ACCOUNTING FOR THE PROCEEDS OF THE SALE OF THE NEW YORK COLISEUM

Submission to the New York City Audit Committee
by
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Deputy State Comptroller for the City of New York
March 30, 1988

I. INTRODUCTION AND RECOMMENDATION

We have brought to the attention of the Audit Committee the concerns expressed by the State Comptroller about certain issues surrounding the sale of the New York Coliseum. This statement summarizes these concerns, which have been presented in several reports as well as in discussions at the Audit Committee's January 5, 1988 meeting, and goes on to provide additional information requested by the Committee at that meeting. Our concerns are focused in two basic areas.

The first is the area of budgetary policy and financial management. We consider it imprudent for the City to rely on such a large non-recurring funding source as the Coliseum proceeds to support a major expansion of recurring expenditures in its Financial Plan, especially since those proceeds are earmarked for transit capital purposes. Contrast the City's intended action with what New York State did last year when it faced the prospect of receiving a large one-time revenue resulting from changes in Federal tax law. The State created a special trust fund for these revenues and limited it to capital purposes, stating in the legislation that "prudence dictates that such revenues should not be expended to meet recurring state operations requirements."

We have also criticized the City's plan because it makes the sale of bonds a prerequisite for using the Coliseum proceeds in the operating budget, an arrangement that comes perilously close to the highly discredited practice of capitalized operating expenses that contributed significantly to the City's fiscal woes of the 1970s.

The sale of bonds, which is planned to meet the transit capital commitment, will saddle future generations with the payment of principal on those bonds plus hundreds of millions of dollars in interest costs. Here, too, the State has taken a better tack with the trust-fund law. One of the Legislature's stated findings in passing the legislation was that "to the extent that such revenues are available and may be used to avoid the issuance of debt, the burden on current and future generations of taxpayers will be diminished."
Because of all these objections, we have urged the City to abandon its current plan for using the Coliseum proceeds. In our view, the plan should be re-designed in a way that demonstrates a continuing dedication to the high standards of budgetary management and fiscal integrity that have facilitated the City's fiscal recovery.

Our second major area of concern is the propriety of the City's proposed accounting for the transaction. The Audit Committee has asked me to prepare comments grounded in the accounting literature that outline our concerns in this area. Having reviewed this matter in depth, we are now even more firmly convinced that the City's proposed accounting for this transaction does not reflect the substance of the Coliseum transaction. Indeed, it could result in the preparation of misleading financial statements in contravention of some of the basic concepts and objectives of governmental accounting and financial reporting standards.

The Coliseum sale transaction is described in some detail below. Here at the outset we can summarize our argument: the proceeds from the Coliseum transaction that the City will receive in effect constitute an interest-free loan from the Triborough Bridge and Tunnel Authority (TBTA) that the City is obligated to repay in the form of capital contributions to the mass transit system. Accordingly, we propose that the New York City Audit Committee urge the City to set aside the Coliseum proceeds for transit capital purposes. Since these funds are already earmarked for this purpose, the preferred accounting treatment would be to recognize the proceeds in the City's Capital Projects Fund. Only by doing this can the twin objectives of sound fiscal management and proper government accounting be achieved.

Generally accepted accounting principles (GAAP) currently in effect could, alternatively, allow the City's financial statements to classify the funds to be received from the TBTA as an "Other Financing Source" and to account for the corresponding liability in the General Long Term Debt Account Group. While we would regard this alternative for reporting the transaction as minimally acceptable at the present time, it is important to note that even this accounting treatment would be precluded outright by pending changes in Governmental Accounting Standards (in conjunction with State law) that are likely to go into effect starting with the City's fiscal year beginning July 1, 1990. As is more fully explained below, these changes would preclude the City from passing the burden of current operating expenses along to future generations, which would be the outcome of its present plan. Given that the Coliseum sale has already been delayed more than two years since the originally scheduled sale date early in fiscal year 1987, and that further delays in consummating the sale appear all but inevitable, it seems highly likely that the TBTA/City/TA transaction will eventually be governed by these
new standards. Accordingly, we believe it is far preferable for the City to take the high road now, in line with the practices it has followed in recent years, rather than face the shock of readjustment in the near future. Or as Mayor Koch said when he proposed the City's first balanced budget before the law required it, "it is better to deal early with a financial problem than put off its consequences."

The basis for our conclusion and recommendation is presented in the balance of this communication.

II. STATEMENT OF FACTS

1. The City acquired the Coliseum site for the TBTA and then conveyed the entire tract to the TBTA in two stages in 1953 and 1954 for the price of $2,182,230. The City's Corporation Counsel has concluded that the TBTA's ownership of the Coliseum is "an undisputed fact."

2. Although the TBTA is the Coliseum's owner, there is a circumstance under which the Coliseum could return to the City: under the statute creating the TBTA, if that agency were to cease to exist, the Coliseum would then pass to the City. (This provision, it is worth noting, is not specific to the Coliseum; should the TBTA ever cease to exist, "all its remaining rights and properties" pass either to the City or the State.) The City's interest in the Coliseum, insofar as it depends on the TBTA's demise, is plainly not vested. On the contrary, the Corporation Counsel, noting that the TBTA's corporate existence is for "an essentially indefinite and self-perpetuating period," has concluded that the City has "only a contingent reversionary interest in the site."

3. On March 30, 1984, the Mayor and the Governor entered into an agreement -- the Municipal Assistance Corporation (MAC) Surplus Agreement -- which, among other things, calls for the disposition of the Coliseum following the opening of the new Jacob K. Javits Convention Center. The agreement provides that the full amount of the net proceeds from the Coliseum sale "shall be used for the purpose of improving public transportation facilities in the City" by augmenting transit capital expenditures.

4. The MAC Surplus Agreement also provided for the net proceeds from the sale of the Coliseum to be divided evenly between the City and the TBTA. The City's receipt of these proceeds would be "in consideration" of its agreement to use these proceeds for additional capital funding for the Transit Authority.
5. On December 19, 1984, a Memorandum of Agreement between the City and the MTA and TBTA further detailed the plans for the disposition of the Coliseum proceeds, including a schedule for the payment of the City's required additional capital funding to the Transit Authority. The agreement provided for the additional funding to be paid over a five-year period following receipt of the Coliseum proceeds.

6. This Memorandum of Agreement was amended on February 6, 1987. Among the amendments was the inclusion of an express reference to section 557-a of the Public Authorities Law. Section 557-a authorizes the Mayor to enter into a legally binding contract with the TBTA requiring the City to make capital expenditures without any further authorization. The significance of that section is that the City's contractual promise to pay its share of the Coliseum proceeds to the Transit Authority for capital improvements is made a legally binding obligation through the force of statute even in the absence of an appropriation. In a 1987 memorandum of law submitted to the State Supreme Court, the City's Corporation Counsel further underscored the statutory basis of the City's payment obligation: "this type of agreement between the City and the TBTA is expressly authorized by Pub. Auth. Law §557-a."

7. The City's Financial Plan for fiscal years 1988 through 1991 initially showed a total of $455 million from the sale of the New York Coliseum, of which the City's $227 million share was to have been received in late 1987. As a result of a law suit and other events, the total amount has now been reduced to $357 million, of which the City's share is $178 million. The City now expects to receive that amount in mid-1989. When the Coliseum proceeds first appeared in a City Financial Plan, they were expected to be received in mid-1986.

III. THE CITY'S PROPOSED ACCOUNTING TREATMENT

A. The City's Proposed Accounting for the Coliseum Proceeds. The City proposes to record its share of the Coliseum proceeds as General Fund revenue. The City does not intend to recognize its promise to provide additional capital funds to the Transit Authority as a liability in the General Long Term Debt Account Group.
The City explains its proposed accounting by citing the general rule that when the City sells an asset that it owns outright, GAAP permits the sale proceeds to be recorded as General Fund revenues. Applying this rule to the Coliseum sale, the City's Budget Director has taken the position that "fundamentally, this transaction is no different than the sale of any other City asset where the proceeds are credited to the general fund." The City's independent accountants have concurred in this position, viewing the Coliseum as leased by the City to the TBTA.

The Budget Director has also taken the position that the City's promise to provide additional funds for transit capital projects in the future is a wholly separate matter unrelated to the Coliseum sale. What is more, the Budget Director has said that the promise to provide these funds is not legally binding in the absence of an appropriation, a conclusion that affords the basis for a second accounting opinion upholding the City's proposed accounting. For these reasons, the City does not intend to recognize the promise to provide additional capital funds to the Transit Authority as a liability.

B. The Flaws in the City's Proposed Accounting Treatment.
Accounting literature emphasizes the substance of a transaction over its form. The fundamental objective of accounting and financial reporting is that the financial statements accurately record a transaction's economic substance (Statement No. 4 of the Accounting Principles Board).

It is axiomatic that a transaction's economic substance can be accurately recorded only if the transaction is first accurately understood. Conversely, if a transaction's underlying facts are misperceived, its economic substance cannot be grasped. On this axiom, the City's proposed accounting treatment fails apart. For neither of the two premises that provide the basis for the City's accounting treatment accords with the underlying facts.

First, the City's assertion that "fundamentally, this transaction is no different than the sale of any other City asset" is manifestly wrong. Likewise the contention of the City's accountants that the City has leased the Coliseum to the TBTA is devoid of any basis in fact. As the Corporation Counsel has acknowledged, the asset being sold is owned by the Triborough Bridge and Tunnel Authority (Statement of Facts, points 1 & 2). The City's contingent reversionary interest is so tenuous and "remote" (the Corporation Counsel's term) that the parties themselves were unsure whether the City retained any legally cognizable interest. So, just to be sure all bases were covered (apparently to make certain that the TBTA could convey an unclouded title to the purchaser), the agreement between Boston Properties and the TBTA for the purchase and sale of the Coliseum site provides for the City to
convey all its right, title, and interest in the Coliseum site "if any" (emphasis supplied).

Second, the "separate transactions" argument -- the theory that the Memorandum of Agreement governing both the Coliseum sale and the provision of funds to the Transit Authority should be read as creating two separate transactions which are not linked, and that the City's provision of funds to the Transit Authority is, in any case, in the nature of an unenforceable promise -- is also plainly at odds with the facts. When one agreement is expressly made "in consideration" of another (Statement of Facts, point 4), the connection between them is evident. Indeed, this connection was implicitly acknowledged by the City's Budget Director when he stated that the City agreed to provide additional funding to the Transit Authority "in order to induce" the TBTA to dispose of the Coliseum in the way the City wanted.

What is more, the binding nature of the City's obligation to provide additional funds for transit capital purposes is established by operation of the City's agreement with the TBTA and by operation of law (Statement of Facts, point 6). This means that whether the City's promise to provide additional capital funding to the Transit Authority is linked to the sale of the Coliseum (as we believe) or is an entirely separate transaction (as the City argues), the existence of this legally binding obligation must be recorded on the City's books as a liability in the General Long Term Debt Accounts Group.

IV. OSDC'S ANALYSIS

A. The Economic Substance of the Transaction. The proceeds that the City will receive upon the sale of the Coliseum are "in consideration" of the City's agreement to provide an equal amount of funds to the Transit Authority at a later date (Statement of Facts, point 4). The repayment of the proceeds in the form of additional capital funding to the Transit Authority is not within the City's discretion, judgment, or choice. The payment is a matter of obligation as established by the City's agreement with the TBTA and by operation of State statute (Statement of Facts, point 6). The parties have agreed, however, that the payments are to be made over a five-year period under a set schedule. In the meantime, the unexpended portion of the proceeds is available to the City. Because the amount the City must eventually repay equals the amount it receives, and no more, the transaction we have just described amounts to an interest-free loan from the TBTA to the City.
The City will relinquish its contingent reversionary interest in the Coliseum site (Statement of Facts, point 2). The only gain the City will realize from the transaction is the value of the foregone interest on the loan. Perhaps the City's Corporation Counsel put it best in saying that the transaction gives the capital improvements to the transit system while giving the City the time value of the cash proceeds. This is the underlying economic substance of the transaction that the City's financial records should reflect under GAAP.

B. Proposed Accounting Treatment.

1) OSDC's Recommended Accounting Treatment. Since under GAAP the Capital Projects Fund exists to account for the financial resources to be used for the acquisition or construction of major capital facilities (GASB Cod. §1300.104), the Capital Projects Fund, rather than the General Fund as the City proposes, would be the most appropriate place in which to recognize the loan proceeds. This recognition would be in the form of an "Other Financing Source." At the same time that these proceeds become available to the City upon the sale of the Coliseum, a corresponding liability would be incurred in the form of a long-term debt: the commitment to repay the TBTA over the following five years by means of additional capital contributions to the transit system.

Although that obligation springs from an agreement rather than a debt issuance, it is properly reckoned a general long-term debt as defined by the Government Accounting Standards Board (GASB):

General long-term debt is the unmatured principal of bonds, warrants, notes..., or other forms of noncurrent or long-term general obligation debt that is not a specific liability of any proprietary fund or trust fund. General long-term debt is not limited to liabilities arising from debt issuances per se, but may also include noncurrent liabilities on capital leases... and other commitments that are not current liabilities properly recorded in governmental funds (GASB Cod. §1500.103)(emphasis supplied).

General long-term debt is required to be accounted for in the General Long Term Debt Account Group (GLTDAG). Accordingly, the liability to provide future capital funding to the Transit Authority should be recorded in the City's GLTDAG when the commitment arises, i.e., when the proceeds from the Coliseum transaction are made available to the City.
For considerations of sound budgetary policy and prudent fiscal management, we have argued that the City should reserve the Coliseum proceeds for pay-as-you-go financing to satisfy this obligation. The GLTDAG liability would be paid as the capital funding is provided.

Since the loan proceeds become available immediately upon the sale of the Coliseum while the repayment obligation extends over five years, the interest earned on the balance of the proceeds during the time that they are in the Capital Projects Fund would be available to the City as an operating budget resource. On the basis of the current estimate that the City will receive $178 million in proceeds -- in effect, the principal amount of the loan -- we calculate the value of the interest savings over the five-year life of the loan to be about $30 million. In our view, this amount would constitute all the financial gain that the City is to receive for relinquishing any rights it may have in the Coliseum site and may be recorded, when earned, as a General Fund revenue.

Because this treatment gives full effect to the demands of sound budgetary policy and prudent fiscal management while at the same time being wholly consistent with GAAP, it is the approach that we recommend. We urge the Audit Committee to do the same.

2) Alternative Accounting Treatment. Short of the result that we have recommended, we maintain that at a minimum the City must be required to recognize its obligation to provide additional funding for Transit Authority capital improvements. Accordingly, a liability should be recorded in the General Long Term Debt Account Group. When such long-term debt is recorded in the GLTDAG, the GASB Codification (§1500.107) states that the norm is for the proceeds to be reflected as an "Other Financing Source" in the operating statement of the recipient fund, in this case, the General Fund or Capital Projects Fund. (An appropriate caption for the Coliseum transaction might be "Proceeds from Financing Agreements.") What the GASB Codification does not contemplate is for such proceeds to be classified as revenue in the operating statement, as the City proposes.

Under our alternative accounting treatment, the GLTDAG liability would be defeased through the City's planned issuance of bonds.

V. FUTURE IMPLICATIONS FOR FINANCIAL REPORTING

We believe that either our recommended accounting treatment or our alternative accounting treatment would more accurately reflect the economic substance of the Coliseum transaction than would the City's proposed accounting. Moreover, our treatments would also provide for the preparation of financial statements that more clearly show the impact of budgetary practices on the
results of operations for the reporting period. By so doing, either of our accounting treatments would be better aligned than the City's proposal with the objectives established by GASB in its "Concepts Statement 1" regarding the principle of "interperiod equity."

GASB believes that interperiod equity is a significant precept of governmental accountability and is fundamental to public administration (GASB Cod. §100.161). The principle is that current-year citizens should assume the burden of paying for current-year services, rather than shifting that burden to future-year citizens. GASB acknowledges, however, that interperiod equity cannot be measured completely in any individual governmental fund because current standards permit accounting for governmental activities to be spread among a number of funds or account groups.

Believing that current standards permit budgetary practices to unduly influence the financial reporting of results of operations (GASB Proposed Statement, Para. 174), GASB has issued an exposure draft for a proposed Statement to establish a new measurement focus and basis of accounting standards. This pending Statement, which is scheduled to take effect for fiscal years beginning after December 31, 1989, reflects GASB's conclusion that existing standards do not permit sufficient measurement of interperiod equity for transactions where an event in one reporting period results in a liability payable in future periods.

To better measure interperiod equity, GASB has proposed that accounting and reporting should reflect the extent to which a transaction requires the use of financial resources in current or future periods. In its pending standards, GASB has specifically addressed the question of how to account for the proceeds from general long-term debt undertaken for other than capital purposes, which precisely describes the City's proposed use of the Coliseum proceeds. The pending standards would both require the proceeds to be recorded as a liability on the balance sheet of the fund receiving the cash and -- still more significantly -- preclude their being recorded as a financing source in an operating statement.

Thus, under the pending standards, New York City would be precluded from using the Coliseum proceeds to support operations in one year while passing the burden for payment onto future taxpayers, as it now intends. To do so under the pending standards would throw an otherwise balanced operating budget into deficit, violating State statutes that require the City to prepare annual operating budgets the results of which would not show a deficit when reported in accordance with GAAP.

Upon the pending Statement's adoption, the City's budget and financial statements beginning July 1, 1990 would have to be prepared in accordance with the new standards. The City
presently hopes to consummate the Coliseum transaction during the latter part of its 1989 fiscal year. However, legal challenges and other events have already delayed the sale for over two years (the Coliseum sale, now scheduled for the end of fiscal year 1989, was first scheduled for early in fiscal year 1987). Further delays are highly likely, and even if those delays were measurable in months rather than years, this would place the sale under the more stringent new standards. This is yet another reason why we believe it would be far preferable for the City to set aside the Coliseum proceeds for its commitment to the TA, an action that accords both with the current standards and with the standards that are pending.

VI. STAYING ON THE HIGH ROAD

The Governmental Accounting Standards Board's Codification of its accounting and reporting standards states that:

financial reporting should provide information to determine whether current-year revenues were sufficient to pay for current-year services. This also implies that financial reporting should show whether current-year citizens received services but shifted part of the payment burden to future-year citizens... (GASBCS 1, Para. 77).

GASB has recognized that existing standards do not adequately promote these objectives. The direction in which governmental accounting standards are heading is clear: the adoption of standards that accurately measure and report interperiod equity. Under such standards, what the City is proposing to do here would stand exposed as being little removed from the practices that brought it to the verge of bankruptcy not so very long ago. In our judgment, the City should not -- as it did in recent history -- by-pass the objective of sound long-term financial management in order to accomplish its short-term budgetary goals.

Rather, the City should stay on the high road it took in fiscal year 1981 in moving to a GAAP-balanced budget a year earlier than required by law. In presenting his Executive Budget for that year, the Mayor said:

A balanced budget is not an abstraction sought for the sake of fiscal purity. Rather, it provides a discipline, a measure of our ability to deal honestly with ourselves and our fellow citizens and City workers about the limits of our resources and the cost of services demanded.

This commitment to discipline and honest dealing has as much relevance today as when it was first pronounced.
Date: 4 April 1988

To: Board of Directors

From: Stephen J. Weinstein

Re: MTA Capital Program

Enclosed is the most recent MTA Capital Program Report covering the October-December 1987 quarter.

The funding summary discusses the deferral of proceeds from the proposed sale of the New York Coliseum for Transit Authority capital projects from 1987 to later years. It has been reported that the MTA subsequently revised its funding schedule to reflect further delay and diminution in the receipt of those funds. Both the eventual outcome of the current Coliseum sale proposal and its impact on the MTA capital program funding remain uncertain at this time.

Under the City's plan, it would apply the sale proceeds to its operating budget and raise an equal sum for transit capital projects from general obligation bond sales. A recent statement prepared by the State Deputy Comptroller, also enclosed, continues to question the propriety of the City's treatment of the proceeds of the proposed sale.

Another development that may negatively impact MTA operating revenues is the possible secession of Dutchess and Rockland Counties from the MTA region, which State law makes possible for the remainder of this year. Rockland County has already indicated its intention to withdraw and Dutchess County is considering a similar move.

Enclosures (2)

aa:201
October 15, 1979

MEMORANDUM TO: Audit Committee for the City of New York
Alternates and Assistants of Audit Committee Members
Consortium of Independent Auditors Observers

FROM: P.F. Defliese, Chairman

1. Enclosed is a draft of the minutes of the October 3, 1979 Audit Committee meeting. Anyone having a revision to propose should advise me with a copy to Dan Rosen no later than October 25.

2. Enclosed is a proposed agenda for the October 27, 1979 meeting. Anyone wishing to add items to the agenda should advise me, with a copy to Dan Rosen no later than October 25.
AUDIT COMMITTEE FOR THE CITY OF NEW YORK

PROPOSED AGENDA

Meeting October 27, 1979

10 A.M.

Municipal Building

Fifth Floor Boardroom (530)

I. Adoption of Minutes of Meeting of October 3, 1979 (copy attached)

II. Report by P.L. Defliese, Chairman on October 3 Executive Session.

III. Draft financial statements for fiscal 1979. The City will be mailing draft financial statements to Committee Members by October 18, 1979. Anyone having substantive comments should forward them to Dan Rosen, with a copy to me, no later than October 25, 1979.

IV. New Business

October 15, 1979
THE AUDIT COMMITTEE FOR THE CITY OF NEW YORK

MINUTES

OCTOBER 3, 1979

IN ATTENDANCE

Public Members -
Comptroller, Harrison J. Goldin
Representing the Mayor, Budget
Director James R. Brigham, Jr.
Representing the City Council
President - Deborah Chapin

Private Members -
Philip L. Defliese, Chairman
Robert N. Anthony
John F. Thompson
Stephen M. Peck

Independent Auditors -
Peat, Marwick, Mitchell & Co
Donald R. Sloane, Robert Happ
Harold Steinberg, John Miller
Dennis O'Connor, Alfred Thoben
Richard A. Eisner & Company
Toby Feinerman
Mitchell, Titus & Co.,
Jeffrey Green
Stewart, Benjamin & Brown, P.C.
Ronald Benjamin

Observers -
Representing the Special Deputy
Comptroller for the City of New York
Abraham Bederman
U.S. Treasury, Lawrence Keives

Others -
Daniel P. Rosen, Audit Committee,
Secretary
Martin Ives - First Deputy Comptroller
Mark B. Shernicoff - Chief Accountant
Louis A. Friedrich - Deputy Budget
Director
Robert Werner - Consultant, City
Council President
H. Andrew Decker - Municipal Assistance
Corporation
Gary Kaplan - Financial Control Board
James Ryan - U.S. General Accounting Office
Irving Cohen, Michael Gibbons, Staff,
Special Deputy Comptroller
The meeting was called to order by Chairman Defliese.

The first order of business was the adoption of the minutes of the July 24, 1979 meeting. Mr. Rosen noted the changes proposed to him. These being the only comments, the changes, (enclosed as Appendix A) were accepted and the minutes were adopted as amended.

The second order of business was the Peat, Marwick, Mitchell & Co. Management Letters (Appendix B). Mr. Ives explained that the City has proposed postponing a detailed discussion of the Management Letters until the January Audit Committee meeting. He noted that while Directives and guidance memoranda (Appendix C) can be issued by the Comptroller's Office, agencies need time to adequately respond to the suggestions and comments. Mr. Happ noted that they are preparing a separate letter for the Board of Education which the Committee could receive if it so desired. He further noted that if during the remainder of the consortium's audit, any material weakness in internal controls are noted, PMM will issue a separate letter communicating such weakness and appropriate recommendations.

Mr. Defliese stated that the detailed discussion and response to the Management Letter is postponed until the January meeting. However, Mr. Defliese did note his concern for FISA's lack of a disaster recovery plan. Mr. Friedrich noted that the City is
in the process of devising such a plan. Mr. Defliese emphasized that a disaster plan should be given priority. Closing the discussion Mr. Ives noted that there are two types of disasters; the kind discussed in the Management Letter and an operations disaster. In Mr. Ives' opinion, with which Mr. Friedrich concurred, the operational aspects of FISA take precedent.

The third order of business concerned accounting issues. Before addressing the two items of business on the Agenda, Mr. Defliese asked whether there were any other accounting issues either resolved or unresolved. Mr. Happ said there were none to his knowledge. The only issues to be resolved were those normal audit issues that required judgment. Mr. Ives agreed that only factual type issues remain.

Mr. Deliese prefaced the discussion on the accounting issues by noting that the Committee's By-Laws emphasize that the independent auditors are the final arbiter on accounting issues; the Audit Committee can only give its guidance.

**Non-Pensionable Cash Payment**

Mr. Ives summarized the City's position on the Non-Pensionable Cash Payment ("NPCP") as detailed in Mr. Rosen's September 21, 1979 Memorandum For The Record (attached as Appendix D-1). Mr. Bederman summarized the position of the Office of the Special Deputy Comptroller for the City of
New York ("OSDC") as detailed in their Statement of Position (attached as Appendix D-2). Mr. Defliese asked if it was the State's position that the (coalition) agreement was a sham? Mr. Bederman replied that their position was that the agreement was written in the best interests of the City and its unions. A general discussion ensued which enabled various private committee members to clarify their understanding of the facts as well as to allow the City and OSDC to debate the issue. Mr. Happ noted that in making their decision to charge part of the NPCP to 1978, PMM had their research department thoroughly review the issue before making their decision. While they were aware of the budgetary issues and consideration, the question they had to answer was that from a GAAP and balance sheet viewpoint, was there a liability? They concluded that there was a liability and that the accountants' report would have been qualified if the liability was not recorded.

Mr. Defliese noted that the Committee was obligated to comment on this issue. He stated that the committee will determine its response in an executive session immediately following the regular meeting.

MAC REFUNDING

Mr. Rosen summarized the City's position on Accounting for MAC refundings as detailed in his September 10, 1979 Memorandum For The Record (attached as Appendix D-1). Mr. Bederman summarized OSDC's position as detailed in their
Statement of Position (attached as Appendix E-2). Mr. Defliese asked Mr. Happ to explain the difference between the City's accounting for MAC in the 1977 financial statements and the present refunding. Mr. Happ noted that in 1977, the City did not make a definitive policy decision concerning prepayments of debt service but rather presented the facts to PMM for a decision on how the 1977 restructuring should be accounted for. PMM relied on the provisions of Statement on Auditing Standards No. 1 in arriving at their decision. Mr. Happ continued that in the current situation, the City has developed a definitive policy concerning MAC refundings. Nowhere does GAAP preclude legal transfers from the General Fund to a Debt Service Fund for future debt service. And the City is attempting to present MAC in the City's financial statements exactly as presented in MAC's published financial statements to the extent possible. Extensive negotiations were held with MAC prior to publishing the City's 1978 financial statements, and the City and MAC want to maintain that format. Mr. Hopp deferred to Mr. Decker, MAC treasurer, to explain to the Committee MAC's operations concerning their take-outs and refunding.

Mr. Decker noted that once State appropriated revenues from sales tax, stock transfer tax or per capita aid is certified by MAC (the MAC "take-out") into MAC's funds, such money cannot be released. Concerning refundings, any benefit derived is pari passu - equal for all bonds issued. Further it is beyond the City's control to have knowledge of the timing or amount of MAC's take-outs or any refundings. The City and
MAC are on a cash basis in their mutual dealings.

Mr. Happ noted as a further point that the accounting system directives (ASD's) of the State for the City state that the City must account for the MAC take-out at the time of the take-out. A general discussion concerning the ASD's and GAAP ensued, as well as certain budgetary considerations.

Mr. Thompson noted that from the point of view of the municipal credit markets, he seconds Mr. Decker's concept that once money goes into a debt service fund it stays there. Mr. Decker noted that from MAC's oversight viewpoint the City's proposed accounting is conservative in that once MAC certifies a take-out, the City no longer has use of these revenues. Further discussion ensued to enable Committee members to clarify certain points concerning this issue.

Mr. Happ noted that concerning the NPCP decision, if PMM's decision to charge the NPCP to 1978 and 1979 is overruled, they would have no choice but to withdraw their opinion on the 1978 financial statements.

There being no further discussion, the issue was deferred to the executive session by the Chairman.

The Chairman brought up the first order of new business.
He inquired when and how the City budget once adopted can be revised. Mr. Brigham responded that any modification of the budget goes through the same process as the adoption of the original budget. The Mayor proposes a modification and the City Council and the Board of Estimate must approve it. The Financial Plan is then appropriately modified and must then be approved by the Financial Control Board. Mr. Defliese requested that Mr. Brigham provide the audit committee with all modifications to the current budget and Financial Plan.

Mr. Defliese then asked when the Pro-forma financial statements of the City would be available. Mr. Shernicoff stated that the audit committee would have them by the week of October 22. Mr. Defliese suggested that the financial statements with preliminary numbers be sent to the audit committee by the week of October 15 but no later than October 20. At the October 27 meeting of the Audit Committee the Committee will review the final draft. Anyone having comments will furnish them to Mr. Rosen no later than October 25.

A discussion ensued whether or not observers should receive a copy of the draft financial statements. Mr. Rosen noted that since the financial statements were the responsibility of the City, it would be inappropriate for observers to receive a copy for comment. Mr. Brigham and Mr. Shernicoff concurred. Mr. Bederman preferred to have Mr. Schwartz respond directly.
Mr. Defliese agreed that the distribution of the draft financial statements would be restricted to Committee members.

The meeting was adjourned to the Executive Session.
"The Audit Committee may request the Comptroller, the Auditors, or both, and shall be entitled to receive, an explanation of any item included in the financial statements, or proposed to be included in the financial statements." (The next sentence was deleted.)

A general discussion in support of this change ensued. Mr. Thompson moved that the proposed change be adopted. Mr. Anthony seconded, and the change was adopted.

There being no further comments on the proposed By-Laws, Mr. Thompson moved that the By-Laws, as amended be adopted; Mr. Anthony seconded, and the By-Laws as amended were adopted.

The adopted By-Laws are enclosed as Appendix B.

The next item on the agenda was the review and adoption of the "General Audit Plan" for the annual examination of the City's financial statements for the year ended June 30, 1979 as proposed by the consortium headed by Peat, Marwick, Mitchell, & Co. Mr. Defliese conducted the discussion one section at a time. (See Appendix C for General Audit Plan.)

Section I. Audit Objectives - No comments
Section II. The City - No comments
Section III. Overview of the City's Accounting System

A discussion of the Integrated Financial Management System (IFMS) ensued. Mr. Ives noted certain "bugs" still remain in the computer system and that they are being worked on. Mr. Hopp noted that Peat, Marwick, Mitchell & Co. (PMM) is doing an Electronic Data Processing (EDP) evaluation of the IFMS system.
Appendix A

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Section VI. Audit Approach

Concerning the internal control review, Mr. Forsythe inquired when the economic review, including PMM's analysis of the impact on City revenues, would be completed. Mr. Happ noted that this memo had already been completed. Included in the memo were reviews of recent City Official Statements, reports of other oversight bodies, and PMM's own economist's reviews. Mr. Defliese requested PMM send a copy of the memo to the Committee.

Concerning PMM's review of data processing centers, Mr. Ives noted that the City does do its own internal review of the data processing centers, but mainly from a "users" perspective, concentrating on timeliness of reports, percentage of "up-time" etc.

Materiality was the next topic discussed. The Audit Plan noted a materiality criteria of $193 million for the Statement of Revenues, Expenditures, Encumbrances and Transfers. Mr. Defliese questioned whether this implied that line items of less than $193 million would not be audited. Mr. Happ - No. The materiality amounts discussed on page 18 were used in determining statistical sample sizes. The consortium would not overlook an item of $193 million.
payments and accruals to the pension funds and the required contributions in accordance with GAAP.

VIII. Critical Audit Areas - No comments

There was no further discussion on the Audit Plan.

Mr. Anthony moved to adopt the Audit Plan as proposed with the clarifications noted. Mr. Thompson seconded the motion and the Audit Plan was adopted.

The next order of business were the five accounting issues. Mr. Rosen discussed in various memoranda submitted to the Committee (Appendix D):

- Accounting Treatment of Transfers from the Capital Budget
- Phase Out of Encumbrances
- Per Capita Aid Revenue Recognition
- MAC Refunding
- ECF Bond Issue

Accounting Treatment of Transfers from Capital Budget - This memo was written in response to a question proposed on June 25, 1979 by Mr. Thompson (included in Appendix D). Mr. Thompson also presented his July 23, 1979 memo which further explains his concerns. A general discussion ensued concerning the transfers from the Capital Budget; Mitchell Lama mortgage sales, MAC contributions and the $1,267 million change in estimate of bondable expenditures recorded as a charge to 1978's fund balance.

Mr. Thompson noted that the explanation to his question in the memo and the general discussion were satisfactory. However, Mr. Thompson further added that since part of the Capital Budget Transfers were in effect financed by the sale of Mitchell-Lama mortgages, the proceeds from the sale of Mitchell-Lama mortgages should be accounted for in the Statement of Changes in Fund Balance in the same manner that MAC bonds issued to finance Capital Budget Transfers are accounted for.
the threat of being named in this report may add further
pressure on the agency. Mr. Ives noted that the Mayor is
very responsive and supportive in having agencies comply.

Mr. Anthony raised the question of the bonus
payment chargeable to fiscal 1979 which will be paid during
1980. This issue was put on the Agenda for the next meeting.

Mr. Defliese asked if there was any new business.
Mr. Ives brought the Committee up to date on the progress of
the fixed asset accounting project. He noted that the project
was proceeding very well.

The date for the next meeting was scheduled for
October 3, 1979 at 10 a.m. The Preliminary agenda for this
meeting would include a discussion of the Peat, Marwick,
consortium's management letter, the MAC refunding
and Bonus issue. An additional October meeting was arranged
for Saturday, October 27, 1979 at 10 a.m. The tentative agenda
for the October 27 meeting was a review of the draft fiscal 1979
financial statements.

There being no further business, Mr. Peck moved for
adjournment and the meeting was adjourned.
MEMORANDUM

TO: Members of the Audit Committee of the City of New York
FROM: Sidney Schwartz

I have enclosed, for the consideration of the Committee Members, Statements of Position of my office on the two accounting matters related to the fiscal 1979 financial statements, which have been included in the proposed agenda for the October 3, 1979 meeting. In preparing these statements we have considered the views expressed in the memoranda prepared by the secretary of the Committee, Daniel P. Rosen.

We will be available at the October 3rd meeting to participate in the discussions of these matters.

cc: Daniel P. Rosen
Statement of Position

Accounting for "Non-Pensionable Cash Payments"

Background

In June 1978 the City entered into a collective bargaining agreement with a coalition of labor unions representing its employees, which contained a provision for payments of $1,500 to be made in FY 1979 and FY 1980 to employees "for services rendered during the City's fiscal years ending June 30, 1978 and June 30, 1979." (a) These payments were referred to by the City as "Non-Pensionable Cash Payments" (NPCP). The City accrued in its FY 1978 financial statements $216 million of the payments to be made in FY 1979 and FY 1980, and plans to charge another $110 million worth of payments to be made in FY 1980 to FY 1979. No FY 1980 charges are anticipated from this wage agreement, despite the fact that half of the cash payments will be made in that year. However, the City has indicated that certain payments related to the FY 1981 and FY 1982 wage settlements may be prefunded in FY 1980. The General Accounting Office (GAO) had previously questioned the validity of this accrual and proposed accounting treatment, stating that it believed that the payments charged to FY 1978 were substantive liabilities of FY 1979 and FY 1980 and that they were charged back to FY 1978 only to use up the State-defined budgetary surplus which was projected for that year. A copy of the GAO's statement on this matter is attached.

Statement of Position

We agree with the position taken by the GAO in this matter and believe that the NPCP which were charged by the City to FY 1978 should have been properly charged to FY 1979 and FY 1980. In our opinion, the NPCP payable in FY 1979 and FY 1980 in bi-weekly installments at the rate of $750 per annum represents a continuation of, and is substantially equivalent to, the approximately $700 annual cost-of-living adjustments (COLA) which were paid to the employees in FY 1978, but which were not continued in the new contract.

(a) Per the Coalition Economic Agreement.
In its place the new contract provided for an annual payment of $750 to be made in each paycheck. By charging $1,000 of the $1,500 payment to FY 1978, the City in effect charged 16 months of such payments (from July 1978 through October 1979) to FY 1978 based on the availability of funds, in addition to the regular COLA payments made in FY 1978.

Our conclusion in this matter is based on the following factors, some of which are presented in the GAO statement:

. The fact that the $1,500 payment was provided for in a contract covering FY 1979 and FY 1980, which was entered into at the very end of FY 1978. The contract covering the FY 1978 period had been negotiated some years earlier.

. The fact that eligibility for these payments was based in part on services to be rendered in FY 1979 and FY 1980, with employees not rendering such service ineligible for payments.

. The fact that even employees who were on leave of absence or on recall lists during FY 1978 are eligible for such payments in FY 1979 and FY 1980, based upon service in the latter years. (These employees performed no services and received no other compensation in FY 1978.)

. The fact that the agreement to distribute the surplus was made at the conclusion of the period during which the surplus was generated rather than at the start of the period, when such an agreement could have served as a basis for developing an employee incentive program to increase worker productivity.

. The fact that the amount of the payments charged to FY 1978 was based upon the size of the FY 1978 surplus without any attempt made to relate the amount distributed to employees to that portion of the surplus reasonably attributable to their efforts. In fact, the payment to be charged back to FY 1978 was originally computed as $937 but was revised to $1,000
when a larger surplus was projected. There is no other rationale for the distribution of the $1,500 payment between FY 1979 and FY 1980 except the estimated size of the FY 1978 surplus. In fact, when the City presented a financial plan modification to the FCB on June 25, 1978 incorporating the effects of the labor settlement, the entire surplus previously projected had been used for the labor settlement with the exception of a $100 million statutory general reserve.

The fact that the payments are made in each regular paycheck which tends to indicate that they are part of normal compensation in FY 1979 and FY 1980 as opposed to a bonus for services rendered in prior years.

All these facts support the conclusion that the chargebacks to FY 1978 and FY 1979 were used as budgetary expedients, and that the payments are in fact FY 1979 and FY 1980 labor costs pursuant to a contract entered into for the FY 1979 and FY 1980 contract period. As such, they should be recognized when the costs are incurred pursuant to GAAP.
Use of the 1978 surplus as funding source is not in accordance with generally accepted accounting principles.

You specifically asked that we look into the city's plan to utilize its 1978 "surplus" to fund this 1979-80 labor settlement and for our opinion as to whether this funding technique was in accordance with generally accepted accounting principles. 1/

The importance of your question, of course, lies in the fact that the city is functioning under strict annual financial plans, and so, charging the cost of this labor settlement 100% to 1979 and 1980 would increase the deficit in those years and require the city to make offsetting budget cuts. On the other hand, if the city charged approximately $220 million in expenses to 1978, that would substantially ease the budgetary pressures in 1979 and 1980 and obviate the need to make budget cuts to pay for this wage settlement.

In our opinion, the city's accounting treatment of the transaction is not in accordance with generally accepted accounting principles. The facts of the situation, as we see them, are as follows. In early April 1978, city officials indicated that they intended to use their 1978 underspending or surplus to provide some of the funding necessary to pay for the wage settlement which was being negotiated. At the time, however, it was not clear just what the surplus would be used for. The city's Deputy Mayor for Finance, had at one point, suggested the surplus might be used to pay for deferred cost of living adjustments. Subsequently, other city officials suggested the surplus might be used to pay for bonuses. During the course of all these discussions this issue had become a public one and was being explored in the local press in articles like "NYC AND UNIONS STUDY USING 78 SURPLUS". 2/

In addition to these discussions about what the so-called surplus would be used for, there were also discussions about how to arrange to use it. From an accounting standpoint this presented a problem. Some city officials initially suggested bringing forward the surplus into 1979 and using it as a revenue in that year. This idea was quickly rejected by the Special Deputy State Comptroller for New York City as not being in accordance with

1/ This surplus exists only under special accounting criteria in State law. According to generally accepted accounting principles, no surplus exists; in fact, a deficit resulted from 1978 operations and a very large cumulative deficit exists from previous years.

generally accepted accounting principles. His conclusion was based on the fact that there was no true surplus, but one existed only after certain adjustments permitted by State law. In addition, the city has a large cumulative deficit so that, under generally accepted accounting principles, there were no available funds to bring forward to 1979. We believe the Special Deputy Comptroller's conclusions are sound.

Ultimately, this matter was resolved when the city and the unions agreed that of the $1,500 cash payment ($750 x 2 years) $937.50 would be considered to have been earned in 1978 and charged to that year. Subsequently, this amount was charged to $1,000. If the payment was considered earned by the employees in 1978, the accounting problem would be solved since the payment could then be properly accounted for as a 1978 expense.

City officials conferred with their certified public accountants and prepared a representation letter which stated that $1,000 of the $1,500 in cash payments had been earned by the employees in 1978 and that it was the city's intention to expense the payments against fiscal year 1978. The CRs stated that, based on the city's representations as to when the payments were earned, the proposed accounting in their opinion would be in accordance with generally accepted accounting principles.

Our view of this transaction differs from that of the city and its CRs. As set forth in a statement of the Accounting Principles Board, a basic feature of financial accounting is that it emphasizes the economic substance of events rather than their form. In this case, the parties publicly stated on several occasions their intention was to utilize the 1978 surplus thereby easing 1979 and 1980 budgetary pressures. They stated that they would do so by some appropriate accounting technique which they had not yet decided upon.

Therefore we believe the use of the surplus and the relief of budgetary pressure in 1979 and 1980 was the objective of the parties and that is the substance of the transaction. In our opinion, this cannot be overlooked in assessing the propriety of the accounting involved. Looking toward the substance of the transaction then, we can see no justification for charging it as a 1978 expense.

Beyond the question of substance over form, there is, in our opinion, another flaw in the justification for charging this as a 1978 expense. The agreement requires that for employees to be paid the full $1,000 payment they must continue to work for the city during 1979 and part of 1980. This requirement clearly suggests that the employees have not earned the $1,000 payment for services rendered in 1978, and therefore that expense should not be charged to 1978.
In arriving at our assessment of this transaction we were guided in part by some particularly germane comments made some years ago in an accounting research study. While the study does not have the force of accounting principles it is nevertheless part of the accounting profession's body of knowledge. The authors said in part:

"Unless accountants are forewarned, they could slip into acceptance of accounting 'principles' which are not independent expressions of the results of accounting considerations but instead simply validate the policies established in the field of collective bargaining."

On July 17, 1978, we provided this section of the letter to the city for its review and comment. A copy of its comments is included as Enclosure III.

The city strongly disagrees with our opinion that its accounting for the costs of the labor settlement is not in accordance with generally accepted accounting principles. The city contends that budgetary relief for fiscal year 1979 and 1980 was only one of the effects of the settlement and not a primary objective as we contend.

The city's comments contain information which supports its accounting treatment of the labor settlement. According to the city, at meetings in early April, representatives of the Mayor's office expressed the city's intent to share part of the estimated statutory surplus with its employees, because the surplus was partially derived from increased employee productivity. The city states it was advised by its independent auditors that if payment to employees was earned and related to services provided in fiscal year 1978, the cost of that payment should be charged to 1978. The city maintains that since this was its intent, negotiating this concept with the unions was the problem it faced and not accounting for the transaction.

We recognize that payment for services rendered in a given fiscal year is an appropriate expense of that year. We nonetheless continue to believe that the size of the labor settlement coupled with the financial difficulties faced by the city and its need to ease budgetary pressures in fiscal years 1979 and 1980 were the motivating forces in arriving at the terms of the labor settlement. While relieving an immediate fiscal problem, this strategy...
compounds the financial pressures the city faces in the years beyond this contract. As a result, we feel strongly that charging part of the wage settlement to fiscal year 1978, a year in which the city anticipates a deficit under generally accepted accounting principles, not a surplus, obscures the impact of the settlement and will distort the results of the city's financial operations in fiscal year 1979 and 1980.

The overriding consideration from an accounting point of view is that under the terms of the labor agreement there is no liability for fiscal year 1978. The $1,000 payment is, in effect, for services to be rendered in fiscal year 1979 and part of fiscal year 1980, subject to the condition that the employee worked in fiscal year 1978. This amount was not earned in fiscal year 1978, because employees who do not work in fiscal years 1979 and 1980 are not entitled to the payment.
Statement of Position

Accounting for MAC Debt Refundings

Background

MAC withholds tax revenues ratably during the four quarters prior to
the quarter in which debt principal comes due and ratably over the two quarters
prior to the quarter in which debt interest comes due. In accordance with
this schedule, in FY 1979 MAC withheld funds in the last two quarters of
FY 1979 for the February 1, 1980 debt principal payment. On July 12, 1979
MAC proposed a refunding of $119 million of its outstanding bonds. The
proposed refunding would result in reduced MAC debt service in FY 1980 and
hence the need for a reduced MAC revenue 'takeout' in FY 1979. A question
arises as to whether the takeouts made in FY 1979 should be recognized as
MAC debt payments and hence general fund expenditures. Or whether since
subsequent events indicated that the withholdings were not needed, the take-
outs should be considered as advances and not general fund expenditures.

Statement of Position

MAC takeouts are computed in accordance with funding procedures contained
in various MAC bond resolutions. These resolutions specify the dates and
percentages of the takeouts that should be made each quarter to provide
for the payment of MAC debt service. MAC transfers are not arbitrary and
takeouts are made in accordance with the provisions of the bond
resolutions. Furthermore, because MAC's corporate purpose is to assist the
City, except for takeouts for administrative expenses, all funds withheld
by MAC are used for debt purposes or returned to the City. Clearly then if
during the fiscal year as a result of some inadvertent error or subsequent change in events it was determined that an excessive takeout had been made, it would be treated as an advance and an adjustment would subsequently be made in that year. In the instant case as well, it is anticipated that MAC will reduce its takeout in October to reflect the overwithholding made in April and June. The question that arises here, however, is since the amount of the excessive transfer was not known at June 30, 1979 should an adjustment to this debt service estimate be made as a result of subsequent information.

Statement on Auditing Standards (SAS) No. 1 provides that

"events or transactions sometimes occurring subsequent to the balance sheet date, but prior to the issuance of the financial statements... have a material effect on the financial statements and therefore require adjustment or disclosure in the statements" and "All information that becomes available prior to issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates are based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence."

Adjustments of this type are mandated when changes occur which represent the culmination of conditions that existed over a relatively long period of time. On the other hand, subsequent events which occur completely after the balance sheet dates do not warrant adjustments. Examples of the latter cited in the SAS are:

Settlement of litigation when the event giving rise to the claim took place subsequent to the balance-sheet date.

Loss of plant or inventories as a result of fire or flood.

Losses on receivables resulting from conditions (such as a customer's major casualty) arising subsequent to the balance-sheet date.
Thus in order to determine if FY 1979 recognition of the subsequent event was appropriate, a determination has to be made as to whether the event began during fiscal year 1979. With regards to the FY 1980 refunding plan, the following had occurred by June 30, 1979.

Funds for a MAC refunding were provided for in the four-year financing plan entered into on November 15, 1978 with $600 million of the financing proceeds pursuant to that plan earmarked for refunding purposes.

The financial plan approved by the Financial Control Board in November 1978 and every financial plan approved thereafter provided for an estimated reduction in MAC debt service as a result of the refunding.

The FY 1980 refunding was anticipated in the City's Executive Budget for FY 1980 issued on April 26, 1979. As noted in the Mayor's Budget Message: "The MAC debt service funding requirement also reflects savings from the projected refunding of certain outstanding MAC bonds in advance of their maturity." A similar statement was also included in the City's Official Statement dated June 28, 1979. Both MAC and the FCB accepted this anticipation as reasonable.

Clearly then events during FY 1979 reflected the anticipation that the FY 1979 takeout would be excessive and this fact was confirmed shortly after year-end. The actual July 12 refunding proposal and the subsequent closing on August 16, 1979 thus represented the culmination of a series of related events which provided further evidence regarding the availability of the withheld tax revenues and estimates of MAC debt service as of June 30, 1979. Pursuant to GAAP, therefore this information should be reflected in the preparation of the FY 1979 financial statements.
We note that the same conclusion was reached by Peat, Marwick, Mitchell & Company (PMM) in FY 1977 with regards to a similar instance. In that year MAC was contemplating a restructuring of some $2.5 billion of outstanding City and MAC debt held by the clearinghouse banks and the City's sinking funds and pension funds. At June 30, 1977, however, although there was an anticipation that a restructuring agreement would be concluded, the terms of the restructuring were still not agreed upon. For instance, at June 30, there was an anticipation that the restructured bonds would carry an interest rate of 6 percent. Ultimately the rate negotiated was 7\% percent - for an additional cost of $355 million over the life of the bonds. Also, one of the parties to the negotiation at June 30 - the City's sinking funds - ultimately did not participate. The terms and the maturities of the bonds also had not yet been agreed to. Nonetheless, because the restructuring effort had begun before June 30, 1977 and because an agreement was reached prior to the issuances of the 1977 financial statements, the need for adjustment was deemed necessary. The facts in this instant case, where the transactions are less complex, certainly warrant a similar conclusion.

City Controller's Opinion

In a memorandum for the record dated September 10, 1979 Daniel P. Rosen, Assistant City Controller for Financial Management, concluded that:

"When MAC has an advance refunding of any of its publicly-held securities, any funding (or "takeout") in one fiscal year for interest or principal payments to be made to bondholders in the following fiscal year (which would be reduced because of the refunding) shall be considered General Fund expenditures in the fiscal year the take-out is made."
A number of factors were cited as the basis for that conclusion. A discussion of these factors follows.

**Factor Cited**

- The fact that GAAP permits the City to make a managerial decision to transfer to debt service funds an amount greater than the actual debt service, provided it discloses the impact of such a transfer.

**Discussion**

The National Council on Government Accounting (NCGA) Statement No. 1 provides that "transfers should be recognized in the accounting period in which the interfund receivable and payable arise." The purpose of this criterion is to preserve the discrete nature of each fund's transactions while at the same time providing a rational guideline for the interfund transfer of resources. The criterion clearly was not intended to permit arbitrary transfers between funds which could result in obscuring the actual operating results of the respective funds. With respect to MAC debt service, as noted previously, the interfund payables arise as a result of MAC certifications issued in accordance with a pre-set procedure based on the various MAC bond resolutions. Consistent with historical policy, there was no managerial decision to arbitrarily increase funding. Rather, the funding decision was based upon existing debt service assumptions which, however, were expected to change. Therefore, since subsequent information (by August 1979) revealed that the takeout was in excess of that required, an adjustment of the takeout is required which should be recognized in FY 1979.

It should be further noted that restricting transfers to actual needs provides a consistent and logical basis for budgeting MAC debt service and yearly reporting. By contrast, any treatment involving arbitrary transfers would be inconsistent with past practice, would provide no basis
for rational annual budget development, and would vitiate the controls
over the annual budget process contained in both Federal and State legislation.
(Similar concerns were also acknowledged in the City Controller's
memorandum.)

Factor Cited

- The fact that MAC was legally required to "take-out" the debt service prior to June 30, 1979.

Discussion

Although legally required as of June 30, subsequent events indicated that in fact no takeout was necessary and thus the takeout should be recognized as an advance which will be adjusted in either October 1979 or January 1980. Similarly in 1977, when the City was in the midst of a debt restructure, Peat, Marwick, Mitchell & Company stated that the takeout revenues should be accrued even though MAC was legally required to takeout the debt service prior to June 30 of that year.

Factor Cited

- The fact that budgetary discipline is enhanced by eliminating the guesswork involved in trying to anticipate refundings taking place 18 months after the budget is prepared.

- The fact that accounting and budgeting is kept in tandem by such a decision.

Discussion

As noted previously, the FY 1980 budget prepared in April of 1979 anticipated that the MAC refunding would occur. By contrast, the accounting treatment proposed by the City implies that the takeouts were necessary and thus that the refunding would not occur. As noted by FMM in relation to the FY 1977 restructuring:

"We believe there is an inconsistency in developing a budget during the fiscal year ending June 30, 1977 for the fiscal year ending June 30, 1978 that projects a savings from the deferral of anticipated principal payments, and at the same time concluding that the taken-out revenues will be required for the principal payments in fiscal 1978 and thus are not available in fiscal 1977."
A similar inconsistency is evident in this case. In contrast, accounting and budgeting would be kept in tandem if consistent assumptions were used for both the budget and financial report.

As for the fact that the refunding could not reasonably have been anticipated in April 1978 when the FY 1979 budget was prepared, the City's budget process is one of flux and modifications are made routinely. A quarterly modification schedule is also provided by law for the financial plan; refunding savings would thus be reflected in the budget at some later point in the process. We note that the City insisted on recognizing as a FY 1978 charge $93 million in debt service costs resulting from the establishment of the debt service fund in FY 1979 even though there was no anticipation of these costs when the FY 1978 budget was prepared.

Factor Cited

- The fact that this policy provides a conservative accounting treatment by recognizing debt service expense at the time of the "take-outs".

Discussion

The recognition of debt service costs at the point of takeout regardless of the merits of that takeout rather than being a conservative policy is one that could result in significant budgetary abuse. Takeouts could be made to shift revenues and expenditures from one fiscal period to another without regard for economic substance. Furthermore, in this case the effects of this policy are for the City to realize eighteen months worth of savings in FY 1980 instead of the normal twelve months. Thus, this accounting treatment as opposed to recognition of the first six months of refunding savings in FY 1979 when the takeout occurred provides the City with more spending power over the two-year period without any concomitant increase in funds. This creation of additional spending power without an increase in funds is not consistent with the conservativism concept.
Conclusion

Based on the factors cited and our evaluation of the City Controller's opinion, we believe that pursuant to GAAP (particularly SAS No. 1) the reduction in debt service costs due to refunding should be recognized in FY 1979 when the debt service costs were incurred. This conclusion results in a more consistent and conservative accounting policy which relates the savings to proper fiscal years rather than grouping eighteen months worth of savings in one year and is in line with previous decisions made by the City and PMM in similar circumstances in the past.
August 31, 1979

Mr. Robert Vagt
Executive Director
Municipal Assistance Corporation
1 World Trade Center
New York, NY

Dear Mr. Vagt:

Submitted herewith is a memorandum relating to my attendance at the New York City Audit Committee meeting as an observer.

Copies of the memorandum have also been furnished to the Executive Director of the Financial Control Board, the members of the Municipal Assistance Corporation and to the private members of the Financial Control Board.

Sincerely yours,

[Signature]

Sidney Schwartz
The New York City Audit Committee established pursuant to Federal and State legislation held its first meeting on March 29, 1979. A second meeting was held on July 24, 1979.

I attended both these meetings as an official observer. The Director of my Special Projects Bureau accompanied me and will act as my alternate in the event I am unable to be present at any of the meetings. The Executive Director of the Financial Control Board also asked that I act as an observer on his behalf.

A full description of the proceedings of these meetings is contained in the official meeting minutes. However, as of this date copies of the minutes of the first meeting as revised and approved have not yet been prepared and draft minutes of the second meeting are not yet available. Accordingly, I have prepared a synopsis of the proceedings of these meetings in this memorandum.

The March 29 meeting was largely organizational in nature. Philip Defliese, one of the two private Certified Public Accountants on the Committee, was elected Chairman of the Committee. He indicated that he would establish a subcommittee to draft by-laws prior to the next meeting. After his election, a briefing on New York City's financial history was given by Mr. Ives. Mr. Ives also discussed the management letter which had been prepared by Peat, Marwick, Mitchell & Company (PM&M) and summarized what the City was doing in dealing with some of the matters raised in that letter. Mr. Happ of PM&M also indicated
that some of the matters raised in the management letter would be discussed in our audit progress report for FY 1979, which would be available later on in the year.

Mr. Anthony, one of the other accountants on the Committee, then raised the question as to the Committee's involvement in the resolution of "accounting issues". Mr. Anthony indicated that the Committee would expect to look into such issues that may arise in the future. Mr. Happ and Mr. Ives both indicated that the Committee's views on these matters would be sought. Mr. Defliese then adjourned the meeting, noting that he would be ready to reconvene the group promptly if significant accounting issues were raised relating to the FY 1980 budget.

The second meeting took place on July 29, 1979. After some discussions the Committee adopted by-laws and approved the minutes of the prior meeting. The Committee also appointed Dan Rosen, Assistant City Controller for Financial Management, to be the Secretary of the Committee.

The Committee then began its review of matters related to the FY 1979 audit. First, the Committee reviewed and approved an audit plan for FY 1979 which had been prepared by PM&M. Then a number of issues related to the FY 1979 audit were raised. The issues related to a) the accounting treatment of transfers from the Capital Budget, b) the phase out of encumbrances, c) Per Capita aid revenue recognition, d) MAC refunding and e) the ECF bond issue. These issues and the City Controller's views thereon are discussed in a memorandum prepared by Dan Rosen (copies of which are attached). An OSDC staff memorandum on two of these subjects is also attached. After much discussion, particularly related to the encumbrance issue and the MAC refunding issue (both of which have budgetary implications), it was agreed that these matters would be considered by the Committee once
again in its meeting of October 3. Prior to that time, however, those present were invited to present memorandum to the Committee on these subjects. It is my intention to submit a memorandum of these subjects to the Committee members before the October 3 meeting.

The Chairman adjourned the meeting noting that there would be at least two more meetings before the completion of the audit. One on October 3, 1979 to resolve any outstanding accounting issues (those cited in this memo, and others which might be brought to their attention) and one on October 27, 1979 to review the draft financial statements prior to their issuance.

SS/mer
Attachments

Audit Committee
Enclosed Memoranda from Daniel P. Rosen
Phase Out of Encumbrances
Per Capita Aid Revenue Recognition
Encumbrance Policy
MAC Refundings
ECF Bond Issue
Transfers from the Capital Budget
DEPARTMENT OF AUDIT AND CONTROL

INTER-OFFICE MEMORANDUM

To: Sidney Schwartz

From: Abe Biderman

Date: July 23, 1979

Subject: Audit Committee

In preparation for the Audit Committee meeting of July 24, 1979, Dan Roson prepared five memoranda concerning various accounting issues. In a covering memo he noted that "the City does not consider any of these matters to be controversial, nor have any of the City's fiscal monitors raised these or any new accounting issues".

I do not believe that this statement accurately reflects our thinking on these matters. In point of fact, we have raised the issue regarding the MAC refunding in our draft report on the Four Year Adopted Financial Plan. Furthermore, the accounting treatment proposed as a result of the revised encumbrance procedure raises serious questions and should be carefully reviewed before it is put into effect.

The questions raised by the proposed policies as reflected in these memoranda are discussed below.

Encumbrance Policy

The memoranda concluded that the phase-out of the encumbrance policy in FY 1979 and FY 1980 is not an accounting change that requires an adjustment of the beginning fund balance in accordance with APB 20. To support this conclusion, it states that the changes being proposed by the City Comptroller for FY 1979 and FY 1980 are merely a further 'tightening' of the existing method.
APB 20, in discussing accounting principles for which a restatement is required notes the following. "The term accounting principle includes not only accounting principles and practices but also the method of applying them". As noted in the memo, the proposed encumbrance policy may result in a 25% reduction in City encumbrances - $50 million out of a total FY 1978 encumbrance of $195 million. We believe this type of change with an estimated effect of the magnitude noted would be a revised method of application within the scope of the APB.

This conclusion is also supported by data contained in M. Ives' letter to J. Brigham of March 12, 1978. In that letter M. Ives stated that "as late as March 7, 1979 there were more than $60 million of unliquidated OITPS encumbrances applicable to fiscal 1978". Since none of these encumbrances would have been outstanding pursuant to the newly proposed procedures, a change in policy of significant magnitude is obviously being contemplated.

The need for consistent application of accounting principles clearly requires that appropriate adjustments be made to both the opening and closing encumbrance balances, if any significant procedural changes are made.

Another point to consider is the impact the proposed change would have on the City's budget. Because of the interrelationship between the City's budget and accounting procedures, the proposed decision to recognize the impact of the change in the year in which it occurred (primarily FY 1980) would result in the City's having available for appropriation and expenditures in FY 1980 up to an additional $50 million. These amounts exist not as a result of City initiatives to increase revenues or reduce expenditures but purely as a result of a revised determination as to which fiscal period the expenditures should be recognized. This funding source created solely by the change in an accounting technique between the beginning and end of the fiscal period is reminiscent of the procedures which helped precipitate the
fiscal crises - wherein funds would be created by changes in accounting policies, which resulted in one shot revenue increases or expenditure reductions.

In summary, therefore, the change in encumbrance policy, if it has a material impact on the amount of encumbrances registered, should be recognized as a prior period adjustment in accordance with GAAP and sound fiscal policy.

MAC Refunding

The memorandum concludes that the impact on the FY 1979 takeout of the current MAC refunding requires a different accounting treatment than did the impact of the restructuring agreement on the FY 1977 takeout. In support of this conclusion, the memorandum notes the following:

"The factors that existed in 1977 do not parallel those in existence today. To begin with, the restructuring accomplished in 1977 was negotiated privately between the clearing house banks, MAC, the City and the pension systems; was disclosed in City and MAC Officials Statements; and was well along prior to June 30, 1977. The future refundings in MAC's financing plan will be of publicly held bonds and be accomplished through public announcements pursuant to applicable securities laws. Also, the 1979 balance sheet date has not past without any refunding announcements being made by MAC. At this time, any estimates of the effect of a refunding are speculative. Thus, the only similarities between the present situation and the 1977 restructuring is that the April and June MAC take-outs are affected."

I believe that these conclusions may not be warranted and that some of the statements are not completely accurate. The basic questions which must be addressed in deciding whether accrual is warranted are a) whether there was a reasonable prospect at June 30, 1979 that the tax revenues would be available for FY 1979 and b) whether subsequent events confirmed these conclusions. As regards the prospects as of June 30, PMM in 1977 noted

"...we believe there is an inconsistency in developing a budget during the fiscal year ending June 30, 1977 for the fiscal year ending June 30, 1978 that projects a savings from the deferral of anticipated principal payments, and at the same time concluding that the taken-out revenues will be required for the principal payments in fiscal 1978 and thus are not available in fiscal 1977."
A similar situation exists at this time. As noted in the Mayor's Message dated April 29, 1979 "the MAC debt service funding requirement also reflects savings from the projected refunding of certain outstanding MAC bonds in advance of their maturity". A similar statement was also included in the City's Official Statement dated June 28, 1979. Clearly than the anticipation that the refunding would occur and that the revenues would be available was an integral part of the City's Financial Plan and it would be inconsistent to assume differently for financial statement purposes. It should also be pointed out that some $600 million of the $4.5 billion in proceeds anticipated from the Four Year Financial Plan entered into in November of 1978 was earmarked for the refunding of MAC debt.

The statement made that "any estimates of the effects of the refunding are purely speculative" is also refuted by the fact that estimates of the refunding savings are reflected as part of the MAC debt service requirement in both the Adopted Budget and Four Year Financial Plan and have been reflected in such plans since the financing agreement was negotiated in November of 1978. In fact, no changes in those estimates have been made since November.

As regards subsequent events; on July 12, 1979 MAC announced a plan to advance refund in August 1, 1979 outstanding bonds with an aggregate value of $119 million. As a result of the refunding, $17 million in tax revenues which were taken out by MAC prior to July 1 will now be available. To the degree that this refunding is successful it represents the culmination of a series of related events which began well before the end of this fiscal year and which were anticipated in the City's financial plan. Accordingly, they provide additional evidence to management that the FY 1979 tax revenues withheld by MAC are available and hence subject to FY 1979 accrual.

AB/mer
cc: L. Halpern
    I. Cohen
    A. Greenstein
July 11, 1979

TO: MEMBERS OF THE AUDIT COMMITTEE OF THE CITY OF NEW YORK

FROM: DANIEL P. ROSEN, Assistant Comptroller (Financial Management)

SUBJECT: ENCLOSED MEMORANDA

Enclosed are 5 memoranda concerning various accounting issues. One memorandum is written at the request of Philip Defliese in response to John Thompson's letter of June 25. The remaining four memoranda deal with certain accounting and financial reporting issues that City officials and Peat Marwick have discussed at various times in recent months.

I would like to emphasize that the City does not consider any of these to be controversial, nor have any of the City's fiscal monitors raised these or any new accounting issues. These four memoranda are nevertheless presented to the committee since they are representative of the type of accounting issues the City faces.
July 9, 1979

TO: MEMBERS OF THE AUDIT COMMITTEE OF THE CITY OF NEW YORK

FROM: DANIEL P. ROSEN, Assistant Comptroller (Financial Management)

SUBJECT: ACCOUNTING TREATMENT OF TRANSFERS FROM CAPITAL BUDGET

Philip DeFliese, Chairman of the City's Audit Committee has requested that the Comptroller's Office provide the committee with an explanation of the accounting treatment of transfers from the capital budget to the expense budget. Specifically, John Thompson raised certain issues detailed in the attached letter.

On a Financial Plan Basis, the City's FY 1978 financial statements include as a revenue $633,024,000 captioned "Transfers From Capital Budget." This transfer consists of $56,362,000 of expenditures, pursuant to interfund agreements ("IFA's") which are properly includable in the capital budget, and $576,662,000 of operating expenses funded by transfers from the capital budget. However, on the "Accounting Basis" which is in accordance with generally accepted accounting principles ("GAAP"), there are no transfers from the capital budget shown as a revenue. The IFA's are treated as an expenditure reduction. Therefore, the net accumulated fund balance deficit as of June 30, 1978 is a true deficit not distorted by any legally permitted deviations from GAAP.

To fully respond to Mr. Thompson's question, and since showing transfers from the capital budget as a revenue source is a deviation from GAAP that is unique to the City, it would be helpful to provide the audit committee with the historical background on the City's accounting for this deviation from GAAP.
Prior to FY 1977, expense items financed from the capital budget were not included in the General Fund but rather as part of the Capital Projects Fund. Therefore, since the General Fund did not include any capitalized expense items, the deficit reported in FY 1976 was not affected by these capitalized expense items. The City's financial reporting was substantially improved during FY 1977. All expense items were included in the General Fund, and the concept of "Fund Balance Credits" was expanded upon and refined.

Fund balance credits reduce the City's gross deficit. These credits arise from cash contributions from MAC, MAC acquisitions of City debt, and certain City issued bonds (e.g., the bonding during FY 1978 of $117,275,000 for the moratorium judgment) and $23,701,000 for other judgments and claims. The bonds and cash transfers from MAC that give rise to these "credits" are forms of deficit financing sometimes called "deficit bonds". These fund balance credits are reduced, with a corresponding reduction in the City's gross deficit, when MAC debt is redeemed or when City issued deficit bonds are redeemed. For illustrations of this accounting treatment, please refer to the Comptroller's Annual Report, "General Fund Statement of Changes in Fund Balance" for the year ended June 30, 1978.

An example of deficit financing is given under the heading "Other Charges, Credits and Transfers," in the line "Conversion of short to long term debt." Here, the fund balance credits are increased by $117,275,000 from the bonding of the moratorium judgment. This credit therefore reduces the City's cumulative deficit.

An example of the reduction of the fund balance credit and a corresponding reduction of the gross fund balance deficit is shown in the "Redemption of debt" line. Here, the fund balance credits "Contribution From MAC" and "MAC Acquisition of Short-Term Debt" are reduced, reflecting the pro-rata portion of MAC debt, which gave rise to the fund balance credits, redeemed during FY 1978. Since these two reductions in the fund balance credits are offset by a reduction in the cumulative gross deficit, there is no net effect on the net fund balance as the deficit bonds are redeemed.

To summarize, the City's net deficit is immediately reduced by the deficit financing (which is isolated as a fund balance credit). And as the deficit bonds are redeemed, these credits are reduced along with a corresponding reduction in the gross fund balance deficit.
I also would like to clarify another item raised by Mr. Thompson concerning the FY 1978 financial statements that still may be unclear. The increase of $1,267,160,000 in the City's accumulated deficit results from a change in estimate of operating expenses which the City had anticipated would be bonded. This increase in the deficit is fully disclosed in Note C of the 1978 audited financial statements:

"At June 30, 1977, pending review by its bond counsel, the City had segregated that portion of the General Fund accumulated deficit which in its opinion could be financed from bond proceeds; i.e., operating expenditures from Capital Budget appropriations. Based upon a review of individual items of expenditure, the City's bond counsel concluded that bonds could not be legally issued for a substantial portion of such expenditures. Accordingly, the City determined that the entire "Amount to be Financed" at June 30, 1977 ($1,267 million) should be added to the accumulated deficit. Currently, only those bonds actually sold for such purposes will be reported as fund balance credits."

In conclusion, to answer Mr. Thompson's questions, the net fund balance deficit is reduced as it is financed through the sale of either MAC or City bonds. To the extent that it is not financed, the deficit is increased. The deficit is also segregated into an unfinanced amount, the net deficit, and a financed amount, the fund balance credits. As the deficit is financed it is reduced through the creation of fund balance credits. As the financings are repaid, the credits are reduced as well as the gross deficit.

The contents of this memo have been reviewed by representatives of Peat, Marwick, Mitchell & Co., and they concur with the conclusions expressed in the memo.
Mr. Philip L. Defliese  
Coopers & Lybrand  
1251 Avenue of the Americas  
New York, N.Y. 10020

Dear Phil:

Responding to your memo of June 5, I would like to suggest as a subject for discussion at the July 24 meeting of the Audit Committee the accounting treatment of transfers from the capital budget to the expense budget. The amount of these is scheduled to decline and then to terminate at the close of the four-year plan.

The audited figures in the Comptroller's Report for fiscal 1978 show this transfer as $633,024,000, making up most of the $712,132,000 operating deficit according to generally accepted accounting principles (page 4). In the "Statement of Changes in the Fund Balance" (page 5) the increase in the accumulated fund balance deficit from June 30, 1977 to June 30, 1978 is due almost entirely to the $712 million deficit and the revised treatment of "bondable operating expenses," presumably carried forward from previous years.

The question I wish to raise is this: should not this accumulated fund balance deficit be reduced each year by the amount of those New York City bonds retired and paid each year, which were initially issued to fund operating expenses paid by transfer from the capital budget in previous years? So far as I can see these amounts are not separately identified in the Report, but I should think they would be available. It is my belief that the bonds sold for this purpose were always one to five year serial maturities. As a result, if the amount each year remained static, after five years the amount of bonds retired would equal the new transfers from the capital budget. Rephrasing my question: if the fund balance accumulated deficit is increased each year by the amount transferred from the capital-budget and financed from bond issues, should not that deficit also be reduced each year by the amount of bonds retired from similar financings in previous years?
I find it hard to reconcile the increasing fund balance deficit with the declining balance of combined City and MAC debt. The total can be obtained by adding the totals for each in footnote G 1 on page 16. This total was $12.861 billion on July 1, 1977, and $12.485 billion on June 30, 1978. There was a similar decline in fiscal 1977.

Whether this question warrants a place on the agenda I will leave to you as chairman, but I would like to have the matter discussed.

With best wishes,

Sincerely,

[Signature]

John F. Thompson

Copy: Mr. Daniel P. Rosen
TO: DISTRIBUTION
FROM: DANIEL P. ROSEN
SUBJECT: PHASE OUT OF ENCUMBRANCES

BACKGROUND

Statement 1 - Governmental Accounting And Financial Reporting Principles, issued by the NCGA has been accepted by the AICPA and constitutes GAAP for municipalities. One of the major changes resulting from the issuance of Statement 1 is that the "encumbrance method" is no longer an acceptable option for municipalities. Therefore, for the City's fiscal year beginning July 1, 1980, encumbrances will no longer be treated in a manner similar to expenditures, and only liabilities (accounts payable and accrued expenditures) will flow through the operating statement.

On March 16, 1979, officials of the Comptroller's Office, OMB, and Peat Marwick met to discuss Marty Ives March 12 memorandum to Jim Brigham concerning the City's encumbrance accounting policies (attached). (With the issuance of Statement 1 this memo is now considered City policy). Because of the difficulties encountered in having the agencies properly account for encumbrances, as detailed in instructional memoranda
from the Comptroller's Office, we agreed that the proposed phase-out of encumbrance accounting and move toward pure accrued expenditure reporting over a three year period makes sense.

This change has a major budgetary impact as well as an accounting impact. At the meeting we generally discussed the need for a dual budget— an "Expense Budget" in conformity with GAAP and an "Obligation Budget" which would authorize agencies to commit resources for purchases that require long lead time. However, major budgetary issues will certainly require considerable discussion and refinement over the next few years.

(Encumbrances, as discussed in this memo, refer to "pure encumbrances." It must be noted that many agency officials do not distinguish true accrued expenditures (e.g. accruals for estimated additional electric bills for services already provided) from other encumbrances (e.g. purchase orders for streetlights not received by June 30.) These distinctions will be impressed on the agencies during the 1979 financial statement closing period and subsequent submissions to FISA.)

ACCOUNTING IMPACT

Statement 1 provides guidance for accounting and reporting for the City's change in encumbrance policy for FY 1981:

"Adjustments resulting from a change to comply with these principles should be treated as adjustments of prior periods, and financial statements presented for the periods so effected should be restated. In the years in which these principles are first applied, the financial statements should disclose the nature of any restatements and their effects."
Clearly, accounting and reporting of the change in FY 1981 is covered by Statement 1. However, there is still the question concerning the effect of phasing in this change in FY 1979 and FY 1980.

Accounting changes other than those governed by specific transition rules (similar to the above), are governed by APB Opinion No. 20, as amended, particularly paragraph 7:

"A change in accounting principle results from adoption of a generally accepted accounting principle different from the one used previously for reporting purposes. The term accounting principle includes 'not only accounting principles and practices but also the methods of applying them.'"

Reporting of accounting changes is governed by paragraph 19 which requires that the "...cumulative effect of changing to a new accounting principle on the amount of (fund balance) at the beginning of the period in which the change is made should be included in (operations) of the period of the change." The "cumulative effect" which would be reported is the difference between the beginning fund balance in the year of change and what the beginning fund balance would have been if the new accounting principle (or application of the principal) was in effect prior to the year of change.

The question therefore becomes whether the phase-in of the "accrued expenditure only" policy results in an accounting change during FY 1979 and FY 1980. It is my conclusion that we do not have an accounting change until FY 1981. The following sections deal with how I have arrived at this conclusion.
FY 1979

"For the year ended June 30, 1979 we will continue to use encumbrance accounting. However, valid encumbrances will consist only of (a) those items that have actually been delivered by August 31, 1979 and (b) those additional items that can be clearly demonstrated to be deliverable by December 31, 1979. Unless the supplies have been delivered or the services rendered by December 31, the encumbrance will be reversed."

Application of this policy will not result in an accounting change.

The only difference between encumbrance policies for FY 1979 and FY 1978 is that in order to document the validity of an encumbrance in FY 1979, the agencies will have to clearly demonstrate that the item will be delivered by December 31, 1979. For FY 1978, we required a letter from the vendor that explained why goods ordered prior to June 30, 1978 could not be delivered by August 31, 1978 and that the Agency has requested delivery as soon as possible after receipt of the purchase order.

For FY 1979, we will merely be putting a more definitive time frame in our encumbrance guidelines to the agencies. We will require a letter from the vendor that explains why goods ordered prior to June 30, 1979 could not be delivered by August 31, 1979, and that the Agency has requested delivery as soon as possible after receipt of the purchase order and that the vendor will deliver by December 31, 1979.
Thus, what we have done is to further define for the Agencies (without changing the basic encumbrance policy) what constitutes a valid encumbrance chargeable to FY 1979 — we have not effected a change in accounting principles. In particular, I also conclude that we have not changed the method of applying the encumbrance policy. Since we have not effected a change in accounting principles, no disclosure is required concerning the encumbrance policy for FY 1979.

**FY 1980**

"For the year ended June 30, 1980, we would consider as valid encumbrances only those items that have been delivered by August 31, 1980. Unless delivered, the encumbrance will be reversed."

For FY 1980 this means that agencies no longer will be allowed to charge FY 1980 for items requiring a lead time beyond August 31. Again, this is a further "tightening" of the encumbrance policy. Whether this tightening results in a change in accounting principles (i.e., "a change in method of applying an accounting principle") depends on the materiality of the effect of eliminating lead time items.

Excluding transfers and other payments to debt service funds, the City incurred $11,608 million in expenditures and encumbrances during FY 1978. Outstanding encumbrances as of June 30, 1978 were approximately $195 million. Of this amount officials in the Bureau of Accountancy who controlled the reinstatement of encumbrances last fall, estimate that no more than $10-50 million of the $195 million relate to lead time items beyond August 31. $10-50 million is certainly not material relative to $11.6 billion.
In addition, officials at OMB have indicated that agencies will be strongly encouraged to speed up the timing of their major expenditures to facilitate delivery by August 31. If this is the case, then it is very possible that the effect of eliminating any encumbrances where the goods or services were not received by August 31 would certainly be even less than the $10-50 million estimate for FY 1978.

CONCLUSIONS

Since the cut-off in FY 1980 is only for lead-time items extending beyond August 31, and if it is adequately documented that agencies have expedited their timing of planned expenditures (this would be the case if only minor write-off's occur as of August 31, 1980), then a very strong case can be made that FY 1979 and FY 1980 encumbrance methods are comparable and that only an immaterial change in accounting policy has occurred, and additional financial statement disclosure is not required. This is the position I take.

Therefore, agencies must understand that all of their planned FY 1980 purchases requiring more than a 60 day lead time be made sufficiently early to allow delivery by August 31, 1980. This would avoid the need to use the "cummulative effect" accounting approach for FY 1980. From a financial reporting viewpoint and comparability between fiscal years, it certainly would be undesirable to have a cummulative effect in FY 1980 followed by a restatement in FY 1981.
Budgetary Considerations

City agencies presently cannot enter into purchase commitments or contracts without encumbrance authority. I think we all agree that the encumbrance concept does impose necessary controls on agency expenditures. Although the encumbrance concept has been abused by the agencies, this control feature needs strengthening, not elimination. The movement toward accrued expenditure accounting will therefore require agencies to control both encumbrances and accrued expenses.

Unless spending authority is provided in an agency's budget, the agency cannot encumber funds by issuing purchase orders. Since certain agency purchases require long lead times (sometimes in excess of one year) purchase orders that are not filled prior to June 30 of any given year must be able to extend into the following fiscal year.

Budgets, therefore, must be adopted on both an accrued expenditure basis and on an encumbrance authority basis. Using the assumptions given below, the following "budget" would result for FY 1981, if this method was adopted for the 1981 fiscal year:

<table>
<thead>
<tr>
<th>Liquidation of 1980 encumbrances (a)</th>
<th>1981 &quot;spending&quot; plus accrued encumbrances (b)</th>
<th>1981 estimated encumbrances (c)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$115 million</td>
<td>$1 billion</td>
<td>$100 million</td>
</tr>
</tbody>
</table>
Thus, the charge to the 1981 "expense" budget is $1.115 billion (a & b) and the charge to the 1981 "obligation" budget is $1.1 billion (b & c). In the financial statements for FY 1981, the $100 million would be shown as a reservation of fund balance.

It seems to me that only minor modifications would have to be made to the IFMS system in order to maintain control over the dual expense - obligation budget format. The larger question arises, however, in determining an appropriate cut-off at June 30. Agencies presently do not have the discipline required to facilitate a "clean" cut-off of accrued expenses as of June 30 of any given year. I see this as a major audit and reporting problem unless all agencies adopt standardized cut-off features at year end. These procedures should facilitate maintenance of a good audit trail.

The system modifications required by this change in use of encumbrances should be made in as short a time frame as is possible. The key to the changeover is not the dual encumbrance/accrued expenditure budgets, but the ability to document a clean cut-off at June 30 in order to report only true accrued expenditures.
THE CITY OF NEW YORK
OFFICE OF THE COMPTROLLER

To: MARTY IVES, LOU FRIEDRICH

From: DAN ROSEN

Subject: PER CAPITA AID REVENUE RECOGNITION

April 26, 1979

The recently enacted State Budget provides for the receipt of per capita aid by the City in two different fiscal years of the City. It is my opinion that this aid be recognized as revenue in the fiscal year in which the entitlement period commences.

DISCUSSION

$909.28 million in local assistance aid has been approved by the state legislature by means of two appropriations. The first appropriation, for $902.28 million, has an entitlement period beginning April 1, 1979, and provides for payment of approximately $483 million to the City during June of 1979 — clearly 1979 revenue. The second appropriation for $87 million, has a twenty-four month entitlement period beginning April 1, 1979. However, for the City's portion of this appropriation, approximately $52 million, the entitlement period does not begin until July 1, 1979, and payment will not be received until April 15, 1980. Because of these factors, a question may arise whether the additional $52 million to be received on April 15, 1980 is susceptible to accrual at June 30, 1979.
The rationale for accruing would be that the $52 million is either measurable and available to finance the City's operations, or of a material amount not received at the normal time of receipt. In my opinion, there is no merit in either argument since the aid is not really "available" to the City, nor of a material amount not received at the normal time for receipt.

From one perspective, to determine availability, one must look to the State to determine both the intent of the State in appropriating the aid in the manner they did, and the ability of the State to pay on April 15, 1980. Certainly, the intent is clear. The City's entitlement period begins July 1, 1979, the beginning of the City's 1980 fiscal year. In addition, this appropriation is not payable until April 15 in the State's 1981 fiscal year. Thus the State benefits by deferring the cost to a future State fiscal year and reducing its requirements for the current State Budget. Also, since this payment is in the State's 1981 fiscal year, notwithstanding the fact that the appropriation for this aid is a 24 month appropriation, such appropriation can be amended prior to April 15, 1980. However, the overriding factor is the clear intent of the legislature to provide additional aid to the City in the City's 1980 fiscal year.
Under the modified accrual basis of accounting, a city also would accrue revenue of a material amount not normally susceptible to accrual and not received at the normal time of receipt. The example generally used is sales taxes normally received during the last week of the fiscal year being delayed into the following fiscal year. The amount is accrued since a "mechanical" type delay (a strike, processing delay, etc.) should not be able to distort revenue recognition in any given fiscal year.

This is clearly not the case in this situation. The revenue is not delayed inadvertently beyond its normal time of receipt. Instead, it is the deliberate intent and action by the legislature that an additional amount of appropriated funds will not be received by the City until April 15, 1980, nor will the City be entitled to such funds until July 1, 1979.
Another important factor to consider is the City's consistency in recognizing State aid. In both FY 1977 and FY 1978, the City made similar decisions concerning the timing of revenue recognition; in both cases the entitlement period during which the appropriated aid was received ruled the revenue recognition. During FY 1977, when the State put a "cap" on per capita aid resulting in $33 million not being received by the City until January, 1978, the $33 million was not accrued to FY 1977. Instead, the $33 million was recognized as revenue when received during FY 1978. During the FY 1978 closing, $49 million in additional per capita aid was not accrued to FY 1978, but was determined to be FY 1979 revenue and recognized when received in November, 1978.

During the 1978 closing, we discussed the revenue recognition issue at great length and Peat Marwick concurred with the ultimate decision to base the timing of revenue recognition of the entitlement period. The entitlement period is clearly indicative of the intent of the legislature. Since this aid is generally unrestricted and not tied to any particular expenditure, there is no reason, from an accounting or budgetary viewpoint, to recognize such revenue during any period other than during the entitlement period.
However, this reliance on the entitlement period and legislative intent does not mean that I agree with a willy-nilly moving about of per capita or any other State aid from year to year based solely on entitlement period. As noted above, consistency in application is a basic tenent of GAAP. For instance, suppose the State had permanent legislation providing 8% of total State revenues as per capita State aid to all municipalities. Could the State help New York City by appropriating 7-1/2% one year and 8-1/2% in the next year, making payments on June 25, and July 5, simply to suit the City's budgetary processes? Even if the State were to express legislative intent and even if the State were to set forth specific entitlement periods, I do not think that monies can be shifted from year to year for the sole purpose of helping the City to balance its budget. Unless the consistency theory is followed, we can not develop any sound principle of revenue recognition.
Obviously, State aid payment dates have been, and probably will continue to be moved about. But such movements, even when accompanied with changes in entitlement periods must also be considered in light of the basic accounting principle of substance over form. Moving a payment by two weeks or even two months for the sole purpose of helping the City balance its budget does not change the substance of the legislated transaction (state aid). However, moving a payment date by six or more months to accommodate both City and State budgets and to provide additional aid to the City certainly impacts not only the form of a transaction but the substance of the transaction as well. Therefore, it is important to distinguish what occurred this year from the willy-nilly moving about of per capita aid from year to year.

This position is also consistent with the City's recognition of CUNY's expenditure driven revenue in FY 1977 despite state legislation which had the specific intent of moving the revenue into FY 1978 purely for budgetary reasons.
CONCLUSIONS

The concept of accruing various revenue sources is further discussed in Statement 1:

"The susceptibility to accrual of the various revenue sources of a governmental unit may differ significantly. Likewise, the susceptibility to accrual of similar revenue sources (e.g., property taxes) differs among governmental units. Thus, each governmental unit should adopt revenue accounting policies that appropriately implement the susceptibility to accrual criteria, apply them consistently, and disclose them in the Summary of Significant Accounting Policies." (emphasis added).

These factors all lead to the conclusion that the additional per capita aid scheduled to be received on April 15, 1980 should not be accrued to FY 1979, but should be budgeted as FY 80 revenue.
March 12, 1979

TO: James R. Brigham, Jr., Director, OMB

FROM: Martin Ivey

SUBJECT: Encumbrance Policy

I would like to meet with you to discuss a "tightening up" of our encumbrance policies. The need for further tightening up stems from the following factors:

A. Peat Marwick, in its management letter, indicated that the agencies were not complying sufficiently with our encumbrance policies, causing difficulties in verifying the outstanding encumbrances.

B. Our recent review of outstanding fiscal 1978 encumbrances as of December 31, 1978 indicates that there were still very large amounts of unliquidated OTPS encumbrances; as late as March 7, 1979 there were more than $60 million of unliquidated OTPS encumbrances applicable to fiscal 1978. Our attempts to have the agencies rejustify the outstanding encumbrances have not been particularly successful.

C. The accounting profession is moving increasingly toward accrued expenditure reporting. The new GAAPR will indicate that the only appropriate method is accrued expenditures, and that year-end outstanding encumbrances should be reported as a reservation of fund balance rather than be treated similar to expenditures. Although the latest version of GAAPR still indicates in a footnote that the encumbrance method is an acceptable option, there is a move toward eliminating the footnote. In the meantime, the AICPA Committee on State and Local Government Accounting is publishing an experimental document which indicates that accrued expenditures is the only acceptable method. Hence, it is only a matter of time before the accrued expenditure method will be considered as the only GAAP method.
Under the circumstances we need to develop a means of moving closer toward accrued expenditure accounting. Ultimately, I think we will need to develop a system which will allow for both encumbrance controls and accrued expenditure controls.

We suggest the following approach in moving toward accrued expenditure accounting:

1. For the year ended June 30, 1979, we will continue to use encumbrance accounting. However, valid encumbrances will consist only of (a) those items that have actually been delivered by August 31, 1979 and (b) those additional items that can be clearly demonstrated to be deliverable by December 31, 1979. Unless the supplies have been delivered or the services rendered by December 31, the encumbrance will be reversed.

2. For the year ended June 30, 1980, we would consider as valid encumbrances only those items that have been delivered by August 31, 1980. Unless delivered, the encumbrance will be reversed. Agencies should be told of this changeover now so that they can better plan their purchases.

3. The new GAAFR will become GAAP for fiscal years beginning after June 30, 1980. Hence, for the year ended June 30, 1981 we should be on a complete accrued expenditure basis for financial reporting.

My secretary will call yours for a meeting this week.

ML/sd
cc: Mark Shernicoff
    Dan Rosen
    Bob Happ, PMM
July 5, 1979

MEMORANDUM FOR THE RECORD

FROM: DANIEL P. ROSEN

SUBJECT: MAC REFUNDINGS

On May 29, 1979 representatives of the Comptroller's Office, OMB, Peat, Marwick, Mitchell & Co., and Price Waterhouse met to discuss the possible accounting effect of any MAC refundings that could take place during FY 1980. (MAC's financing program includes future refundings of outstanding high coupon bonds). The meeting was held to familiarize City and Peat Marwick officials with the facts of a possible refunding and whether such a refunding would impact on the City's accounting for MAC debt service. The question was raised since MAC withholds (the MAC "take-out") certain City revenues in April and June for interest and principal payments made the following January and February (see Exhibits I and II.)

The issue being explored is: If MAC has a refunding of certain First and Second Resolution Bonds during FY 1980 what is the effect on the April and June 1979 MAC take-out relative to these bonds?

Background

During fiscal 1977 the City, MAC, the City's pension funds, and the clearing house banks were engaged in negotiations which would adjust the maturities of certain MAC bonds and City notes held by the banks and pension funds. This restructuring would affect the April and June 1977 MAC take-out requirements. The restructuring took place prior to the issuance of the City's FY 1977 financial statements.
The City, in reporting the result of its 1977 fiscal year, adjusted its financial statements to reflect the take-outs that would have been required through June 30, 1977 by the restructuring agreement and deferred the recognition of the additional expenditure until FY 1978. The rationale for this decision was that since the restructuring agreement was sufficiently advanced prior to June 30, 1977, the fact that the agreements were not signed until after June 30, 1977 did not affect the substance of the transaction. In addition, the decision was also based on Statement on Auditing Standards No. 1. - Section 560 which states that concerning "those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet..."; "All information that becomes available prior to issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates are based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence."

Current Issue

The factors that existed in 1977 do not parallel those in existence today. To begin with, the restructuring accomplished in 1977 was negotiated privately between the clearing house banks, MAC, the City and the pension systems; was disclosed in City and MAC Official Statements; and was well along prior to June 30, 1977. The future refundings in MAC's financing plan will be of publicly held bonds and be accomplished through public announcements pursuant to applicable securities laws. Also, the 1979 balance sheet date has now past without any refunding announcements being made by MAC. At this time, any estimates of the effect of a refunding are speculative. Thus, the only similarities between the present situation and the 1977 restructuring is that the April and June MAC take-outs are affected.

Another factor to consider is that the AICPA has issued a Statement of Opinion on advance refunding which concludes that advance refundings, including the recognition of all gains and losses, be accounted for at the time of the refunding.

In conclusion, based on the factors discussed in the previous paragraphs, and since MAC is authorized by law to take-out an amount larger than the minimum required to meet MAC's debt service, I am led to the opinion that the April and June MAC take-outs should be shown as 1979 debt service expenditures in the City's FY 1979 financial statements.
FUNDING OF MAC BONDS

First Resolution Bonds:

Principal Payable  February 1
Interest  February 1 and August 1

Principal funded in four equal installments in four take-outs prior to
February 1.
Each Interest payment funded in two equal installments in take-outs
prior to interest payment dates.

Second Resolution Bonds:

Principal Payable  July 1
Interest  July 1 and January 1

Principal funded in four equal installments prior to July 1.
Interest funded in two equal installments in take-outs prior to interest
payments dates.

(In 1977 a full year's interest has funded in the preceding fiscal year).
Fundings dates that are affected by HAC accounting Issue

<table>
<thead>
<tr>
<th>Month</th>
<th>Rate</th>
<th>Interest</th>
<th>Date</th>
</tr>
</thead>
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<tr>
<td>Jan.</td>
<td>1/2</td>
<td>Interest</td>
<td>1/2</td>
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<tr>
<td>Jan.</td>
<td>1/2</td>
<td>Interest</td>
<td>1/4</td>
</tr>
<tr>
<td>Jan.</td>
<td>1/4</td>
<td>Interest</td>
<td>I/4</td>
</tr>
<tr>
<td>Apr.</td>
<td>1/4</td>
<td>Interest</td>
<td>I/4</td>
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<tr>
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<td>Interest</td>
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<td>Interest</td>
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<tr>
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<tr>
<td>July</td>
<td>1/4</td>
<td>Interest</td>
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</tbody>
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First Resolution

Payment Dates

Max Take-out

EXHIBIT II

FY 1979

FY 1980
July 11, 1979

TO: MEMORANDUM FOR THE RECORD
FROM: DANIEL P. ROSEN
SUBJECT: ECF BOND ISSUE

The question of when the City should recognize the revenue from the City's share of the proceeds of the proposed bond sale of the New York City Education Construction Fund (ECF) has been considered for FY 1977, 1978 and now 1979. The revenue is currently budgeted for 1980. Based on the fact that this one time only revenue has not been received yet (although originally included in the FY 1978 and 1979 budgets) leads me to the conclusion that the ECF bond proceeds should not be accrued to FY 1979.

Background

This issue goes back to September 25, 1975 when the City paid off certain ECF BAN's coming due. The payment was made by the City since ECF, because of its relationship with the City, was precluded from the public bond market. At the time that the City advanced ECF money to repay their BAN's an expenditure was recorded. Since at the time of that sale we were not sure if the City would ever be repaid, no receivable was established. Before we can record a receivable (and hence revenue) we would have to justify a change not only in our estimate concerning repayment, but determine with a reasonable amount of certainty when the repayment will be made (measurable and available concept).
Current Discussion

City officials and the financial monitors all tend to agree that the ECF bond sale will eventually take place. It is therefore proper for the City to budget for such revenue. The fact that the bond issue originally proposed as a FY 1978 action has been often postponed because the necessary State and City approvals have been delayed, does not mean it should not be budgeted for (it is for contingencies such as these postponements that a $100 million general-reserve is required in the City's annual budget). However, the reasons that allow the City to budget a revenue are not necessarily sufficient to warrant the accrual of such revenue. Before ECF can sell its bonds, the Board of Estimate must approve the ECF/City agreement on the sale, including finalization of the disposition of the bond proceeds; and a revised bond purchase agreement must be negotiated. The sale is currently scheduled for sometime in November (although a similar projection was made last year at this time).

In conclusion, it would be consistent with the City's general revenue recognition policy concerning a one time only revenue of this sort to only recognize the ECF bond proceeds as a revenue at the time it is received.