 1960's and when it did, they were nearly always paid off by year-end. The 1965 enactment permitted the City to borrow against certain taxes and fees which were not scheduled for receipt by the City prior to the end of the fiscal year.

1/ Municipal Assistance Corporation, August 29, 1975 press release.

2/ Legislative Memoranda: "New York City - Revenue Anticipation Notes" at 2064.

It appears that the City of New York viewed this bill as having only a limited effect on future budgets. In a memorandum issued by the City in 1965 in support of the bill, the City noted:

> "This proposed change will enable the City to borrow approximately $50,000,000 more in the current fiscal year, in anticipation of revenues to be collected in 1965-1966 which are attributable to activities occurring in 1964-1965. <u>It will not increase the temporary borrowing power in subsequent fiscal years</u>, but will merely change the anticipated revenue base to include the revenues attributed to activities occurring in the fiscal year in which the notes are issued." 1/ [Emphasis added].

It has been asserted that the City's continuing use of the June accrual was a necessary feature of the City's finances. This is apparently based on the premise that once the June accrual was introduced to help balance the City's budget in 1965, it had to be used in following years or there would be a "shortage" of revenue, since revenues received during that year would be applied to the previous year.

1/ Memorandum of City of New York on Chapter 441, 1965 N.Y. Laws.

This argument attempts to justify a continuation of the June accrual but does not explain why the City increased the size of the accrual from 1965 to 1974. The City did not merely remain on the treadmill, it increased the speed. Pursuant to the 1965 legislative authorization year-end balances of RANs grew to $298.3 million by June 30, 1974 as follows:

RANs Outstanding

REDEEMABLE FROM GENERAL FUND REVENUES

As of June 30	Millions
1965	$ 56.6
1966	45.0
1967	93.8
1968	93.8
1969	93.8
1970	116.7
1971	131.3
1972	150.0
1973	162.1
1974	298.3 1/

These increases in the June accrual aggravated the mismatching in the City's recognition of revenues and

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1/ This data is taken from the Annual Report of the Comptroller of the City of New York ["Annual Report of the Comptroller"], Part 6-C, Statement 1 for the appropriate years.

expenses by annually boosting accrued revenues. This escalation included both the introduction of new categories of revenues and increases in dollar amounts applicable to revenue items accrued in prior years. The chart on the following page shows the components included from year to year in the June accrual.

City officials, in testimony before the staff, have maintained that the June accrual was imposed upon them by State statute. 1/ The 1965 legislation was permissive, not obligatory however, and related to allowable borrowings, not accounting practices *per se*. In addition, when the State legislature passed the bill, it appears to have viewed the related increased short term borrowing to be approximately $50 million. In 1965 and 1966 the City borrowed approximately this amount, but in subsequent years it markedly and regularly increased borrowings.

1/ See, e.g., colloquy during the Testimony of Abraham D. Beame at p. 68.

JUNE ACCRUAL
DATA TAKEN FROM COMPTROLLER'S ANNUAL REPORT
FOR APPROPRIATE YEAR, PART 2-E, STATEMENT 6

FOR	AS OF JUNE 30, (000's OMITTED)						
	1965	1970	1971	1972	1973	1974	1975
SALES TAX	$ 35,100	$ 36,100	$ 42,500	$ 45,000	$ 45,400	$ 56,700	$ 79,400
UTILITY TAX	2,300	3,800	3,800	4,200	5,000	5,600	7,700
COMMERCIAL RENT AND OCCUPANCY TAX	6,800	8,500	11,000	12,000	13,700	17,100	19,600
GASOLINE AND MOTOR FUEL TAX	6,200	8,000	8,000	9,000	11,000	14,000	10,500
MORTGAGE TAX	3,000	1,200	1,000	2,000	2,500	700	500
WATER METER REVENUES	2,000						
WATER CHARGES		3,300	5,700	6,700	7,000	114,800	117,200
SEWER RENTS							25,000
COMPENSATING USE TAX	200						
AMUSEMENT TAX	400						
HORSE RACE ADMISSIONS TAX	200						
TAX ON CONVEYANCE OF REAL PROPERTY	400						
PERSONAL INCOME TAX				25,000	29,000	45,100	46,700
PERSONAL INCOME TAX AND UBT		13,200	16,700				
GENERAL CORPORATION TAX		34,000	34,000				
GENERAL CORPORATION AND UBT				34,800	37,000	36,600	40,000
CIGARETTE TAX		2,600	2,600	4,300	4,500	2,600	1,600
STOCK TRANSFER TAX		6,000	6,000	7,000	7,000	5,100	8,500
AUTO USE TAX							1,700
TOTALS	$ 56,600	$116,700	$131,300	$150,000	$162,100	$298,300	$358,400

For instance, in June 1973 the City Council enacted a law, submitted by the Mayor, 1/ which permitted the City to budget eighteen months of water charge revenue in the twelve month 1973-1974 fiscal year, yielding an additional $52.5 million in accrued revenues. Prior to the enactment of this law, the City billed such charges on the first day of each January for the following twelve calendar months. The City Council enactment revised this billing procedure as follows:

> "1. One-half of the annual charges for un-metered water shall become due and payable, in advance, on January 1, 1974, for the period January 1 to June 30, 1974.
>
> "2. Commencing on June 30, 1974, all annual water charges for un-metered water shall be due and payable in advance on June 30th of each year." 2/

As a result of this enactment, the City was permitted to boost water charge revenue budgeted for the 1973-74 fiscal year by including six months' revenues (January 1-June 30, 1975) in the 1973-1974 fiscal budget. The City issued RANs in anticipation of the receipt of those revenues estimated by the Mayor to be attributable to 1973-74 but still uncollected as of June 30, 1974. The related increase in RAN debt is reflected in the City's Expense Budgets and Annual Reports:

1/ Office of the Mayor, City of New York, Executive Budget, 1973-1974, Message of the Mayor, 15 May 1973, p. 2.

2/ Proceedings of the Council of the City of New York, June 19, 1973, p. 1241.

Fiscal Year Ended June 30	Budgeted Revenue (Millions)	RANs Outstanding at June 30 (Millions)
1973	$185.0	$ 7.0
1974	242.5	114.8
1975	180.9	117.2

In order for the 1974-1975 budget to reflect twelve months of water charge revenue, water charge revenue applicable to 1975-1976 was accrued. None of these "revenues" had been earned in the accounting sense, since the related services had yet to be rendered.

MAC wrote off the entire $358.4 million June accrual to the June 30, 1975 cumulative deficit. Of that amount $117.2 million was attributable to water charge revenue.

Another practice used by the City to inflate its budgeted revenue was its treatment of sewer rent revenue.

In May 1974, the City Council enacted legislation which permitted the City to budget additional sewer rent revenue in the 1974-1975 fiscal year. Prior to this enactment, sewer rents for a fiscal year ending June 30 were billed on January 1 <u>during</u> that particular fiscal year. The 1974 enactment permitted the City to advance its billings by six months, making sewer rents payable on June 30th in advance of the particular fiscal year to which the rents applied. Thus, sewer rents for fiscal 1975 were payable on June 30, 1974.

In recommending adoption of the law, the City Council's Committee on Finance reported that "the initial 6 month acceleration of sewer rent collections from January 1, 1975 to June 30, 1974 is estimated to yield approximately $28 million in additional revenue in fiscal 1974-1975." 1/ The City's Expense Budgets reflected budgeted sewer rents of $46.0 million in fiscal 1973-74, and $73.0 million in fiscal 1974-75. The increase in 1974-75 reflects the early accrual of the 1975 sewer rents.

Following the change in collection dates, the City introduced sewer rents as part of the June accrual for fiscal 1975. MAC ascribed $25 million of the June 30, 1975 write-off amount to accrued revenue for sewer rents. The MAC mandated adjustment appears to be proper, since these revenues were also unearned.

1/ Proceedings of the Council of the City of New York, May 23, 1974, p. 956.

2. Federal & State Aid Revenue

The City also accrued revenue for Federal and State aid and issued RANs in anticipation of the receipt of this revenue. This practice resulted in deficit financing to the extent that this accrued revenue was inflated.

Both the National Committee on Governmental Accounting ("National Committee") in 1968, and the American Institute of Certified Public Accountants ("AICPA") in 1974, have set similar criteria concerning the accrual of revenue by municipalities. 1/ The State Comptroller's MAC Directives 2/ are based for the most part on the promulgations of these two authoritative sources and have further delineated the criteria for the recognition of revenues from Federal and State aid as follows:

> "To be recognized as a revenue and as a receivable, the related expenditure must be within statutory and regulatory limitations. Revenues and receivables should not be recognized to the extent that: (a) expenditures are not allowable by law or regulation; (b) expenditures exceed the dollar amount of available grants; (c) claimed expenditures are disallowed upon audit; and (d) past experience indicates that claimed expenditures will be disallowed upon audit." 3/

1/ See Appendix A.

2/ The MAC legislation requires that the City adopt the New York State Comptroller's uniform system of accounts, as modified for New York City. These changes were issued in a series of "MAC Directives."

3/ Office of the New York State Comptroller, Division of Audits and Accounts, Accounting Systems Directive No. 1; Budgetary and Accounting Practices for State and Federal Receivables (19 September 1975): 2.

It appears that the City accrued its Federal and State aid revenue in a manner which was at variance with the recommendations of existing authoritative sources. The Office of the New York State Comptroller indicated in an audit report on the City dated July 1, 1975 that:

> "...the City had included as accounts receivable substantial amounts that were not collectible or where the likelihood of collection was extremely remote - such as claims for reimbursement of disallowed costs, claims in excess of stipulated limitations, and claims that had been rejected but were on appeal." 1/

In August 1975, MAC attributed $778 million of the cumulative deficit to uncollected Federal and State aid and other receivables. In October 1976, in refining the MAC figures, the Office of the City Comptroller attributed $963 million of the revised $5.078 billion deficit to a revaluation of aid receivables ($678 million) and to the establishment of a reserve for federal and state aid disallowances ($285 million). 2/

The issuance of RANs in anticipation of the receipt of Federal and State aid is authorized by Section 25 of the Local Finance Law, which was amended in 1965 to expand the City's authority to issue RANs against Federal and State aid.

1/ Office of the New York State Comptroller, Prior Year Accounts Receivable, Managerial Summary, p. 3.

2/ Office of the Comptroller, City of New York, Annual Report of the Comptroller of the City of New York for the Fiscal Year 1975-1976 p. 25, note M.

Prior to 1965, the City could issue RANs against uncollected Federal and State aid owed for a fiscal year, even if not paid until after the end of a fiscal year. However, the law required that RANs outstanding at the end of a fiscal year, when added to the receipts for the year, could not exceed the amount of aid actually collected in the preceding fiscal year. Thus, if a billion dollars in federal and state aid was received in fiscal 1963 and $900 million in revenue had been received by the end of fiscal 1964, outstanding RANs could only total $100 million. This was designed to assure that RANs issued in a given fiscal year were virtually repaid at year-end.

The new law changed this restriction, eliminating the requirement that borrowings against aid be tied to the prior year's collections. Instead, it permitted the City to borrow against the Mayor's estimate of Federal and State aid applicable to the current year's budget. The law was apparently intended to conform the temporary borrowing power in anticipation of revenues to the operations of the City budget and revenue collections. 1/ However, it left open the question of how the notes would be repaid if these estimates turned out to be overly optimistic.

1/ Memorandum of the City of New York on Chapter 441, 1965 N.Y. Laws.

RANs outstanding related to Federal and State aid at fiscal year ends 1963 through 1969 were as follows:

RANs outstanding

As of June 30	Millions
1963	$ -0-
1964	40.0
1965	62.0
1966	-0-
1967	-0-
1968	-0-
1969	35.0 1/

As of June 30, 1970, year-end borrowings against Federal and State aid climbed to $420 million.

The law pertaining to RANs was again changed in 1971 and the City was permitted to issue RANs in anticipation of the receipt of various revenues on an overall basis rather than by specific sources of revenue. This change was sponsored by then Comptroller Beame 2/ who argued that the restrictions of Section 25 of the Local Finance Law required "complicated and

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1/ This data is taken from the Annual Report of the Comptroller, Part 6-C, Statement 1 for the appropriate year.

2/ Letter dated 28 June 1971 from Ronald E. Stringer, Law Secretary, Office of the Comptroller, The City of New York to Michael Whiteman, Counsel to the Governor.

unnecessary recordkeeping at local levels of government" which resulted from "the recent expansion of federal and state aid to finance local governmental activities, and because this aid is received pursuant to a plethora of assistance programs." 1/

Thereafter, the City's balances of RANs outstanding at year end related to Federal and State aid were as follows:

RANs outstanding

As of June 30	Millions
1970	$ 420.0
1971	965.0
1972	1,030.0
1973	725.0
1974	1,500.0
1975	2,560.0 2/

The staff attempted to draw comparisons for corresponding years between these balances of RANs outstanding and balances of federal and state aid receivables against which the RANs were issued. In an effort to obtain the balances of these

1/ Undated Memorandum from Abraham D. Beame, Comptroller, The City of New York, in Support of Senate Act No. 3568, An Act to Amend the Local Finance Law, in Relation to Revenue Anticipation Notes.

2/ This data is taken from the Annual Report of the Comptroller, Part 6-C, Statement 1 for the appropriate year.

aid receivables, we reviewed financial data contained in the statement entitled "Part 1 - Consolidated Statements - Summary 2" in the Annual Report of the Comptroller for each year during the period 1970 to 1975. We were unable to identify such balances due to the lack of information as to the extent to which federal and state aid receivable balances were included in various accounts in this statement. For example, there is a statement on page 2 of the Comptroller's 1973-1974 Annual Report that reflects receivables due from federal and state aid, but also reflects cash and receivables due from "miscellaneous sources," from "various sources for prior reimbursable outlays by the City," and from the "Stabilization Reserve Corporation." There is no indication of the extent to which balances in such accounts support RAN balances. Aid receivable balances are set forth in the "Foreword" in each Annual Report, but these balances apparently refer only to aid receivables for current outlays without regard to receivables from prior years which may support the issuance of RANs.

Had sound accounting principles been used, the City would have been unable to show sufficient accrued revenue to support the outstanding RANs. To the extent that these aid receivables were uncollectible, the accrual represents a portion of the City's cumulative deficit. As mentioned previously, in August 1975 MAC, using the State Comptroller's accrual criteria, attributed $778-million of the cumulative deficit to potentially uncollectible federal and state aid and other receivables, and in October 1976, the City revised this estimate upwards to $963 million.

Although approximately $300 million of the $778 million aid writeoff identified by MAC was attributable to aid claims which may have been in dispute, the City's financial reports should have given consideration to potentially uncollectible aid claims. The National Committee recommends that an:

> ". . . accrued receivable recorded on the books should be offset by an estimated allowance for amounts which will not be collected . . . .This should be done for the same reasons that it is done in commercial accounting for accounts receivable namely, to present an accurate picture of resources which will actually be realized in the course of operations and to prevent an overstatement of assets and equity accounts on the periodic statements of financial position." 1/

1/ National Committee, Governmental Accounting, p. 12.

The effect of these deviations from GAAP was far more significant than a simple failure to adhere to accounting guidelines. As the Office of the New York State Comptroller noted:

> "The significant overstatements of receivables also meant that revenue anticipation notes issued by the City and which were stated to be supported by Federal and State aid receivable were not so supported." 1/

The City's published financial reports consistently reflected these aid receivables as "resources," 2/ without indicating the questionable collectibility of this aid by either an offsetting allowance or footnote disclosure. For example, the Comptroller's Annual Report for the fiscal year 1973-1974 published on October 31, 1974, the last Annual Report published prior to the City's fiscal crisis, contained the following disclosure without mention of potential losses arising from either disputed claims or bookkeeping errors:

1/ Office of the New York State Comptroller, Division of Audits and Accounts, Audit Report on Review of New York City's Central Budgetary and Accounting Practices; Interim Report No. 1-Prior Year Accounts Receivable (Report No. NYC-3-76: 1 July 1975) Managerial Summary, p. 4. /Hereinafter referred to as "Office of the New York State Comptroller, Prior Year Accounts Receivable"/.

2/ See the Annual Report of the Comptroller of the City of New York for the Fiscal Year 1973-1974, Part 1, Consolidated Statements, Summary 2, p. 2.

"Federal and State funds of various kinds constituted 44.46 per cent of the 1973-1974 Expense Budget as compared to 44.64 per cent in preceeding year. The dollar amounts of such aid were $4.557 billion in 1973-1974 and $4.163 billion in 1972-1973.

"While such funds are urgently needed, the delays which occur between expenditures and reimbursements requires heavy borrowings with a consequent heavy burden of interest. This interest expense draws funds from other high priority needs. It is extremely necessary, therefore, that the other levels of government which supply the funds agree to a plan for advance installment payments.

"Unaudited State and Federal aid still receivable as of June 30, 1974 totaled $998.1 million, an increase of $55 million over the amount of such aid still receivable on the same date in 1973." 1/

The National Committee published its accounting guidelines in 1968, followed by the AICPA's Audit Guide in 1974. Since its foreclosure from the credit markets in 1975 the City apparently has adopted procedures recommended by the State Comptroller for recording federal and state aid receivables.

1/ Ibid, p. viii. The Annual Report also stated that $300 million in short-term debt outstanding as of June 30, 1974 represented RANs for aid receivables "for 1972-1973 and prior years." Ibid., p. vii. There is no explanation of the apparent anomaly between these receivables (totalling less than $1.3 billion) and the $1.5 billion of outstanding RANs related to State and Federal aid which were reported as outstanding at June 30, 1974.

3. Real Estate Tax Revenue

The City also accrued revenue for real estate taxes and issued tax anticipation notes ("TANs") in anticipation of the receipt of such accrued revenue. Similar to its practice in issuing RANs, the City's issuance of TANs resulted in a deficit to the extent that accrued real estate tax revenue was inflated.

GAAP permits the accrual of real estate tax revenue in certain instances. The National Committee recommended accrual of real estate tax revenue because:

> "...the tax is levied pursuant to law as of a specific date, the amount of the tax is precisely determinable in advance, and an enforceable legal claim attaches to the properties and/or taxpayers subject to the tax." 1/

The AICPA, did not make specific recommendations regarding accrual of real estate tax revenue but instead outlined the following criteria:

> "One major source of revenue which may or may not be accruable is property taxes. In many jurisdictions throughout the country, accounting for property taxes is on a cash basis because a portion or all of the payment is not due until the year following the year billed. Timing considerations and the availability of such revenues to meet expenditures in the related budget year should be considered in determining whether or not property taxes should be accrued." 2/

1/ National Committee, Governmental Accounting, p. 12.

2/ AICPA, Audit Guide, p. 15.

Where real estate tax revenue is accrued, GAAP requires that an allowance be established to provide for real estate taxes which are estimated to be uncollectible:

> "Where this /accrual/ method of accounting is followed, the accrued receivable recorded on the books should be offset by an estimated allowance for amounts which will not be collected. For example, an Allowance For Uncollectible Taxes should be set up and shown as a deduction from the receivable account, Taxes Receivable Current, on the asset side of the fund balance sheet. This should be done for the same reasons that it is done in commercial accounting for accounts receivable, namely, to present an accurate picture of resources which will actually be realized in the course of operations and to prevent an overstatement of assets and equity accounts on the periodic statements of financial position" 1/ [Emphasis in Original].

Prior to the fiscal crisis, the City recorded real estate taxes at variance with these criteria by accruing real estate tax revenue without offsetting the accrual with an "Allowance for Uncollectible Taxes." The City then issued TANs in anticipation of receipt of the accrued revenue.

The following balances of real estate taxes receivable and TANs outstanding illustrates the extent to which these accrued outstanding receivables allegedly supported the City's issuance of TANs:

1/ National Committee, Governmental Accounting, p. 12.

As of June 30	TANs Outstanding	Taxes Receivable per Annual Report
	Millions	
1963	$ 63.1	$ 94.2
1964	77.4	104.7
1965	88.8	115.9
1966	100.3	130.3
1967	136.5	168.8
1968	147.5	176.4
1969	155.5	187.5
1970	170.0	204.9
1971	206.0	241.9
1972	232.0	282.8
1973	265.0	337.5
1974	317.0	408.5
1975	380.0	502.2 1/

A major portion of amounts carried as receivable at June 30, 1975 were of questionable collectibility. In August 1975, the Office of the State Comptroller, in an audit report, concluded that over 80% of the real estate taxes listed by the City as receivable as of June 30, 1975 was neither collectible nor readily available. 2/

The State Comptroller's report was critical of the City's procedures as to internal accounting control of real estate taxes receivable, 3/ and outlined the problem created by the inflation of these receivables as follows:

1/ The data in column 2 was taken from "Part 6-C - Temporary Debt - Statement 1," and the data in column 3 was taken from "Part 1 - Consolidated Statements - Summary 2" of the Annual Report of the Comptroller for the appropriate year.

2/ Office of the New York State Comptroller Audit Report No. NYC-26-76, Uncollected Real Estate Taxes, p. 4.

3/ See discussion under "Internal Control," infra.

"The City's budgetary and accounting practices result in an inflated estimate of real estate taxes to be collected to balance the annual expense budget, and do not make adequate provision for taxes that will not be collected. The result has been that budgeted real estate tax amounts have not been realized; for the most part, the revenue shortfall has been met by continued borrowing.

* * *

"Two major causes for this shortfall are: (1) the City included properties in its tax rolls which were not subject to real estate taxes or for which taxes would not be collected, and (2) there has been insufficient provision for the increasing volume of defaulting taxpayers and tax cancellations and remissions." 1/

Taxes receivable which fall into the first category amount to $282.6 million, and include real estate taxes receivable for publicly-owned property ($126.6 million), 2/ diplomatic

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1/ Office of the New York State Comptroller, Uncollected Real Estate Taxes, p. 4. In the "Managerial Summary", the theme of the first cited paragraph was stated as follows: "The City's Budgetary practices result in an inflated estimate of real estate taxes that it can reasonably expect to collect to balance the annual expense budget. Unless expenditures are reduced to make up the shortfall, the City's budget is automatically out of balance; borrowings thus become necessary to meet the cash flow deficiency." Office of the New York State Comptroller, Uncollected Real Estate Taxes, Managerial Summary, pp. 1-2.

2/ Examples include a high school, a public park, an urban renewal sight, abandoned City waterworks, a community college, City occupied office buildings, and Carnegie Hall. See Uncollected Real Estate Taxes, p. 7. The City's Tax Commission grants exemptions based upon the owner's and/or the parcel's use as defined by law. This procedure is contingent upon the owner filing an application for exemption with the Tax Commission. Barring submission of an application, there is no mechanism for the Finance Administration to exempt the property regardless of who owns the property or for what it is used.

"The absence of such a procedure has resulted in levying significant amounts of real estate taxes on properties from which taxes will not be collected....

"...the City is generating a built-in real estate tax collection shortfall by continuing the practice of including its own property on the tax rolls." Ibid, p. 8.

property ($4.7 million); 1/ Mitchell-Lama property ($53.0 million); 2/ "in rem" property ($54.4 million); 3/

1/ "The need for some provision for uncollectible taxes is evident in the City's handling of diplomatic property. The City has on its tax rolls diplomatic properties whose status would be exempt if the proper filing for exemptions were instituted by the owners. Thus, 40 out of a total of 60 diplomatic properties have unpaid real estate taxes, with most of the taxes outstanding for extremely long periods....the City's ability to collect these taxes is limited, since diplomatic properties are exempt from in rem foreclosure proceedings." Ibid, pp. 8-9.

2/ Mitchell-Lama properties are properties which are permitted, by law, to apply for "shelter rent exemptions which in effect, are an abatement of real estate taxes." Real estate taxes were overbilled to these properties because "the tax was determined exclusive of tax abatements authorized under shelter rent exemptions" due to the "lack of communication between City departments." Ibid, pp. 9-10.

3/ "In rem properties are those in the process of being foreclosed because of nonpayment of real estate taxes. The City's procedures for accomplishing foreclosure are painfully slow....Although the City will ultimately realize some revenue from the sale of these properties, the amount that will ultimately be collected is uncertain. Meanwhile, the full amount of the receivables is included in the City's total of uncollected taxes." Ibid, pp. 9-10.

and for property belonging to Penn Central, a bankrupt corporation ($43.9 million). 1/ Taxes receivable which the State auditors considered as uncollectible and which fall into the second category amount to an additional $125.7 million. 2/ Thus, the State auditors noted that "out of a balance due of $502.3 million, it is likely that only $94 million will be collected and available within a reasonable period." 3/

As a result of these findings, the Office of the State Comptroller questioned the extent to which TANs issued by the City were, in fact, secured by real estate taxes, noting:

1/ "The Penn Central Corporation is in reorganization and the collectibility, in the foreseeable future, of outstanding real estate taxes is extremely doubtful." Although "the Finance Administration feels that Penn Central arrears should not be written off as uncollectible," the State auditor's report recommended that rather than writing off Penn Central arrears, the City should keep the arrears on the books and make a bookkeeping entry establishing a provision for uncollectibility. "Such a provision would be fiscally prudent, in that the central records would show the amounts of taxes readily available to meet expenditures; it would also prevent borrowing against taxes that either may never be collected or may not be collected in the foreseeable future." Ibid, pp. 10-12.

2/ The State auditors noted that this estimate was computed based upon "collection experience statistics for prior years," but did not disclose these statistics. Ibid. p. 4.

3/ Ibid.

> "The City issued $380 million of TAN's on June 11, 1975 secured by $448 million of uncollected real estate taxes. We found that real estate taxes that could be reasonably construed as 'collectible' or 'available' would support less than one-third of these TAN's. According to our analysis, only $106 million of $448 million of uncollected real estate taxes were potentially collectible at June 10, 1975, leaving 72 percent or $274 million of the TAN's unsupported. (Between June 10 and our later study as of June 30, 1975, a total of $12 million was collected or cancelled)." 1/

The State Comptroller's report noted that in selling these TANs, the City Comptroller had issued: ". . . a certification as to the amount of real estate taxes uncollected and not cancelled as of June 10, 1975. However, the amount of potentially uncollectible real estate taxes was not determined and deducted from the certified amount." 2/ In an extension of his analysis of the annual patterns of TAN borrowings, the State Comptroller stated, "while the TAN's issued earlier in the fiscal year would be fully supported by collectible tax receivables, the year-end borrowings may not have been fully secured by collectible receivables. . ." 3/

1/ Ibid., p. 20.

2/ Ibid., p. 22.

3/ Ibid., p. 22.

Although the Office of the State Comptroller estimated that approximately 20 percent, or $94 million, of the June 30, 1975 receivable balance for real estate taxes would be "collected and available within a reasonable period," 1/ the August 29, 1975 MAC adjustment wrote off the entire $502 million receivable. In March 1976, the Office of the New York State Comptroller issued a MAC Directive, which outlined budgetary and accounting practices to be followed by the City in budgeting and recording real property tax revenue. This directive required that the City record its real estate tax revenue on a cash basis, "giving recognition to uncollected real estate taxes so that expenditures will not be budgeted on the basis of revenues that will not be collected." 2/

1/ Ibid, p. 4.

2/ Office of the New York State Comptroller, Summary of Accounting Systems Directives for New York City, Managerial Summary, p. 2.

4. Stabilization Reserve Corporation Receivables

In 1974, the Stabilization Reserve Corporation ("SRC") (a corporate governmental agency of the State of New York) was formed for the purpose of "assisting the City of New York . . . in the provision of essential services to its citizens on a sound financial basis during a limited period of unprecedented fiscal crisis for the City: July 1, 1973 - June 30, 1975." 1/

SRC was established to assist the City in the management of short-term debt. Through the SRC, the City proposed to issue bonds and notes in an aggregate maximum amount of $520 million. The bonds of the corporation were to be general obligations with maturities not greater than 10 years. Provisions for repayment of the principal and interest on the bonds were to be made in 10 approximately equal annual installments. A capital reserve fund would be created through which SRC bonds were to be redeemed. 2/

Through May 1975, the City was unable to issue any SRC debt due to the Wein litigation. 3/ On March 7 and March 8, 1975 it was suggested by Wood Dawson Love & Sabatine, the bond counsel who passed upon the legality of bonds issued by the City, that the City might issue anticipation notes for the SRC bonds in order to assist the City in its cash flow problems during the early part of 1975 even though the borrowing itself was delayed

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1/ Official Statement of the New York City Stabilization Reserve Corporation, dated January 31, 1975, at p. 1.

2/ Official Statement of the New York City Stabilization Reserve Corporation, dated January 31, 1975, at pp. 1, 4.

3/ Preliminary Draft Official Statement of the City of New York, dated May 23, 1975, at pp. 41, 42-43.

by the _Wein_ suit. In the Annual Report for fiscal year 1973-1974, the City included among its _actual receipts_ $150 million from SRC. The following language appears in the explanatory material prefacing a table in this report: "A receivable of $150,000,000 was set up against the proposed borrowing by the New York City Stabilization Reserve Corporation established pursuant to Chapter 594 of the laws of 1974." 1/ Nothing more was said to justify this "receipt."

In the subsequent fiscal year (1974-75), there was a similar entry for $370 million, again under the heading of actual receipts.

1/ _Annual Report of the Comptroller_ for the Fiscal Year 1973-1974, at p. 175.

5. Expenses

In contrast to the City's method of accelerating recognition of revenue, the City delayed recognition of expenses.

This delay accounted for $365 million of the City's recorded June 30, 1975 cumulative deficit. 1/ It was also revealed that correction of a two-year lag between the incurrence and payment of municipal employee pension expense would add an additional $2.167 billion to the June 30, 1975 cumulative deficit. In placing expenses on an accrual basis, therefore, the City has so far recognized $2.532 billion as part of its cumulative deficit as of June 30, 1975.

Both the National Committee and the AICPA recommend that under both the modified accrual and the full accrual bases, expenses be recognized at the time liabilities are incurred, (with certain exceptions not pertinent here.)

1/ Annual Report of the Comptroller, 1975-1976, p. 25, Note M.

The City, however, recorded its expenses in a manner which was at variance with these recommendations. Responding to a staff questionaire, dated October 14, 1976, the City stated that it recognized expenditures against budgetary accounts as follows:

> "1. Personal Service (PS) - cash basis
>
> "2. Contracts - upon registration of a contract
>
> "3. Other OTPS [Other Than Personal Services] - largely upon receipt of a voucher." 1/

The Arthur Andersen report noted:

> "Expenses should be recognized when incurred. The accounting presently recognizes expenses only when vouchers are processed for payment. Instances of significant delay in agency processing of vouchers have been cited so that there is not accounting of incurred expenses on a timely basis.
>
> "While the Comptroller has a system for encumbering outside contracts, expense is still not recognized until vouchers are processed. Also, year-end payrolls have not been accrued." 2/

1/ City of New York, "Draft Response," October 14, 1976, p. 5. We have not requested that this response be finalized because we believe that information as to certain clarifications is available from other sources.

2/ Arthur Andersen & Co., Report for the Secretary, pp. 24-25.

The City Comptroller stated in the Annual Report of the Comptroller of the City of New York for the Fiscal Year 1974-1975 that in general, the City "employed a cash basis for recognizing expenses." 1/ Comptroller Goldin had noted earlier that "New York City maintained a cash basis for payables, carefully preserving the fiction that incurred expenses did not exist until the bills were paid." 2/

The August 1975 MAC adjustment included adjustments for $105 million accrual of payroll expense, $25 million accrual of overtime pay, and $95 million of various other expenses incurred prior to June 30, 1975.3/

1/ Office of the Comptroller, City of New York, Annual Report of the Comptroller of the City of New York for the Fiscal Year 1974-1975, Foreward, p. xiii.

2/ Goldin Exhibit 99, p. 4.

3/ Municipal Assistance Corporation, August 29, 1975 press release.

There is also evidence that in addition to utilizing the cash basis to delay recognition of expenses, the City increased from year to year the amount of expenses so delayed. Similar to the annual increments in the accrual of revenue, annual increments in delaying recognition of expenses aided the City in annually balancing its budget. Certain of these matters are discussed below.

(a) Payroll.

The City's treatment of payroll expense is illustrative of how the City's recognition of expenses on a cash basis served to defer expense recognition and to assist the City in annually balancing its expense budget.

In 1971, the City's Board of Education reported a deficit of $40 million in its fiscal 1970-71 budget. To deal with this estimated deficit, City Comptroller Beame requested the Board to provide data to his Office in support of this reported deficit. The Comptroller denounced as "inexcusable" the "failure of the Board of Education to responsibly gauge its expenditures," and pending analysis of this supporting data, "urged the Board to defer implementing cutbacks in teaching personnel." 1/

The Comptroller also offered an emergency proposal to "provide the funds " necessary to avoid the Board's planned cutbacks in teaching personnel. He noted that his proposal

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1/ Office of the Comptroller, City of New York, Press Release (8 March 1971), p. 1.

would "not cost our taxpayers one penny in this or in next year's budget." Comptroller Beame outlined his proposal as follows:

> "This is how my emergency proposal would work: Under present procedures, teachers are paid, at the end of the school year, by a single check on July 1st covering the second half of June and the month of July. This procedure will still continue.
>
> "At present, the charge for this July 1st payment is split between the current budgetary year and the upcoming year. In other words, part is charged to June, and part to July.
>
> "I propose, starting this year, to charge the entire July 1st check — which, I said, includes June payroll — to July, that is, the upcoming fiscal year. This new procedure would then continue each year thereafter.
>
> "Thus, the projected education budget gap for this year, could be closed by relieving the current budget of this charge.
>
> "It is estimated that about $50 million of the education payroll paid out on July 1 is applicable to the month of June. Inasmuch as the Board of Education says $25 million is needed to avoid any cutback in teaching personnel, . . . , about half of the $50 million can be used to balance the current 1970-71 education budget. The remainder can be used to carry this cost into the new 1971-72 education budget year, so as to avoid any additional taxes next year for this purpose.
>
> "If the Corporation Counsel thinks legislation is needed to make this plan effective, it should be introduced at once.

"I also want to point out that this same procedure could be used with respect to non-educational payrolls, where the last few days in June are paid in early July. This would make more than $20 million available for 1971-72, and would reduce the need, to that extent, for additional taxes being suggested for the 1971-72 City budget, or can help meet our deficit for the current year. If legislation is required, as indicated above, this phase should also be included.

"I am making this proposal only because of the extraordinary crisis facing the City right now. In balance, I believe this is a reasonable resolution of a difficult problem." 1/

In a press release issued in response to this proposal, Mayor Lindsay sympathized with and shared the Comptroller's desire to seek an answer to the crisis. However, Mayor Lindsay labeled the device to defer recognition of payroll expense as "stopgap financial juggling", and emphasized that this should be understood:

"It merely puts off today's pain until tomorrow.

"It underscores the need for new City taxes, for it will <u>not</u> correct the overspending which produced the problem. It will <u>not</u> increase the City's ability to finance the growing burden of education. What it <u>will</u> do is mortgage the budget in the fiscal year 1972-73 by passing forward $75 million in increased payments which we have no present means of financing. This is unsound fiscal practice." 2/ [Emphasis in Original]

1/ Ibid, pp. 1-2. The initial impact was subsequently revised upward by $3.5 million by implementation of the same deferral procedure for per diem substitutes and administrative employees of the Board of Education.

2/ Office of the Mayor, City of New York, <u>Press Release</u> (8 March 1971): 1.

Comptroller Beame shortly thereafter announced that since the Office of the Corporation Counsel had determined that legislation was not required to implement his proposal, he would take all appropriate steps to implement the proposal to "provide funds" in the fiscal 1971 budget. 1/

Documents submitted to the staff by the City indicate that this procedure of recognizing payroll expense when paid assisted the City in reducing the recognition of payroll expense in fiscal years 1972, 1973, 1974 and 1975 as well. For each of those years, the procedure of recognizing payroll expense on a cash basis (when paid) enabled the City to record payroll expense for only 364 days. We believe this worked as follows: During the course of a fiscal year, the City issued 26 bi-weekly paychecks (one paycheck for every two weeks), each of which covered a 14 day period. Over the course of a 52 week year, the City disbursed monies for (and recognized payroll expense for) only 364 days' payroll (26 paychecks x 14 days per check).

1/ Office of the Comptroller, City of New York Press Release (10 March 1971). See also Office of the Comptroller, City of New York, Press Release (22 March 1971).

The unaccrued payroll liability was therefore growing by one day's payroll each year (two days payroll in leap years). One document publicly issued by the City Comptroller's Office indicates that the City's payroll for one day amounted to more than $10 million. 1/ The initial benefit to the City resulting from implementation of the procedure set forth in Comptroller Beame's March 8, 1971 press release was $70 million, while MAC's adjustment for payroll accrual amounted to $130 million, 2/ a difference of $60 million. Benefits realized in fiscal 1972, 1973, 1974 and 1975 resulting from the recognition of 364 days' payroll in those years appears to account for most of the $60 million difference. One document notes that, "perhaps the most imaginative gimmick is the 364 day fiscal year, initiated a few years ago to exclude a payroll period from the budget." 3/

1/ June 17, 1975 Memorandum, "Restructuring the City's Accounting Services", written by Stephen Clifford.

2/ This amount consisted of $105 million for the accrual of payroll and $25 million for the accrual of police, fire, and correction overtime.

3/ May 15, 1974 memorandum from Stephen Clifford to the Commissioners of the Charter Revision Commission, appendix, p. 3.

However, excluding consideration of leap years, under the 364 day payroll year the City would have recognized 54 weeks' payroll expense every 14th year, requiring the City to issue 27 paychecks. This 27th pay period would have occurred, absent reforms as mandated by MAC, in fiscal 1978-79, representing an additional charge of approximately $170 million in that fiscal year. 1/

(b) "Reserve" account transactions

Another procedure utilized by the City to reduce recorded expenses and assist in annually balancing its budget was by the recording of transactions in two accounts entitled the "Tax Deficiency Account," and the "Tax Appropriation and General Fund Stabilization Reserve Fund," the latter being commonly referred to as the "rainy day fund". These two accounts are maintained pursuant to Sections 127 and 128 of the City Charter, and were established to provide internal reserves to the City. The City had so depleted the reserves in these accounts that, in August 1975, MAC attributed $100 million of

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1/ June 11, 1975 memorandum from Stephen Clifford to Harrison J. Goldin.

the June 30, 1975 cumulative deficit to a shortage in these reserves. In October 1976, the City apparently increased this June 30, 1975 write off to $119 million.

The City Charter stipulates that the tax deficiency account be charged (debited) with tax cancellations and remissions, and with discounts allowed for the prepayment of taxes. The account is increased (credited) with expense budget appropriations no longer required and certain other credits. The Charter provides that the City make an annual appropriation to this account equal to the amount that the debits exceed the credits as of February 1st of each year and sets forth limitations for this appropriation. Although required appropriations were apparently made to the Tax Deficiency Account, the appropriations failed to offset the increasing amounts of tax cancellations and remissions in recent years. As a result, the Tax Deficiency Account had a negative (debit) balance of $141.9 million as of June 30, 1975. 1/

1/ Office of the Comptroller, City of New York, Annual Report of the Comptroller of the City of New York for the Fiscal Year 1974-1975, (New York: New York City, 1975, Part 2-A-Expense Budget-Statement 10, p. 156.

All amounts stated hereafter in this subsection were taken from the City's various Annual Reports and Reports of the Comptroller Pursuant to Section 113 of the Charter.

The rainy day fund was also established to help stabilize the City's finances. Unlike a corporate "contingency reserve", the rainy day fund was designed to be "funded" in the cash sense by liquid assets including cash and mortgages. Assets in this account were intended to provide a ready internal reserve for the City to use during fiscal years when actual revenue fell short of budgeted revenue. The Charter also requires the City to make an annual appropriation to the rainy day fund until it reaches a certain level. 1/ Furthermore, the Charter requires that in addition to these normal annual appropriations, the City must also make appropriations pursuant to a mandated schedule to replenish the rainy day fund for any transfers from the fund to meet expense budget shortages. Thus, the rainy day fund was designed "to build up in 'good' years an amount which could be drawn on if revenue shortfalls were to occur in 'bad' years." 2/

1/ The Charter provides that when the rainy day fund assets exceeded 30% of the real estate tax levy, those assets might be applied to the reduction of taxes. However, that level was neverreached.

2/ Office of the New York State Comptroller, Uncollected Real Estate Taxes, p. 2.

It appears that initially the rainy day fund served its intended purpose of helping to stabilize the City's finances. In fiscal years 1963 and 1964, pursuant to law passed by the City Council, the City made no appropriations to the rainy day fund. Instead, the City transferred $81 million from the rainy day fund to the City expense budgets for those years, and transferred an additional $11.9 million for fiscal 1965. During the late 1960's, in addition to making normal appropriations as required, the City appropriated $39.4-million in partial repayment of the above transfers.

For each fiscal year beginning in 1969, the City Council passed legislation waiving the required appropriation. A Committee of the City Council reported in June 1968 that in waiving this appropriation, it considered that the rainy day fund had a substantial balance and that there were "many pressing demands to be met" in the fiscal 1968-69 budget. 1/ Since fiscal 1968, the City has failed to appropriate any funds to the remaining unreplenished balance of $53.5 million attributable to fiscal 1963 through 1965.

In addition to not replenishing the earlier withdrawals, the City failed to make its required normal annual appropriations to the fund. Instead, the reverse occurred. The City has further depleted the rainy day fund by transferring $35.1 million from that account to the General Fund for fiscal 1970 and $42 million

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1/ Proceedings of the Council of the City of New York, June 25, 1968, p. 2388.

for fiscal 1974 with concomitant offsets to the expense budget. Had the rainy day fund "been maintained and replenished as required by the Charter, it would have provided a cushion of over $280 million at the point.../in 1975/ when the City faced a possible shutdown of operations for lack of cash." 1/ This cushion could not be provided because, as of June 30, 1975, the rainy day fund had a purported credit balance of only $22.8 million. All that remained was $10.5 million of mortgages receivable, $13.8 million of taxes receivable for fiscal 1970 and prior years, and a cash overdraft of $1.5 million.

(c) Accrued pension liability.

City employees are covered by five actuarial retirement systems: the New York City (1) Employees', (2) Teachers', and (3) Board of Education Retirement Systems, and the (4) Fire Department, and (5) Police Pension Funds.

Prior to 1971, four of these five systems traditionally had funded their retirement programs on a "two year lag" basis. On this basis, there was a two year delay between the time the City incurred pension costs for these systems and the time contributions were made to the systems. For example, monies paid into these four systems in fiscal 1971 actually represented liabilities arising during fiscal 1969. As was later noted:

1/ Office of the Comptroller, City of New York, "Report of the Comptroller Pursuant to Section 113 of the Charter with respect to the Proposed Expense Budget for 1976-1977," February 14, 1976, as quoted in the City Record, February 24, 1976, p. 500.

> "The ostensible reason for the lag is that it facilitates the administration of the systems, since it gives all concerned a period of time after the close of the year in which to ascertain the exact number of employees and the amount of payrolls involved."1/

During this same period, the fifth system, the Teachers' Retirement System, was financed on a current basis, i.e., contributions were being made in the year in which the liability was incurred.

In 1971, the New York State Legislature changed the law so that the Teachers' Retirement System was also placed on a two-year lag.2/ As a result, during the fiscal years 1971-72 and 1972-73 (the two fiscal years following the year of the change) the City's contributions to the Teachers' Retirement System were significantly smaller than amounts otherwise due under prior practice.

The impact on the expense budget is illustrated in the chart below.

1/ State of New York, Permanent Commission on Public Employee Pension and Retirement Systems, Otto Kinzel, Chairman, Financing the Public Pension Systems, Part I: Actuarial Assumptions and Funding Policies (New York: Permanent Commission, March 1975), p. 33. The Permanent Commission points out that with the single exception of the New York City Teachers' Retirement System, "all of the public retirement systems in the City and the State,...,have traditionally funded their programs on a 'two-year lag' basis." [Hereinafter referred to as "Permanent Commission, Financing the Public Pension Systems"].

2/ New York State Laws of 1971, Chapter 407.

Contributions to Teachers' Retirement Systems 1/
(Millions)

1 Fiscal Year Ended June 30	2 Annual Reports of Teachers' Retirement System	3 Comptroller's Annual Report	4 Expense Budget
1969	$103	$ 93	$105
1970	102	102	101
1971	141	138	134
1972	33	40	26
1973	85	84	74
1974	258	258	283
1975	263	314	316

Although we were unable to reconcile differences among columns 2, 3 and 4 because of differences in descriptive captions and dollar amounts, the pattern plainly indicates that contributions made in 1972 and 1973 were materially curtailed.

1/ The data in column 2 is extracted from Pensions, City of New York, Mayor's Management Advisory Board, Richard R. Shinn, Chairman, (April 1976). The data in column 3 is extracted from expense codes 612-614 of Part 2-A, Statement 7 of the Annual Report of the Comptroller for the appropriate year. The data in column 4 is extracted from the Expense Budgets of the City as published in the subsequent year.

In a memorandum, dated December 1974, the Special Deputy Comptroller of the City, Steven Clifford, requested that research be undertaken concerning the postponement of payments to the Teacher's Retirement System. He hypothesized that this postponement amounted to $70 million in fiscal 1972-1973 and $17 million in fiscal 1973-1974. This is an apparent reference to the introduction in 1971 of the two year lag in postponing payments to the Teacher's Retirement System. 1/ The Permanent Commission on Public Employee Pension and Retirement Systems ("Permanent Commission") 2/ also noted the funding lag. Because the City recognized this expense on a cash basis, the change in the law clearly resulted in a reduction of the City's budgeted and actual expenditures in fiscal years 1971-72 and 1972-73.

The City recognized the effect of the two-year lag with respect to all five systems in allocating $2.167 billion to the revised cumulative deficit as of June 30, 1975. 3/

1/ Division's Exhibit "Harrison J. Goldin No. 50 for Identification," p. 3.

2/ The Permanent Commission was created in 1971 by the Governor and Legislature of New York State and given authority to "examine into and make recommendations with respect to all aspects of public employee retirement benefits and systems in the City and State of New York, as a guide for State legislative and executive action." Permanent Commission, Financing the Public Pension Systems, p. 1.

3/ Office of the Comptroller, City of New York, Annual Report of the Comptroller of the City of New York for the Fiscal Year 1975-1976, p. 25, note M.

Generally accepted accounting principles recognize the essential difference between the incurrence of the liability for a pension cost and the actual contribution to the pension fund. 1/ Legal requirements mandated the "two-year lag" for contribution purposes. It might also be argued that budgeting on this basis was similarly necessary. No basis appears to exist however, for the failure of the City to either record or disclose this massive liability.

The $2.1 billion adjustment to correct for unrecorded pension costs resulting from the "two-year lag" was only a minor part of the total problem. Additional potential pension liabilities of about $6 billion were subsequently identified, partly as a consequence of the City's use of outdated and unrealistic actuarial assumptions.

In an examination of the New York City Retirement Systems, the Permanent Commission noted that despite continuous annual statements by the City Actuary concerning the need to update actuarial assumptions, "the New York City systems' actuarial assumptions continue to be out of touch with reality." The Permanent Commission further noted:

> "Amazingly, the assumptions used for the New York City Employees' Retirement Systems were prepared for a 1914-18 Commission on Pensions from the City's records of experience from 1908-14 -- more than a half-century ago.

1/ See, e.g. National Committee, Govermental Accounting, pp. 11-12 "Basis of Accounting" and Accounting Principles Board, APB Opinion No. 8; Accounting for the Cost of Pension Plans (New York: AICPA, 1966).

Data from the same period is used for the City Teachers' System. The Police and Fire Systems, created in 1940, use data based upon the same 1908-14 experience, with only slight modification. With the exception of some changes made in the 1940's with respect to mortality after retirement and interest credits, no changes have been made in the assumptions since these systems were first established.

"The latest experience data in the New York City systems show that continued use of unchanged assumptions leads to understatement of the true costs of retirement systems." 1/

Specific criticisms of actuarial assumptions included:

Mortality Assumptions.

"Experience indicates that the City systems have consistently overestimated the death rate for regular service pensioners and their beneficiaries, disability pensioners, and active employees, thereby underestimating the total number of persons who will be alive and drawing benefits at various ages....

The following examples demonstrate the divergence between actual mortality experience and the official assumptions:

—Actual mortality among retired City firemen is approximately one-fifth of the assumed rate - an error of almost 500 percent....

—Actual mortality among disabled City firemen who are receiving pensions is about one-eighth of the assumed rate - an error of 800 percent....

—Actual mortality among currently employed women who are members of the City Employees' Retirement System is less than one-fifth of the assumed rate—an error of over 500 percent."

Turnover Assumptions.

"The rate at which employees terminate employment before earning a vested benefit is also an important determinant of pension costs. All other things being equal,

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1/ Permanent Commission, Financing the Public Pension System, pp. 12-13.

the higher the turnover rate among a group of employees, the lower the cost of providing retirement benefits. Once again, there are glaring instances in some City systems where the assumed rate is substantially greater than actual experience would justify....For example, the turnover of members of the Fire system is about one-fifth of the assumed rate - an error of almost 500 percent...."

Disability Assumptions.

"...In the City systems, all but the City police rates lead to a substantial overestimation of non-service connected disability costs. In the case of the City Police system, the actual number of non-service disabilities is about 43 percent greater than the official assumptions predict....

[T]he police and fire systems in New York City have many more service-connected disabilities than anticipated. Since service-connected disability benefits, or more accurately, "accidental" disability benefits, provide a retirement benefit of 75 percent of pay, a disproportionate number of such cases can have serious cost implications. (Table 6) demonstrates that accidental disability awards presently are running at least six times the assumed rate for City policemen, and at more than nine times the assumed rate for City firemen. Thus, the "official estimates" seriously underestimate the costs of these benefits, allowing the City to contribute less each year than is actually required to pay the full cost of the benefits."

Salary Rate Assumptions.

"The actuarial assumption which has the greatest impact on pension costs is the assumption for future salary increases. Unlike most other assumptions, even a slight understatement of projected salary increases will have a substantial effect on costs. (Table 9) illustrates substantial disparities between actual and assumed rates of salary increases for virtually all the public retirement systems. The disparity, and the resulting understatement of costs, is especially significant in the New York City systems." 1/

1/ Ibid, pp. 13-29. (Referenced tables omitted)

The Permanent Commission concluded that "the actuarial assumptions used in the New York City retirement systems are highly inaccurate because they bear little or no resemblance to actual experience." 1/ A report by Arthur Andersen & Co. mirrored certain of these criticisms. 2/

APB Opinion No. 8 provided guidelines for accounting for the cost of deviations from actuarial assumptions and observed that "there is broad agreement that pension cost, including related administrative expense, should be accounted for on the accrual basis." 3/ APB Opinion No. 8 recommended that the annual provision for pension cost "be based on an accounting method that uses an acceptable actuarial cost method". 4/ An Appendix to the Opinion described acceptable actuarial cost methods, and noted that these methods must be based on actuarial assumptions which are reasonable. 5/

In estimating the cost of a pension plan to a business or governmental unit, actuarial assumptions are made regarding the return on pension assets invested, expenses of pension fund administration, the amounts and timing of benefits to be paid and other matters including "interest".

1/ Permanent Commission, Financing the Public Pension Systems, p. 13.

2/ Arthur Andersen & Co., Report for the Secretary of the Treasury Regarding Information Relating to the Financial Requirements Under the New York City Seasonal Financing Act of 1975, 29 December 1975, pp. 5-6.

3/ Accounting Principles Board, APB Opinion No. 8; Accounting for the Cost of Pension Plans (New York: AICPA, 1966), para. 11.

4/ Ibid, para. 17.

5/ Ibid, para. 24.

The importance of utilizing realistic assumptions was emphasized by the Permanent Commission:

> "The accuracy of cost estimates and the degree to which the employer is paying the full cost of retirement liabilities as they accrue depend on just how close the actuarial assumptions come to actual experience.
>
> * * * *
>
> "If the actuarial assumptions used...are unrealistic, the result can be a serious understatement of the cost of the proposed benefits." 1/

One study published by the Mayor's Management Advisory Board, in April 1976, recommended the implementation of major changes in actuarial assumptions and funding methods, and estimated that these changes would result in an increase of \$208-million in pension contributions per year. 2/ In May 1977, the City estimated that as of June 30, 1974, there was an unfunded accrued liability of \$8.481 billion for the five major systems (using updated actuarial assumptions and eliminating the two-year lag in funding), and, as of June 30, 1975, approximately \$1.2 billion for the non-actuarial and supplemental pension plans. 3/ This supports the earlier observation by the Permanent Commission, which concluded that the City's failure to adopt realistic actuarial assumptions resulted in the failure to pay current pension costs and that the City had used "pension underfunding as one method of balancing its operating budget. The

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1/ Permanent Commission, Financing the Public Pension Systems, p. 9.

2/ Mayor's Management Advisory Board, Pensions, p. 26.

3/ City of New York, Official Statement (New York: City of New York, 20 May 1977), p. 52. Unfunded accrued liability is the excess of the liability accrued for total future pension benefits on account of services already rendered less the value of the assets of the pension systems.

result has been a progressive deterioration in the financial adequacy of the City's retirement systems." 1/

The notes to the City's June 30, 1976 "Estimated Financial Statements" disclose that they are not prepared in accordance with GAAP and that with respect to pension costs:

> "The amounts provided are not necessarily the amounts which would have to be provided under generally accepted accounting principles for municipalities. As a detailed study has not been made, such amounts are not determinable."
>
> "In 1976, the Mayor's Management Advisory Board issued its report on pensions, which recommended, among other matters, that the actuarial assumptions be revised. Such revision would increase pension costs by $208 million per year. A task force of the Board is currently continuing its study of the City's pension program. The ultimate result of such study cannot presently be predicted." 2/

The increased pension cost of $208 million per year mentioned in the note is apparently based on a forty year amortization period for purposes of determining the required contribution necessary to eventually eliminate the unfunded accrued liability. Employees covered by these plans can generally retire after 20 to 25 years service, however. The average remaining working lives of covered employees is not known, but surely must be

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1/ Permanent Commission, Financing the Public Pension Systems, p. 30

2/ City of New York, Official Statement (New York: City of New York 20 May 1977), p. 138.

considerably less than 40 years. 1/ Arthur Andersen & Co. recommended a 20 year amortization period. 2/ The City, however, proposes to spread its costs over a period substantially greater than that for which the related services are rendered and thereby perpetuate the process of deferring costs into unrelated future periods.

No estimate of the unfunded accrued liability is included in the notes to the financial statements, although the matter is discussed in some detail in the textual portion of the City's Official Statement.

The City has recorded only part of this liability as part of its cumulative deficit, noting that "unfunded accrued liabilities are generally amortized over a 20 to 40 year period." 3/ While this is true when such liabilities arise from underfunding pension costs otherwise properly calculated and recognized on an ongoing basis, there is considerable question as to whether such a "forward looking" adjustment is appropriate for accounting purposes in this situation.

1/ The Permanent Commission (Financing the Public Pension Systems p. 30) estimated, for instance, that the average remaining working lives of teachers covered by the state pension plan was approximately 15 years.

2/ Arthur Andersen & Co., Report for the Secretary of the Treasury Regarding Information Relating to the Financial Requirements Under the New York City Seasonal Financing Act of 1975 29 December 1975, p. 6.

3/ City of New York, Official Statement (New York: City of New York, 20 May 1977), page 52.

In the change to GAAP for its pension costs the City must recognize the essentially different nature of its funding of the pension plans and recognition of pension costs and related liabilities. The future funding of the unfunded accrued liability is designed to place the plans on a sound actuarial basis with minimum drain on the cash resources of the City. 1/ This has little to do with generally accepted accounting principles however. "Unfortunately, it is actual experience and not 'official estimates' which produces the real cost that must eventually be paid by the taxpayer." 2/ These very real costs and the related liability have continued to grow geometrically, due in large part to the City's historic failure to adjust for the facts as brought to its attention by the City Actuary. Thus the unfunded liability is also an unrecorded liability.

1/ Ibid.

2/ Permanent Commission, Financing The Public Pension Systems, p. 32 (Emphasis Added).

If the Permanent Commission's observations are accurate, the use of archaic actuarial assumptions was an error which should have been corrected many years ago. 1/ The correction for accounting purposes should be an additional substantial adjustment of the cumulative deficit, not continued postponement of liability recognition. 2/

(d) Excess pension interest

In order to balance its budget for fiscal 1974-75, the City budgeted revenue for "excess pension interest". Authorized by state law, this accounting device permitted the City to credit three years of this "revenue" to the expense budget for fiscal 1974-75.

The Permanent Commission outlined the City's use of "excess" pension interest as a means to reduce recorded pension costs:

> "In the past, the City had always made an additional contribution to the Systems when the interest earnings for the year fell below the statutory 3% assumption (now 4%). In the 1960's, interest earnings began to exceed the statutory assumption, and the excess interest earned during the year for which contributions were being made was used to reduce the current contribution.

1/ Arthur Andersen & Co. apparently would agree with the City's proposed treatment, however. In their Report for the Secretary of the Treasury (page 6) they assert that "...the understatement of costs in the past must be made up by added cost recognition in the future."

2/ For a more complete technical discussion of the application of the authoritative accounting literature see Appendix C.

> Thus, in fiscal year 1970-71, for example, the City would be making the contribution for the pension costs attributable to the 1968-69 fiscal year. If the Retirement System had earned interest in excess of the 4% statutory rate during 1968-69, the excess interest would be used to reduce the contribution in 1970-71. This 'excess interest deduction' is improper from an actuarial viewpoint, since sound actuarial practice requires that any such excess (or, indeed, any loss, together with any other actuarial gains or losses) be spread over a realistic period. An even more serious objection to such 'interest deductions' is the fact that the City failed to consider unrealized appreciation or loss in determining whether there were any excess earnings. In short, the City would declare an interest 'excess' in a particular year even though the losses in value in its stock and other holdings far exceeded the entire interest earnings for the year." 1/

Under generally accepted accounting principles there is no such thing as "excess" interest. Earnings of pension fund investments which exceed the actuarially assumed "interest" rate are viewed only over a long term. If long term earnings exceed the assumption, the assumption is adjusted. The actuarial "gain" resulting from the use of an estimate is then spread over future years. 2/ In addition, it is difficult to differentiate between "earnings" on pension fund assets (dividends and interest) and gains and losses (both realized and unrealized) resulting from fluctuations in the value of pension fund investments. The true "earnings" of the pension fund should reflect both of these factors since both impact upon the value of fund assets available for payment of benefits. 3/

1/ Permanent Commission, Financing the Public Pension Systems, pp. 34-35.

2/ See Accounting Principles Board Opinion No. 8 for a detailed technical discussion.

3/ Permanent Commission, Financing the Public Pension Systems, p 36.

Current recognition of pension fund "excess interest" is clearly contrary to generally accepted principles of accounting. 1/ The law which permitted this practice for budgetary purposes did not change the City's true liabilities or costs with respect to its pension plans.

The Permanent Commission noted that the practice of crediting "excess" interest to reduce the City's pension contributions was originally done on a two year lag basis. In 1974 State legislation eliminated the two year lag, and permitted the City to credit "excess" interest earned over a three year period (fiscal 1972-73, 1973-74, and 1974-75) to the budget for one year, fiscal 1974-75.

An unaddressed memorandum contained within the Governor's Bill Jacket analyzing the issue presented by the 1974 legislation, noted that the bill was "the purest form of fiscal gimmickry." The memorandum nevertheless recommended the adoption of a "no objection" position on the bill "because the Governor agreed to this measure as part of the City's fiscal package, and because the bill will provide some much-needed fiscal relief to the City during 1974-75...." In reviewing possible objections to the bill, the memorandum observed, "in a very real sense, there

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1/ See Accounting Principles Board, APB Opinion No. 8; "Accounting for the Cost of Pension Plans" (New York: AICPA, 1966), paragraphs 30 and 32.

is no 'excess income' in the City's retirement systems," and noted the adverse impact such treatment of "excess" pension interest would have on the budget in the next two fiscal years. 1/ The Permanent Commission described this change as follows:

> "Despite the obvious objections to such interest deductions, the practice was actually expanded in 1974. Under Chapter 595 /of the New York State Laws of 1974/, the 1974-75 City contributions not only were reduced by the interest 'excess' in 1972-73 (pursuant to prior practice), but also for the 'excess' in 1973-74. Finally, the bill required the actuary to estimate the 'excess' which would be earned in 1974-75, and also allowed such 'estimated excess' to be used to reduce the 1974-75 appropriations. Thus, the City and contributing authorities reduced their 1974-75 contributions to the City retirement systems by approximately $261 million - the alleged interest 'excesses' for a three-year period. During this approximate period, the City Employees' Retirement System and the Police Pension Fund lost approximately $334 million in the value of their stock portfolio. This loss alone would have completely eliminated the alleged 'interest excess,' and would have actually produced an interest 'deficit' of approximately $75 million. No fund, regardless of the valuation technique utilized, should claim and act upon an alleged earnings 'excess' without considering the value of its stock holdings." 2/ [Emphasis in Original]

The City credited "excess" interest to reduce pension contributions as follows: 1972: $17.5 million; 1973: $41.9 million; 1974: $50.7 million; 1975: $261.4 million.3/ The extent to which the change in the law affected the City's

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1/ Richard E. Hegner, Examiner, Unaddressed Memorandum dated 14 May 1974.

2/ Permanent Commission, Financing the Public Pension Systems, pp. 35-36.

3/ City of New York, Official Statement, p. 32. note 8.

fiscal 1974-75 expense budget is uncertain as there is conflict among the documents reviewed. One document indicates a total credit to the budget of $168 million for "excess" pension interest, of which $125 million resulted from the _change_ in the law, 1/ while other documents indicate a credit of $261 million to the fiscal 1974-75 expense budget, 2/ but fail to reveal the impact of the _change_ in the law. Resolution of this conflict, however, would not affect the validity of the basic conclusion that crediting three years' "excess" pension interest to the fiscal 1974-75 budget was a material and non-recurring element in "balancing" the budget for that fiscal year.

The crediting of one years' "excess" pension interest by the City in each fiscal year impacted favorably upon the City's expensé budget over the years. The elimination of the "two year lag", however, permitted the City to record _three_ years "excess" interest in fiscal 1975.

1/ Richard E. Hegner, Examiner, Unaddressed Memorandum dated 14 May 1974, in Governor's Bill Jacket.

2/ Permanent Commission, _Financing the Public Pension Systems_, p. 35. An analysis of the City's Expense Budget for the fiscal year 1974-75, as adopted, also indicates that the City credited $261 million for "excess" pension interest in that year.

C. Capitalization of Expenses

Pursuant to the City Charter, the City operates under two budgets which are prepared for different purposes and are funded from different sources. The expense budget provides a plan for City operations of a current nature. It is financed largely by recurring revenue obtained from State and Federal aid, the real estate tax levy, and a variety of taxes accounted for within the so-called General Fund. These revenues are used to fund the departmental operations of the City, to provide current services in areas such as police and fire protection, education, health and social services, and debt service. The capital budget represents a plan of proposed expenditures for capital projects such as streets, parks, bridges, tunnels, property of a permanent nature, and physical public betterments or improvements. 1/ Except for that portion financed by the state and federal governments, the capital budget is financed by the sale of long term debt.

Increasingly, in recent years, the City utilized the capital budget to issue indebtedness to finance expense budget appropriations. One document, dated November 8, 1974, which was prepared by the Citizens Budget Commission, indicates that from 1965 to 1975 the City borrowed through its capital budget to finance appropriations in the expense budget as follows: 2/

1/ Charter of the City of New York, Section 211.

2/ Citizens Budget Commission, "A Presentation to Mayor Beame's Council of Economic and Business Advisors", November 8, 1974.

Fiscal Year	Amounts (in millions)
1965	$ 26
1966	57
1967	68
1968	68
1969	84
1970	151
1971	195
1972	225
1973	274
1974	564
1975	722

Analyses of the City's expense budgets by the staff for the years 1973 to 1975, and by the Office of the State Comptroller for the years 1970 to 1975, basically confirm these figures. 1/

The escalating utilization of capital budget funds (totaling $2.434 billion during this eleven year period) to meet expense budget needs has been recognized to have various effects, including:

> "1. Expenses of a current nature will be financed by revenues (primarily real estate taxes) obtained in later years.
>
> "2. Future years bear an added burden of paying interest on the borrowings - in effect compounding the original costs.

1/ Office of the New York State Comptroller, Report on the Debt Structure of the City of New York (Report No. NYC-42-74: 16 May 1974), p. 33 [Hereinafter referred to as "Office of the New York State Comptroller, Report on Debt Structure (1974)"]; Report on the Debt Structure of the City of New York (Report No. NYC-33-76: 27 February 1976), p. 43 [Hereinafter referred to as "Office of the New York State Comptroller, Report on Debt Structure (1976)"].

> "3. This funding procedure significantly increases annual borrowings, expands outstanding debt, and lowers the City's debt incurring margin." 1/

The New York State Constitution and the Local Finance Law empower the City to incur long-term indebtedness under certain conditions. Article VIII of the State Constitution prohibits the issuance of indebtedness "for longer than the period of probable usefulness of the object or purpose for which such indebtedness is to be contracted," and section 11 of the Local Finance Law sets forth the "period of probable usefulness" for various items. In practice, the City included in its capital budget only those items to which the Local Finance Law assigned a period of probable usefulness.

The concept of "period of probable usefulness," according to the Office of the New York State Comptroller, has its origins in the New York State Constitutional Convention of 1915, when "...for the first time, the recommendation was made that the Constitution contain language directing the Legislature to fix maximum periods and that such determination shall be conclusive." 2/ These concepts were ultimately codified in 1918. 3/ Thus, "through the years the legislature has enacted numerous laws empowering municipalities to issue bonds for a multitude of objects and purposes having a 'period of probable usefulness.'" 4/

1/ Office of the New York State Comptroller, Report on Debt Structure (1974), p. 34.

2/ Ibid, p. 35.

3/ Ibid. p. 36.

4/ Ibid, p. 37.

However, the Office of the State Comptroller observed that laws assigning a "period of probable usefulness" have been receiving an ever broadening interpretation that has resulted in a dramatic increase in the issuance of debt to finance the City's expense budget. "Costs connected with ongoing functions of governmental service are being bonded; educational expenditures in increasing amounts and nature are being bonded; and even debt service is being met by the issuance of more debt." 1/ The State Comptroller considered that if such views were expanded to an extreme the concept of "period of probable usefulness" would permit local governments to bond virtually all expenditures, and questioned the practice of borrowing for recurring type expenditures:

> "By its nature, certain governmental functions, such as education, social, physical and mental rehabilitation, environmental protection, etc., have 'periods of probable usefulness' extending far beyond the period in which the expenditure is made. Thus, carried to an extreme, the concept of 'period of probable usefulness' could conceivably be extended by the Legislature to permit local governments to bond virtually all its expenditures. While we don't suggest that only 'brick and mortar' expenditures should be bondable, we do question the practice of continuously borrowing for recurring-type expenditures. Such a practice permanently increases the cost of government." 2/

The 1975 MAC Law stipulates that the City eliminate from the capital budget over a ten year phase out period those operating

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1/ Ibid, p. 37.

2/ Ibid.

expenses which properly belong in the expense budget. In February 1976, the State Comptroller issued a directive that set forth guidelines for the City to use in determining which expenses might properly be included in its capital budget. The major thrust of this directive was that "the capital budget should include only those expenditures which result in the construction or acquisition of major permanent facilities or additions having a relatively long life." 1/

D. Fund Accounting

The City, prior to 1975, utilized a "needlessly complex" fund structure that was used to effect budget-balancing 'gimmickry' through transfers of revenues and expenditures between fiscal years and funds. 2/

The inadequacy of the City's fund accounting structure has been acknowledged in such areas as the failure to conform to accepted practice regarding terminology, account titles, fund classifications, and financial statements; 3/ failure to maintain a "fund balance" account reflecting surpluses or deficits; 4/ the inability of

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1/ Office of the New York State Comptroller, Audit Report on the Planned Elimination of Operating Expenses from New York City's Capital Budget (Report No. NYC-45-76: 27 April 1976), Managerial Summary, p. 1.

2/ June 17, 1975 memorandum "Restructuring the City's Accounting Services", written by Stephen Clifford.

3/ Donald W. Beatty, Executive Director, Municipal Finance Officers Association, Letter dated 27 March 1975 to Harrison J. Goldin, Comptroller, City of New York.

4/ Office of the New York State Comptroller, Summary of Accounting Systems Directives, p. 7.

the City's fund structure to control City expenditures; 1/ and the failure to appropriately classify hundreds of accounts representing a mixture of asset, liability, and capital transactions. 2/ The City's methods of fund accounting served to obfuscate rather than illuminate the City's financial activity.

As part of the investigation, the staff submitted a questionnaire to the City which dealt with certain aspects of the City's accounting and budgeting practices. The City's "draft response" to this questionaire, reflected, among other things, that the City's fund account structure was analogous in certain respects to the fund structure under GAAP, and in other respects differed from a GAAP type fund structure. 3/

For example, the City maintained an "operating" fund which appears, in some respects, to be similar to a "General Fund" under GAAP. This "operating" fund was used to account for a variety of revenues and expenditures. Other "fund accounts"

1/ June 17, 1975 memorandum, "Restructuring the City's Accounting Services", written by Stephen Clifford.

2/ Office of the New York State Comptroller, Division of Audits and Accounts, Audit Report on Review of New York City's Central Budgetary and Accounting Practices; Interim Report No. 3-Special and Miscellaneous Revenue Accounts (Report No. NYC-31-76 : 5 January 1976); p. 23. Hereinafter referred to as "Office of the New York State Comptroller, Special and Miscellaneous Revenue Accounts.

3/ See Appendix A for an explanation of fund accounting under generally accepted accounting principles.

maintained by the City which appear, in some respects, to have GAAP equivalents are "fund accounts" for capital improvements (GAAP: Capital Projects Fund), trust and agency (GAAP : Trust and Agency Fund), sinking funds (GAAP : Debt Service Fund), private enterprise housing (GAAP : Enterprise Fund), assessable improvements (GAAP : Special Assessments Fund), and long term debt (GAAP : General Long Term Debt Group of Accounts). "Fund accounts" maintained by the City which appear to have no GAAP equivalent are accounts for "specials." 1/

GAAP call for two additional types of funds, Special Revenue Funds and Intragovernmental Service Funds, and one additional group of accounts, the Fixed Assets Group of Accounts. Although the State Comptroller considered that there was no immediate need to establish a Special Revenue Fund, he recommended that the City establish, as of July 1, 1977, an Intragovernmental Service Fund. He also recommended the establishment of a Fixed Asset Group of Accounts. 2/

1/ It might be argued that "specials" should appropriately be placed within a GAAP "trust and agency fund". However, the New York State Comptroller's Office noted that "Many of the [special] accounts have been maintained as if they were agency or trust funds, even though neither situation existed." Office of the New York State Comptroller, Special and Miscellaneous Revenue Accounts, p. 5.

2/ Office of the New York State Comptroller, Accounting Systems Directive No. 5.

In reviewing the Annual Report of the Comptroller of the City of New York for the Fiscal Year 1973-1974, a representative of the Municipal Finance Officers Association remarked that "significant modification" would be required in "organization, terminology, account titles, classification of funds, combined statements, and statistical tables to conform the City's report to GAAFR. 1/ Another representative observed that it "could be a monumental task to review and criticize the report in the context of GAAFR ...." He considered that this was partly because the City performs a "vast range of services," and partly because of the format of the report. "Some balance sheets are prepared but since the City operates virtually on a single fund basis (General Fund) into which everything is tossed, considerable restructuring would be needed." 2/

On January 5, 1976, the State Comptroller's Office published a report on the City special accounts ("Special Accounts Fund") and so-called miscellaneous revenue accounts ("Miscellaneous Revenue Account Fund"), both of which the City maintained outside its regular operating and capital accounts. 3/ This report was highly critical of these two "funds" and recommended that they be discontinued.

1/ Ray E. Anderson, Consultant, Municipal Finance Officers Association, Chicago, Unaddressed Memorandum dated 3 March 1975. "GAAFR" refers to the authoritative text Governmental Accounting, Auditing, and Financial Reporting.

2/ Robert L. Funk, Assistant Director, Municipal Finance Officers Association, Chicago, Letter dated 15 January 1975 to S.G. Fullerton, President, Municipal Finance Officers Association.

3/ Office of the New York State Comptroller, Special and Miscellaneous Revenue Accounts, p. 1.

The report observed that the City maintained "about 260 accounts involving almost all City Departments in the Special Accounts Fund, and 475 accounts involving about 60 City departments in the Miscellaneous Revenue Account Fund." 1/ The State auditors noted that "without analyzing each of the hundreds of accounts it is not possible to determine the true significance of each account's balance." 2/

The National Committee, the AICPA, and the Office of the New York State Comptroller each recommend that the "fund balance" for each fund be clearly revealed. The National Committee defines "fund balance" as:

> "The excess of the assets of a fund over its liabilities and reserves except in the case of funds subject to budgetary accounting where, prior to the end of a fiscal period, it represents the excess of the fund's assets and estimated revenues for the period over its liabilities, reserves, and appropriations for the period." 3/

1/ Ibid, Managerial Summary, p. 1.

2/ Office of the New York State Comptroller, Special and Miscellaneous Revenue Accounts, p. 12.

3/ National Committee, Governmental Accounting, p. 161.

The City, however, failed to maintain a fund balance account within the General Fund. 1/ As a result, the use of the special and miscellaneous revenue funds served to mask the full extent of deficits. The Office of the State Comptroller stated that the City's use of these two funds (and the hundreds of accounts within them):

> "...to record significant transactions affecting City operations, which in the absence of a general fund balance account (into which would be recorded the surplus or deficit from the year's operations), served to mask the full extent of the City's reported deficits. Since these Special and Miscellaneous Revenues Account funds were outside the City's expense budget, the City's financial reports did not clearly show the results of the City's operations." 2/

In discussing the reasons for establishing these two funds, the State auditors turned to the Comptroller's Annual Report:

> "The special accounts contain a group of non-operating accounts established to record the advances made to other funds and agencies, revolving funds, deposits received for specific purposes, and undistributed receipts which are subsequently distributed to appropriate accounts. Some of these accounts represent unneeded

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1/ Office of the New York State Comptroller, Special and Miscellaneous Revenue Accounts, Managerial Summary, p. 1.

2/ Office of the New York State Comptroller, Summary of Accounting Systems Directives, p. 7.

balances which are used to finance the expense budget by transfer to the General Fund, while others are maintained for existing liabilities, capital accounts, the real property fund and transfers estimated in the expense budget as financing certain expenditures." 1/

* * *

"The miscellaneous revenue accounts reflect revenues received from various sources for special purposes that constitute part of the ordinary functions of the City government, such as certain state and federal aid, sewer rentals and parking meter revenue, but not included in the expense budget. These revenues, not required to be deposited in the general fund, are recorded in individual accounts and are not part of the supplementary revenues estimated in the expense budget except for certain transfers relative thereto." 2/

However, the State auditors also noted that Section 126 of the City Charter states:

"All revenues of the City...from whatsoever source except taxes on real estate, not required by law to be paid into any other fund or account shall be paid into...the general fund." 3/

1/ Office of the Comptroller, City of New York, Annual Report of the Comptroller of the City of New York for the Fiscal Year 1973-1974, p. 403.

2/ Ibid, p. 145.

3/ Office of the New York State Comptroller, Special and Miscellaneous Revenue Accounts, pp. 4-5.

The State auditors concluded that through their long standing use of the Special Accounts, City officials had created both a form of discretionary reserve and a vehicle for recording non-realizable revenues. 1/ In emphasizing the "discretionary" nature of the availability to the expense budget of the balances in these two funds, the State auditors observed:

> "...the City's Expense Budget includes lump sum amounts as an Expense Budget reduction and/or revenues, contemplating that such amounts will be transferred from Special and Miscellaneous Revenue Accounts. However, not until after budget adoption does the City Comptroller determine the composition of individual amounts and accounts to be transferred to support the Expense Budget." 2/ [Emphasis Added]
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> * * * *
>
> Specific examples include:
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> "In recent years, Special Accounts balances were used to meet City revenue shortfalls. For example, in addition to $98 million from Special Accounts authorized to be used in support of the fiscal 1974

1/ Ibid, p. 5. The State auditors remarked, "By excluding Special Accounts from the normal budgetary process, City officials have created a form of discretionary reserve. This has been a long standing practice, as evidenced by our previous audit report on the same matter, issued approximately three years ago. On other occasions, an opposite effect was achieved: that is, transactions recording purported receivables served as the basis for including currently non-realizable cash in the revenues used to finance the Expense Budget. Many of the accounts have been maintained as if they were agency or trust funds, . . .even though neither situation existed."

They also noted, "Trust and Agency Fund Accounts are usually established to account for cash and other assets received or accepted in escrow and held by the governmental unit in the capacity of trustee, custodian or agency for subsequent distributions, transmittal or release to individual or other governmental entities or funds."

2/ Ibid, p. 12.

Expense Budget, $23 million was transferred to make up a shortfall in General Fund revenues. During this period, another $74 million was transferred to meet expense budget deficits of fiscal years 1969 through 1972. Thus, the City has belatedly used these Special Account fund balances to reduce the impact of previous year deficits." 1/

* * * *

"The City anticipated receiving $520 million General Fund revenues from the New York City Stabilization Reserve Corporation during fiscal years 1974 and 1975. Although the Corporation was unable to provide the funds, the City recorded $150 million as a General Fund "Source of Revenue" in 1974 and $370 million in 1975, classifying the item as a receivable due the Miscellaneous Revenue Accounts Fund.

* * * *

"Repayments since 1971 of $7.7 million by the Off-Track Betting Corporation for computer equipment purchased for them and paid for by the City out of capital funds were credited to a special account instead of being considered as a revenue in the year of receipt and used to offset debt service costs incurred in purchasing the equipment.

* * * *

"The City Comptroller set up a Miscellaneous Revenue receivable account for a $98.7 million "Advance to make up revenue shortfall in 1974-75 General Fund," as a means of recording General Fund revenues, even though the revenues were not available in cash. There was no advance and no transfer, and the entry did not involve the receipt of cash. As a result, this aspect of the 1974-75 deficit was not readily apparent.

* * * *

"Real estate taxes of $191.2 million for 1975-76 collected in advance were recorded as a special account credit. This obscured the true nature of these advance tax payments, which should have been recorded as a liability of the City in the year of receipt.

1/ Ibid, p. 5.

> "Prior to June 30, 1975, the State advanced the City $800 million in State aid applicable to the City's fiscal 1976 expense budget to help ease the City's cash shortage problem. Although the City could not incur the expenditures to earn these funds until fiscal 1976, the receipt was not shown as a liability of the City's General Fund at June 30, 1975. Instead, the $800 million, less an incorrect adjustment, was recorded as a credit to the Miscellaneous Revenue Fund. Had it been recorded properly, its relationship to the City's deficit would have been evident." 1/

It is evident that the use of the special and miscellaneous revenue accounts:

> "...permitted the City discretion to retain revenues as fund balances for extended periods, instead of including them as revenues in the year of receipt; to close or reduce account debit or credit balances by transferring all or a portion of the debit or credit balance to other accounts; and to make loans, advances and incur expenditures to or for other governmental units without express authorization through the City's budget and legislative mechanisms." 2/

In recommending discontinuance of the special and miscellaneous revenue accounts and establishment of a General Fund fund balance account, the State Comptroller observed that: "...the two funds and the accounts within them contributed significantly to the loss of budgetary and accounting discipline in New York City. <u>The net effect was generally a failure to clearly and timely disclose the City's actual financial status</u>." 3/

1/ Ibid, Managerial Summary, pp. 2-3.

2/ Ibid, p. 4.

3/ Ibid, emphasis supplied.

II. INTERNAL CONTROL

A. Introduction

Internal control encompasses organizational and accounting controls which are designed to provide reasonable assurance that financial records produce reliable information and that assets are safeguarded. An effective system of internal control is recognized as essential to an effective accounting system in providing reliable data. 1/

The inadequacies of New York City's system of internal control have been extensively described in publicly available documents. The inadequacy of such controls in providing reliable data, independently of certain City "accounting gimmicks", significantly hindered the City's capability to generate financial data which was reliable and accurate. As Comptroller Goldin noted in a speech before the Municipal Finance Officers Association in May 1976:

> "There was a broad feeling, I believe, that even though the City's accounting and budgeting had been revealed as a kind of Rube Goldberg conception - a system which defied understanding or control - it was better to leave it alone as long as it churned out enough money to meet the bills and pay the debts." 2/

1/ For a brief overview of the attributes of an adequate internal control system and its relationship to municipal accounting, see Appendix B.

2/ Office of the Comptroller, City of New York, Press Release (4 May 1976): p. 2.

B. Audits Commissioned by City Comptroller Goldin

On March 25, 1974, the City Comptroller's Office issued a press release stating that three accounting firms had been selected to "examine and independently verify some ten billion dollars in City securities, mortgages, and bank accounts". The Comptroller's Office had commissioned Peat, Marwick, Mitchell & Co. to audit securities and mortgages in the City employee retirement funds totalling approximately $7.4 billion, S. D. Leidesdorf & Co. to audit trust funds of which the Comptroller was custodian amounting to $88 million, and Clarence Rainess & Co. to audit general City Treasury funds of approximately $1.5 billion. The release indicated that the three accounting firms were expected to comment upon any weaknesses in the City's internal control procedures. 1/

The three audit reports were transmitted to the Comptroller's Office in July, 1974 and

> ". . . confirmed each other in documenting a deplorable, chaotic condition within the Comptroller's Office with respect to recordkeeping, condition of books, systems, controls, and the physical protection of hundreds of millions of dollars in securities." 2/

1/ Office of the Comptroller, City of New York, Press Release (25 March 1974): 1.

2/ Office of the Comptroller, City of New York, Press Release (5 August 1974): 1.

The Leidesdorf audit report, transmitted to Comptroller Goldin on July 12, 1974, found that $5.4 million in securities were missing from the vault where the Comptroller's ledgers reflected they should have been. In addition, the report also noted that $1.1 million in securities were found in the vault but were unrecorded in the Comptroller's ledgers. 1/ The audit report criticized the internal control over assets, and recommended that in order "to safeguard assets more effectively . . . " improved accounting procedures and strengthened control over operations would be necessary. 2/ Twenty-four recommendations for such improvements were made. 3/ The various internal control weaknesses, the Leidesdorf report noted, existed in 1974 notwithstanding the exposure of such weaknesses in a 1972 report by the City Comptroller's Bureau of Municipal Investigation and Statistics, Division of External Audit. 4/

1/ A subsequent investigation into the missing $5.4 million in securities traced "the discrepancy to sloppy bookkeeping in the Comptroller's office." New York Times, 1 August 1974, p. 1.

2/ S.D. Leidesdorf & Co., Report on Examination of Certain Funds and Securities Held by the Comptroller of the City of New York in a Trust or Fiduciary Capacity, July 1974, transmittal letter dated 12 July 1974. [Hereinafter referred to as "S.D. Leidesdorf & Co., Examination of Certain Funds."]

3/ Ibid., Section III, pp. 1-22.

4/ " . . . it is apparent that these conditions have existed for an extended period of time prior to March 31, 1974. We note, for example, that a report dated August 1972, issued by the Comptroller's Bureau of Municipal Investigation and Statistics, Division of External Audit, disclosed differences between book records and a physical count of securities as of December 31, 1971 and related weaknesses in the system of internal controls. Furthermore, various matters commented upon in such report still existed as of March 31, 1974." Ibid, Section III, p. 2.

The audit by Clarence Rainess & Co. dealing with City treasury funds reported unreconciled differences of approximately $45 million between cash balances reflected in the Comptroller's general ledger and cash balances reported by outside depositories in response to confirmation requests, noting that "because of the lack of reliable documentation available the amount of discrepancy could differ substantially." 1/

Like the Leidesdorf report, the Rainess audit report criticized the City's internal control. 2/ Rainess noted that its documentation illustrated "the inadequacy of the Comptroller's records and the inaccuracies deriving therefrom." 3/ Additionally, the report reflected that its comments were:

1/ Division's Exhibit "Harrison J. Goldin No. 8 for Identification," p. 15.

The mayor was aware of the "problem of reconciling these accounts . . . since they had been under continuous scrutiny since the latter part of 1972 and through most of 1973." Comptroller Beame "directed the First Deputy Comptroller to undertake an intensive effort to rectify this matter," and "as a result . . ., the account balance was narrowed down to a $6-million overage, as of June 30, 1973." Office of the Mayor, City of New York, Press Release (22 July 1974): 4. Clarence Rainess & Co. observed in its report that "the only recorded incomplete attempt to achieve a reconciliation of bank balances that came to our attention is for the period ending June 30, 1973." (Division's Exhibit "Harrison J. Goldin No. 8 for Identification," p. 15).

2/ Division's Exhibit "Harrison J. Goldin No. 8 for Identification," p. 13. The report stated that "present deficiencies relate to accounting, communications, and controls. Each of them is basic to the inadequacies of the total system."

3/ Ibid, p. 18.

". . . not designed to be critical of the personnel who can do little other than respond to the immediate needs of the Comptroller's Office. It was obvious from our discussions that they would like to improve their performance standards. In every instance, each individual with whom we discussed various problems recognized the inadequacies of the system, the need for change, and the lack of controls. Unfortunately, they have inherited an antiquated method for recording and reporting.

"Accountability enhances fiscal integrity. The impetus must come from leadership. Dedicated employees can then be given the opportunity to perform more effectively." 1/

On July 22, 1974, Peat, Marwick, Mitchell & Co. ("Peat Marwick") transmitted its audit report dealing with securities and mortgages in City employee retirement funds to Comptroller Goldin. Peat Marwick reported that while cash approximating $310,000 was recorded on the Comptroller's books of account, there existed no corresponding bank balances for such funds. Peat Marwick's report noted that these accounts had not been reconciled for many years. In addition, Peat Marwick criticized internal control relative to the various retirement and pension systems, and stated that "due to the absence of adequate internal control procedures and security over the handling and recording

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1/ Ibid, p. 12.

of cash and related short term investments . . ., we express no opinion with respect to such items. 1/

It is significant that prior to the City's "fiscal ordeal" of 1975, there was little political support to alter the structure of the City's accounting system. The three audit reports released in the summer of 1974 documented a "deplorable" and "chaotic condition within the Comptroller's Office" with respect to internal accounting control, but there appeared to be little interest in remedying the situation. As Comptroller Goldin noted in May 1976:

> "Although there was a public furor at the time over one reported discrepancy involving securities in a vault, I cannot say there was any broad support generated for the kind of expensive restructuring which is now underway. There was a short-lived move to provide funds to employ fifty additional accountants, but the movement quickly lost steam, and a bill to authorize new personnel died in the City Council. 2/

1/ Division's Exhibit "Harrison J. Goldin No. 9 for Identification," p. 1.

Note 5 to the financial statement in Peat Marwick's report stated that:

> "Adequate internal control and security procedures to ensure the proper handling and recording of cash and related short term investments have not been formalized and practiced by the Comptroller's Office for some years. Examples of deficiencies are: (1) failure to reconcile bank accounts on a timely basis; (2) inadequate check signing procedures; (3) failure to provide proper security for unissued blank checks; (4) inadequate control over drawn but unissued checks; (5) absence of application of audit procedures to returned paid checks; and (6) failure to investigate and clear checks remaining outstanding for long periods of time."

2/ Office of the Comptroller, City of New York, Press Release, (4 May 1976): 3.

C. Audits by the Office of the New York State Comptroller

The New York State Comptroller's Office by statutory mandate has made audits of certain of the books of the City since July 1971. Initially, it directed its inquiries to areas of high expenditure within the City for the purpose of reducing expenditures and increasing operational efficiency. The State Comptroller later broadened the areas of inquiry and undertook an analysis of the City's debt structure and of various aspects of the City's central budgetary and accounting practices. In an "interim report" published in July 1975 dealing with receivables for state and federal aid, 1/ the State Comptroller's Office stated that it was:

> ". . . examining into New York City's central budgetary and accounting practices in order to (1) identify shortcomings which have a bearing on the accuracy of the City's financial statements, . . ." 2/

With respect to accounts receivable for state and federal aid on the City's books as of March 31, 1975 which were applicable to the years ended June 30, 1974 and June 30, 1973, the State Comptroller's report noted that the City's records indicated these receivables amounted to $432.2 million, of which the State auditors examined $373.3 million. The State auditors found that the $373.3 million in receivables examined were overstated by $324.6 million, or by over 85%. 3/

1/ Office of the New York State Comptroller, Prior Year Accounts Receivable.

2/ Office of the New York State Comptroller, Prior Year Accounts Receivable, Managerial Summary, p. 1.

3/ Ibid, p. 2.

With regard to internal accounting control, the State auditors commented that "the City's procedures provided for only limited monitoring of these balances", and gave examples of such limited monitoring. 1/ They stated, for example, that:

> "On or about October 31. . ., the Bureau of the Budget and City Comptroller jointly request City agencies for which receivable balances appear on the central books to reconcile the balances recorded centrally with the agency records, and to explain any differences. Out of 46 agencies for which receivable balances were recorded, only 30 were requested to reconcile their balances with the balances appearing on the City's central books. Furthermore, only 24 agencies responded to those requests." 2/

This and other problems led the State auditors to conclude that:

> "The City's internal procedures for recording, maintaining and monitoring State and Federal accounts receivable are inadequate. Therefore, one cannot rely upon the central accounting records and related financial reports to present fairly the status of these receivables." 3/

1/ Ibid, p. 3.

2/ Office of the New York State Comptroller, Prior Year Accounts Receivable, p. 7. Until recently one agency "had not complied with State requirements for reconciling its claims to applicable revenue and appropriation accounts. Their representatives had contended that such a reconciliation was not possible." However, although the State auditors admitted that such a reconciliation is a complex task, they "demonstrated not only that it was possible (by successfully reconciling two test months), but that it was necessary on a continuous basis." Ibid.

3/ Office of the New York State Comptroller, Prior Year Accounts Receivable, Managerial Summary, p. 2.

During periods in which the City was selling RANs ostensibly backed by these receivables, no disclosure was ever made of the inherently unreliable nature of the City's records designed to account for the amounts allegedly anticipated.

The State Comptroller's Office published a second "interim report" on August 4, 1975, in which it concluded that over 80% of the $502.3 million in real estate taxes listed by the City as receivable as of June 30, 1975 was either not collectible or not readily available. 1/ The report noted that:

> "The City's budgetary and accounting practices result in an inflated estimate of real estate taxes to be collected to balance the annual expense budget, and do not make adequate provision for taxes that will not be collected. The result has been that budgeted real estate tax amounts have not been realized; for the most part, the revenue shortfall has been met by continued borrowing. 2/

As to the causes for the shortfall, the State Comptroller's report found:

> "Two major causes for this shortfall are: (1) the City included properties in its tax rolls which were not subject to real estate taxes or for which taxes would not

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1/ Office of the New York State Comptroller, Division of Audits and Accounts, Audit Report on Review of New York City's Central Budgetary and Accounting Practices; Interim Report No. 2- Uncollected Real Estate Taxes (Report No. NYC-26-76: 4 August 1975), p. 4. [Hereinafter referred to as "Office of the New York State Comptroller, Uncollected Real Estate Taxes"].

2/ Ibid. In the "Managerial Summary," this theme was stated as follows: "The City's Budgetary practices result in an inflated estimate of real estate taxes that it can reasonably expect to collect to balance the annual expense budget. Unless expenditures are reduced to make the shortfall, the City's budget is automatically out of balance; borrowings thus become necessary to meet the cash flow deficiency." Office of the New York State Comptroller, Uncollected Real Estate Taxes, Managerial Summary, pp. 1-2.

> be collected, and (2) there has been insufficient provision for the increasing volume of defaulting taxpayers and tax cancellations and remissions." 1/

The amounts involved are substantial since real estate taxes receivable in the first category (property not taxable or from which taxes would not be collected) amount to $282.6 million. 2/

The State Comptroller's audit report concluded:

> "This report provides strong evidence that the City has not taken into account uncollectible real estate taxes in making its decisions. Practically all the information on these uncollectible receivables was readily available to City officials; however, the Finance Administration did not distribute it and neither the City Comptroller's Office nor the Budget Office requested it.
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> "It is vital that the City overhaul its real estate tax accounting, budgeting and reporting systems to preclude further distortion of the City's financial status and to make available accurate fiscal information on which to base future decisions." 3/

1/ Ibid, p. 4.

2/ Ibid, p. 4.

3/ Office of the New York State Comptroller, Uncollected Real Estate Taxes, p. 23.

D. Audit Commissioned By The Treasury Department

On December 12, 1975, another public accounting firm, Arthur Andersen & Co., was retained "to advise the Department of the Treasury on various financial and accounting matters related to Public Law 94-143, the 'New York City Seasonal Financing Act of 1975'." 1/

Arthur Andersen's report, dated December 29, 1975, was highly critical of internal control. In its transmittal letter to the Secretary of the Treasury, Arthur Andersen stated that they agreed with observations made by various City officials that "the City's financial systems and controls were and continue to be inadequate to provide complete and reliable financial data." 2/ Their report noted:

> "In general, the lack of controls and inadequacies in the overall accounting systems and procedures raise questions about the City's ability to exercise control over the collection of revenues, the expenditures of money and the preparation of financial reports." 3/

1/ Arthur Andersen & Co., Report for the Secretary of the Treasury Regarding Information Relating to the Financing Requirements Under the New York City Seasonal Financing Act of 1975, 29 December 1975.

2/ Ibid, p. 3.

3/ Ibid, p. 20.

E. The Effects of Weak Internal Control

The City's lack of adequate internal control directly affected the City's fiscal plight and played a major role in the sale of revenue and tax anticipation notes based on information that was neither reliable nor accurate as to the true financial condition of the issuer.

Although it is difficult to completely separate the problems attributable to inadequate internal controls from those attributable to the City's accounting practices, it is apparent that the questionable veracity of underlying financial data served only to compound the incomplete and misleading picture which resulted from questionable accounting techniques.

The lack of adequate internal control provides no excuse for the inaccurate information which was published. Even accepting the City's unrealistic measurement premises, the overriding principles of reasonably adequate disclosure demanded that the lack of reliability inherent in reported information be fully revealed. Furthermore, the public duties of those responsible for the system mandated that an adequate system be maintained, not simply for financial reporting but also for the safeguarding of assets and other critical purposes of such a system. The ability of responsible officials to effectively administer the City's business could only be hampered by a state of affairs where both the records of the City and the assets subject to accountability were innately susceptible to errors, irregularities and manipulation.

III. FINANCIAL REPORTING BY NEW YORK CITY

A. Introduction

Although municipalities differ in many respects from commercial enterprises, the availability of reliable financial information is no less an important feature of the investing process with respect to their securities. In this regard it is evident that the City's various statutory reports, budgets and similar documents were defective in several material respects. None of these documents were drafted in a meaningful or understandable fashion or contained more than a modicum of disclosure of significant financial information. By focusing upon limited areas of expense and capital budget activity, certain reports successfully obscured the City's fiscal problems. In addition, many of these documents were prepared only annually and were quickly outdated.

The City also prepared "Statements of Essential Facts" in connection with its statutory "Notices of Sale" inviting bids on certain debt issues. These documents reflected many of the defects of other reports. Revenues were shown as equalling expenditures, implying a balanced budget condition. Textual disclosures were almost totally absent so that even the most sophisticated investor could not evaluate the degree of risk inherent in the obligations of the City.

The City also publicized information through various media on a piecemeal basis, including press releases, the City Record (an official daily publication) and speeches by representatives of the City government. While the total volume of information so disseminated was great, there was no real coherence and little effort was expended to make the disclosures comprehensible in the broader context of the City's financial affairs. Virtually every such discrete disclosure was characterized by the omission of material information necessary to make the communication comprehensible or meaningful.

B. Legal Considerations

It might be argued that the City's budgeting, bookkeeping and financing practices were in conformity with various relevant laws such as the City Charter, the General Municipal Law and the Local Finance Law, and that such laws evolved over a substantial period of years. Implicit in this assertion is an inference that the City could not comply both with the applicable local laws and with recognized accounting and disclosure standards.

These arguments are falacious. In discussing compliance with legal requirements, it is necessary to carefully distinguish the issue from various other aspects of the conduct of the City's affairs. These include:

1) The budgetary process;
2) The basis of accounting;
3) Financing practices; and
4) Financial reporting and disclosure.

Both the budgetary process and the City's financing policies do appear to be closely related to legislative considerations. These in turn may impact on the basis of accounting chosen for a particular transaction. As the National Committee noted:

> "It should be emphasized...that budgetary compliance is a paramount consideration in governmental accounting and must take precedence over the basis of accounting _per se_." 1/

In the chapter on financial reporting, they go on to point out however:

> "...As applied to business entities generally, the principle of full disclosure means that the financial statements must reflect complete information on the financial position and operations of the entity to the extent that such statements will not be misleading to users... In this sense, the concept has equal applicability to the financial reports of governmental entities..." 2/

Even assuming that legal requirements permitted or mandated particular financing methods, budgeting techniques or even accounting bases, the City's fundamental obligations to make financial information comport with economic reality are not relieved.

In point of fact, however, nearly all the legislative considerations discussed herein had a direct effect only on the financing practices of the City, e.g. the issuance of debt instruments. In addition, many of the laws in question were

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1/ National Committee, _Governmental Accounting_, p. 12.

2/ Ibid, p. 107.

permissive, not mandatory. We are aware of no New York State or City law which either required the City to use particular bases of accounting or mandated the sale of debt securities.

As Comptroller Goldin stated in the 1974-1975 Annual Report:

> "The City's accounting and budgeting system, although lawful and uncritically accepted for many years, accomodated what in other accounting and budgeting systems would have been exposed as deficits." 1/

Mayor Beame, in his testimony, referring to the use of non-recurring revenues as a means of balancing the budget, remarked that this is "a common practice in use, not only in the City of New York, but in practically all cities throughout the country, in the State, and...in the Federal budget." 2/ He added:

> "Now, of course, you might know and should know that all of these things in connection with the use of these one-shot items in most instances they were State permitted under legislation and sometimes state mandated." 3/

Distinctions must be drawn, however, between compliance with various provisions of local law and presentatation of financial information for purposes of communicating to the public in a manner which is understandable and meaningful.

1/ City of New York, Annual Report of the Comptroller of the City of New York for the Fiscal Year 1974-1975, p. xii.

2/ Testimony of Abraham D. Beame, p. 43.

3/ Ibid, pp. 46-47.

The National Committee stated that a governmental accounting system must satisfy the twin objectives of both compliance with various legal provisions and fair presentation of financial data:

> "A governmental accounting system must make it possible: (a) to show that all applicable legal provisions have been complied with; and (b) to determine fairly and with full disclosure the financial position and results of financial operations of the constituent funds and self-balancing account groups of the governmental unit." 1/

Certainly, legal considerations cannot be construed to mandate or permit incomplete or misleading disclosure to the public. Compliance with legal requirements is an important consideration in the presentation of financial data, but it is not, in and of itself, dispositive. Consideration must also be given to the needs and rights of public managers, legislative and governing bodies, individual citizens, taxpayers, political groups, other governmental entities, investors, investment bankers, bond rating services and other persons whose professional or personal activities require them to acquire and analyze financial data. Where compliance with statutory conditions results in financial information which does not reflect financial reality, the need for full and complete disclosure becomes particularly acute.

C. Notices of Sale and Statements of Essential Facts

A document referred to as a "Notice of Sale" and "Statement of Essential Facts" was prepared by the City in connection with the sale of securities. The Notices of Sale announced the sale of securities and invited bids to be made.

1/ National Committee, Governmental Accounting, pp. 3-4.

The Statements of Essential Facts contained information, as of dates recent to the sales, concerning funded and temporary debt, a determination of the City's debt-incurring power (including assessed and full valuations of real estate), a schedule of bond maturity by years, schedules of debt issued within debt limits, summary figures indicating a balanced budget, schedules of general fund revenues, debt limitation exclusions, and a schedule of the tax levy and amounts still uncollected at various dates. There were no financial statements.

Partially as a result of the City's methods of balancing its budget and its overstatement of real estate taxes, certain of the financial data was incorrect. For example, the Statements of Essential Facts present a "balanced" budget, but the data was derived using the City's factitious accounting practices. As a further example, the computation of the debt incurring power was misstated because it was based upon valuations of real estate which included non-taxable properties. Most of the information contained in these documents was numerical in nature, without textual clarification. Conclusions which might be drawn from the numerical data on its face would almost surely be erroneous.

D. <u>The Budget</u>

During the budget preparation process, the Mayor's budgetary representatives gather data regarding expected revenues and expenditures for the forthcoming year, which is then compiled into a proposed budgetary program. Ultimately, after much review, a proposed program, or Executive Budget, is submitted by the Mayor to the City Council and Board of Estimate for approval. 1/

Subsequently, the City Council and Board of Estimate amend the Executive Budget as deemed appropriate, and submit a budget, balanced according to the City's methods, to the State Legislature for ratification.

Although the Executive and Adopted budgets contain a substantial volume of detailed information, these documents fall considerably short of meeting the test of full and fair disclosure.

In the Mayor's Message of May 15, 1974, the Mayor indicated the following actions, among others, to reduce the budget gap:

> "Utilize surplus earnings of pension funds, for approximately $125 million.

1/ The Executive Budget is comprised of budget analyses of various agencies of City government, as well as a "Mayor's Message" outlining areas considered important. The Mayor's Message dated May 15, 1974, for example, submitted in connection with the fiscal 1974-1975 budget, emphasized the "austere" nature of the budget, and discussed such matters as federal aid, budget priorities, and the problem of reducing and closing the "budget gap."

> "Transfer sewer rent surpluses to the General Fund, for $28 million."

Without further elaboration by the Mayor, it would seem difficult for an investor to assess the nature of these items. For example, the proposal to transfer pension fund "surplus" earnings fails to mention the outdated actuarial assumptions or the enormous unfunded liability of the pension systems. Similarly, with regard to the use of sewer rent "surpluses," no mention is made that these are caused by budgeting eighteen months' rents in the twelve month 1974-1975 fiscal year.

Other problems were evident with regard to the City's adopted budgets. Budget modifications throughout the year gave the budget a constantly changing nature, so that the adopted budget became quickly outdated. Changes were published in the City Record but interim updated versions of the budget were not generally available. Expenditures were summarized by department, but there was no indication, absent detailed analysis, of how they were to be financed. For example, the 1974-1975 budget (as adopted) had a summary schedule of revenues which set forth revenues in amounts as low as $16,000, but failed to detail revenues totaling $1,177,763,984. Instead, this massive figure was described as:

> "Capital Budget and Special Funds including surplus interest earned on investments, services rendered to independent agencies such as Housing Authority, Transit Authority, etc." 1/

1/ City of New York, Expense Budget, 1974-1975, p. vi.

Extensive analysis is required to ascertain that included within this large revenue figure were amounts financing the expense budget from the transfer of capital funds ($723,824,370), "special" funds ($2,900,000), and "surplus" pension interest ($261,424,983). A similar situation existed in the prior year (1973-1974), where the adopted budget obscured transfers of $563 million from capital funds and $48.1 million from special funds to support the budget for that year.

E. Annual Reports of the Comptroller

The City Comptroller, an elected official, is required by the City Charter annually to publish a report summarizing the financial activity of the City for the year. Usually running in excess of five hundred pages and weighing several pounds, it purports to present certain information regarding the City's expense budget, various tax and other revenues, uncollected real estate taxes, the City's reserve funds, borrowing limits, short and long term debt and other matters. About 550 copies were printed annually and distributed to banks, libraries and others. 1/

This report fails to reveal accurately the financial condition of the City in a manner understandable to a reasonably informed reader. This failure was confirmed by the testimony of bankers, brokers, bond counsel, rating agency personnel and

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1/ Testimony of Sol Lewis, pp. 318-319.

representatives of the City who were unable to answer with certainty questions concerning the financial status of the City based upon information contained in the Comptroller's Annual Report. Steven Clifford, when he was associated with the New York State Charter Revision Commission for New York City described the 1972 Annual Report:

> "This document . . . rivals Paradise Lost and the line budget in indigestibility. Running 542 pages, it includes a 161 page itemization of capital budget expenditures, a 77 page statement of expenses by department, a 22 page itemization of sinking fund operations, a 30 page listing of debt statistics, etc." 1/

Each of the deficiencies discussed herein relating to accounting practices, disclosures and internal control weaknesses are reflected in some way in these Annual Reports.

1. Receivables and revenues

Information is set forth in the report to the effect that the achievement of a "balanced budget" is predicated upon the assumption that the City will collect all of its Federal and State aid and real estate taxes receivable. Appropriate accounting principles applied by the State Comptroller established that

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1/ Report of The Office of Comptroller of the City of New York, Prepared by Steven Clifford for the New York State Charter Revision Commission for New York City, February 1973, at 15.

the City had cumulatively overstated its receivables for real estate taxes by approximately $408 million and for federal and state aid by about $325 million at June 30, 1975. The City reflected these receivables throughout the report as if they were 100% collectible but failed to reveal that many of these balances represented little more than an imaginative approach to revenue accural.

Financial schedules in the Annual Reports for 1974 and 1975, for example, failed to disclose the City's unusual basis for recording water charge and sewer rent revenues. The 1973-1974 report fails to adequately highlight the eighteen months of water charge revenues included in that year's budget. The 1974-1975 report is similarly deficient with respect to the accrual of sewer rent revenues made during that fiscal year.

Another itemized "receivable" concerned the New York Stabilization Reserve Corporation. This entity was organized to finance the City's expense budget through the issuance of debt securities. These securities were never issued, and the Stabilization Reserve Corporation was unable to provide the funds. The City nevertheless recorded the $150 million as an "actual receipt" of the General Fund in 1974, classifying the item as a receivable from another fund, the "Miscellaneous Revenue Accounts Fund." Notwithstanding the problems concerning the issuance of debt by the Stabilization Reserve Corporation to support the 1973-1974 budget, the City budgeted an additional $370 million as indirectly receivable from SRC for fiscal 1974-1975.

2. Liabilities and expenses

The 1973-1974 Annual Report also failed to reflect liabilities for such items as payroll and pensions. Payroll costs are reflected on a 364 day year basis with no disclosure of the annual escalation in unrecorded liabilities. In addition, the financial presentations in this Annual Report do not appear to reflect any liability for unpaid payroll and fringe benefit-related costs, such as vacation pay. The City's huge obligations for unfunded pension costs are reflected nowhere in the 1973-1974 Annual Report, and the unique treatment of so-called "excess" interest on pension fund assets was obscured in various financial presentations, which tracked the budgetary techniques contrived by the City to "balance" its revenues and expenditures.

3. Disclosures

The usefulness of any financial presentation is significantly dependent upon the understanding of the accounting policies followed in its preparation. Although the City did not purport to prepare its reports in accordance with GAAP, there was no meaningful disclosure, prior to 1975, of the basis on which they were in fact prepared.

While hardly a model for accounting policy disclosure, the City's methods of recognizing revenues and expenditures were described in the Comptroller's Annual Report issued on October 31, 1975:

"The Report which follows has been compiled on the basis of accounting principles and procedures in effect for New York City accounts during 1974-1975 and prior years. In general, this system employed a cash basis for recognizing expenses and an accrual basis for recognizing revenues, including end-of-year accruals in the case of local taxes other than real estate taxes and accruals crossing fiscal years in the case of non-reimbursable Federal and State aid. In the case of real estate taxes, the entire tax levy has been accrued as revenue. Tax Anticipation Notes were issued against the unpaid balance at the end of each year, which Notes were not fully redeemed until the end of the fifth year. In the case of reimbursable Federal and State aid, budgetary revenue estimates have been recognized as receivables." 1/

This explanatory note is conspicuously absent from earlier Annual Reports in which the Forewords imply that revenues were accrued, but which do not make apparent the City's treatment of recording expenditures:

"The operations of the Expense Budget for the Fiscal Year 1972-1973 are shown in detail in Part 2-A of this report, and are summarized in Statement 1. The receipts and receivables amounted to $9,325,587,540 and the expenditures including contracts registered, totalled $9,139,165,053." 2/

Other comments in the Annual Reports for fiscal years 1973 and 1974 alluded to the City's method of recognizing revenues and expenditures, but failed to explicitly set forth that the City recognized revenues on an accrual basis and expenditures on a cash basis.

1/ Annual Report of the Comptroller 1974-1975, at xiii.

2/ Annual Report of the Comptroller 1972-1973, at v.

In reviewing the Comptroller's 1974 Annual Report at the request of Comptroller Goldin, representatives of the Municipal Finance Officers Association informed the Comptroller that among the areas which required "comments or explanation" was the City's method of revenue and expense recognition because "[t]he basis of accounting is neither explained nor apparent from the report." 1/

The inherent unreliability of data reflecting cash, securities balances, receivables and similar items which were products of the City's "Rube Goldberg" system of internal control was disclosed nowhere. Instead, the Comptroller outlined in the foreword to the 1973-1974 Annual Report steps that had been undertaken to improve systems, procedures, and internal controls.

The deficiencies of the Annual Report as a vehicle for meaningful disclosure seem beyond dispute. In addressing the Municipal Finance Officers Association in May 1976, Comptroller Goldin said:

> "To describe as 'some difficulties' what must have been the sheer futility of trying to understand the City's Annual Report under the old system is to demonstrate a diplomacy worthy of high office in the State Department.
>
> "It is like saying that I, Harrison J. Goldin, might expect some difficulties should I climb into the ring with Muhammed Ali." 2/ [Emphasis in Original]

1/ Letter from Donald W. Beatty, Executive Director, Municipal Finance Officers Association, Chicago, to Harrison J. Goldin, Comptroller, City of New York, dated 27 March 1975.

2/ Office of the Comptroller, City of New York, Press Release, (4 May 1976), p 2.

APPENDIX A

Historical Overview of Municipal Accounting

A. History

1. Prior to 1930

Although it has been acknowledged that "the history of authoritative accounting pronouncements dates only from the 1930's," 1/ prior to this time there existed an extensive pool of accounting thought, knowledge, literature, and practice.

In this country the genesis of governmental accounting - federal, state, and municipal taken together - can be traced to the early years of the United States. In fact, certain procedures introduced into the federal fiscal system by Alexander Hamilton were still being utilized in 1948. 2/ However, governmental accounting practices prior to the twentieth century bear only slight resemblance to governmental accounting as it exists today. Current concepts of governmental accounting had their origin at the beginning of the twentieth century, as part of the municipal reform movement which sought to eliminate the scandalous and inadequate practices which had existed in the fiscal administrations of many American

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1/ James M. Williams, Paper entitled "Generally Accepted Accounting Principles Applicable to State and Local Government," (Chicago: Municipal Finance Officers Association, 1976), p. 3.

2/ Lloyd Morey, "Trends in Governmental Accounting," Accounting Review (23 July 1948): 227.

cities. 1/ Among the reformers were the National Municipal League 2/ and the U.S. Census Bureau which began to seek uniformity in municipal accounting and reporting. 3/ As part of the thirteenth census of the United States, the Census Bureau issued a publication entitled "Statistics of Cities" which was based upon a uniform system of data classification intended as a standard for all cities in the United States.

During the first decade of this century, the growth of municipal government led to increasing interest in governmental accounting. In 1901 and 1902, the cities of Newton, Massachusetts, and Baltimore, Maryland published annual reports "along lines recommended by the National Municipal League. 4/ In the next two years, Chicago, several cities in Massachusetts and seventy cities in Ohio also adopted recommendations of the National

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1/ Edward S. Lynn and Robert J. Freeman, Fund Accounting Theory and Practice (Englewood Cliffs, New Jersey: Prentice Hall, Inc., 1947), p. 25.

2/ The National Municipal League was formed in 1894 to establish a forum for good City government. See Frank Mann Stewart, A Half Century of Municipal Reform (Los Angeles: University of California Press, 1950), p. 21, as quoted in 1976 by James H. Potts in a dissertation written for the University of Alabama entitled, "An Analysis of the Evolution of Municipal Accounting to 1935 with Primary Emphasis on Developments in the United States."

3/ Lynn and Freeman, Fund Accounting Theory and Practice, p. 25.

4/ Ibid, pp. 23-27.

Municipal League. In 1904 New York State enacted legislation to place cities within the State on a uniform basis, and in 1906 Massachusetts passed a similar law. 1/

Indeed, at this time, New York City was in the forefront of municipal reform. In 1905, Herman A. Metz was elected Comptroller of the City of New York, having campaigned on a platform which portrayed him as a ". . .business man for the head of the city's business office." By the time Metz became Comptroller, an estimated one-fourth of the City's eighty-million dollar personal services budget had been lost due to collusion, idleness, or inefficiency; and City departments were issuing bonds to finance their current operating expenditures. 2/ After spending a year "employed in getting in touch with the problem," 3/ Metz, in his remaining three years, established procedures to guide the City's fiscal operations with the active assistance of the Bureau of Municipal research. 4/

1/ DeWitt Carl Eggleston, Municipal Accounting (New York: The Ronald Press Company, 1914), pp. 23-24.

2/ Lynn and Freeman, p. 26.

3/ Bureau of Municipal Research, Handbook of Municipal Accounting (New York: D. Appleton and Company, 1913), p.v.

4/ The Bureau of Municipal Research had among its goals, "... to promote the adoption of scientific methods of accounting and of reporting the details of municipal business. . ." See DeWitt Carl Eggleston, Municipal Accounting (New York: Ronald Press Company, 1914), p. 24.

Metz, as Comptroller, prepared a "Manual of Accounting and Business Procedure for the City of New York," and had it promulgated by executive order. This manual set forth its purposes as:

> "1. To describe definitely the forms of documents to be used and the procedure to be followed by employees of the city, to the end that responsibility may be located for each step taken in each transaction resulting in the receipt and payment of money, the acquisition and sale of property, and the incurring and liquidating of liabilities
>
> "2. To establish and place in the hands of employees a manual containing definite rules, departures from which, in the administration of the city's affairs, may be treated as breaches of duty
>
> "3. To require those making any change in corporate practice to state such change in writing, and to assume official responsibility therefor
>
> "4. To make available to each one who has business dealings with the city the means of knowing the technical requirements and of understanding his rights
>
> "5. To establish a procedure which will make available to the public a definite test of economy, efficiency and fidelity of service." 1/

After Metz retired from office in 1909, having served only one term, he established a fund within the City's Bureau of Municipal Research. The purpose of this fund was to assist the Bureau in making available to other cities the experience of the City of New York in revising its accounting methods. 2/

1/ Bureau of Municipal Research, Handbook of Municipal Accounting, pp. v-vi.

2/ Ibid, p. vi.

With the aid of Metz's gift, in 1913 the Bureau of Municipal Research consolidated its literature into a single text entitled Handbook of Municipal Accounting. Commonly referred to as the Metz Fund Handbook, this text was distributed to approximately 325 American cities. The handbook brought together for the first time "many of the basic characteristics and requirements of municipal accounting, and outlined methods of appropriate treatment." This handbook has been identified as "the most significant contribution of the 1910 decade." 1/

One of the concepts in the Metz Fund Handbook still bears validity today. The handbook in its introduction, asserted that "the function of accounting is to produce complete, accurate, and prompt information about business transactions and results." 2/

In 1912 Congress passed the Federal Budget and Accounting Act which ". . . brought about a major change in the fiscal procedures of the government. In the budget area its provisions proved to be generally sound and productive of good results. In

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1/ Morey, "Trends in Governmental Accounting," p. 227.

2/ Bureau of Municipal Research, Handbook of Municipal Accounting, p. ix.

accounting and auditing less satisfactory results were secured . . . ." 1/ A year later, New York City reappeared at the forefront of reform when its Comptroller transmitted to the Board of Estimate and Apportionment a plan for organization of a central purchasing department modeled on similar departments in railroad organizations. 2/

Textbooks now began to appear and in 1914 DeWitt Eggleston, a member of the AIA and former employee of the Department of Finance of New York City, published Municipal Accounting, the first reference work by a private author, which has been applauded as "a rather complete program of accounting practice and procedure for a municipality." 3/ During the next ten years, interest in governmental accounting continued with the publication of articles, pamphlets, and textbooks. Municipal leagues were formed in various states as others became more interested in the subject. 4/

The 1920's saw significant work in municipal accounting by various distinguished authors, 5/ but general interest in governmental accounting waned until the early 1930's. 6/ By 1933, although some progress could be seen, at least one expert in the area

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1/ Morey, "Trends in Governmental Accounting," pp. 227-228.

2/ Eggleston, Municipal Accounting, p. 26.

3/ Morey, "Trends in Governmental Accounting," p. 227.

4/ Lynn and Freeman, Fund Accounting Theory and Practice, p. 26.

5/ Morey, "Trends in Governmental Accounting," p. 227.

6/ Lynn and Freeman, Fund Accounting Theory and Practice, p. 26.

was lamenting that there was a marked absence of general improvement. 1/

Thus, a request to twenty-seven cities, in 1930, for information concerning municipally owned water plants revealed that only eleven cities had "accounting systems that would allow them to present complete information about a certain single activity of the city, unless a detailed analysis were made." 2/ A more comprehensive review conducted in 1931 revealed that few of the fifty-six cities studied either prepared budgets or complete - financial statements, and "none of these cities brought budget accounts into use so that they would be continuous with the other accounts." 3/

2. Subsequent to 1930

The advent of the Depression gave rise to renewed interest in municipal accounting practices. The Municipal Finance Officers Association sponsored the organization of the National Committee to address accounting and financial reporting problems in the public sector.

1/ R.P. Hackett, "Recent Developments in Governmental and Institutional Accounting, "The Accounting Review (8 July 1933): 122.

2/ Ibid.

3/ Ibid.

The establishment of the National Committee came at a time when there was still virtually no authoritative private sector or public sector accounting standards literature. 1/ During the 1930's, however, the AIA established its Committee Accounting Procedure to "work toward resolution of accounting and reporting problems of private sector enterprises, particularly those within the purview of the newly established Securities and Exchange Commission." 2/

The Municipal Finance Officers Association supported the organization of the National Committee "in order to bring together representatives of various groups concerned with municipal accounting and to put into effect sound principles of accounting, budgeting, and reporting." 3/ It was believed that the National Committee would formulate these principles in response to the "deplorable situation" that existed in the 1920's. 4/ The National

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1/ Maurice Moonitz, Obtaining Agreement on Standards in the Accounting Profession, Studies in Accounting Research, No. 8 (Sarasota, Florida: American Accounting Association, 1974), pp. 15-16, cited by A.M. Mandolini in "Comments by A.M. Mandolini, Member of the Executive Committee of the National Council on Governmental Accounting (NCGA) on the Financial Accounting Standards Board (FASB) Discussion Memorandum - 'An Analysis of Issues Related to Accounting and Reporting for Employee Benefit Plans'", Exhibit A, page 1, Emphasis added /Hereinafter referred to as "Comments by A.M. Mandolini"/.

2/ A.M. Mandolini, "Comments by A.M. Mandolini" Exhibit A, p. 1.

3/ Lynn and Freeman, Fund Accounting Theory and Practice, p. 27.

4/ Joseph M. Lowery, "Governmental Accounting, Auditing and Financial Reporting," Municipal Finance (February 1968): 111.

Committee was created in 1934 "to formulate principles of municipal accounting, to develop standard classifications of accounts, uniform terminology for financial reporting by governmental units, to consider principles which should be followed in making governmental audits and to promote the recognition and use of these standards." 1/

The National Committee has historically maintained a close association with the Municipal Finance Officers Association, its sponsoring organization. The National Committee, furthermore, is national and international in membership and upon organization included the chairman of the Municipal Accounting Committees of each of the following:

> "1) American Association of University Instructors in Accounting (Now the American Accounting Association);
>
> "2) American Institute of Accountants (Now American Institute of Certified Public Accountants);
>
> "3) American Municipal Association;
>
> "4) American Society of Certified Public Accountants (Now merged with the American Institute of Certified Public Accountants);
>
> "5) International City Managers' Association;
>
> "6) Municipal Finance Officers Association of the United States and Canada, the sponsor;
>
> "7) National Association of Cost Accountants (Now National Association of Accountants);

1/ Municipal Finance Officers Association, Exposure Draft - A Report of the MFOA Task Force on the Sponsorship of the National Committee on Governmental Accounting and Related Programs (Chicago: MFOA, 1973), p. i.

"8) National Association of State Auditors, Comptrollers and Treasurers;

"9) National Municipal League; and

"10) U.S. Federal Bureau of Census in a liaison capacity." 1/

The National Committee took immediate action and at its organizational meeting tentatively adopted certain principles and set out a fourteen point program of research into areas of municipal accounting. 2/ These initial steps were endorsed, in 1934 and again in 1935, by the Special Committee on Governmental Accounting of the AIA. 3/

The National Committee, however, was an impermanent entity whose staff and facilities were provided by the Municipal Finance Officers Association. The original National Committee was discharged in the mid-1930s, and new Committees were later established on an ad hoc basis to review and revise earlier National Committee publications. When their review was completed these later Committees were discharged.

1/ Lowery "Governmental Accounting, Auditing and Financial Reporting," pp. 111-12.

2/ Lynn and Freeman, Fund Accounting Theory and Practice, p. 27.

3/ Special Committee on Governmental Accounting, American Institute of Accountants, Audits of Governmental Bodies (New York: American Institute of Accountants, 1934); and Special Committee on Governmental Accounting, American Institute of Accountants, Accounts of Governmental Bodies (New York: American Institute of Accountants, 1935).

a. National Committee on Governmental Accounting

In 1948 the President of the Municipal Finance Officers Association pressed for reactivation of the National Committee to review and modernize its previous work. The resulting entity was called the National Committee on Governmental Accounting ("National Committee") ostensibly to reflect that its recommendations were applicable to other governmental units as well as to municipalities.

Thus, a reactivated and renamed Committee began its review with input from recognized experts in the field of governmental accounting and finance. 1/ The National Committee's efforts culminated with the publication of two significant volumes, Municipal Accounting and Auditing, published in 1951, and A Standard Classification of Municipal Accounts, published in 1953. These volumes updated and consolidated many of the ideas in the Committee's earlier releases.

In the late 1960s the National Committee reconvened to again update the concepts contained in these 1951 and 1953 publications. In March 1968, the National Committee issued Governmental Accounting, Auditing, and Financial Reporting, its eighteenth and most comprehensive volume, in recognition of "some changed concepts, procedures, and requirements related to governmental accounting and financial reporting which have taken place since the publication [in 1951 and 1953] of those two books." 2/

1/ Lowery, "Governmental Accounting, Auditing, and Financial Reporting," p.114.

2/ National Committee, Governmental Accounting, p. iii.

Governmental Accounting sets forth in one comprehensive, 234 page volume the principles and procedures of accounting, auditing, and financial reporting for all governmental units except national governments and their agencies. The statements and tables:

> ". . . when used together, constitute a detailed annual financial report of the finance officer of a governmental unit. These statements can, however, also be used in an annual audit report, and some of them could be adapted for use in the financial section of a so-called popular report. Also included are illustrative statements for interim reports prepared for shorter periods during a fiscal year. 1/

The account classifications recommended are "adaptable to all types of state and local governmental units irrespective of their size, activities, structure, or system of accounting." 2/ The National Committee explained:

> "The classifications have been made elastic so that they can be condensed or expanded to meet the needs of an individual governmental unit without destroying the basic uniformity underlying its structure. The classifications will enable governmental units to report on a comparable basis simply by listing the account titles on a reporting schedule. In states which require their local governmental units to report financially on a uniform basis, some predicate their requirements on the account classifications promulgated by NCGA /the National Committee/, modified to meet needs of the given state." 3/

1/ Ibid.

2/ Ibid.

3/ Ibid [Footnote omitted].

The comprehensive and elastic nature of Governmental Accounting illustrates the utility of this text to professionals concerned with the accounting, auditing, and financial reporting process of a governmental unit. As one authority has noted, by combining generally accepted standards and principles applicable to governmental accounting with recommended procedure and practice, Governmental Accounting is:

> ". . . essential to any individual involved in the accounting, auditing, or financial reporting aspects of state and local government. It is a synthesis of principles, budgetary and accounting techniques, explanatory discussions, sample journal entries, and illustrative financial statements and schedules." 1/

Since the Municipal Finance Officers Association has distributed at least 32,000 copies of Governmental Accounting since its publication in 1968, 2/ it is not surprising that the activity of the National Committee on Governmental Accounting over the years has gained wide acceptance. Indeed, by 1940, the National Committee had distributed more than 12,000 of its publications, and by that time, "its statements were recognized as the generally accepted standards for municipal accounting." 3/ Such widespread distribution lead one textbook author to note, in 1948, that:

1/ Williams, Paper entitled "Generally Accepted Accounting Principles Applicable to State and Local Government," p. 7.

2/ Ibid, p. 8.

3/ The National Council on Governmental Accounting, Rules of Procedure (Chicago: NCGA, 1975), p. 1.

> "There is no longer any doubt as to what constitutes good accounting, reporting, and auditing for public bodies. The work of the National Committee on Municipal Accounting in particular, in establishing standards and models in these subjects, provides an authority to which officials, accountants, and [the] public may turn with confidence." 1/

b. AICPA involvement

In contrast to the Municipal Finance Officers Association and the National Committee, the role of the AICPA until recently has been relatively passive in nature. The AICPA's predecessor entity, the AIA, supported the activity of the National Committee in two separate endorsements. A Special Committee of the AIA published a bulletin in 1934 dealing with governmental audits which noted, "the form and contents of the audit report should conform as far as practicable to the recommendations of the National Committee on Municipal Accounting, with due allowance for local conditions and requirements." 2/ The following year, the Special Committee repeated its endorsement of the National Committee, recommending that governmental accounts "be kept in accordance with the principles and classifications recommended by the National Committee on Municipal Accounting." 3/

1/ Morey, "Trends in Governmental Accounting," p. 231.

2/ Special Committee on Governmental Accounting, American Institute of Accountants, Audits of Governmental Bodies (New York: AIA, 1934), pp. 3, 7.

3/ Special Committee on Governmental Accounting, American Institute of Accountants, Accounts of Governmental Bodies (New York: AIA, 1935), pp. 3, 7.

Again, in 1953, the AIA's Committee on Accounting Procedure 1/ issued a statement of objectives which gave tacit endorsement to the activity of the National Committee. 2/

Thus, in the 1930's the AIA expressly endorsed the activities of the National Committee, and over the years the AIA and the AICPA have focused their attentions to areas other than governmental accounting. Although the National Committee and its successor organizations have received input from various sources including the AICPA and individual certified public accountants, the National Committee and its successors appear to have been the primary bodies in establishing GAAP applicable to governmental units.

The AICPA, however, has recently taken an active role in developing principles of governmental accounting. In 1974, its Committee on Governmental Accounting and Auditing published the AICPA's Audit Guide which relied heavily on the principles set forth in Governmental Accounting. The Committee noted in the preface to the Audit Guide that:

1/ The Committee on Accounting Procedure was an ancestor of the Financial Accounting Standards Board.

2/ Committee on Accounting Procedure, Accounting Research Bulletin No. 43 - Restatement and Revision of Accounting Research Bulletin Introduction, para. 5 (New York: AICPA, 1953).

"Proper use of this guide requires thorough knowledge of Governmental Accounting, Auditing and Financial Reporting. . . . published in 1968 by the National Committee on Governmental Accounting. . .

"The blue book [Governmental Accounting] and this audit guide represent significant steps in the evolution of governmental accounting and financial reporting. This evolutionary process is continuing even today." 1/

The Committee further elaborated as to its endorsement of Governmental Accounting:

"A body of accounting practices for governmental units, that has received the general endorsement of governmental officials, the general public, and other persons interested in the financial statements of such units, has evolved over the years. The National Committee on Governmental Accounting (NCGA) in its publication entitled Governmental Accounting, Auditing and Financial Reporting (GAAFR), which has been acknowledged as an authoritative publication in the area of accounting for governmental units, has set forth 13 'basic principles' to be applied in accounting for governmental operations.

* * * *

"GAAFR's principles do not represent a complete and separate body of accounting principles, but rather are a part of the whole body of generally accepted accounting principles which deal specifically with governmental units. Except as modified in this guide, they constitute generally accepted accounting principles." 2/

1/ AICPA, Committee on Governmental Accounting and Auditing, Audits of State and Local Governmental Units (New York: AICPA, 1974), p. xi. [Hereinafter referred to as "AICPA Audit Guide"].

2/ Ibid, pp. 8-9 [footnote omitted].

The Audit Guide was published for the guidance of AICPA members "in examining and reporting on financial statements of state and local governmental units." In publishing the Audit Guide, the Committee noted:

> "It [the Audit Guide] represents the considered opinion of the Committee on Governmental Accounting and Auditing and as such contains the best thought of the profession as to the best practices in this area of financial reporting. Members should be aware that they may be called upon to justify departures from the Committee's recommendations." [emphasis added] 1/

c. National Council on Governmental Accounting

Although the performance of the National Committee has had a major impact upon the development of governmental accounting, its sponsor, the Municipal Finance Officers Association expressed concern in 1973 that the ad hoc nature of the National Committee was insufficient in meeting the needs of modern society. 2/

For example, in the late 1960s, the AICPA determined that an industry audit guide was needed, and that certain aspects of Governmental Accounting required clarification or modification. Since the most recent National Committee had been discharged in 1968, there was no active National Committee to address these issues. Additionally, since the AICPA's Audit Guide was required to be

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1/ Ibid, Copyright page, Notice to Readers.

2/ Robert J. Freeman, "Governmental Accounting Research and Standards - Setting: The Role of the NCGA," Governmental Finance 5 (May 1976): 7.

cleared by the Accounting Principles Board prior to the expiration of that body on June 30, 1973, the AICPA's committee could not wait for a new National Committee to be formed. 1/

The leaders of the Municipal Finance Officers Association established a task force to assess the situation. In March 1973, this task force issued its report and "stressed the need for an ongoing authoritative body to research governmental accounting and related issues and to promulgate and interpret governmental accounting and reporting standards." 2/

As a result, the Municipal Finance Officers Association established the National Council on Governmental Accounting in June 1974 as a continuing, quasi-independent body in recognition of the need "for a body to survey constantly governmental accounting principles and standards and to promulgate changes as needed." The Council is mandated to:

1/ A.M. Mandolini, "Comments by A.M. Mandolini," Exhibit A, p. 2. The AICPA's need to issue an Audit Guide prior to June 1973 lead to collaboration between the AICPA's Committee on Governmental Accounting and Auditing and a Committee of the Municipal Finance Officers Association in writing the Audit Guide, and resulted in an informal agreement of future cooperation. See Ibid, pp. 2-3.

2/ Freeman, "Governmental Accounting Research and Standards - Setting: The Role of the NCGA," p. 7.

"....develop, promulgate and interpret principles of accounting, financial reporting, and related financial management activities for governments in the United States and Canada...[and to] develop and promulgate appropriate methods, practices, and procedures for the effective implementation of such principles." 1/

Such activity in the area of governmental accounting has recently attained greater visibility. The financial crisis of of the City of New York has helped to expose the "overwhelming inadequacy" of the City's accounting (and financial information) system. 2/ One consequence of this exposure has been the enactment of the 1975 MAC Law that requires the City to adopt accounting standards which more closely approximate those standards set forth over the years by the National Committee and the AICPA.

d. MAC legislation

In June 1975, the New York State Legislature mandated the implementation of new accounting standards upon the City. In order for the City to receive financial assistance from MAC, the legislature required that the City adopt the New York State comptroller's uniform system of accounts for cities as modified by the State Comptroller for application to the City. The State Comptroller issued such modifications in a series of Accounting

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1/ National Council on Governmental Accounting, Rules of Procedure (Chicago: National Council on Governmental Accounting, 1975), pp. 1-2.

2/ Jan M. Lodal, "Improving Local Government Financial Information Systems," Duke Law Journal 1976 (January 1977): 1133.

Systems Directives ("MAC Directives") which set forth the accounting and reporting principles to be followed by the City. 1/

These MAC Directives are based in large part upon accounting principles previously promulgated by various interested organizations and accounting bodies. Three of such organizations are the National Council on Governmental Accounting, the AICPA, and the Financial Accounting Standards Board.

As noted earlier herein, the AICPA's Audit Guide endorsed the earlier work of the National Council on Governmental Accounting. Thus, the MAC legislation in effect mandates that the City adopt accounting principles as set forth in large measure over the years by the National Council on Governmental Accounting and its predecessor organizations.

Although the emphasis in the development of accounting principles has largely been in the commercial sector, it is clear that governmental accounting principles have developed as a result of considerable effort, research, and thought.

1/ Office of the New York State Comptroller, Summary of Accounting Systems Directives for New York City (As of August 31, 1976) (Report No. NYC-44-77: 30 September 1976), Managerial Summary, p. 1. [Hereinafter referred to as "Office of the New York State Comptroller, Summary of Accounting Systems Directives"].

B. Municipal Accounting and Generally Accepted Accounting Principles

The unique nature of governmental operations requires that governmental units maintain accounting systems different in character from other types of accounting systems. The National Committee and the AICPA each recommend that governmental accounting systems be organized on the basis of eight types of "funds", (segregated for the purpose of carrying on specific activities or attaining certain objectives) and two account groups. Each fund and account group constitutes an independent, separate reporting entity with individual sets of financial statements. This system is referred to as a fund accounting system. This differs from accounting for commercial enterprises, where the financial activity of an enterprise is summarized and reported in one set of financial statements for the entire reporting entity.

The meaning of the term "fund" as utilized in governmental accounting is distinguished from the meaning of the term as it is sometimes employed in commercial accounting in that the latter term refers to a type of account - an earmarked sum of cash or other assets - and in governmental accounting the term refers to a separate, distinct entity with its own self-balancing group of accounts.

The National Committee on Governmental Accounting and the AICPA recognize eight types of funds, which fall into two general categories: "operating" funds and "project" funds. "Operating" funds are designed to account for continuous and recurring transactions, and include the General Fund, Special Revenue Funds, Debt Service Funds, Enterprise Funds, Trust and Agency Funds, and Intragovernmental Service Funds. "Project" funds are principally used to account for capital improvement and similar programs of long term benefit, and these include Capital Projects and Special Assessment Funds.

In addition to eight funds, two account groups are recognized - a General Fixed Asset Group of Accounts and a General Long-term Debt Group of Accounts. Fixed assets are usually recorded in the accounts of a fund only when the fund is of a nature where the costs of the assets are recoverable from the operations accounted for by the fund, e.g., the costs of automobiles would appropriately be recorded in an Intragovernmental Service Fund. Otherwise, fixed assets which are "employed in the rendition of general governmental services to the public at large from general revenues and without renumeration on a direct service charge basis" 1/ such as roads, bridges, and fire trucks are referred to as "general fixed assets" and are accounted for

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1/ National Committee on Governmental Accounting, Governmental Accounting, Auditing, and Financial Reporting (Chicago: Municipal Finance Officers Association, 1968) p. 9, [Hereinafter referred to as "National Committee, Governmental Accounting"].

appropriately be accounted for in an "Intragovernmental Service Fund", which is a fund "established to finance and account for services and commodities furnished by a designated department or agency to other departments and agencies within a single governmental unit." 1/

Municipal accounting differs from commercial accounting in other respects as well. Commercial entities generally follow the accrual basis of accounting, while in municipal accounting, the basis of accounting is determined on a fund by fund evaluation.

The term "basis of accounting" refers to the time when revenues and expenses are recorded in the accounting records. For example, under the cash basis of accounting revenues are not recorded in the books of account until they are actually received in hand, and expenses are not recorded until each payment is made. Generally under the accrual basis of accounting, revenues are recorded at the time they are earned and expenses are recorded when the liability for them is incurred.

The National Committee stated its preference for the accrual method as a basis of accounting because this method:

1/ Ibid, p. 163.

> "...provides a superior method of accounting for the inflow and outgo of economic resources in any organization, because it relates costs and expenditures to the time period in which benefits of the outlays are received and because it provides a more accurate matching of these benefits with any associated revenues." 1/

In endorsing the accrual method, the National Committee was critical of the cash basis 2/ and recommended that governmental units make "...maximum use of the accrual basis except in those cases where the nature of governmental financial operations does not permit the full accrual basis. In the latter cases, the modified accrual basis should be used." 3/ The AICPA has largely adopted these recommendations. 4/

1. Funds of a General Nature

According to the AICPA and the National Committee, funds established primarily to account for the revenues and expenditures for governmental operations of a general nature should use a modified accrual basis of accounting. These funds are classified as budgetary funds, and include the general fund, special revenue funds and debt service funds. The National Committee

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1/ National Committee, Governmental Accounting, p. 11.

2/ The National Committee stated:

> "Under the cash basis, an accurate comparison of expenditures in relation to services rendered is not possible, because the services may be rendered in one fiscal period and the disbursements related to such services not be made until the following fiscal period." Ibid.

3/ Ibid, pp. 11-12.

4/ AICPA, Audit Guide, pp. 13-17.

noted that for these funds:

> ". . . the use of the full accrual basis is not feasible or practicable because of the character of their financial operations and revenue sources. . . . . the expenditures of the General, Special Revenue, and Debt Service Funds do not generate and are not directly associated with fund revenues raised by taxation and other revenue-producing powers unique to state sovereignty. It is illogical, therefore, to attempt to match revenues and expenditures for the purpose of determining net income in the generally accepted manner - applicable to profit-motive organizations. At the same time, however, the basis of accounting is important in arriving at the financial position of these governmental funds, and it is for this reason that the Committee carefully defines the modified accrual basis which it recommends for these particular funds." 1/

The particular modified accrual basis recommended for such funds is:

> "...that method of accounting in which expenditures other than accrued interest on general long-term debt are recorded at the time liabilities are incurred and revenues are recorded when received in cash, except for material or available revenues which should be accrued to reflect properly the taxes levied and the revenues earned."2/

The National Committee gave examples and outlined treatment appropriate for certain revenues:

> ". . . some general revenues are assessed and collected in such a manner that they can be appropriately accrued on the governmental unit's accounts, whereas others cannot. Among the latter are current income taxes, sales taxes, gross receipts taxes, and such miscellaneous sources as parking meter revenues, fines and forfeits. Revenue sources which can and should be recorded on the accrual basis

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1/ National Committee, Governmental Accounting, p. 12.

2/ Ibid, p. 11.

include property taxes, charges for current services, grants from other governments, and sales and income taxes where taxpayer liability has been definitely established and is legally enforceable. In the case of the property tax, for example, the tax is levied pursuant to law as of a specific date, the amount of the tax is precisely determinable in advance, and an enforceable legal claim attaches to the properties and/or taxpayers subject to the tax. The amount of property tax due a government can therefore be billed to taxpayers and recorded on the accounts of the taxing jurisdiction at the time tax statements are rendered in precisely the same manner that accounts receivable are recorded on the books of a private business enterprise." 1/

The AICPA Audit Guide defines the modified accrual basis of accounting as one in which revenues should be recorded as received in cash except for (a) revenues susceptible to accrual and (b) revenues of a material amount that have not been received within the normal time for receipt. The Audit Guide then defines susceptibility and materiality as follows:

"Revenues susceptible to accrual....Revenues considered susceptible to accrual are those revenues that are both measurable and available. In substance, 'available' means that the item is a resource that can be used to finance the governmental operations during the year.

1/ Ibid, p. 12.

"Few types of revenues in budgetary funds possess all of the characteristics essential to meet both criteria of being measurable and available, which are requisite to being considered susceptible to accrual.

"Revenue sources that generally are not considered susceptible to accrual include those generated on a self-assessed basis, such as income taxes, gross receipts taxes, and sales taxes. Normally, such taxes would be recorded as revenue when received.

* * * * *

"Revenues of a material amount. Some revenues, even though not susceptible to accrual, should be recorded prior to actual receipt. Generally, material revenues otherwise not recorded until received should be accrued if receipt is delayed beyond the normal time of receipt. . . .

"Material revenues received prior to normal time of receipt should be recorded as deferred revenue. For example, if sales tax revenue normally is received after the financial statement date, but for some reason is received before the financial statement date, the amount should be recorded as deferred revenue until time of normal receipt." 1/ [Emphasis Added]

1/ AICPA, Audit Guide, pp. 14-16.

Expenditures, on the other hand, should be recorded on the accrual basis, except for:

> "(a) disbursements for inventory type items, which may be considered expenditures at the time of purchase or at the time the items are used; (b) prepaid expenses, which normally are not recorded; [and] (c) interest on long term debt, which should normally be an expenditure when due." 1/

2. Funds of a Specific Nature

Funds established primarily to account for the revenues and expenditures for governmental operations of a specific nature should generally utilize the accrual basis of recognizing revenues and expenses. The AICPA classifies these funds as (1) funds which are similar to commercial enterprises, classified as (i) enterprise and (ii) intragovernmental service funds, and (2) other governmental funds, such as (i) capital projects funds, (ii) trust and agency funds, and (iii) special assessment funds. 2/ As the National Committee noted:

1/ Ibid, pp. 16-17. In addition to these three exceptions, the accrual method: further altered in situations where municipalities use an encumbrance method of accounting, initially recording expenditures based on commitments such as purchase orders and contracts.

2/ Ibid, p. 13.

> "In each of these funds, expenditures can be recorded as soon as liabilities are incurred, and the nature of each fund's revenues is such that all revenues and other resources can be recorded when earned or levied. Thus, in the case of a conventional enterprise fund operation, the enterprise spends and consumes its resources to provide a product or service, the product or service is sold, and costs are matched with associated revenues to determine net income or loss. A similar cycle of commercial-type operations takes place in an intragovernmental service fund which periodically bills using departments for services rendered by the fund to them." 1/

Within a given municipality, the basis of accounting is determined on a fund by fund evaluation. It is likely that some funds within a given municipality might utilize the accrual basis of accounting and others the modified accrual basis.

Except for minor differences, the views of the National Committee and the AICPA are in agreement concerning the basis of accounting to be used by the funds of a municipality.

These and other GAAP standards applicable to governmental units have evolved over the years and since at least 1968, have been codified by a recognized authoritative body. While GAAP standards are not perfect they ". . . have been developed as a result of considerable research and thought, and . . . represent the 'state-of-the-art' in municipal financial reporting." 2/

1/ National Committee, Governmental Accounting, p. 12.

2/ Price Waterhouse & Co., draft copy of a report entitled, "A Review of Certain New York City Financial Reports for the Fiscal Years 1974-75 and 1975-76," December 13, 1976, pp. 2-3.

The phrase "generally accepted accounting principles" is a term which "emcompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time....Those conventions, rules and procedures provide a standard by which to measure financial presentations." 1/

Generally accepted accounting principles for municipalities have existed authoritatively since at least 1934. 2/ Since that time, the National Committee on Municipal Accounting and its successor organizations under the sponsorship of the Municipal Finance Officers Association have periodically published guidelines for governmental accounting with the cooperation and support of the AIA.

The eighteenth such publication, Governmental Accounting, is the most comprehensive of these publications. Also referred

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1/ AICPA, Professional Standards, Volume 1: Auditing, Management Advisory Services, Tax Practice (New York: AICPA, 1975): Section 411.02 [Hereinafter cited as "AICPA, Professional Standards, Volume 1"].

2/ The reader should be aware that accounting thought, knowledge, and literature as applicable to both municipal and commercial entities existed prior to the decade of the thirties, but it wasn't until the thirties, with its economic depression in the aftermath of the stock market crash, that professional accounting societies began issuing their "authoritative" pronouncements.

to as the "blue book", Governmental Accounting updates and combines many of the previously issued guidelines and has gained recognition as an authoritative publication by many professional organizations dealing with governmental accounting and finance. including the AICPA 1/ and the Office of the New York State Comptroller. 2/

The accounting concepts set forth by these organizations, clearly represent the "state of the art" in municipal financial reporting. City Comptroller Goldin recognized the importance of these concepts in observing, that by deviating from such standards, New York City during the last decade and longer had "developed an accounting and budgeting system which by neatly accomodating deficits, provided an invitation to profligacy." 3/

1/ AICPA, Audit Guide, p. 9.

2/ Office of the New York State Comptroller, Accounting Systems Directive No. 6 (13 April 1976): 1-2.

3/ Division's Exhibit "Harrison J. Goldin No. 99 for Identification," p. 3. Comptroller Goldin testified that this document was apparently prepared after the creation of MAC in June 1975.

APPENDIX B

The Nature and Importance of Internal Control

Although internal control procedures vary with each individual entity, in general:

> "Internal control constitutes the methods followed by a company /or other fiscal entity, such as a City/ (1) to protect assets; (2) to protect against improper asset disbursement; (3) to protect against the incurrence of improper liabilities; (4) to assure the accuracy and dependability of all financial and operating information; (5) to judge operating efficiency; and (6) to measure adherence to company-established /or City-established/ policies." 1/ /Emphasis added/.

The Comptroller General of the United States has stated that "internal control comprises the plan of organization and all the coordinate methods and measures adopted to safeguard assets, check the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. The term embraces the policies, procedures, and practices established or encouraged by management as well as the plan of organization and other measures intended to carry them out." 2 /

1/ Arthur W. Holmes and Wayne S. Overmyer, Auditing Principles and Procedures (Homewood, Illinois: Richard D. Irwin, Inc., 1971), p. 86.

2/ Comptroller General of the United States, Standards for Audit of Governmental Organizations, Programs, Activities & Functions (Washington, D.C.: U.S. General Accounting Office, 1972), pp. 32-33.

The Comptroller General goes on to note that the characteristics of a satisfactory system would include:

> "1. A plan of organization that provides segregation of duties appropriate for proper safeguarding of the entity's resources.
>
> "2. A system of authorization and record procedures adequate to provide effective accounting control over assets, liabilities, revenues, and expenses.
>
> "3. An established system of practices to be followed in performance of duties and functions of each of the organizational departments.
>
> "4. Personnel of a quality commensurate with their responsibilities.
>
> "5. An effective system of internal review.
>
> "These elements, as important as each is in its own right, are mutually reinforcing and all are so basic to adequate internal control that serious deficiencies in any one normally would preclude effective operation of the system." 1/

The AICPA divides its discussion of internal control into administrative control and accounting control, and has focused principally on accounting control:

> "Accounting control comprises the plan of organization and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records and consequently are designed to provide reasonable assurance that:
>
> a. Transactions are executed in accordance with management's general or specific authorization.
>
> b. Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.

1/ Ibid, p. 33.

c. Access to assets is permitted only in accordance with management's authorization.

d. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences." 1/

Of these, the AICPA considers that the overriding criterion for both administrative and accounting controls "is the bearing which particular controls have on the reliability of financial statements . . . " 2/ Any appropriate system of internal control should serve to provide reasonable assurance that financial information is reasonably accurate.

The AICPA has outlined certain concepts implicit in the definition of accounting control, some of which it applied to the definition generally, and some of which it applied to the "essential" character of accounting.

1/ AICPA, Professional Standards, Volume 1, Auditing, Management Advisory Services, Tax Practice (New York: AICPA, 1975), Section 320.28. Administrative controls are described as controls which "comprise the plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls." Ibid, Section 320.27. See also Section 320.27. [Hereinafter referred to as "AICPA, Professional Standards, Volume 1"].

2/ AICPA, Professional Standards, Volume 1, Section 320.12. On January 19, 1977 in Securities Exchange Act Release No. 13185, the Commission issued rulemaking proposals concerning internal control for registrants falling under its jurisdiction. These proposals are "designed to . . . promote the reliability and completeness of . . . financial information," and substantively adopt the objectives articulated by the AICPA as set forth above.

A. General Concepts

It is management's responsibility to establish and maintain the system of accounting control, and the cost of accounting control should not exceed the benefits to be derived. The concepts of accounting control are independent of the method of data processing used and apply equally to manual, mechanical, and electronic data processing systems. There are inherent limitations in any system, such as the possibility of errors arising from misunderstanding of instructions, mistakes of judgment, employee carelessness through distraction or fatigue, and intentional circumvention through collusion. 1/

b "Essential" Concepts

The AICPA also has outlined concepts, distinct from its "general" concepts. These are applicable to the essential characteristics of internal accounting control: 2/

Personnel. Personnel should be competent, honest, independent and should understand prescribed procedures.

Segregation of functions. Procedures designed to detect errors and irregularities should be performed by persons other than those who are in a position to perpetrate them.

1/ For a more complete discussion of these concepts see Professional Standards, Volume 1, Sections 320.31-320.34.

2/ For a more complete discussion of these characteristics see Professional Standards, Volume 1, Sections 320.35-320.48.

<u>Execution of transactions</u>. Independent evidence should be obtained to provide assurance that transactions are executed as authorized by persons acting within the scope of their authority and that transactions conform with the terms of the authorizations.

<u>Recording of transactions</u>. Transactions should be "recorded at the amounts and in the accounting periods in which they were executed and [should] be classified in appropriate accounts". This depends "largely on the availability of some independent source of information that will provide an indication that the transactions have been executed." In addition, transactions "should be recorded as promptly as practicable when the recording is necessary to maintain accountability for assets such as cash, securities, and others that are susceptible to loss from errors or irregularities."

<u>Access to Assets</u>. Access to assets should be limited to authorized personnel. "The number and caliber of personnel to whom access is authorized should be influenced by the nature of the assets and the related susceptibility to loss through errors and irregularities." 1/

1/ Access to assets in this context includes both direct physical access and indirect access through the preparation or processing of documents that authorize the use or disposition of assets.

<u>Comparison of recorded accountability with assets.</u>

Records of assets should be compared with actual assets "to determine whether the actual assets agree with the recorded accountability. . . .Typical examples of this comparison include cash and securities counts, bank reconciliations, and physical inventories."

By its nature internal control is intrinsic to an effective accounting system and has a bearing upon the accuracy and reliability of an entity's financial data. While a poor system of internal control may not necessarily mean that financial data is unreliable, incomplete, or incorrect, it substantially increases that risk.

C. <u>Applicability of Internal Control to Municipalities</u>

Although the concept of internal control is often considered with reference to expression of an opinion by an independent auditor, the absence of independent audit does not affect the need for a properly functioning system of internal control. The system of internal control is one of checks and balances. The absence of an independent audit removes an important check and therefore <u>increases</u> the need for a strong system to compensate. This is no less true of a municipality than of any other entity. As early as 1956, one expert wrote that internal control is one of the most important considerations in any accounting system, including a governmental accounting system. "In governmental accounting, internal control is important because the essence of representative government is the existence of a system of checks and balances to safeguard taxpayers and other citizens." 1/

The National Committee noted in 1968 that although a detailed discussion of internal control was beyond the scope of Governmental Accounting, they mentioned that such discussion is readily available in numerous standard texts on accounting systems and auditing.

1/ R.M. Mikesell, Governmental Accounting (Homewood, Illinois: Richard D. Irwin, Inc., 1956), p. 15. The author was a CPA and professor of accounting at Indiana University. He noted on page 16 of his book that the three most important factors in the effectiveness of an internal control system are:

"1. An organizational structure with sufficient diffusion of responsibilities to permit apportionment of steps in a transaction, or in recording it, among two or more persons.

"2. A personnel staff large enough to permit distribution of duties and operations among a number of employees, that is, to provide for what is commonly called 'cross-checking'.

"3. Competent and thorough administration of the system. No system of internal control is self-enforcing, and a poorly administered system may be worse than none at all."

APPENDIX C

Application of Generally Accepted Accounting Principles to the Unrecorded Pension Cost Liability of New York City

In the normal course of business, all pension plan sponsors regularly make adjustments, usually minor, in actuarial assumptions. Such changes are based on changes in circumstances (higher employee turnover for instance) which necessitate changes in assumptions. Generally accepted accounting principles require that these estimates be adjusted on a regular and timely basis.

The AICPA Industry Audit Guide for state and local governments 1/ states that the provisions of APB Opinion No. 8 are applicable to governmental units and the MAC Directive No. 8 2/ effectively prescribes the treatment set forth in Opinion No. 8. While some portion of the liability (that arising prior to the effective date of APB Opinion No. 8 - December 31, 1966) might be applied prospectively in connection with any retroactive adoption by the City of the Principles set forth in that Opinion, 3/ at least that portion of the additional liability resulting from the use of outdated actuarial assumptions during the period subsequent to the City's fiscal year ended June 30, 1968 (the year which the opinion was first applicable to the City) should be treated as an adjustment to the cumulative deficit.

1/ AICPA Industry Audit Guide "Audits of State and Local Governmental Units" (1974), pages 152-153.

2/ Office of the New York State Comptroller, "Accounting Systems Directive No. 8" (July 7, 1976).

3/ Accounting Principles Board Opinion No. 8 "Accounting for the Cost of Pension Plans" (AICPA, November 1966), paragraphs 48-49.

Under APB Opinion No. 20 1/ an error must be distinguished from a change in estimate. Errors result from mathematical mistakes, mistakes in application of accounting principles, or "oversight or misuse of facts that existed at the time the financial statements were prepared". 2/ A change in estimate results from new information or subsequent developments and accordingly better insight or improved judgment. APB Opinion No. 20 requires prospective treatment of changes in estimates but retroactive treatment for correction of errors. 3/ The provisions of Opinion No. 20 are applicable to governmental units. 4/

1/ Accounting Principles Board Opinion No. 20 "Accounting Changes" (AICPA, 1974), paragraph 13. APB Opinion No. 8 did not address the question of error corrections.

2/ Ibid, paragraph 13 (Emphasis added).

3/ Ibid, paragraphs 31 and 36.

4/ AICPA Industry Audit Guide "Audits of State and Local Governmental Units (1974), pages 145-147.