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New York City has made substantial progress in the design and implementation of a new accounting system under the Seasonal Financing Act of 1975. A new accounting system is needed to improve control over the city's resources and to improve the accuracy and timeliness of financial information needed to manage the system. The new accounting system will not be implemented by July 1, 1977 as planned. Problems in the accounting system which will prevent the city from producing adequate financial statements for the year ending June 30, 1978 and from receiving an auditor's unqualified opinion are: (1) inclusion of probable inaccurate payroll data in the statements; (2) lack of required financial statements for intragovernmental and enterprise funds; (3) inclusion of inaccurate data in the financial statements for the Capital Projects fund; and (4) lack of a required statement of general fixed assets. Although the city has made major budget cuts under the financial plan, a number of problems remain unresolved, and progress has been marred by the city's inability to hold expenses to the levels originally projected. Other problems involve: the moratorium debt, Federal loan repayment, and the city's ability to reenter the credit market. (RRS)

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Statement of

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before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

on

The New York City Seasonal Financing Act of 1975
Public Law 94-143

Mr. Chairman, we are pleased to appear today to discuss the work we are doing in connection with the New York City Seasonal Financing Act of 1975 - PL 94-143. We have been monitoring the financial situation of the City since January 1976 and we welcome this opportunity to present our observations to you.

Last month we issued three reports summarizing our views of the situation. The gentlemen appearing with me today were responsible for the preparation of those reports, and they will assist me in responding to your questions.

The tone of our reports, overall, was one of caution. We see substantial progress in the City's efforts to design and implement a new accounting system; a mix of progress and problems in the short range fiscal picture; and some difficult problems in the City's long-range economic outlook. We will address each of these areas in our discussion with you today and we will also discuss the questions you raised in your letter inviting us to testify.

IMPROVEMENT OF THE ACCOUNTING SYSTEM

We would like to start by addressing the City's efforts to design and implement its new accounting system.

The credit agreement, which sets forth the terms under which the Federal Government provides loans to the City, contains essentially four requirements regarding accounting systems. First, it requires the City to implement a new accounting system by July 1, 1977. Second, it requires the new records and controls to be such that an auditor can perform an audit and render an opinion. Third, it requires the new records and controls to comply with the accounting principles established by the State Comptroller. Fourth, it requires the City, as an interim measure, to improve its existing systems.

The principal objective of our review was to determine the City's progress toward meeting the first two requirements; that is, the implementation of a new accounting system by July 1, 1977, and establishment by that date of records and controls which would permit an auditor to perform an audit and express an opinion on the City's financial statements. Although we have not reviewed the City's existing accounting systems, we understand that the new system is urgently needed to improve control over the City's resources and to improve the accuracy and timeliness of financial information needed to manage the City. The receipt of an auditor's opinion on the City's financial statements is also needed to facilitate the City's attempt to reenter the credit markets.

In regard to the requirement that the City implement a new accounting system by July 1, 1977, we reported that, although the accomplishments of the City and its contractors have far exceeded those which would normally be expected in developing such a complex system, the new system will not be implemented by July 1, 1977.

The new accounting system consists of four subsystems: budget, encumbrance control, accounting and financial reporting and payroll. City officials have already deferred implementation of the payroll subsystem until after July 1, 1977, and have informed us that they may also defer implementation of the encumbrance control subsystem. We believe that it is highly possible that the other subsystems will also be deferred because of the amount of work to be completed in the relatively short time remaining until July 1, 1977. The City already faces two major problems as a result of the short time remaining. One involves the readiness of the agency which will perform the automatic data processing operations for the new system. The other involves the time required to train City employees who will be associated with the new system.

Regarding the credit agreement requirement that the City establish records and controls by July 1, 1977, which would permit an auditor to perform an audit and express an opinion on the City's financial statements, we reported that the City did not design the new system to include all of the information that a certified public accountant would need to express an unqualified opinion on the City's financial statements. An unqualified opinion would indicate that the financial statements fairly present the financial condition and results of operations of the City for the period specified. Although the credit agreement does not require an unqualified opinion, a qualified opinion, depending upon its significance as perceived by the financial community, could discourage investors and affect the City's return to the credit markets. Therefore, we took the position that the City should have done everything possible to receive an unqualified opinion.

Problems in the system which we believe will prevent the City from producing adequate financial statements for the year ending June 30, 1978, and receiving an auditor's unqualified opinion are (1) inclusion of probable inaccurate payroll data in the statements, (2) lack of required financial statements for intragovernmental and enterprise funds, (3) inclusion of inaccurate data in the financial statements for the Capital

Projects Fund, and (4) lack of a required statement of general fixed assets.

Unless the applicable terms of the credit agreement are waived or amended, the City will be in technical violation of the credit agreement on July 1, 1977. The new accounting and budgeting system will not be completely implemented and the City will not have established some of the records and controls necessary for an auditor to perform an audit and render a meaningful opinion.

We believe that the City should move with all possible speed to correct its problems and conform to the requirements of the credit agreement, but we do not believe that it should proceed so rapidly that it does not complete the work in an orderly and effective manner. We have seen many instances where dogged devotion to meeting a deadline has resulted in ineffective, error-prone systems that, despite all the money put into them, do not achieve the desired results.

Therefore, we recommended that the Secretary of the Treasury examine the City's progress toward completion of the accounting and auditing requirements under the credit agreement, and, giving due consideration to the interests of the Federal Government, authorize reasonable extensions of time in those cases where additional time is needed to complete the work in an orderly and effective manner.

PERFORMANCE UNDER THE PLAN

Regarding the City's performance under the financial plan, we see a mix of progress and problems. The City has made major budget cuts and has achieved significant successes, particularly in working with its employee pension funds and the Municipal Assistance Corporation to manage its debt. There are, however, a number of problems still to be resolved in the short run, that is, the plan period ending June 30, 1978, and the period immediately beyond. These problems suggest to us that it is uncertain whether the City will be able to regain sufficient access to the credit markets when the Seasonal Financing Act expires.

In our previous testimony before this Committee, and in our recent report, we referred to a serious problem which we believe could cause some misunderstanding of what the City is trying to accomplish through its financial plan. The City, as you know, has, with the permission of the State of New York, been financing certain operating expenses through borrowings. These amounts are substantial - $654 million reported by the City in 1976 - and they are not reflected in the operating budget deficit. To that extent, the deficits in the financial plan are understated and, further and perhaps more importantly, the financial plan does not represent a plan to truly balance the City's budget but only a plan to partially close the budget gap.

I would like to point out that we are not taking issue with this fiscal practice of the City solely on the basis of its accounting impropriety. The effect of borrowing each year for operating expenses is significant in terms of the City's fiscal recovery since it rapidly builds up future debt which must be serviced. Between 1972 and 1975, for example, the State Comptroller reported that the City borrowed $1.8 billion for these purposes. We estimate the City will borrow another $3.5 billion before this practice is phased out in 1986.

We raise this issue again, because in the 1978 budget the City estimates an increase in the expenses to be funded in this way. The plan for 1978 showed that these expenses were expected to be $515 million. The City's 1978 budget shows that these expenditures supported by capital funds have now grown to $713 million. According to City officials, this growth resulted from stricter City compliance with the directives of the State Comptroller on this matter. We intend to look more closely into this situation.

We raise the issue of expense classification to point out the difference between the City's financial plan and a true balanced budget which it is still far from achieving.

PROGRESS DURING THE FIRST PLAN YEAR - JULY 1, 1975 - JUNE 30, 1976

Regarding operations in the first year under the plan the City did make progress. It realized more revenues than originally planned; managed debt with some success; and implemented budget cuts. The City's progress was unfortunately marred by the fact that it was unable to hold expenses to the levels originally projected. Its expenditures exceeded the original projections by $217 million, well beyond the increased revenues of $93 million which it realized.

During that first year, City figures indicate a budget gap of $968 million. That gap was $124 million in excess of the gap of $844 million projected in the City's original financial plan. Those amounts do not include the $654 million of operating expenses included in the capital budget for that year. The inclusion of those expenses would indicate a first year budget gap of $1.6 billion. These estimates are based on unaudited figures and, therefore, should be viewed with some caution because of the widely recognized deficiencies in the City's accounting system.

SECOND YEAR PROGRESS - JULY 1, 1976 - JUNE 30, 1977

For the year ending June 30, 1977, the City is projecting a gap of $642 million in its latest report to Treasury. This gap is $44 million lower than the gap of $686 million forecast in the financial plan. Although projected expenditures are larger than originally planned, projected revenues should more than offset the increases.

Our report addressed the City's second year program to close the budget gap and criticized it, essentially because we believed it relied too heavily on actions of the Federal and State governments which were beyond the City's control. Similar criticisms were leveled by other interested parties. The City subsequently modified or eliminated many of these budget balancing actions.

We also pointed out in our report another matter which caused us some concern. Toward the end of the first year, the City discontinued the practice of detailing specific budget cutting actions and stopped using the companion system of milestone dates to monitor their progress. We objected to the discontinuance of this practice but Treasury disagreed with our position and permitted the change. Our belief was that, although the system was not foolproof, every possible control was needed during that critical time. The City maintained that overall so-called bottom line control, was a better approach than the monitoring of specific cutting actions. We raise this point because we want to alert you that the monitoring of the City's progress, will be more difficult and uncertain in the future considering the absence of a milestone system and a fully functioning accounting system.

THIRD YEAR PLAN AND BUDGET - JULY 1, 1977 - JUNE 30, 1978

The Mayor's proposed budget for fiscal year 1978 was released on April 22, 1977. It balances revenues and expenditures at a level of $13.9 billion. This is a substantial increase over the level projected for 1978 in the latest financial plan which balanced revenues and expenses at $12.5 billion. The substantial increases are accounted for by increased Federal and State aid ($1.0 billion) primarily to cover increased public and medical assistance costs, as well as increases in expenditures paid from capital funds ($198 million).

As we view the recently released budget, we believe the optimism created by it must be tempered somewhat since it is balanced in part based on uncertain actions, such as the proposed stretch-out of MAC bond repayments ($253 million).[redacted]). In addition, its balance relies on some one-time revenues such as the sale of the Westway right of way ($80 million) and some one-time expense reductions such as the $54 million the City is planning to advance to the City University before the start of the fiscal year.

In addition to these uncertain and one-time actions the City may have understated its pension liabilities by as much as $150 million contrary to the directives of the State Comptroller. To that extent the budget may be out of balance and may require future cuts. There is, of course, always the possibility that the City may receive unanticipated non-recurring revenues from the State or Federal government. To the extent that this happens it could offset problems projected for 1979.

BEYOND THE FINANCIAL PLAN - AFTER JUNE 30, 1978

Although the City's recently released budget anticipates a balanced budget for fiscal year 1978 it projects deficits for 1979, 1980, and 1981. These deficits are \$86 million, \$368 million and \$373 million respectively and may be understated.

Although we have not reviewed the projections for 1979 - 1981 in detail, our preliminary inquiries indicate the City may have significant problems in those years. Using 1979 for example, the City is going to be faced with the following problems:

--\$86 million - the deficit projected by the City to begin with;

--\$180 million increase in the deficit unless the bank and pension fund stretch is successful;

--\$250 million increase in the deficit if MAC does not refinance principal payments due in 1979;

--\$130 million increase in the deficit if the City records full pension accrual on current salary data;

In addition, the City may be faced with demands for wage increases after June 30, 1978. For each 1 percent of increase in wages, an additional deficit of about \$50 million would result.

Moreover, the \$86 million projected deficit does not include \$650 million of operating expenses in the capital budget.

MORATORIUM DEBT

One of the matters of concern during the entire plan period was the moratorium debt. The \$1.8 billion of notes placed in moratorium in 1975 were not expected to require repayment until fiscal year 1979, and were therefore not provided for in the financial plan. Banks and pension funds held \$819 million of this amount and had agreed to extend the payment on their portion through 1987. However, as a result of a lawsuit by the Flushing National Bank, which had not been a party to the extension agreement, the moratorium was declared unconstitutional and the City was faced with the immediate need to repay $984 million of the notes. The City developed a plan to raise this amount. The plan involved issuing new or restructured debt, selling City assets, and making use of recently available cash. If successful, the settlement of the moratorium debt should have no impact on the financial plan.

The City has been successful in achieving at least the first piece of its plan to repay the moratorium debt. It had anticipated converting only $268 million of the notes to MAC bonds, but succeeded in converting $403 million. The only disappointment here was the fact that the City had to pay 9 3/4 percent interest.

Because of this conversion, however, only $580 million of the publicly held notes remain outstanding and in need of payment fairly soon.

City officials estimate a total of $350 million of this amount may have to be repaid during the current fiscal year and they believe this is achievable.

There is however an unresolved problem in the moratorium situation. The banks, which had previously agreed to the extension, petitioned the State Court of Appeals to require that their holdings of moratorium notes -- about $548 million -- also be repaid. The Court denied the banks petition without prejudice to other proceedings which the banks might bring. To our knowledge the banks have not taken any further action. Since the 1978 budget does not provide any funds to pay off these notes should the banks bring action and be successful the City may be faced with another serious problem in the future.

The pension funds have not requested payment of their $271 million in notes still covered by the extension agreement. The City's 1978 budget anticipates that all of these notes held by the banks and pension funds will be converted to City bonds.

PROSPECTS FOR FEDERAL LOAN REPAYMENT

With regard to the City's ability to repay its seasonal loans, certain revenue sources, such as State aid to education, are identified as collateral for the loans when they are made. As the revenues are received, they are deposited in a special bank account from which funds cannot be withdrawn without the signature of a Treasury official. In addition, the Seasonal Financing Act gives the Secretary of the Treasury the right of offset against other Federal payments due to either the City or the State, in case the City fails to make repayment.

To date, all Federal loans have been repaid on time, or ahead of schedule. Of the $2.1 billion loaned this year, $1.45 billion remains to be paid with interest by June 30. We have no reason to question the City's ability to repay the remainder of this year's loan especially in light of the State's successful Spring borrowing on which aid to New York City is dependent.

ABILITY TO REENTER THE CREDIT MARKET

According to the Credit Agreement between New York City, the Municipal Assistance Corporation (MAC) and the Department of the Treasury, the City must use its best efforts on or after July 1, 1977, to meet its seasonal borrowing needs without resort to Federal seasonal loans. We understand the City plans to attempt to market short term notes in the near future.

The impact of a successful, or an unsuccessful, marketing of City notes on the City's ability to obtain financing in July 1978, is unknown at this time. However, we have expressed uncertainty about whether the City will be able to achieve its total needs for 1979 in the market place. Its needs will be about $4 billion -- $.5 billion or more for the capital budget, $3 billion to cover seasonal needs currently being met by Federal loans and State advances and another $.5 billion to cover the operating expenses in the capital budget.

Success in marketing City notes during fiscal 1978 might indicate potential for meeting at least some of the 1979 financing needs, but other factors cause us concern. These factors, which could affect the marketability of City notes and/or bonds include:

--the fact that an auditor's opinion on the City's financial statements will probably not be ready until the Fall of 1978;

--the recent statement by the New York City Comptroller that the City's bond counsel has raised a question concerning the State constitutionality of including operating expenses in the capital budget. This may result in possible problems in issuing any future City bonds;

--a lawsuit pending against the banks in connection with sales of City securities, which may impact on their willingness to participate in any future sales of such securities;

--the resolution of the disagreement between the City and the banks over the need for a continuation of some type of control board; and

--the condition of the securities market at the time the City attempts its sales.

If the City is not able to reenter the market, in fiscal year 1979, MAC may be a potential source of funds for the City. Although it is now approaching its debt limit, possibly this ceiling could be raised.

Although the pension funds will have already invested about $3.8 billion in the City by June 30, 1978, they still will have remaining assets of about $6 billion. But, whether they would be willing to invest any further in the City is open to question.

It seems likely that even if the City is able to reenter the credit market in fiscal year 1979, it will not be able to meet its total needs there.

We believe the City still faces a long and difficult battle with its budget. True budget deficits exist and they suggest that the City still has a long way to go toward fiscal recovery.

On that note I'd like to turn to New York City's long-term economic outlook.

LOOKING BEYOND 1978

In our opinion, an efficient city administration and a balanced Fiscal 1978 budget will not be sufficient to solve all of the City's long-term economic difficulties. At the root of New York City's fiscal crisis is the continuing deterioration of its economic base. People, businesses and jobs have been leaving the City in large numbers, some for nearby suburbs, but many for other parts of the country. The reasons for the decision to move vary, but generally they include changes in the cost of living and doing business, the availability of land and labor, lower business and individual tax levels, and to some extent the outdoor life-style more readily available in warmer climates.

The economic impact of decisions to migrate is substantial, not only in New York City but also in the States and a large number of communities in the Northeast and Midwest.

The response of New York City, and many other cities and States facing similar problems, has been to decrease substantially the growth in public expenditures and, in some cases, to cut the actual dollar size of jurisdictional budgets. This has been done despite the continuing inflation that creates pressure for higher expenditures and decreases the value of each dollar available for public services. It has not always been possible to make cuts that do not result in service reductions for those who remain in areas affected by out-migrations.

In the case of New York City, some of the cuts have eliminated fat which should have been removed from the City's budget. Some others have meant a real decrease in City services in important areas.

The budget reductions made thus far have been difficult. Those that will be required in the future will be more difficult. A large fraction of the present City budget is in program areas, such as welfare and Medicaid, over which the City exercises little control. Additional cuts may have to be made in many of the same programs and services which have borne the brunt of the already-achieved budget decreases. If budget adjustments result in a significantly diminished quality of public service, an increasing number of migrations of people and businesses could occur.

An alternative to budget cuts is to increase City revenues, but because of the already extremely high burden on individuals and businesses, tax increases at this time could contribute to a further deterioration of the City's economic base.

New York City faces an unpleasant trade-off which creates a r the City. It is necessary that New York City attain a budget management that will enable the City to return to the credit markets and will provide an environment which will ige economic redevelopment. But it is also necessary that short- actions not contribute to continued deterioration.

The City has recognized that its economic base is an important ment of its future financial viability. The City's newly founded partment of Economic Development has recently completed a detailed tudy aimed at securing a fundamental change in the City's policies as they affect its economic base. The proposed 5-year economic recovery plan includes capping the real estate tax, reducing the commerical occupancy tax, eliminating the sales tax on machinery and equipment through a tax credit process, and generally reducing business taxes when possible. Many other steps designed to improve the local business climate are also set forth. The program has been launched by the City administration. Various implementing steps will require the approval of the Emergency Financial Control Board and State or local legislation. We believe that these and future City efforts to firm up its economic base are steps in the right direction. However, it is not known whether these actions, by themselves, are sufficient to counteract the dramatic declines the City has experienced in its economic base.