



Citizens for Public Accountability



Protecting Your Tax Dollars

CPA is a bipartisan group of retired partners of some of Houston's accounting firms.
It was founded by Aubrey M. Farb, Earl Lairson, Tom Roberts and Bob Lemer, Chairman.

CITY OF HOUSTON
TOTAL OPERATING LOSSES
FISCAL YEARS 2004 – 2008

\$1.5 BILLION!



The City Of Houston Has Incurred A \$1.5 Billion Operating Deficit Over The Last Five Fiscal Years And Is Ill-Prepared For The Sudden National Fiscal Crisis. The Houston Private Sector Needs To Force The City To Address This Extremely Critical Situation Before Officially Approving The Just Released Proposed Budget For Fiscal Year Ending June 30, 2010. The Law Requires Official Approval No Later Than June 30, 2009.

By: Bob Lemer

Executive Summary

The City of Houston has incurred operating losses totaling \$1.5 billion over the last five fiscal years ending June 30, 2008. So the City is ill-prepared to weather the national financial crisis now finally arriving in Houston.

The already-existing self-inflicted financial crisis apparently is due to the City's huge transfer of wealth from Houston taxpayers to City employees in the form of unrealistic levels of retirement and health benefits for City employees.

Proper and timely reporting of the crisis has been impeded by material weaknesses in the City's financial accounting and reporting systems.

It appears that the City is unable to correct the problems without outside aid, as evidenced by the recently released proposed budget for the fiscal year ending June 30, 2010.

Therefore, it is imperative that a public oversight board be immediately established to take control of the situation, before the City's proposed fiscal 2010 budget is officially adopted before June 30, 2009.

The national fiscal crisis continues to deepen and even though its effect has been slow to reach Houston it is certainly arriving here. Adding to the seriousness of the Houston situation is the fact that our City of Houston government already had created its own fiscal crisis before the national crisis arrived.

The City ran up huge operating deficits ("Change in Net Assets") totaling approximately \$1.5 billion for fiscal years 2004-2008, according to pages 198-199 of its audited Comprehensive Annual Financial Report (CAFR) for fiscal year ended June 30, 2008.

Houston's five-year operating deficit of \$1.5 billion is monumental, particularly so when compared to the operating results at San Diego, San Francisco, and Los Angeles in the bankrupt state of California, at Detroit in the automotive bankruptcy plagued state of Michigan, and at our sister Texas city of Dallas. See attached Exhibit A.

The \$1.5 billion operating deficits occurred even though the City's revenues (program and general combined) increased a very generous 37.7% in fiscal years 2004-2008. The operating deficits occurred because operating expenditures increased an even greater 44.9% rate during that five-year period. (CAFR pages 198-199)

The 44.9% increase in operating expenditures is considerably above the combined 29.4% increase in population (10.3%, including the Katrina influx, CAFR page 223) and inflation (19.1% per the Houston SMSA CPI from June 2003-2008).

As shown by attached Exhibit B, the City has had a structural financial problem for a quarter-century, in that its revenues have continued to ever more greatly outstrip the combined growth in the City's population

and inflation. And the City's long-term debt has also greatly outstripped the growth in population and inflation, finally literally exploding beginning about 1996.

Prior to fiscal 2004, apparently the City had at least limited growth in its operating expenditures to growth in its revenues, except for instances of plowing savings from refinancing bonds into operating expenditures.

However, since fiscal 2003 operating expenditures have been out of control.

The City indicates that the \$1.5 billion operating deficit during fiscal years 2004-2008 was caused primarily by a 75% increase in the expansion of public safety services---see the purported increase in public safety expenses from \$0.8 billion in 2003 to \$1.4 billion in 2008 (CAFR page 198).

The purported 75% increase in the cost of public safety during 2004-2008 is contradicted by the 9.2% decrease in the combined number of police officers and cadets and the 1.2% decrease in the number of firefighters and cadets from 2003 to 2008 (CAFR pages 228-229). So which set of CAFR facts is correct? Can they be reconciled?

The true principal cause for the \$1.5 billion of operating deficits for fiscal years 2004-2008 appears to be the enormous increases in City employee pension and health care benefits. Exhibit C vividly demonstrates this tremendous transfer of wealth from Houston taxpayers to City employees.

Exhibit C shows that the City already is technically bankrupt at June 30, 2008, with an unrestricted net asset (deficit) of \$1.3 billion, while the City employee pension plans' net assets-surplus grew from \$5.0 billion at June 30, 2003 to \$8.3 billion at June 30, 2008.

Exhibit C also demonstrates the additional dramatic transfer of wealth from Houston taxpayers to City employees as of June 30, 2008, if the unfunded costs of employee pension (\$2.0 billion) and health care (\$3.2 billion) benefits---existing at June 30, 2008 but not yet recorded on the City's books---are factored in.

Exacerbating this transfer of Houston taxpayer wealth to City employees is the fact that, in these perilous financial times, the City, already the second largest employer in Harris County, is planning to expand its civilian workforce by another 3.6% in fiscal 2010 on top of the 7.1% increase expected in fiscal 2009, while expanding its police officer and firefighter workforces by only a combined 1.2% in fiscal 2010 on top of their 3.7% increase expected in fiscal 2009 (2010 budget, pages 14-15).

The City's \$1.5 billion operating deficit for fiscal years 2004-2008 and the related transfer of Houston taxpayer wealth to City employees was accomplished primarily through the following debt financing and disposal of City assets:

1. A \$0.6 billion increase in the recorded liabilities to the City employees' pension funds,
2. Issuance of \$0.5 billion of City pension plan bonds to be paid from property taxes assessed on Houstonians. The principal on these pension bonds will not commence coming due until 2014, with over 90% of the principal not coming due until 2021 and later, resulting in future generations of Houstonians paying the debt and interest costs of over \$678.6 million (2010 budget, page XIV-6), and
3. A transfer of the City's \$0.3 billion note receivable from the Houston Convention Center Hotel Corporation (HCCHC) to the non-classified employees' pension plan. After fiscal year 2008, this note was returned to the City with HCCHC receiving \$0.3 billion plus \$41 million of accrued interest. This was accomplished by using proceeds obtained by the City issuing yet more property-tax-supported pension bonds.

The existence of the very large full accrual basis of accounting operating deficits each year during fiscal 2004-2008 was hidden from view in that:

1. Very few of the City's elected officials have a sufficient level of understanding of the City's CAFR (see item 4), which utilizes the full-accrual-basis-of-accounting, let alone an understanding of how the CAFR relates to the "modified-accrual"-basis-of-accounting and the cash basis of accounting (see items 2 and 3) utilized in the monthly operating reports and annual budgets prepared by the finance and administration department and the city controller's department for presentation to city council. For example, Exhibit D shows that the General Fund (the focus of city council), under its "modified-accrual"-basis-of-accounting, actually had a \$19.9 surplus for fiscal 2008 operations, yet, in actuality, the City had a citywide operating deficit of \$281.6 million under the full-accrual-basis-of-accounting, used in the real business world.
2. The City uses the "modified-accrual"-basis-of-accounting in its monthly financial reporting and the cash basis of accounting (as required by law) in its budgeting process. The "modified-accrual"-basis-of-accounting does many things foreign to normal full-accrual-basis-of-accounting, such as:
 - a. Counts bond proceeds as income and debt principal repayments as expenditures.
 - b. Ignores liabilities not to be paid using current resources (for example, the constant build up in pension liabilities is ignored).
 - c. Counts the purchase cost of capital assets in the year acquired and not annual depreciation.
3. The City's monthly financial reports and its budgeting process do not include presentation of balance sheets.
4. The City prepares full-accrual-basis-of-accounting financial statements (CAFR) only once a year, and the CAFR is prepared so tardily every year that it is rendered essentially useless as a timely management tool. Beginning with the fiscal 2005 CAFR, the City commenced being more tardy than at any time in at least the last 30 years in getting out its annual CAFR, until finally its 2006 and 2007 CAFRs were not issued until almost one year after fiscal year end. The 2008 CAFR was released six months after fiscal year end, but apparently this was accomplished only because the independent auditors filled the breach in doing the critical work. In stark contrast to the City's tardiness, publicly held companies (with worldwide operations and much more complex accounting and financial reporting problems) are required to file their annual financial statements within 75 days after fiscal year end.

Central to the huge delays in getting out the annual full-accrual-basis-of-accounting CAFRs are the critical material weaknesses in the City's internal controls over its financial reporting system. Apparently for the first time in its history, the City received "material weaknesses in internal control" letters from the City's independent auditors for fiscal years 2006, 2007 and 2008. The City's lack of internal control was so bad in fiscal 2008 that the independent auditors refused to even attempt to test the internal control system, and presumably had to extend its other substantive type audit procedures, at assumedly much greater cost to the City. This kind of very serious situation is almost unheard of in the private sector.

Based on the City's just released proposed budget for fiscal year ending June 30, 2010, and our elected City officials' historical and current inactions relative to long-term fiscal problems, it is highly doubtful that our elected officials are capable of solving the current fiscal crisis.

This is extremely troublesome in that most of the announced candidates for mayor and city controller in the forthcoming November elections are persons who served in City office while the City's severe financial problems were created over the last five fiscal years.

Certainly, the Houston economy cannot risk a repeat of the City's supposed solution to the 1980s oil bust situation. During that period, instead of tightening its financial belt, like the public had to do, the City increased its property tax rate 27%, water rates 119% and sewer rates 161%, along with massive increases in debt.

Time is of the essence. The City's problems absolutely must be addressed in the fiscal 2010 budget, the proposed version of which was just released and must be formally approved no later than June 30, 2009. Inasmuch as the City elected officials appear incapable of surmounting the problems on their own, the private sector needs to immediately step in with a public oversight board.

Some of the things the public oversight board may wish to consider are:

- **Immediately investigate this situation to make sure that it does not have the potential to be a bankruptcy/pension plan crisis similar to the one experienced by the City of San Diego a few years ago. There do appear to be some similarities.**
- **Immediately freeze operating expenses in all departments, as well as all construction contracts not yet started.**
- **Have a qualified totally independent expert evaluate the City's financial exposures regarding financial derivatives.**
- **Go to the state legislature and get the employee pension plans converted from defined-benefit to defined-contribution plans.**
- **Correct the material weaknesses in the financial accounting and reporting system, as well as any other impediments to timely financial reporting.**
- **Commence the practice of preparing timely and accurate quarterly financial reports using the full accrual basis of accounting and including balance sheets.**
- **Hire highly qualified consultants to conduct efficiency and effectiveness audits of every department, commencing with the largest first, with no sacred cows. There are unreleased reports on the police and fire departments that can be used as beginning reference points for those departments. Consider using a productivity and quality control consultant to make sure that customer service is adequately considered in the deliberations. Without question, the City's operations contain significant fat and inefficiencies.**
- **Conduct an in-depth inventory of the City's infrastructure and prioritize the discovered needs.**
- **Have a qualified independent consultant evaluate the City employee benefit package.**

Once the national financial crisis and the City's own created financial crisis are over, a permanent oversight City audit committee should be installed, as recommended by the City's independent auditors in their December 17, 2002 letter to the City, and as recommended for all state and local governments by the Government Finance Officers Association.

Summary

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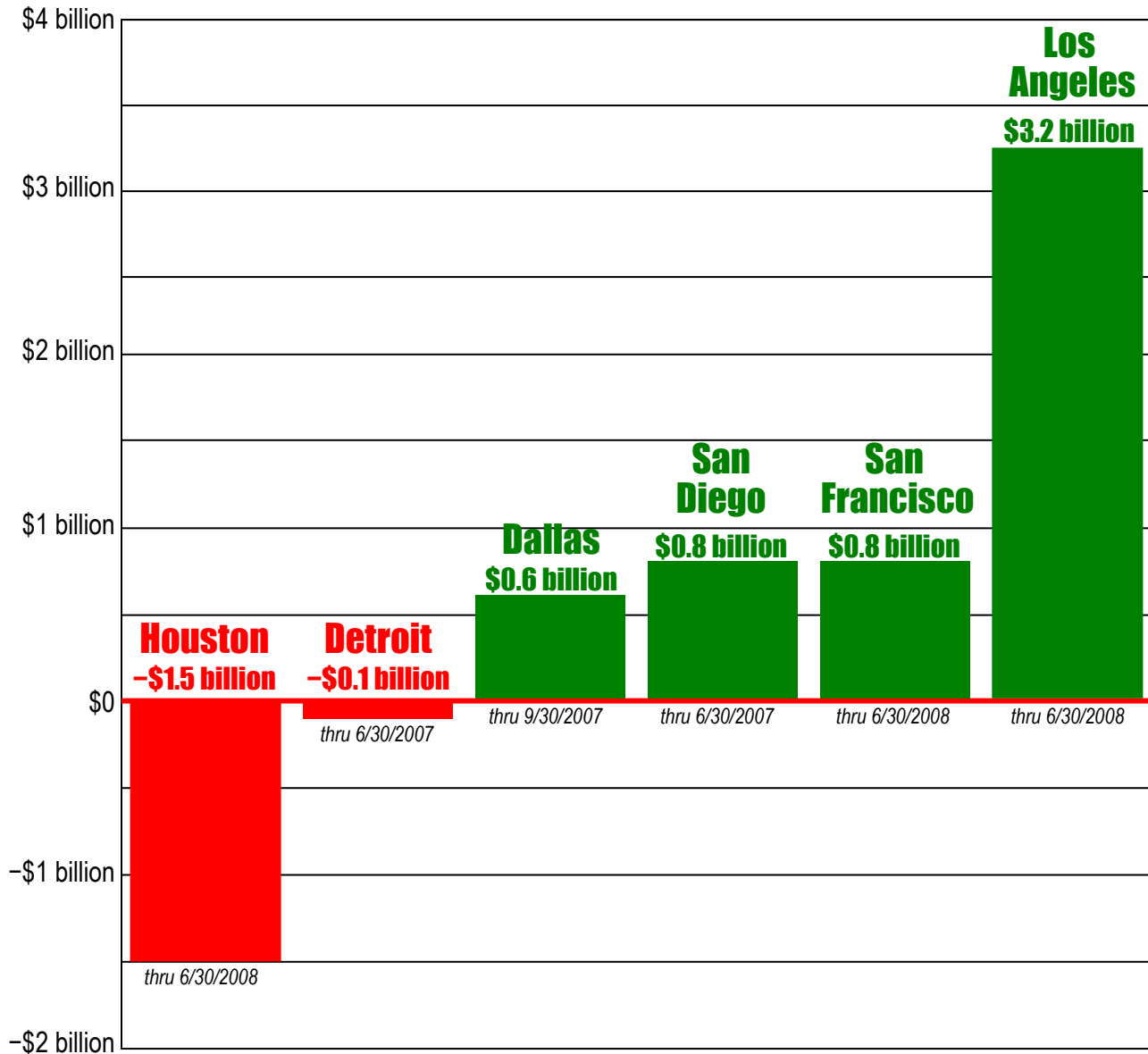
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Comparison of City Government Operating Results

Total for Last Five Fiscal Years Reported on Cities' Web Sites

Exhibit A

By Bob Lemer



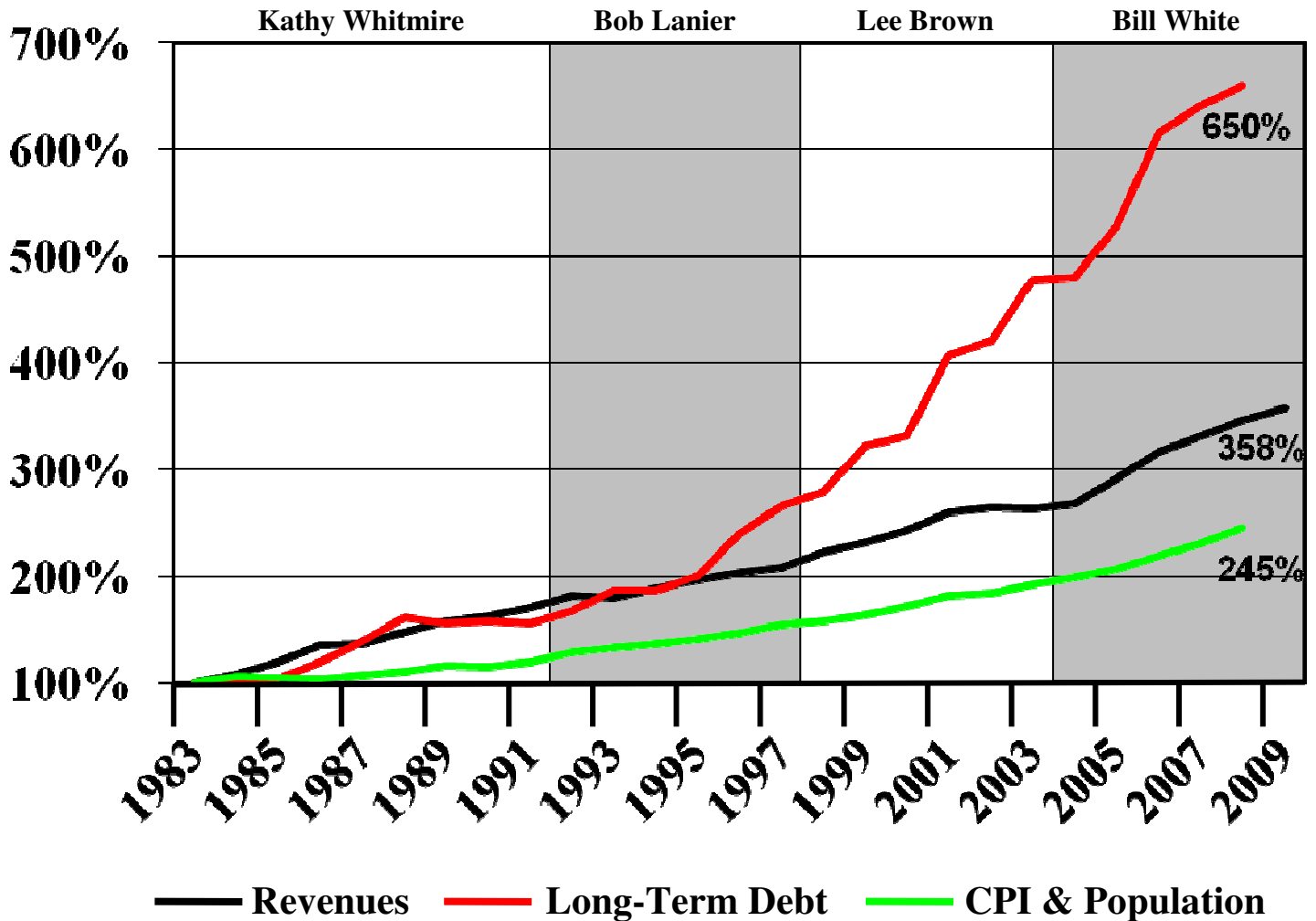
City of Houston

Revenues, Long-Term Debt, and CPI & Population as a Percent of 1983
(Fiscal Years Ending June 30, 1983-2009)

Exhibit B

By Bob Lemer

Mayoral administrations elected November of every odd year,
and take office following January. Maximum service is now 6 years.



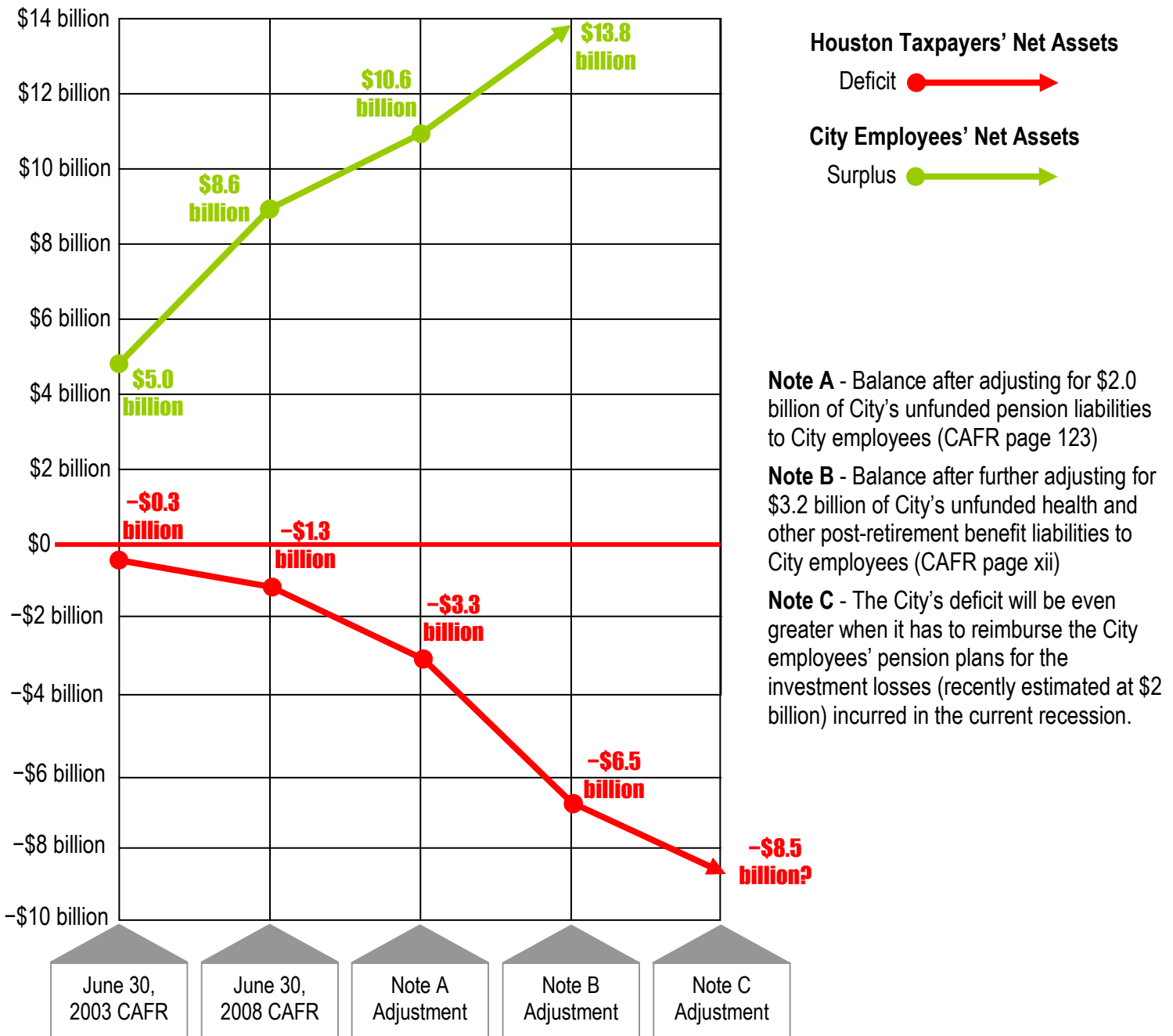
Sources: **Revenues (General Fund and Enterprise Funds) and Long-Term Debt** - City's audited Comprehensive Annual Financial Reports, 2009 revenues per 2009 budget
CPI - Houston Primary Metropolitan Statistical Area, per federal Bureau of Labor Statistics
Population - U. S. Department of Commerce, Bureau of Census

Transfer of Wealth

from Houston Taxpayers to City Employees

Exhibit C

By Bob Lemer



The City of Houston's deficiency in net unrestricted assets increased from -\$0.3 billion at June 30, 2003 to -\$1.3 billion at June 30, 2008, while the net assets of the City employees' pension plans increased 72% from \$5.0 billion at June 30, 2003 to \$8.6 billion at June 30, 2008, according to the City's 2003 and 2008 CAFRs. Certainly much of the increase in the value of the employees' pension plans was due to employee contributions and performance of the pension plans' investments, but a large amount of the increase of the pension plans' net assets, as well as most of the decrease in the City's net unrestricted assets, was due to ballooning costs of City employee pension and health benefits.

Exhibit D
City of Houston Reconciliation of Budgeted "General Fund" Results of Operation to City-wide Results of Operation
Fiscal Year Ended June 30, 2008
Per Audited "Comprehensive Annual Financial Report" ("CAFR") -- Thousands of Dollars

| | Actual Over/(Under) Budget | Budget | Actual |
|--|----------------------------------|-----------------|------------------|
| Budgeted "General Fund" Performance: | | | |
| Revenues-page 117 | 55,493 | 1,706,244 | 1,761,737 |
| Other financing sources-page 117 | 477 | 49,745 | 50,222 |
| Expenditures-page 120 | 12,414 | (1,540,885) | (1,528,471) |
| Other financing uses, transfers out-page 120 | 181 | (263,778) | (263,597) |
| Net annual surplus (deficit) of the Budgeted "General Fund" | 68,565 | (48,674) | 19,891 |
| Non-budgeted "General Funds"-Page 121: | | | |
| Revenues | | | 1,627 |
| Expenditures | | | (71,300) |
| Interest on pooled investments | | | 1,670 |
| Proceeds from issuance of debt | | | 95,623 |
| Transfers in | | | 5,896 |
| Net annual surplus from all "General Funds"- page 20 | | | 53,407 |
| Net annual surplus from other "Governmental Funds": | | | |
| Debt Service-page 20 | | | 21,816 |
| Capital Projects-page 20 | | | 18,447 |
| Grants-page 21 | | | 164 |
| Non-major-page 21 | | | 25,444 |
| Net annual surplus from all "Governmental Funds", on the "modified accrual basis of accounting"-pages 21 & 22 | | | 119,278 |
| Conversion from "modified accrual basis of accounting" to "full accrual basis of accounting"-page 22: | | | |
| Add purchase of capital assets, treated as expenditures | | | 363,687 |
| Deduct depreciation expense | | | (167,630) |
| Revenues that will be collected more than 60 days after FYE | | | 79,546 |
| Previous year 60 day deferred revenues collected this year | | | (97,762) |
| Net effect of reversing "Governmental Funds" handling of these items: (a) bond proceeds as "other resources", (b) repayment of debt principal as expenditures, and (c) expensing bond issuance costs, premiums and discounts when incurred | | | (199,406) |
| Net effect of having deferred non-current liabilities at beginning and end of year | | | (359,706) |
| Net non-reimbursed expense of the internal service funds | | | (524) |
| Net annual operating deficit for the "Governmental Activities"- pages 22 and 17 | | | (262,517) |
| Net annual operating deficit for "Business-Type Activities"-page 17 | | | (19,039) |
| Net City-wide operating deficit-page 17 | | | (281,556) |