



STATE OF MICHIGAN
DEPARTMENT OF TREASURY
LANSING

RICK SNYDER
GOVERNOR

ANDY DILLON
STATE TREASURER

DATE: February 19, 2013¹

TO: Governor Snyder

FROM: Detroit Financial Review Team:
Andy Dillon
Darrell Burks
Ronald E. Goldsberry
Frederick Headen
Thomas H. McTavish
Kenneth Whipple

SUBJECT: Report of the Detroit Financial Review Team

The Detroit Financial Review Team met on December 19th and 20th 2012, and January 3rd, 7th, 9th, 16th, 25th, and February 1st, 14th, and 15th 2013, to review information relevant to the financial condition of the City of Detroit. Based upon those reviews, the Review Team concludes, in accordance with Section 14(3)(c) of Public Act 72 of 1990, the Local Government Fiscal Responsibility Act, that a local government financial emergency exists within the City of Detroit because no satisfactory plan exists to resolve a serious financial problem. Accompanying this report is supplemental documentation in support of our conclusion.

Our conclusion is based primarily upon the following considerations:

1. Cash Crisis. The City continues to experience a significant depletion of its cash. Projections have estimated a cumulative cash deficit in excess of \$100.0 million by June 30, 2013, absent implementation of financial countermeasures. While the Mayor and City Council deserve credit for considering and, in some instances, adopting difficult financial reforms, those reforms are too heavily weighted toward one-time savings and apply only to non-union employees who represent only a small portion of the City's overall wage and benefit burden.

¹ Pursuant to Section 14(3) of Public Act 72 of 1990, the Local Government Fiscal Responsibility Act, a Review Team is required to report its findings to the Governor within 60 days of its appointment, unless the Governor specifies an earlier date or grants a one-time 30-day extension. This Review Team was appointed on December 18, 2012, and in accordance with statutory convention, 60 days thereafter was February 16, 2013, a Saturday.

However, Section 6 of the Revised Statutes of 1846, which applies to statutes and administrative rules, provides that "[i]n computing a period of days, the first day is excluded and the last day is included. If the last day of any period or a fixed or final day is a Saturday, Sunday or legal holiday, the period or day is extended to include the next day which is not a Saturday, Sunday or legal holiday." Therefore, this Review Team report is due on February 19, 2013.

2. General Fund Deficits. The City's General Fund has not experienced a positive year-end fund balance since fiscal year 2004. Since that time, the General Fund has had cumulative deficits ranging from \$155.4 million in fiscal year 2005, to \$331.9 million in fiscal year 2009. The General Fund deficit was \$326.6 million in fiscal year 2012. The primary methods by which City officials have sought to address these deficits has been by issuing long-term debt. While such an approach reduces the deficit in the year in which the debt is issued, it also reduces fund balance over time as debt service payments increase. Had City officials not issued debt, the City's accumulated General Fund deficit would have been \$936.8 million in fiscal year 2012.
3. Long-Term Liabilities. As of June 30, 2012, the City's long-term liabilities, including unfunded actuarial accrued pension liabilities and other post-employment benefits, exceeded \$14 billion. City officials have projected that over the next five years, the expenditures needed to fund certain long-term liabilities will total approximately \$1.9 billion. However, City officials have not yet devised a satisfactory plan to address the long-term liability issue.
4. Bureaucratic Structure. The City Charter contains numerous restrictions and structural details which make it extremely difficult for City officials to restructure the City's operations in any meaningful and timely manner. These restrictions include numerous steps and time periods which must be observed before certain proposed changes may be implemented and provisions which make it all but impossible to restructure municipal services.

Based upon the foregoing, the Review Team concludes, in accordance with Section 14(3)(c) of Public Act 72 of 1990, the Local Government Fiscal Responsibility Act, that a local government financial emergency exists within the City of Detroit because no satisfactory plan exists to resolve a serious financial problem. Section 14(3) of the Act also requires that a copy of this report be transmitted to Mayor Dave Bing, Detroit City Councilmembers, the Speaker of the House of Representatives, and the Senate Majority Leader.

cc: Dave Bing, Mayor
Detroit City Councilmembers
James Bolger, Speaker of the House of Representatives
Randy Richardville, Senate Majority Leader



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FROM: Detroit Financial Review Team:
Andy Dillon
Darrell Burks
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Kenneth Whipple

SUBJECT: Supplemental Documentation of the Detroit Financial Review Team

This document is supplemental to our report of February 19, 2013, and is intended to constitute competent, material, and substantial evidence upon the whole record in support of the conclusion that a financial emergency exists within the City of Detroit.

I. Background

A. Preliminary Review

On December 11th through December 14th, 2012, the Department of Treasury conducted a preliminary review of the finances of the City of Detroit to determine whether or not a serious financial problem existed. Section 12(1) of the Act provides that a preliminary review may be conducted if one, or more, of the conditions enumerated therein occurs. The preliminary review of the City of Detroit resulted from the conditions enumerated in subdivisions (j) and (k) of Section 12(1) having occurred within the City.¹ The preliminary review found, or confirmed, the following:

- The City violated requirements of Section 17 of Public Act 2 of 1968, the Uniform Budgeting

¹ Subsection (j) provides that “[t]he local government has violated the requirements of sections 17 to 20 of the uniform budgeting and accounting act, 1968 PA 2, MCL 141.437 to 141.440, and the state treasurer has forwarded a report of this violation to the attorney general.” Subsection (k) provides that “[t]he local government has failed to comply with the requirements of section 21 of the Glenn Steil state revenue sharing act of 1971, 1971 PA 140, MCL 141.921, for filing or instituting a deficit recovery plan.”

and Accounting Act, which requires that local officials monitor and promptly amend an adopted budget as necessary to prevent deficit spending. For example, in the General Fund for the year ending June 30, 2011, the insurance premium line item exceeded its budget by more than \$6.7 million, the adjustment and undistributed costs line item exceeded its budget by more than \$8 million, and the fire fighting operations line item exceeded its budget by more than \$21 million. As a result of these and other line items, the General Fund had line items that exceeded its budget by more than \$97 million.

- In addition, City officials violated requirements of Section 18 of the Uniform Budgeting and Accounting Act providing that “[a]n administrative officer of the local unit shall not incur expenditures against an appropriation account in excess of the amount appropriated by the legislative body. The chief administrative officer, an administrative officer, or an employee of the local unit shall not apply or divert money of the local unit for purposes inconsistent with those specified in the appropriations of the legislative body.” City officials also violated requirements of Section 19 of the Act providing that “[a] member of the legislative body, the chief administrative officer, an administrative officer, or an employee of a local unit shall not authorize or participate in the expenditure of funds except as authorized by a general appropriations act.”
- The City experienced cash flow problems throughout the 2010 and 2011 fiscal years, some of which had been alleviated by the issuing or refinancing of debt. The City projected possibly depleting its cash prior to its June 30, 2013 fiscal year end. However, because of inherent problems within the reporting function of the City, the projections continued to change from month to month making it difficult to make informed decisions regarding its fiscal health. For example, a cash flow estimate in August projected a June 2013 cash deficit of \$62 million, while estimates for October and November projected deficits of \$84 million and \$122 million, respectively. The City would not be experiencing significant cash flow challenges if City officials had complied with statutory requirements to monitor and amend adopted budgets as needed. In turn, such compliance requires the ability to produce timely and accurate financial information which City officials have not been able to produce.
- The City incurred overall deficits in various funds including the General Fund. The General Fund’s unrestricted deficit increased by almost \$41 million from a June 30, 2010 amount of \$155.7 million to a June 30, 2011 amount of \$196.6 million and was projected to increase even further for 2012, which would not have happened if the City had complied with its budgets.

As depicted in Table 1 on the next page, the City has experienced cumulative General Fund deficits that have exceeded \$100 million dating back to 2005. These deficits have fluctuated between \$155.4 million and \$331.9 million. One of the primary methods the City has used to reduce the deficits has been to issue more debt. Total General Fund debt and other long-term liability proceeds for the years between 2005 and 2011 were over \$600 million, temporarily reducing the deficits by an equal amount. Debt proceeds reduce the deficit in the year the debt is issued, but reduce fund balance over time as debt service payments increase.

Table 1
General Fund Deficits, Debt Proceeds, and Effect Of
(In Millions)

<u>Year</u>	<u>Actual Deficit</u>	<u>Debt Proceeds</u>	<u>Approximate Cumulative Deficit without Debt Proceeds*</u>
2005	(\$155.4)	\$248.4	(\$403.8)
2006	(\$173.7)	\$34.9	(\$457.0)
2007	(\$155.6)	--	(\$438.9)
2008	(\$219.2)	\$75.2	(\$577.7)
2009	(\$331.9)	--	(\$690.5)
2010	(\$155.7)	\$251.7	(\$765.9)
2011	(\$196.6)	--	(\$806.8)
2012	(\$326.6)		(\$936.8)

Source: City of Detroit Annual Financial Audits, 2005 through 2012. * Represents what the deficit would have been if additional debt had not been issued. The approximate amount would be reduced if subsequent debt service payments were added back in.

- On December 27, 2011, City officials filed an audit report that reflected a \$196.6 million cumulative deficit in the General Fund, a \$97.2 million cumulative deficit in the Transportation Fund, and a \$17.1 million cumulative deficit in the Automobile Parking Fund. However, City officials did file, as legally required, an adequate or approved deficit elimination plan with the Department of Treasury.

Based upon the foregoing preliminary review, the State Treasurer concluded, and reported to the Governor on December 14, 2012, that a serious financial problem existed in the City of Detroit and recommended the appointment of a financial review team.

B. Review Team Findings

On December 18, 2012, the Governor appointed a six-member Financial Review Team. The Review Team convened on December 19th and 20th 2012, and January 3rd, 7th, 9th, 16th, 25th, February 1st, 14th, and 15th 2013.

1. Conditions Indicative of a Serious Financial Problem

The Review Team found, or confirmed, the existence of the following conditions based upon information provided by City officials or other relevant sources:

- According to the City’s fiscal year 2012 financial audit, the cumulative General Fund deficit increased by 82 percent, from \$148.1 million as of June 30, 2011 to \$269.5 million as of June 30, 2012. (The unrestricted General Fund deficit increased by 66.1 percent, from \$196.6 million to \$326.6 million.) While the General Fund had an operating surplus (i.e., recurring revenues in excess of recurring expenditures) of \$105.8 million, net transfers out of the General Fund of \$227.5 million resulted in a negative net change in the General Fund balance of \$121.7 million.
- The City continues to experience a significant depletion of its cash. As noted in the preliminary review, cash flow projections provided by City officials have been inconsistent with the precise magnitude of the problem varying somewhat from one projection to another. However, in general, the most recent projections have estimated a cumulative cash deficit in excess of \$100 million by June 30, 2013, absent implementation of financial countermeasures. During its review, the Review Team expressed the position that City officials would need to either increase revenues, or decrease expenditures, or both, by roughly \$15 million per month during the three-month period January through March 2013 to remain financially viable.
- The City has substantial long-term debt. As of June 30, 2012, such debt, exclusive of unfunded actuarial accrued pension liabilities and other post-employment benefits, exceeded \$8.6 billion. However, upon inclusion of those other obligations, the City’s total long-term debt was \$13.6 billion. (Total long-term debt is \$14.99 billion depending upon whether \$1.4 billion in pension system assets is, or is not, factored in the unfunded actuarial accrued liabilities.) The City’s long-term liabilities as of June 30, 2012, are summarized by category in Table 2.

Table 2

**Long-Term Liabilities by Category
 As of June 30, 2012
 (In Millions)**

<u>Category</u>	<u>Amount</u>
Non-General Obligation	\$6,106.1
Other Post Employment Benefits Unfunded Actuarial Accrued Liability	\$5,727.2
Pension Certificates of Participation	\$1,451.9
General Obligation	\$963.4
General Retirement System Unfunded Actuarial Accrued Liability	\$639.9
Other	\$101.9
Police and Fire Retirement System	<u>\$3.9</u>
Total	\$14,994.2

Source: City of Detroit Annual Financial Audit 2012

- According to information provided to the Michigan Legislative Auditor General's Office by the State Court Administrative Office, as of June 30, 2012, the City's 36th District Court had \$279.3 million in outstanding accounts receivables. Of that amount, it is estimated that \$199 million is owed to the City of Detroit, \$76 million is owed to the State of Michigan, and \$100.9 million has been outstanding for more than seven years. The accounts receivables were comprised of fines, fees, and other costs related to parking violations, civil infractions, misdemeanor traffic and drunken driving violations, and other misdemeanor violations. As of June 30, 2012, the 36th District Court's collection rate for accounts receivables was only 7.7 percent compared to an average collection rate of 60 percent for other courts within the seven county region of Genesee, Macomb, Monroe, Oakland, St. Clair, Washtenaw, and Wayne.

In addition, as of January of 2013, 36th District Court officials had taken no actions to reduce expenditures in light of a \$6 million reduction in its appropriation. In fact, the Court's current budget funds 285 employees, but the Court presently has 350 employees, excluding judges.

- The December 28, 2012, management letter which accompanied the City's fiscal year 2012 financial audit report identified numerous material weaknesses and significant deficiencies in the City's financial and accounting operations. These are recited in Attachment 1.
- Financial audit reports for the City reflect significant variances between General Fund revenues and expenditures, both as initially budgeted and amended, versus General Fund revenues and expenditures actually realized. Variances over the last six fiscal years are depicted in Table 3 on the next page. The variances show that City officials consistently have overestimated fund revenues and expenditures and call into question the ability of City officials to adopt and effectively monitor budgets, or to estimate revenues and expenditures upon which those budgets are built.²

² Various provisions of Public Act 2 of 1968, the Uniform Budgeting and Accounting Act, govern the budget adoption and implementation process for units of local government in Michigan. For example, Section 16 of the Act requires, unless another method is provided for by charter, that the local legislative body adopt a general appropriations act which shall set forth "the amounts appropriated by the legislative body to defray the expenditures and meet the liabilities of the local unit for the ensuing fiscal year, and shall set forth a statement of estimated revenues, by source, in each fund for the ensuing fiscal year." Section 17 requires, among other things, that if during a fiscal year, it appears to the chief administrative officer or to the legislative body that actual and probable revenues are less than estimated revenues, the chief administrative officer or fiscal officer must present to the legislative body recommendations which, if adopted, would prevent expenditures from exceeding available revenues for that current fiscal year.

Finally, Section 18 requires, among other things that, "[e]xcept as otherwise provided in section 19, *an administrative officer of the local unit shall not incur expenditures against an appropriation account in excess of the amount appropriated by the legislative body.* The chief administrative officer, an administrative officer, or an employee of the local unit shall not apply or divert money of the local unit for purposes inconsistent with those specified in the appropriations of the legislative body." Emphasis supplied. The sum of the foregoing statutory provisions is not an aspirational goal, but a legal requirement that officials in units of local government annually adopt a balanced budget, monitor throughout the course of the fiscal year the revenues and expenditures contained in that adopted budget, and adjust the budget to the extent necessary to maintain it in balance.

Table 3
General Fund (Amended) Budget to Actual Variances
(In Millions)

	<u>2006-07</u>	<u>%</u>	<u>2007-08</u>	<u>%</u>	<u>2008-09</u>	<u>%</u>
<u>Revenues</u>						
Budgeted	\$1,460.5		\$1,511.4		\$1,424.1	
Amended	\$1,685.1		\$1,711.1		\$1,755.3	
Actual	<u>\$1,487.4</u>		<u>\$1,303.4</u>		<u>\$1,268.4</u>	
Variance	(\$197.6)	(11.73)	(\$407.6)	(23.82)	(\$487.0)	(27.74)
<u>Expenditures</u>						
Budgeted	\$1,466.7		\$1,580.2		\$1,557.5	
Amended	\$1,702.2		\$1,696.5		\$1,798.3	
Actual	<u>\$1,278.1</u>		<u>\$1,181.4</u>		<u>\$1,155.9</u>	
Variance	\$ 424.0	24.91	\$ 515.1	30.36	\$642.4	35.72
	<u>2009-10</u>	<u>%</u>	<u>2010-11</u>	<u>%</u>	<u>2011-12</u>	<u>%</u>
<u>Revenues</u>						
Budgeted	\$1,651.9		\$1,361.7		\$1,275.5	
Amended	\$1,695.7		\$1,650.1		\$1,564.0	
Actual	<u>\$1,188.0</u>		<u>\$1,220.3</u>		<u>\$1,102.3</u>	
Variance	(\$507.7)	(29.93)	(\$429.9)	(26.05)	(\$461.8)	(29.53)
<u>Expenditures</u>						
Budgeted	\$1,644.2		\$1,374.8		\$1,289.8	
Amended	\$1,834.2		\$1,558.9		\$1,473.0	
Actual	<u>\$1,068.9</u>		<u>\$1,070.2</u>		<u>\$996.4</u>	
Variance	\$765.3	41.72	\$488.7	31.35	\$476.6	32.36

Source: City of Detroit Annual Financial Audits, 2007 through 2012

- The City's General Fund has not experienced a positive year-end fund balance within recent years. As depicted in Table 4, the General Fund had negative year-end balances that ranged from \$91.1 million in the 2010 fiscal year to \$269.5 million in the 2012 fiscal year.

Table 4

**General Fund Revenues, Expenditures, and Change in Fund Balance
 (In Millions)**

	<u>2006-07</u>	<u>2007-08</u>	<u>2008-09</u>
Revenue	\$1,487.4	\$1,303.4	\$1,268.4
Expenditures	\$1,278.1	\$1,181.4	\$1,155.9
Current Surplus/ (Deficit)	<u>\$209.3</u>	<u>\$122.1</u>	<u>\$112.5</u>
Other Financing Sources	(\$194.2)	(\$175.0)	(\$236.5)
Net Change in Fund Balance	15.1	(\$52.9)	(\$124.1)
Beginning Fund Balance	<u>(\$107.2)</u>	<u>(\$91.4)</u>	<u>(\$141.7)</u>
Change in Inventories	\$0.7	\$2.7	(\$0.9)
Ending Fund Balance	<u>(\$91.4)</u>	<u>(\$141.7)</u>	<u>(\$266.7)</u>
	<u>2009-10</u>	<u>2010-11</u>	<u>2011-12</u>
Revenue	\$1,188.0	\$1,220.3	\$1,102.2
Expenditures	\$1,068.9	\$1,070.2	\$996.4
Current Surplus/ (Deficit)	<u>\$119.0</u>	<u>\$150.1</u>	<u>\$105.8</u>
Other Financing Sources	\$59.3	(\$206.9)	(\$227.5)
Net Change in Fund Balance	\$178.3	(\$56.9)	(\$121.7)
Beginning Fund Balance	<u>(\$266.7)</u>	<u>(\$91.1)</u>	<u>(\$148.1)</u>
Change in Inventories	(\$2.7)	(\$0.1)	\$0.2
Ending Fund Balance	<u>(\$91.1)</u>	<u>(\$148.2)</u>	<u>(\$269.5)</u>

Source: City of Detroit Annual Financial Audits, 2007 through 2012

- Operational dysfunction contributes to the City's serious financial problem. For example, the Police Department has approximately 2,030 employees. However, the views of City officials differ significantly as to how many of those employees are engaged in police work as opposed to ancillary administrative functions such as payroll. Some City officials asserted to the Review Team that only a third of the Police Department employees are engaged in patrolling the City, while Police Department officials indicated that approximately 68 percent of employees are engaged in patrol work and another 15 percent are engaged in investigations. The Review Team could not resolve this discrepancy because the City's administration has no reliable information concerning what staffing levels are, or should be, within the Police Department.

2. Review Team Meetings

On December 20, 2012, Review Team members Andy Dillon, Darrell Burks, Ronald E. Goldsberry, Frederick Headen, and Thomas H. McTavish conducted a series of meetings in the City of Detroit with Linda Bade, City Assessor; Charles Pugh, City Council President; Gary Brown, City Council President Pro Tem (by conference telephone); Kenneth V. Cockrel, Jr., Councilmember; Irvin Corley, Jr., Fiscal Analyst, Fiscal Analysis Division (City Council); Mary Anne Langan, Deputy Fiscal Analyst, Fiscal Analysis Division (City Council); Mark Lockridge, Deputy Auditor General; David Whitaker, Director, Research and Analysis Division (City Council); Jerry Pokorski, Financial Consultant; Jack Martin, Chief Financial Officer; William Andrews, Program Management Director; Cheryl Johnson, Finance Director and City Treasurer; Gaurav Malhotra and Daniel Jerneycic, of the certified public accounting firm Ernst & Young; Donald Austin, Fire Commissioner; Edsel Jenkins, Deputy Fire Commissioner; Chester Logan, Interim Police Chief; Charles Wilson, Chief of Staff; Todd Bettison, Commander, Communications Operations; Scott Hayes, Director, Technology Services Bureau; Tina Tolliver, Second Deputy Chief, Budget Operations; Patrick Aquart, Human Resources Director; and Lamont Satchel, Labor Relations Director; Dave Bing, Mayor; and Kirk Lewis, Deputy Mayor and Chief of Staff.

On January 3, 2013, Review Team members Andy Dillon, Darrell Burks, Ronald E. Goldsberry, Frederick Headen, and Kenneth Whipple (by conference telephone) met with Mark Diaz, President, Detroit Police Officers Association; Steven Dolunt, President, Detroit Police Command Officers Association; Brian E. Harris, Secretary-Treasurer, Detroit Police Lieutenants and Sergeants Association; John F. Kennedy, Sergeant at Arms, Detroit Police Lieutenants and Sergeants Association; Donna Latouf, Secretary-Treasurer, Detroit Police Officers Association; James Moore, Vice-President, Detroit Police Command Officers Association; Teresa Sanderfer, Secretary, Detroit Fire Fighters Association; Rodney Sizemore, Vice-President, Detroit Police Lieutenants and Sergeants Association; Junetta Wynn, Past President, Detroit Police Lieutenants and Sergeants Association; and Mark Young, President, Detroit Police Lieutenants and Sergeants Association.

On January 7, 2013, Review Team members Andy Dillon (by conference telephone), Darrell Burks, Ronald E. Goldsberry, Frederick Headen, and Kenneth Whipple (by conference telephone) met with

William Andrews, Program Management Director; Jack Martin, Chief Financial Officer; Gaurav Malhotra and Daniel Jerneycic, of the certified public accounting firm Ernst & Young; Irvin Corley, Jr., Fiscal Analyst, Fiscal Analysis Division (City Council); Mary Anne Langan, Deputy Fiscal Analyst, Fiscal Analysis Division (City Council); and Jerry Pokorski, Financial Consultant.

On January 16, 2013, Review Team members Andy Dillon (by conference telephone), Darrell Burks, Ronald E. Goldsberry, Frederick Headen, and Thomas McTavish (by conference telephone), met with William Andrews, Program Management Director; Jack Martin, Chief Financial Officer; David Brayshaw, of First Southwest Company; Lamont Satchel, Labor Relations Director; Suzanne Taranto, Milliman Company; Cheryl Johnson, Finance Director and City Treasurer; Donita Crumpler, Manager, Debt Management Division; Gaurav Malhotra, of the certified public accounting firm Ernst & Young; and Kenneth A. Buckfire, of Miller Buckfire and Company.

On February 1, 2013, Review Team members Andy Dillon, Ronald E. Goldsberry, Frederick Headen, Thomas McTavish (by conference telephone), and Kenneth Whipple met with Lamont Satchel, Labor Relations Director; William Andrews, Program Management Director; Jan Anderson, Program Management Deputy Director; Jack Martin, Chief Financial Officer; Gaurav Malhotra, Daniel Jerneycic, and Juan Santambrogio, of the certified public accounting firm Ernst & Young, and James Doak, of Miller Buckfire and Company.

C. Statutory Conclusions

Section 14(3) of the Local Government Fiscal Responsibility Act requires a review team to include in its report to the Governor one of three conclusions. Those conclusions are: that a serious financial problem does not exist in the unit of local government, or that a serious financial problem exists but that a consent agreement containing a plan to resolve the problem has been adopted, or that a financial emergency exists because no satisfactory plan exists to resolve a serious financial problem.

1. Serious Financial Problem

The findings of the preliminary review and of this Review Team have been set out above. Given those findings, the Review Team could not reasonably conclude that a serious financial problem does not exist within the City of Detroit. To the contrary, those findings, when assessed as a whole, clearly constitute competent, material, and substantial evidence upon the whole record to support the conclusion that a serious financial problem does exist within the City of Detroit. Therefore, we turn next to the option of a consent agreement.

2. Consent Agreement

This State has executed consent agreements with various units of local government under three successive emergency financial management statutes dating back to 1988. That experience has shown consent agreements to be most effective in circumstances in which serious financial problems have

remained unresolved despite diligent attempts at resolution by local officials. In such circumstances, consent agreements have provided cooperative local officials with beneficial guidance and a structural framework within which to resolve the financial difficulties confronting them.³

Given the City of Detroit's financial condition, and the uneven manner in which City officials have dealt with it, the Review Team could not conclude that another consent agreement would provide a satisfactory resolution of the City of Detroit's serious financial problem. We say *another* consent agreement because the existing Financial Stability Agreement is in the nature of a consent agreement. The Financial Stability Agreement was executed on April 4, 2012, between City officials and the previous Detroit Financial Review Team that was appointed on December 27, 2011, pursuant to former Public Act 4 of 2011, the Local Government and School District Fiscal Accountability Act.

The Financial Stability Agreement established a detailed framework within which, among other things, City officials were to restructure the City's financial and operational activities. A component of this detailed framework was a nine-member Financial Advisory Board established to assist City officials in achieving the objectives of the Financial Stability Agreement. In particular, Annex B of the Financial Stability Agreement enumerated 21 specific operational reforms which were to be implemented in the priority and timing as mutually agreed upon by City officials and the Financial Advisory Board.

Candor compels the conclusion that City officials have made limited progress in respect to the financial and operational reforms and restructuring contemplated by the Financial Stability Agreement in the ten months since it was executed.⁴ This conclusion is unaltered by whether the lack of progress lies in the complexity of the City's financial and operational activities, subsequent litigation initiated by

³ Among these have been the Detroit School District, 2008; and the cities of Highland Park, 1996-99; Hamtramck, 2000; Pontiac, 2008-09; River Rouge, 2009-present; Inkster, 2012-present; and the City of Detroit, 2012-present.

⁴ In fact, the initial work upon a number of the financial and operational reforms did not commence until the fall of 2012, some five months after the Financial Stability Agreement was executed. For example:

- Integration of Budgeting, Accounting, and Financial Reporting System: The initial organizational meeting was not held until September 24, 2012, at which time a steering committee and work groups were established. The identification of system needs was ongoing as of December 20, 2012.
- Bank Project to improve Accounts Payable and Accounts Receivables Processes: The initial organizational meeting was not held until September 12, 2012, at which time an external consultant was engaged. The prioritization and implementation of short-term recommendation was to commence in December of 2012.
- Transfer of Planning and Development Department Functions to the Detroit Economic Growth Corporation: A baseline inventory of Planning and Development Department services was compiled in October 1, 2012.
- Long-Term Liability Restructuring: This initiative was not assigned to the City's Chief Financial Officer and Program Management Director until September 15, 2012.
- Workers Compensation Reform: The initial meeting with the City's risk manager was not held until September 12, 2012, and City officials selected a consultant on December 11, 2012.

City officials to challenge the legal validity of the Financial Stability Agreement, or other considerations.

Among those other considerations would be the City's Charter. That document contains numerous restrictions and structural details that make it extremely difficult for City officials to restructure the City's operations in any meaningful manner even were one to conclude that they have been consistently committed to such reforms. For example, various provisions of the City Charter significantly hamper the ability of City officials to provide municipal services in a more efficient and cost effective manner through alternative means.⁵

In addition, the City Charter provides for cumbersome organizational structure consisting of 16 departments, nine of which are headed by boards, commissions, or advisory commissions with at least 76 members in total.⁶ While the City Charter provides that the City may increase the number of departments beyond the number contemplated by the City Charter, there is no provision authorizing a reduction in the number of departments.

⁵ For example, before any determination or action regarding privatization can take place, the City Charter requires that all of the following actions must occur :

- (1) A comprehensive report must be prepared that details the need for privatization.
- (2) Comprehensive written estimates must be prepared of the total cost to the City if the City agency currently providing the service did so in the most cost efficient manner.
- (3) The City Council is required to approve the solicitation bids, but only after the City Council reviews items (1) and (2).
- (4) Any affected City employees must be given an opportunity to organize and prepare a bid.
- (5) A comprehensive written cost analysis of all bids must be prepared.
- (6) Other factors must be considered such as the effect of transferring service delivery to the private sector, the reduction in employment levels of City residents, and differences in work rules and management practices in the private sector.
- (7) The City Council is required to approve any final recommendation by a two-thirds vote, but only after making certain certifications.

⁶ The City Charter establishes three types of departments: Staff; Programs, Services, and Activities; and Independent Departments and Offices. Staff Departments are: Budget, Planning and Development, Finance, Human Resources, and Buildings, Safety Engineering, and Environmental. The Programs, Services, and Activities Departments are: Arts, Public Works, Fire, Historical, Human Rights, Police, Public Lighting, Recreation, Transportation, Water and Sewerage, and Zoological Parks. The Independent Departments and Offices are: Auditor General, Corporation Counsel, Inspector General, and Ombudsperson. The latter have the potential to function essentially as separate and independent branches of City government.

In an apparent effort to increase accountability, various provisions of the City Charter have dispersed decision-making authority, particularly away from the mayoral office. While increased accountability is a salutary goal, one consequence has been to lessen the ability of City officials to decide important matters with appropriate dispatch. For example, whether one agrees or disagrees with specific Annex B operational reforms, their implementation has been too long in coming. In resolving the City's serious financial problem, such delays would be disastrous.

Similarly, the City Charter requires that before any final action may be taken regarding any proposed change in future retirement benefits, the City Council first must obtain from an independent actuary a report regarding the immediate and long-term costs of the change. Even then, final action still may not be taken until at least three months after the actuarial report is made public at a City Council meeting. Because retirement healthcare is the City's single largest liability (estimated to be \$7 billion), any restructuring would require certainty with respect to this liability, and any uncertainties and delays relating to adjusting this obligation would greatly impede the ability of City officials to negotiate with other creditors of the City.

3. Financial Emergency

As noted, the Review Team could not conclude that a serious financial problem does not exist within the City of Detroit and, likewise, could not conclude that a consent agreement has been adopted that will resolve the City's serious financial problem. Having found those two conclusions to be in applicable, the only remaining conclusion allowed by the Act is that a financial emergency exists because no satisfactory plan exists to resolve a serious financial problem.⁷

The Review Team acknowledges that, since its appointment, City officials have advanced various proposals intended to address the City's serious financial problem. However, in arriving at the conclusion that a financial emergency exists within the City, the dispositive consideration is not whether City officials have advanced various proposals, nor whether those proposals when taken as whole constitute a plan. Rather, the only dispositive consideration is whether there exists a *satisfactory* plan as required by the Act.

We begin with the City's cash crisis. It was noted on Page Four of this report that cash flow projections provided by City officials had estimated a cumulative cash deficit of more than \$100 million

⁷ We note that the three statutory conclusions available to this Review Team under Section 14(3) of Public Act 72 of 1990, the Local Government Fiscal Responsibility Act, differ in both number and substance from the four statutory conclusions which were available to the previous Detroit Financial Review Team under Section 13(4) of the former Public Act 4 of 2011, the Local Government and School District Fiscal Accountability Act. The previous Detroit Financial Review Team reached the conclusion that the City of Detroit was in a condition of severe financial stress as provided in Act 4 and that a consent agreement had *not* been adopted pursuant to the Act. However, Act 72 affords this Review Team no such middle ground; if, in this case, a serious financial problem is found to exist and a consent agreement containing a plan to resolve the problem has not been adopted, then we must conclude that a financial emergency exists.

by June 30, 2013, absent the implementation of what City officials have referred to as financial countermeasures. Furthermore, it was noted that Review Team members had expressed the position that City officials would need to either increase revenues, or decrease expenditures, or both, by roughly \$15 million per month during the three-month period January through March 2013 to remain financially viable.

However, City officials concluded that a \$15 million per month adjustment during the three-month period January through March 2013 was not realistic. As an alternative, they proposed a series of structural and short-term countermeasures the financial impact of which is summarized in Table 5.

Table 5
City's Proposal to Address Cash Deficiency⁸
(In Millions)

	<u>Jan.</u>	<u>Feb.</u>	<u>Mar.</u>	<u>April</u>	<u>May</u>	<u>June</u>	<u>Total*</u>
Structural Changes	\$0.1	\$3.1	\$4.7	\$5.4	\$9.8	\$10.2	\$33.3
Short-Term Changes	<u>\$6.4</u>	<u>\$14.1</u>	<u>\$5.3</u>	<u>\$11.5</u>	<u>\$6.0</u>	<u>\$20.2</u>	<u>\$63.5</u>
Total	\$6.5	\$17.2	\$10.0	\$16.9	\$15.8	\$30.4	\$96.8

Source: City of Detroit Document (January 2013). *The \$96.8 million total does not include \$30.0 million in escrowed bond proceeds held by the State, the release of which was conditioned upon achievement by the City of certain milestones for the months of December 2012 (\$10.0 million) and January 2013 (\$20.0 million).

The Review Team recognizes the difficulty of City officials having to make significant budgetary adjustments in the middle of a given fiscal year and commends them for their efforts in attempting to devise a proposal. While the Mayor and City Council deserve credit for considering and, in some instances, adopting difficult financial reforms, those reforms are too heavily weighted toward one-time savings and apply only to non-union employees who represent only a small portion of the City's overall wage and benefit burden.

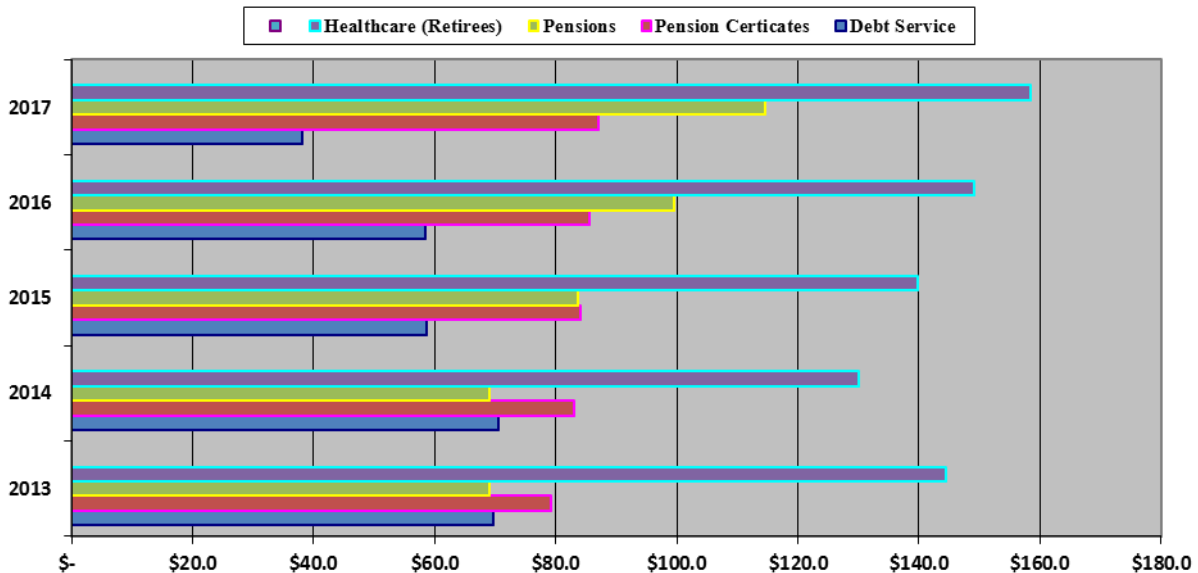
Likewise, City officials have yet to propose a satisfactory plan to address the City's \$13.6 billion in long-term liabilities. The City has a longstanding practice of overspending. As a result, a substantial

⁸ Among the structural changes are: employee furloughs; a one-year suspension of pension accruals; reducing the percentage ratio of employer-employee healthcare contributions from 80-20 to 70-30; and reducing the City's employment headcount by approximately 400 positions by June 30, 2013. Among the short-term changes are: deferral of certain pension payments and the selective sale of certain City assets.

portion of current long-term liabilities consists of debt that City officials issued to address General Fund expenditures in excess of General Fund revenues. For example, according to City documents, General Fund expenditures exceeded General Fund revenues by an average of \$100 million annually during the five fiscal-year period 2008 through 2012. The response of City officials was to issue \$75 million of debt in fiscal year 2008; \$250 million of debt in fiscal year 2010; and \$137 million of debt during the current fiscal year. By issuing this debt, City officials improvidently converted an annual overspending problem into a long-term liability.

City officials have projected that over the five-year period 2013 through 2017, expenditures for healthcare benefits for active employees, healthcare benefits for retirees, pension benefits, principal and interest for pension certificates, and debt service, will total approximately \$1.9 billion. See Chart 1. Therefore, these long-term liabilities will pose an ongoing challenge to the City's financial condition.

Chart 1
Projected Expenditures for Certain Long-term Liabilities
Fiscal Years 2013-17
(In Millions)



Source: City of Detroit Documents (February 2013)

D. Conclusion

Based upon the foregoing information, meetings, and review, the Review Team confirms the findings of the preliminary review, and concludes that a local government financial emergency exists within the City of Detroit because no satisfactory plan exists to resolve a serious financial problem.

II. Section 14(2) Requirements

Section 14(2) of the Act requires that this report include the existence or an indication of the likely occurrence of any of the conditions set forth in subdivisions (a) through (f).⁹ The conditions in subdivisions (b) (iii), (e) and (f) of Section 14(2) exist or are likely to occur, as follows:

- The City did not meet its minimum contribution requirement to its Health and Life Insurance Benefit Plan for the last several years. As of June 30, 2012, the City owed \$804.7 million to the system. (Section 14(2)(b)(iii).)

⁹ Subdivisions (a) through (f) of Section 14(2) of the Act provide as follows:

(a) A default in the payment of principal or interest upon bonded obligations or notes for which no funds or insufficient funds are on hand and segregated in a special trust fund.

(b) Failure for a period of 30 days or more beyond the due date to transfer 1 or more of the following to the appropriate agency:

(i) Taxes withheld on the income of employees.

(ii) Taxes collected by the government as agent for another governmental unit, school district, or other entity or taxing authority.

(iii) Any contribution required by a pension, retirement, or benefit plan.

(c) Failure for a period of 30 days or more to pay wages and salaries or other compensation owed to employees or retirees.

(d) The total amount of accounts payable for the current fiscal year, as determined by the state treasurer's uniform chart of accounts, is in excess of 10% of the total expenditures of the local government in that fiscal year.

(e) Failure to eliminate an existing deficit in any fund of the local government within the 2-year period preceding the end of the local government's fiscal year during which the review team report is received.

(f) Projection of a deficit in the general fund of the local government for the current fiscal year in excess of 10% of the budgeted revenues for the general fund.

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- The City had a General Fund deficit of \$269.5 million (and an unrestricted General Fund deficit of \$326.6 million) as of June 30, 2012, which was not eliminated within the two-year period preceding the end of the fiscal year of the City during which this Review Team report is received. (Section 14(2)(e).)
- The projected General Fund deficit of \$385.6 million as of June 30, 2013, exceeds 10 percent of the \$1.0 billion in General Fund revenues which the City has budgeted for the 2013 fiscal year as reported in the 2012-13 Executive Budget Summary. (Section 14(2)(f).)

III. Review Team Report Transmittal Requirements

Section 14(3) of the Act also requires that a copy of this report be transmitted to Mayor Dave Bing, Detroit City Councilmembers, the Speaker of the House of Representatives, and the Senate Majority Leader.

cc: Dave Bing, Mayor
Detroit City Councilmembers
James Bolger, Speaker of the House of Representatives
Randy Richardville, Senate Majority Leader

Attachment 1

1. Material Weaknesses

The December 28, 2012, management letter which accompanied the City of Detroit's fiscal year 2012 financial audit report identified a number of material weaknesses in the City's financial operations. The management letter defined a "material weakness" as "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the City's financial statements will not be prevented, or detected and corrected on a timely basis." The material weaknesses, contained in findings 2012-01, 2012-02, and 2012-03, are recited verbatim:

Finding 2012-01, Financial Closing and Reporting

"Although the City of Detroit (City) has made incremental improvement in their financial closing and reporting processes, deficiencies still exist in the processes to evaluate accounts, and timely record entries into the general ledger in a complete and accurate manner. These deficiencies include the following:

"The process to prepare closing entries and financial statements relies partly upon decentralized accounting staff and software applications other than the City's DRMS general ledger. The process requires a significant amount of manual intervention in order to get information from these other systems in to DRMS.

"The process to identify significant transactions throughout the City's fiscal year to determine the appropriate accounting treatment does not result in timely consideration of how to record or report such transactions. These transactions often are not identified until the end of the fiscal year during the financial reporting process. There is inadequate communication between various City departments on transactions and on how they affect the individual stand-alone financial reports and the Comprehensive Annual Financial Report (CAFR). Information necessary to effectuate a timely and accurate closing of the books is sometimes not communicated between certain departments and agencies of the City.

"The process to close the books and prepare financial statements includes the recording of a significant number of manual post-closing entries. For the year ended June 30, 2012, there were approximately 350 manual journal entries that were made after the books were closed for the year (i.e., after frozen trial balance).

"The process to close the books and evaluate accounts occurs only on an annual basis instead of monthly or quarterly. As a result, certain key account reconciliations and account evaluations are not performed timely and require an extended amount of time to complete during the year-end closing process.

"The established internal control procedures for tracking and recording capital asset activities are not consistently followed. Physical inventories of capital assets are not being performed annually as required by City policy."

Finding 2012-02, Reconciliations, Transaction Processing, Account Analysis, and Document Retention

“Operations of the City are carried out by numerous City departments utilizing a variety of people, processes, and systems. This type of environment requires diligence in ensuring accurate information is processed and shared with others in the City. Performing reconciliations of data reported from different systems and sources and account analysis are an integral part of ensuring transactional data integrity and accurate financial reporting. During our audit, we noted deficiencies in the areas of transaction processing, account analysis, data integrity, reconciliation performance, and document retention. Those deficiencies include the following:

“The City’s process to identify accrued expenses is not adequate. Our audit procedures identified expenditures related to fiscal year 2012 that were not appropriately recorded as expenditures in fiscal year 2012.

“Certain date related information regarding terminations and new hires in the human resources system did not match information in the personnel files.

“Reconciliations of subsidiary ledgers to general ledgers and other IT systems to DRMS are either not being completed, not completed timely, or contain unsupported or unreconciled items.

“A listing of internal controls employed by service organizations is not prepared and evaluated for adequacy by the City. The City uses various service organizations to process significant transactions such as health and dental claims and payroll. The City does not review the service organization auditor reports (SAS 70 Reports) to ensure that the service organization has effective internal controls. Further, the City does not evaluate the user controls outlined in the SAS 70 reports to ensure that the City has these controls in place to ensure complete and accurate processing of transactions between the City and the Service Organization.

“Bank, investment, and imprest cash reconciliations are not prepared timely and contain unreasonably aged reconciling items.

“The calculation of inventory reserves used data from the prior year that contained errors and is not reviewed by a member of management.

“Interfund and inter-departmental transactions are not reconciled throughout the year on a timely basis or reviewed for proper financial statement classification.

“A physical inventory count of fixed assets is not routinely completed by all agencies, as indicated in the City’s asset management policies.

“The calculation of average weekly wage as a basis for weekly payment of workers compensation is a manual calculation that contained errors and was not reviewed or verified by a member of management.

“The City of Detroit does not maintain individual claim data typically maintained as insurance statistics for self-insurance programs for its workers compensation program. Therefore, only actual payment data is available for the actuary’s analysis.

“Data provided to the actuaries that assist in estimating workers’ compensation liabilities is not reviewed by the City for accuracy nor reconciled by the City to supporting data prior to submission.

“Certain invoices and receipts of goods and services were not matched against purchase orders in the correct period.

“The City’s process to follow up with audit findings is not effectively designed.

“The calculation of grant accounts receivables is inappropriate as the beginning balances being carried forward were not originally performed on a grant by grant basis. The calculation contained errors and was not reviewed by management.

“Manual journal entries are not consistently and accurately reviewed and approved.

“The City of Detroit does not perform a sufficient review of open Accounts Receivable items and their related collectability.

“Certain money market fund investments were incorrectly classified as cash and management review process was not performed at a level to detect the misstatement.

“Certain cash accounts were inappropriately excluded from the trial balance.

“The City’s Accounts Receivable write off policy is not specific enough to explain when and how amounts determined to be uncollectable should be written off. In addition, the City is not following their current policy to write off balances.

“Legal reserve documents are not updated in a timely manner when facts pertaining to the status of cases arise. As such, the City had over accrued claims and judgments.

“The City does not have a process for anonymous reporting of ethical or fraud violations to the City Board of Ethics.

“Supporting documentation is not consistently retained in accordance with the City’s record retention policies.”

Finding 2012-03, Information Technology

“General controls and application controls work together to ensure the completeness, accuracy, and validity of financial and other information in the systems. Deficiencies exist in the areas of general and application controls. Those deficiencies include the following for some or all systems:

“Administrative access is granted to unauthorized accounts.

“Segregation of duties conflicts exist between the database administration function and the backend database administration function.

“Adequate procedures are not in place to remove and review segregation of duties conflicts.

“Automated methods are not in place for tracking of the changes and customizations made to certain applications.

“Program developers have access to move program changes into production for certain applications.”

2. Significant Deficiencies

The management letter also identified three significant deficiencies which did not rise to the level of material weaknesses. The significant deficiencies, contained in findings 2012-04, 2012-05, and 2012-06, are recited verbatim:

Finding 2012-04, Escheats Law

“The City filed the required annual report of unclaimed property to the State of Michigan; however, it was inaccurate as it did not include property tax overpayments. Additionally, the City has not remitted escheatable property to the State. In discussing this with City officials, the stated changes in personnel combined with the lack of written City policies and procedures regarding the monitoring and calculating of escheatment rules caused the City to fail to comply with the rules.

“The Uniform Unclaimed Property Act (Public Act 29 of 1995) requires the Michigan Holder Transmittal Annual Report of Unclaimed Property be submitted annually by July 1.

“Any holder of unclaimed property who fails to file a report of unclaimed property is subject to fines and penalties as prescribed in Public Act 29 of 1995.”

Finding 2012-05, Act 51

“The City of Detroit’s Major and Local Street funds were not in compliance with the State of Michigan Public Act 51. The General Fund borrowed cash and investments from the Street funds, which are restricted for a specific purpose, as stated in Act 51. In discussing this with City officials, because multiple funds, including the General and Street funds, share the same bank account as well as the lack of general awareness of the Street funds’ restricted use caused the City to be noncompliant with Act 51.

“Public Act 51 Section 247.663 states what the Street funds can be used for. Failure to comply with the Act will result in forfeiture of funds to which it may have been entitled for a period of 1 year from and after the failure to apply the money appropriately as prescribed in Act 51 247.666.”

Finding 2012-06, Uniform Budgeting and Accounting Act

“The City was not in compliance with Michigan Compiled Laws Act 2 of 1968, Uniform Budgeting and Accounting Act. For certain appropriations stated in footnote 2(d),¹⁰ the City’s actual expenditures were more than budgeted expenditures. City Council passed an amendment on November 20, 2012 to remove negative balances in various General Fund appropriations by redirecting unused authority within the total budgets of affected departments. However, because the amendment was passed after the fiscal year end, the City was still considered noncompliant as of June 30, 2012.

“Per Act 2 of 1968, Section 141.438 (3), ‘Except as otherwise provided in section 19, an administrative officer of the local unit shall not incur expenditures against an appropriation account in excess of the amount appropriated by the legislative body.’”

¹⁰ Footnote 2(d) refers to Note II of the City’s fiscal year 2012 financial audit report entitled “Stewardship, Compliance, and Accountability.” Subsection (d) of Note II, entitled “Excess of Expenditures Over General Fund Appropriations,” listed expenditures that exceeded their corresponding appropriation for the year ended June 30, 2012.