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October 1, 2010

The Honorable Steve Peterson
Mayor, City of Virginia
327 First Street South
Virginia, Minnesota 55792-2623

Dear Mayor Peterson,

The Office of the State Auditor (OSA) received concerns regarding the City of Virginia's (City) Police Special Revenue Fund, a legally restricted fund containing residual assets received by the City from the Public Employees Retirement Association (PERA).

The OSA reviewed the City's handling of the residual assets. During 2004 through 2009, funds were moved from two residual asset investment accounts to the City's pooled cash accounts. Based upon the OSA's review, it appears that moving the residual assets from the residual asset investment accounts to the City's pooled cash accounts may have technically complied with the requirements of Minnesota law and Resolution No. 99212. However, the activity within the Police Special Revenue Fund lacked transparency and may not have reflected the City's intent for the residual assets.

This letter will summarize the OSA's review and provide recommendations for the future handling and reporting of the residual assets.

Background and Law

As of July 1, 1999, certain local police and fire department pension accounts could become part of the Public Employees Retirement Association (PERA).¹ The local pension funds would be consolidated with PERA accounts.² The liabilities and assets of local police and fire pensions would become the liabilities and assets of PERA, and the accrued benefits of the members would become PERA's obligation.³ If a residual asset amount existed after the consolidation, the residual asset amount was paid to the local municipality with the legal restriction that it "must be used by the municipality . . . to defray police department expenditure items" according to a plan adopted by the

¹ See Minn. Stat. § 353.665, subs. 1 and 2.

² See Minn. Stat. §§ 353.665, subd. 1, and 353A.02, subd. 16.

³ See Minn. Stat. § 353.665, subs. 2 and 3.

municipality's governing body.⁴ The law requires the residual asset amount to "be deposited in a special fund or account in the municipal treasury established for that purpose."⁵ The law further provides that the "special fund or account must be invested and any investment return attributable to the residual asset amount must be credited to that special fund or account and its disbursement similarly restricted."⁶

In 1999, the City of Virginia decided to consolidate its police pensions with PERA.⁷ The police pension fund had a residual asset amount. Therefore, on November 9, 1999, the City Council adopted Resolution No. 99212 containing the City's plan for the use of the residual assets. The Resolution required the City to "create a special fund and invest the residual asset amount", crediting any investment earnings to the fund.⁸ The Resolution limited expenditures from the residual assets to specific police department expenditure items, and specified that only interest earnings could be used for the eligible expenditures.⁹ See Attachment A to this letter.

In 1999, the City received a residual asset amount of \$4,268,221, plus interest of \$96,666, for a total amount of \$4,364,887.¹⁰ The City created and placed the residual asset amount in a Police Special Revenue Fund.

The RMS McGladrey Report

In 2009, concerns were raised about how the residual assets were being handled. In June 2009, the City Council hired RMS McGladrey to conduct a review of the residual assets for compliance with Resolution No. 99212.¹¹ RSM McGladrey issued its Report to the City Council on July 1, 2009.

⁴ See Minn. Stat. § 353.665, subd. 7(f)(2). The residual asset amount was "one-half of the amount by which the current assets of the account exceed 100 percent of the total actuarial accrued liability up to that percentage of the total actuarial accrued liability that equals the public employees police and fire funded ratio on June 30, 1999." See Minn. Stat. § 353.665, subd. 7(f)(1). Before any residual asset funds could be paid to a municipality, the governing body of the municipality had to: 1) hold a public hearing; and 2) formulate and adopt a plan for the expenditure of the residual asset amount. See Minn. Stat. § 353.665, subd. 7(f)(2). The plan had to be filed with the OSA. *Id.*

⁵ See Minn. Stat. § 353.665, subd. 7(f)(2).

⁶ *Id.*

⁷ The City informed the OSA that its Fire Department pension was not fully funded so it was not eligible to become part of PERA.

⁸ See City Resolution No. 99212 (November 9, 1999). See Attachment A to this letter.

⁹ The only exception to the interest earnings expenditure limitation was the possible funding of a new public safety facility or capital improvements for the police department.

¹⁰ See Consolidated Police & Fire Refunds of Residual Assets dated December 19, 2000, that the OSA received from PERA on December 19, 2000. The date of the refund was December 28, 1999. *Id.* The City recorded the \$96,666 of interest income, along with the principal, as miscellaneous revenue.

¹¹ See July 18, 2009, letter to the City from RSM McGladrey. According to the City Council's June 23, 2009, meeting minutes, the City Council hired the firm to prepare a "financial history" report for the City.

The Report found, among other things:

- \$3,409,119.55 had been moved from the Police Special Revenue Fund to the City's General Fund between January 27, 2005, and March 17, 2009.
- The funds were moved "due to cash-flow requirements to meet obligations of the City's operations" because the City's net cash position was negative for each month in 2005 and 2007.¹² "This result is indicative of inadequate funding of the General Fund in order to meet required obligations. The obligations, unfortunately, were not all related to the Police Department, as required by the Council Resolution."
- Residual asset funds "were utilized to provide 'up-front' funding for [City] projects that had not received appropriate funding or had been initiated ahead of their time, thus incurring obligations which had to be met."
- "The interest earnings from [the residual asset amounts] would not support the activities for which it was used from 2005 thru present."

The Report recommended, among other things, that the City reimburse the Police Special Revenue Fund \$3.4 million in order to bring the Fund back to its required level.

OSA Review of the Residual Assets¹³

The OSA reviewed the July 1, 2009, RSM McGladrey Report, the City's 1999 through 2009 audited financial statements, the City's 1999 through 2009 annual overfunded pension reports filed with the OSA, and City records related to the Police Special Revenue Fund.¹⁴

1. Moving Residual Assets From Investment Accounts

The City combines its cash and investments from various City funds into pooled cash and investment accounts.¹⁵ Under generally accepted accounting principles (GAAP), cash and investment accounts may be pooled in most situations with similar assets of other funds to maximize the return on invested resources.¹⁶ When cash and investments are

¹² RMS McGladrey performed "a detailed analysis of all transactions affecting the [Police Special Revenue Fund] and Police Department transactions recorded through the General Fund" for 2005 and 2007.

¹³ The OSA did not perform an audit, the objective of which would be to express an opinion on the City's financial statements. Therefore, the OSA does not provide an opinion. Had the OSA performed additional procedures, other matters might have come to the OSA's attention that would have been reported.

¹⁴ The opinion letter for the City's 2009 Financial Statements was dated June 30, 2010, and the OSA received a corrected version of the City's 2009 Financial Statements on July 12, 2010. In accordance with Minn. Stat. § 353.665, subd. 7(f)(2), the OSA required the City to annually complete and submit a reporting form to the OSA on the overfunded pension plan funds.

¹⁵ The City's 2009 Notes to the Financial Statements state that "[s]everal funds hold cash and investments separate from the cash and investment pool, primarily restricted or designated cash and investments."

¹⁶ See, e.g., Michael A. Crawford and D. Scott Loyd, 2009 Governmental GAAP Guide Accounting and Financial Reporting for Investments Accounting Basis and Measurement Focus.

pooled, a city must maintain adequate records to provide a basis for identifying each fund's share of the pooled assets, including interest earned.¹⁷

Prior to 2004, the residual assets were maintained in two investment accounts. The two investment accounts were recorded in the City's audited financial statements as part of the "Cash and investments" line item in the Police Special Revenue Fund.¹⁸ During 2004 through 2009, however, a total of \$4,776,166 was moved from the residual assets investment accounts to the City's general savings and checking accounts (City's cash accounts).¹⁹ See Attachment B to this letter.

The City's audited financial statements and the City's annual overfunded pension reports filed with the OSA showed that the Police Special Revenue Fund's cash and investments generally remained stable over time.²⁰ The composition of the cash and investments in the Police Special Revenue Fund, however, changed over time. As shown in the following chart, the actual balance of the two residual assets investment accounts decreased over time, while the pooled cash reported in the Police Special Revenue Fund increased.

Value of Residual Assets Investment Accounts Compared to City Financial Statements and Overfunded Pension Reports 2005 - 2009					
Year (As of 12/31)	Value of Residual Assets Investment Accounts According to Account Investment/Bank Statements (rounded to nearest dollar)			"Cash & Investments" for the Police Special Revenue Fund According to the City's Financial Statements & Overfunded Pension Reports	Difference
	Smith Barney Investment Account	Wells Fargo Savings Account	Total of Both Accounts		
2005	\$2,820,013	\$23,903	\$2,843,916	\$4,464,037	\$1,620,121
2006	\$2,764,392	\$24,967	\$2,789,359	\$4,375,691	\$1,586,332
2007	\$2,141,032	\$26,122	\$2,167,154	\$4,470,164	\$2,303,010
2008	\$2,127,775	\$26,575	\$2,154,350	\$4,349,238	\$2,194,888
2009	\$ 924,496	\$26,580	\$ 951,076	\$4,356,529	\$3,405,453

¹⁷ *Id.* The two residual asset investment accounts are not part of the pooled cash and investments for interest earnings.

¹⁸ One of the residual assets investment accounts was with Smith Barney, and the other was with Wells Fargo.

¹⁹ This amount differs from the amount found by RSM McGladrey because the OSA reviewed a longer time period. In all but two instances the funds were moved to the City's general savings account. The City then moved money from its general savings account to its general checking account as needed. In 2007, \$26,000 was moved from the City's general checking account to the Smith Barney residual asset investment account. Therefore, the remaining amount moved from the residual assets investment accounts to the City's cash accounts was \$4,750,166 (\$4,776,166 - \$26,000 = \$4,750,166).

²⁰ The City maintained records that identified the Police Special Revenue Fund's share of the pooled cash.

Consistent with Minnesota law, Resolution No. 99212 requires the residual asset amount to be deposited in a special fund. The City met that requirement by creating the Police Special Revenue Fund.

Consistent with Minnesota law, Resolution No. 99212 requires the City to use the residual asset amounts for authorized police department expenditure items. Some of the residual assets were moved from the investment accounts to the City's pooled cash accounts to reimburse the general checking account for eligible police department expenditures.²¹ This activity met the requirements of Minnesota law and Resolution No. 99212.

The RSM McGladrey Report stated that some of the residual assets were moved to the City's General Fund to meet the City's cash flow needs. If the residual assets were "transferred" to the City's General Fund, the activity should have been recorded as a loan or an interfund transfer, and recorded in the City's books as receivables or payables.²² However, the activity was not recorded in the City's books as interfund activity. If the residual assets were "used" for purposes other than authorized police department expenditures, then the use of the residual assets did not comply with Minnesota law or Resolution No. 99212. However, the City's audited financial statements consistently reported that the Police Special Revenue Fund contained more than \$4.3 million in cash and investments. Therefore, the OSA questions whether the residual assets were "transferred" between funds or "used" as those terms are commonly understood for accounting purposes.²³

Minnesota law and Resolution No. 99212 require the residual assets to be invested and any investment returns/earnings to be credited to the special fund.²⁴ Moving the residual assets from the investment accounts to the City's pooled cash accounts caused the residual assets to earn less interest over time because the interest paid on pooled cash was based upon the savings account rate, which was generally lower than the interest paid on investments. The decrease in investment income earned by the residual assets from 1999 through 2009 is reflected in Attachment C to this letter. However, the residual assets moved to the City's combined cash accounts were still "invested" because they were earning interest.

²¹ The Police Special Revenue Fund does not have a separate checking account for expenditures.

²² See GASBS 34, ¶ 112(a).1. Additional guidance on interfund transfers is provided in the OSA's Statement of Position for Temporary Interfund Transfers found at:

http://www.auditor.state.mn.us/other/Statements/tempinterfundloans_0704_statement.pdf. The City Charter allows the City Council to make interfund loans, but requires the loans to be made by City ordinance or City Council resolution. See City Charter Sec. 7.08

²³ See Minn. Stat. § 645.08(1) ("words and phrases are construed according to rules of grammar and according to their common and approved usage; but technical words and phrases and such others as have acquired a special meaning, or are defined in this chapter, are construed according to such special meaning or their definition").

²⁴ See Minn. Stat. § 353.665, subd. 7(f)(2).

Resolution No. 99212 specifies that only interest earnings could be withdrawn annually for the purposes listed in the Resolution, so the funds could be utilized for a number of years.²⁵ The total interest revenue on the Police Special Revenue Fund from 1999 through 2009, according to the City's audited financial statements, was \$1,781,274, and total miscellaneous revenue was \$31,593, for total revenues of \$1,812,867.²⁶ See Attachment C to this letter. Police Special Revenue Fund expenditures from 1999 through 2009 totaled \$1,812,691, according to the City's audited financial statements.²⁷ See Attachment C to this letter. Therefore, it appears expenditures from the Police Special Revenue Fund from 1999 through 2009 were less than the interest and miscellaneous revenue in the Police Special Revenue Fund during that time period.

Based upon the OSA's review, it appears that moving the residual assets in the Police Special Revenue Fund from the residual asset investment accounts to the City's pooled cash accounts may have technically complied with the requirements of Minnesota law and Resolution No. 99212.

The Police Special Revenue Fund Activity Lacked Transparency

While the moving of the residual assets from the residual asset investment accounts may have technically complied with Minnesota law and Resolution No. 99212, the City's audited financial statements did not provide transparency for the change in account composition within the Police Special Revenue Fund.

1. Moving Residual Assets From Investment Accounts

The movement of the residual assets was recorded on the City's books as decreases in the two investment accounts and increases to the Police Special Revenue Fund pooled cash accounts. The City then combined the two investment accounts and the pooled cash accounts, and reported the combined amount as a single line item of "Cash and investments" within the Police Special Revenue Fund on the City's audited financial statements.²⁸ Therefore, the cash and investments line item generally remained stable and did not reflect the change in accounts within the Police Special Revenue Fund. This

²⁵ The only exception to this policy was funding for a new public safety facility or capital improvements for the Police Department.

²⁶ The information from 1999 to 2009 was obtained from the City's audited financial statements. The OSA included the \$31,593 of miscellaneous revenue in total revenues because the offsetting miscellaneous expenditures were included in total expenditures. Also included in miscellaneous revenue is \$608 of interest revenue classified as part of miscellaneous revenue in the 1999 audited financial statements. The overfunded pension plan reporting form amounts and classifications did not consistently agree with the amounts and classifications in the audited Police Special Revenue Fund Balance Sheets and Statements of Revenues, Expenditures and Changes in Fund Balances from 1999 through 2009.

²⁷ The information from 1999 to 2009 was obtained from the City's audited financial statements.

²⁸ Other accounts affecting cash and investment balances, such as market value adjustments, were also included in the cash and investment line item on the audited financial statements. See Combining Balance Sheet for Special Revenue Funds on the City's audited financial statements.

aggregate balance for cash and investments in the financial statements would not identify that the change in account composition had occurred within the Police Special Revenue Fund.

2. Reporting Fund Balances

The Governmental Funds Balance Sheets in the City’s basic financial statements from 2004 through 2008 did not separately report the fund balance as “reserved” for the Police Special Revenue Fund. Instead, the Police Special Revenue Fund reserved fund balance was combined with other “unreserved” governmental fund balances. Under generally accepted accounting principles (GAAP), the function of a “reserved” fund balance is to separate the portion of the fund balance that is not appropriable for expenditure or is legally segregated for specific future uses. The “unreserved” fund balance can then serve as a measure of current available financial resources.²⁹

The City did not separately report the Police Special Revenue Fund reserved fund balance on the City’s Governmental Funds Balance Sheet until 2009. As a result, the City’s basic financial statements showed the City had the “unreserved” governmental fund balances reflected in the following chart.

City’s Governmental Funds Balance Sheet In City’s Basic Financial Statements for “Other Governmental Funds”		
Year	“Unreserved” Fund Balances	Fund Balances “Reserved” For Police Department
2005	\$10,656,444	Not Separately Reported
2006	\$5,399,562	Not Separately Reported
2007	\$3,127,519	Not Separately Reported
2008	\$2,510,892	Not Separately Reported
2009	(\$2,618,635)	\$4,365,063

Recommendations

Based upon the OSA’s review, the OSA makes the following recommendations:

1. Determine How the Residual Asset Principal Will Be Invested

While the moving of the residual assets may have technically complied with Minnesota law and Resolution No. 99212, it may not have reflected the City’s intent for the residual

²⁹ The OSA’s Statement of Position on Fund Balances for Local Governments details the different fund balance classifications and can be found at:
http://www.auditor.state.mn.us/other/Statements/fundbalances_0708_statement.pdf.

assets. The OSA recommends that the City Council determine how the residual assets principal should be invested. The City Council needs to determine whether the residual assets principal should be maintained in separate investment accounts as was the case prior to 2004, in the City's pooled cash and investment accounts, or in some combination of separate investment accounts and pooled cash and investment accounts as is currently the case. We also recommend that the City Council and Police Chief be provided with periodic account statements.

If the City Council determines that the residual assets principal should be maintained in separate investment accounts, the principal, any interest amount that has not been expended on eligible police department expenditures, and miscellaneous income earned on the residual assets, should be moved to the residual assets investment accounts. As of December 31, 2009, that amount appears to have been \$3,405,453.³⁰ This amount may be reduced by any police department expenditures made in 2010, up to the amount of interest earned on the residual assets.

The OSA calculated the amount of \$3,405,453 as follows: In 1999, the City received the original residual assets principal and interest of \$4,364,887. From 1999 through 2009, the City reported investment revenue on the principal of \$1,781,274, miscellaneous revenue of \$31,593, and eligible Police Special Revenue Fund expenditures of \$1,812,691, leaving \$176 of investment income available at the end of 2009 for additional Police Special Revenue Fund expenditures. The total principal of \$4,364,887 plus the remaining available interest of \$176 totals \$4,365,063.³¹ Therefore, \$4,365,063 was the Police Special Revenue Fund fund balance as of December 31, 2009.³² However, only \$951,076 was in residual asset investment accounts as of December 31, 2009. Therefore, using the fund balance of \$4,365,063 on December 31, 2009, the OSA subtracted the \$951,076 already in the investment accounts, the December 31, 2009, interest receivable of \$8,484, and other receivables of \$50, resulting in the amount of \$3,405,453 that should be returned to the investment accounts as of December 31, 2009.³³ This amount is the pooled cash account balance in the City's books for the Police Special Revenue Fund.

2. Make City's Financial Statements More Transparent

To make the City's financial statements more transparent, the OSA recommends that the City continue to report the Police Special Revenue Fund reserved fund balance on the City's Governmental Funds Balance Sheet. In the future, the City may want to consider

³⁰ The City's 2009 Note to Financial Statements reported that the City had \$6,159,553 in total pooled unrestricted cash and investments. Therefore, it appears the City has the resources available to move this amount to the residual assets investment accounts.

³¹ $\$4,364,887 + \$176 = \$4,365,063$.

³² The Governmental Funds Balance Sheet for December 31, 2009, in the City's basic financial statements reported the Police Special Revenue Fund reserved fund balance as \$4,365,063; the Combining Balance Sheet for Special Revenue Funds reported the Police Special Revenue Fund fund balance total of \$4,365,063 as unreserved.

³³ $\$4,365,063 - \$951,076 - \$8,484 - \$50 = \$3,405,453$.

separately reporting the residual assets investment accounts from any combined cash and investments reported in the Police Special Revenue Fund on the City's Special Revenue Funds Combining Balance Sheet.

3. Obtain City Council Approval

The OSA was informed that the moving of the residual assets out of the investment accounts to the City's pooled cash accounts was not approved by the City Council.³⁴ The OSA recommends that, in the future, the City Council give prior approval to any movement of residual assets principal to pooled cash accounts.

V. Conclusion

The OSA requests that the City provide the OSA with a written response describing how the City will handle the residual assets principal in the future. If you have any questions, you may contact me at 651-297-3673 or by email at Celeste.Grant@state.mn.us or Kathy Docter at 651-282-2388 or by email at Kathy.Docter@state.mn.us.

Sincerely,

/s/ Celeste Grant

Celeste Grant
Deputy State Auditor/General Counsel

Attachments

cc: City Council Members
Mr. Dana Wolden, City Chief of Police
Ms. Sherri Erickson, City Finance Director
Mr. John Tourville, City Operations Director
Ms. Wendy Summers, City Accounting Clerk
Mr. Bart Rodberg, McGladrey and Pullen, City Auditors

³⁴ The City Code and City Council resolutions authorize certain City employees as signatories on the City's accounts, but they do not address the scope of any fund transfer authority. *See, e.g.*, City Code Chapter 2, subd. 5, and City Resolution No. 09065.