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An examination of New York City's efforts to improve its accounting system was part of a review of the city's progress under its 3-year financial plan. The credit agreement under which loans are made to the city by the Federal Government requires the city to establish an accounting system by July 1, 1977, which will enable an auditor to perform an annual audit and render an opinion. Findings/Conclusions: Although much progress has been made, the new accounting system will not be implemented by the required date. City officials have deferred implementation of the payroll subsystem and may also defer other subsystems because of lack of time. The City will not meet requirements for producing financial statements which will allow for an auditor's unqualified opinion because of problems in the system including inaccurate and incomplete data. Recommendations: The Secretary of the Treasury should examine the city's progress in meeting requirements and authorize reasonable extensions of time where it is needed for orderly completion of work. (HTW)

REPORT TO THE CONGRESS



BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

New York City's Efforts To Improve Its Accounting Systems

Department of the Treasury

At least some aspects of the city's new accounting system will not be implemented by July 1, 1977, as required by the credit agreement with the Department of the Treasury. The credit agreement contains the terms under which loans are made to the city by the Federal Government.

The credit agreement also requires the city to include those records and controls in the new accounting system which will enable an auditor to render an opinion on the city's financial statements for the year ending June 30, 1978. The city temporarily deferred the implementation of some records and controls which will require the auditor's opinion to be substantially qualified.



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-185522

To the President of the Senate and the
Speaker of the House of Representatives

Pursuant to provisions of the New York City Seasonal Financing Act of 1975 (Public Law 94-143), we have been reviewing New York City's progress under its 3-year financial plan. This report is one of a series which we will submit to the Congress.

Appendix I contains our observations on the city's efforts to improve its accounting systems. We reviewed these efforts because present and potential creditors must have confidence in the accounting information produced by the city. Reliable accounting information is one of many factors which will influence the city's ability to establish a viable fiscal posture in the long-term, for such information is used as a basis for formulating and executing the budget and program plans.

The credit agreement under which loans are made to the city by the Federal Government requires the city to establish an accounting system by July 1, 1977, which will enable an auditor to perform an annual audit and render an opinion. 1/ The objective of our review was

- to determine the city's plans for improving its accounting systems,
- to determine the status of improvements as of October 1976, and
- to evaluate the problems which may prevent the city from making the accounting system improvements which the credit agreement requires by July 1, 1977.

1/An auditor's opinion is the written finding of an auditor, asserting whether the financial statements fairly present the condition of the entity under audit at the stated date and the results of its operations for the fiscal period ending on that date.

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 accounting system will not be implemented by July 1, 1977, and the financial statements for the year ending June 30, 1978, will not meet the standards necessary to receive an auditor's unqualified opinion.

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. We believe the city should do everything possible to receive an unqualified opinion.

City officials have deferred implementation of the payroll subsystem until after July 1, 1977. They have informed us that they may also defer implementation of the encumbrance (purchase order) control subsystem. We believe that it is highly possible that some, and maybe all, of 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 involving the readiness of the agency which will perform the automatic data processing operations for the new system, and the other involving the time required to train city employees who will be associated with the new system.

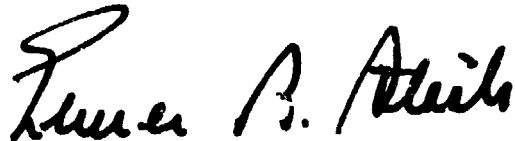
Under the credit agreement, the State Comptroller may authorize a certified public accountant to make the audit for the year ending June 30, 1978. Such an auditor of financial statements would be concerned with whether they fairly present the city's financial position and results of operations and whether they conform with generally accepted accounting principles; therefore, we believe that the city should have designed the new system to include all information that a certified public accountant would need to express an unqualified opinion on the city's financial statements.

The city, however, did not do so. 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.

We recommend 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. On page 19 of Appendix I, we suggest some actions that could be authorized by the Secretary to accomplish this.

In October 1976 we provided the Treasury Department, State, and city with a draft report containing our preliminary conclusions and suggestions. A Treasury Department official, the Deputy to the Assistant Secretary for New York Finances, said that Treasury had no comments on the report. The State's response, dated November 9, 1976 (App. II), and the city's response, dated November 23, 1976 (App. III), were considered in the preparation of this report.

We are sending copies of this report to the Secretary of the Treasury, Director of the Office of Management and Budget, Governor of New York, Mayor of New York City, and other interested parties.



Comptroller General
of the United States

OBSERVATIONS ON NEW YORK CITY'S EFFORTS
TO IMPROVE ITS ACCOUNTING SYSTEMS

The credit agreement under which seasonal loans are made to New York City by the Federal Government requires, among other things, that the city and New York State Emergency Financial Control Board

"pursue with diligence the design and implementation of [a] new accounting system and * * * that by July 1, 1977 the City will have established an accounting system which will establish adequate records and controls which would enable an auditor to perform an annual audit and render an opinion thereon."

The credit agreement also requires the city and the board to improve the reliability of the city's existing financial records and the reports generated from them, and to adopt a system of internal controls over the receipt and disbursement of city funds.

Our review was conducted under authority of the New York City Seasonal Financing Act of 1975 (Public Law 94-143). We reviewed the city's efforts to improve its accounting systems because the improvements are essential to the city's internal management and its return to the credit markets.

SCOPE OF REVIEW

Our review was conducted in New York City, where we examined pertinent documents. Interviews were held with city officials responsible for the accounting systems improvements, and contractors engaged to improve the city's accounting systems. Our review was limited to a determination of the city's plans for improving its accounting systems; the status of the improvements as of October 1976; and an evaluation of problems which may prevent the city from making the accounting system improvements which the credit agreement requires by July 1, 1977.

IMPROVEMENTS NEEDED IN EXISTING SYSTEM

Numerous weaknesses have been identified in the city's accounting system since mid-1975 by various organizations responsible for overseeing the city's financial management. Although we know of no complete listing of the weaknesses, many of them were identified in a report dated December 29, 1975, to the Secretary of the Treasury from the certified public accounting firm of Arthur Andersen & Co., which was engaged by the Department of the Treasury to obtain certain financial and accounting information about the city. Some of the more serious weaknesses identified in the report are as follows:

- Inadequacies and lack of controls in the overall accounting systems and procedures.
- Lack of good accounting and systems discipline in the agencies and data processing centers, and the absence of a capable internal systems staff.
- Fund control structure not useful for control of revenues, expenditures, and fund balances.
- Program budgeting and accounting procedures cumbersome and uncontrolled.
- Expenditures recorded on a cash basis and revenue on an accrual basis.
- Agency processing of vouchers delayed.
- Expenses for contracts not recognized until vouchers are processed.
- Inherent controls in municipal fund accounting weakened by allowing transfers of moneys between funds.
- Two funds for special and miscellaneous revenues not under the normal budgetary control system.
- Accounting and financial data processing systems inadequately integrated, redundant, inconsistent, and unreconciled.
- Bank balances not reconciled for several years.

- Information on cash balances maintained by the Comptroller and the Director of Finance differing by several million dollars.
- Inadequate controls over data entering the disbursement processing system, rejected vouchers, and the timing of disbursement requests.

CITY'S PLAN FOR IMPROVING ACCOUNTING

Weaknesses in the city's accounting system were recognized when the New York State Legislature created the Municipal Assistance Corporation for the City of New York in June 1975 to provide a temporary source of credit until investor confidence could be restored. The act required the city to adopt improved accounting methods and employ them in producing audited financial statements for the fiscal year ending June 30, 1978, and thereafter.

The city elected to get contractual assistance to define new budgeting and accounting principles which conformed to those prescribed by the State Comptroller, develop new public and management financial reports, and develop a systems concept for new budgeting and accounting systems. Two contracts were awarded on December 5, 1975, one to Touche Ross & Co. and the other to American Management Systems, Inc.

The two contractors collaborated and on January 15, 1976, produced a report, "City of New York Financial Management Policies, Procedures, and Systems," to provide the framework for the design and implementation of a new financial management process for the city. The plan called for the design of four subsystems:

- Budget. This subsystem is to provide separate revenue and expense budgets and establish monthly revenue recognition, cash collection, and spending plans. The revenue budget will identify each separate source of funds and responsible organization. The expense budget will be by organizational unit.
- Encumbrance control. This subsystem is to provide central accounting for commitments (requisitions), encumbrances (purchase orders), and expenses (vouchers). It will permit the availability of funds to be determined by the computer before an encumbrance is incurred.

--Accounting and financial reporting. This subsystem is to be the basic management tool for monitoring the city's financial position. The subsystem will include the following accounting operations: cash disbursements, revenue recognition, cash collections, general ledger maintenance, and financial reporting. The subsystem will provide monthly reports comparing revenue, cash collections, and spending against plans provided by the budget subsystem.

--Payroll. This subsystem is to be an integrated system which will perform all of the basic functions of a payroll system and maintain certain personnel information.

In February 1976 the city awarded contracts to American Management Systems, Inc., Touche Ross & Co., and Ernst & Ernst. The contracts required each of them to assist the city in establishing financial management policies, defining reporting requirements, and strengthening organization structures and personnel skills as required. In addition to these general requirements, each contractor was given specific assignments. American Management Systems, Inc., was to prepare a general design for the four subsystems and provide automatic data processing support. Touche Ross & Co. was to assist in the design of the four subsystems and in the development of the overall implementation plan, and prepare procedures for improving control over Federal and State aid revenues and certain types of encumbrances. Ernst & Ernst was to develop an implementation plan for installing the new subsystems and prepare the documentation needed to convert the city's departments to the new system.

Although the new accounting system was not expected to be implemented until July 1, 1977, the three contracts were limited to that work to be performed up to September 15, 1976. The city awarded new contracts to all three contractors in August 1976, permitting the work to continue without interruption.

In June 1976 the city engaged an additional contractor to assist in the accounting system improvement effort. Two contracts were awarded to Bradford National Corporation, one for assistance in the automatic data processing aspects of the new system and the other for the design of the payroll subsystem.

In June 1976 the city also awarded a contract to the Research Foundation of the City University of New York on behalf of the Urban Academy. The contract required the Urban

Academy, with the cooperation of the other contractors, to develop training requirements and, subsequently, to prepare training manuals and conduct training classes.

STATUS OF THE PROJECT AS OF OCTOBER 1976

The city and its contractors have made remarkable progress toward implementing a new accounting system. In the 10 months since the first contracts were awarded, the accomplishments of the city and its contractors far exceed those which would normally be expected in such a complex system development effort.

American Management Systems, Inc., literature indicates that developing a complex system such as this one requires 31 to 88 months, depending on whether certain phases are performed sequentially or concurrently. We believe that these estimates are reasonably accurate. The State of New York, however, mandated in June 1975 that extensive changes be made in the city's accounting system by July 1, 1977, only 24 months later. Only 18 months remained available to develop the new system when the city awarded the first contract in December 1975.

In addition to the work on the new system, the city and its contractors have improved some existing systems and are in the process of improving others. This work was mandated by the Treasury Department.

The status of the various aspects of the budgeting and accounting improvement project as of October 1976 was as follows:

- New system. Except for the payroll subsystem, the general design documentation had been completed and reviewed by Touche Ross & Co. and Ernst & Ernst for the purpose of identifying omissions and errors. They had determined the requirements for implementing the subsystems in the agencies and were preparing implementation plans. American Management Systems, Inc., and Bradford National Corporation were preparing computer programs. The Urban Academy had identified the groups of employees to be trained, reviewed the design documentation to identify training requirements, and had started preparing training manuals.
- New payroll subsystem. The design of the subsystem had been started by Bradford National Corporation.

The city plans to implement the subsystem during the year ending June 30, 1978.

- City Comptroller's system. Touche Ross & Co. was in the process of improving the city Comptroller's present accounting system. The city plans to use the system to do the accounting for the Capital Projects Fund beginning January 1, 1977.
- Present payroll system. American Management Systems, Inc., was in the process of improving procedures for processing information produced by this system. The city plans to continue to use the system until the new payroll subsystem is fully implemented.
- Interim encumbrance system. Touche Ross & Co. designed this system and helped the city to implement it in six agencies on July 1, 1976. The system improves control over certain types of encumbrances.
- Interim Federal and State aid revenue system. Touche Ross & Co. designed this system and was in the process of helping the city implement it in four agencies. The system improves control over revenues from grants.

PROBLEMS MAY PREVENT COMPLIANCE
WITH CREDIT AGREEMENT

The following sections contain our observations on matters which will prevent (1) the new budgeting and accounting system from being fully implemented on July 1, 1977, and (2) the receipt of a meaningful opinion from an auditor on the city's financial statements for the year ending June 30, 1978.

The credit agreement requires the city to implement the new system by July 1, 1977. In this regard, section 6.7 reads:

"The City, with the approval and encouragement of the [New York State Emergency Financial Control] Board, has retained consultants to assist in designing a new system of financial and accounting practices, records and controls to be fully implemented in the City's Fiscal Year beginning July 1, 1977. The City and the Board hereby agree to pursue with diligence the design and implementation

of such new accounting system and further agree that by July 1, 1977 the City will have established an accounting system which will establish adequate records and controls * * *."

As discussed on pages 9 and 10, the city will not comply with this provision because certain aspects of the new system will not be implemented by July 1, 1977. City officials have deferred implementing the payroll subsystem until after July 1, 1977, and may defer the implementation of the encumbrance control subsystem.

We believe that it is highly possible that some, and maybe all, of the other subsystems will also be deferred because of the amount of work to be completed. The city already faces two major problems as a result of the short time remaining. One problem, discussed on pages 10 and 11, involves the readiness of the agency which is to perform the automatic data processing operations for the new system. The other problem, discussed on pages 11 and 12, involves the training of city employees.

The credit agreement requires the city to permit the State Comptroller or an independent certified public accountant to perform an audit as of June 30, 1978. In regard to the audit, section 6.7 of the credit agreement reads:

"The City and the Board * * * further agree that by July 1, 1977 the City will have established an accounting system which will establish adequate records and controls which would enable an auditor to perform an annual audit and render an opinion thereon."

In auditing a municipality, a certified public accountant is expected to comply with the American Institute of Certified Public Accountants' industry audit guide entitled Audits of State and Local Governmental Units. According to the guide, the objective in auditing a municipality is as follows:

"The concern of the independent auditor reporting on the financial statements is that they present fairly financial position and results of operations in conformity with generally accepted accounting principles."

Generally accepted accounting principles for municipalities are prescribed in the guide and in Governmental

Accounting, Auditing, and Financial Reporting, published by the National Council on Governmental Accounting.

Under the credit agreement, the State Comptroller may choose a certified public accountant to make the audit for the year ending June 30, 1978. Therefore, we believe that the city should have designed the new system to produce financial information to conform with generally accepted accounting principles. Without this information, a certified public accountant would not be able to render an unqualified opinion on the city's financial statements.

The city, however, did not do so. The financial information which may not conform during the year ending June 30, 1978, is:

- Payroll information. (See pp. 12 to 14.)
- Information on enterprise and intragovernmental service funds. (See pp. 14 to 16.)
- Information on the Capital Projects Fund. (See pp. 16 and 17.)
- Information on general fixed assets. (See pp. 17 and 18.)

Although the city will not comply with the credit agreement requirement that records and controls be established by July 1, 1977, which would enable an auditor to perform an annual audit and render an opinion thereon, it may comply with the requirement that an accounting system be established by July 1, 1977, that

"* * * is in accordance with the accounting principles set forth in the State Comptroller's Uniform System of Accounts for Municipalities, as the same may be modified by the State Comptroller in consultation with the City Comptroller."

The city will be able to comply, however, only because it requested and received authorization to defer implementing the State Comptroller's requirements regarding enterprise funds, intragovernmental service funds, the Capital Projects Fund, and general fixed assets.

Some aspects of new system will
not be completed by July 1, 1977

City officials have deferred the implementation of some aspects of the system until after July 1, 1977, and may defer others. The design and implementation of a complex automated system involves a lot of time because requirements must be determined, a large volume of documentation must be prepared, and numerous computer programs must be written and tested. On the city's project, time had to be allowed for each of the numerous concerned parties--several State and city officials and representatives of each contractor--to review the documentation.

As stated previously, it usually requires between 31 to 88 months to design and implement a complex automated system, and only 18 months remained available to develop the system when the city awarded the first contract in December 1975.

Through various means, the city and its contractors have successfully minimized slippages in the project. However, in November 1976 city officials said that implementing the payroll subsystem would be deferred until after July 1, 1977, and that consideration was being given to deferring the implementation of the encumbrance control subsystem.

After evaluating the status of the project, we concluded that it was highly unlikely that other aspects of the system will be ready for implementation on July 1, 1977, as planned. Because of our experience with other complex designs, we thought that insufficient time was available to complete the system design, test the computerized aspects of the system, train the large number of personnel needed to operate the system, and perform the numerous tasks required to implement the system. Although we recognized that the system might be implemented on schedule if no major problems were encountered, every large computerized system of which we were aware had experienced major problems as it neared implementation.

Most city and contractor officials agreed with our assessment of the project and with our belief that some major problems could be expected before the system is implemented. They also agreed that the implementation of the system would have to be delayed if such problems required changes in the computerized aspects of the system.

For those aspects of the system that are not implemented as of July 1, 1977, city officials will prepare to capture

and store transactions for processing when the system is capable of handling them.

The deferral of the implementation of one or more subsystems will permit the city to concentrate on the remaining subsystems, which should improve their possibility of success. The preparation of the alternative procedures will permit the city to defer the implementation of additional subsystems if they are not completely ready for operation on July 1, 1977.

Although we believe that the actions taken by the city were necessary, the decision to defer the implementation of some aspects of the system should not have been made without Treasury Department authorization. The credit agreement requires a complete accounting system to be implemented by July 1, 1977, and therefore implementation of less than the complete system will result in a violation of the agreement.

Readiness of Financial Information Services Agency questionable

We believe that the Financial Information Services Agency, which is to perform the automatic data processing operations for the new budgeting and accounting system, will not be operational on July 1, 1977, if certain actions are not promptly taken.

By Executive order dated September 15, 1976, the Mayor created an agency to perform the automatic data processing operations for the new system because the city's existing facilities were inadequate. To begin operations on July 1, 1977, city officials determined that all agency personnel must be acquired and trained by May 1977.

To have a complete and trained staff by May 1, 1977, the city must accomplish the following:

- Obtain the city council's authorization to establish the agency. Although city officials intend to begin staffing the agency before the council's approval is obtained, the agency will have to be dissolved if it is not authorized by the council.
- Prepare position descriptions. The city personnel department is preparing position descriptions for the 75 positions needed to staff the agency. We were informed that preparation of the descriptions

is expected to take several weeks because the personnel department and project officials do not agree on how the positions should be classified and described.

--Acquire personnel. Except for the Director, who was hired on October 12, 1976, no personnel have been hired or transferred to the agency from other agencies. City and contractor officials agreed with our observation that the acquisition of qualified personnel for the agency may be time consuming because of the city's hiring procedures and the fact that the skills required are infrequently found.

--Train personnel. Unless the city acquires highly trained and experienced personnel, extensive training will be required. We believe that it is unlikely that enough qualified personnel can be acquired on short notice, because highly skilled data base management personnel are relatively scarce.

City officials stated that the temporary use of contractor personnel was being considered which would permit the agency to begin operating on time, and also preserve the positions for employees currently assigned to the Office of Management and Budget and the Comptroller's Office. These employees will become available when the city's present accounting systems are no longer needed.

We believe that the temporary use of contractor personnel will do much to help the agency become operational on July 1, 1977. However, city officials should promptly decide. If contractor personnel are to be used, the contract should be awarded as soon as possible so that the contractor can have a fully trained staff available by May 1, 1977.

Training of personnel will not
be completed by July 1, 1977

Not all city employees affecting the operation of the new accounting system will be trained by July 1, 1977.

The training task is monumental since it must address not only the accounting and computer personnel who will be directly concerned with running the system, but also all of the personnel connected with financial management who will influence the input of information to the system. City officials have estimated that about 7,500 personnel will require training. The amount of training required will vary according

to an employee's duties. It will be relatively minor for some and extensive for others.

Little time remains to prepare training materials and conduct the training. With some exceptions, the Urban Academy was unable to start training preparation until the system design documentation was completed in July 1976. Academy officials then reviewed the documentation to identify areas in which the information was insufficient for their purposes. We were informed that, although the documentation was generally excellent, about 100 such areas were identified.

City officials indicated that they did not expect to complete the training of employees by July 1, 1977, but they expect to continue training employees for some time after the new system is implemented. Technical support and supplemental procedures will be used to facilitate the operation of the new system during the startup period.

We recognize that certain employees affecting the new system need not be completely trained before the system is implemented. However, the number of such employees should be relatively small because the new system will make extensive use of new forms, classification codes, and procedures. Such changes often result in a large number of errors which may render a new system inoperable.

Accurate payroll information may
not be produced until fiscal year 1978

The city's decision to delay implementation of the new payroll subsystem may result in the inclusion of inaccurate data in the financial statements for the year ending June 30, 1978.

A new payroll subsystem was included in the new budgeting and accounting system planned for the city because of extensive weaknesses in the old payroll system. In an assessment of the system dated January 15, 1976, American Management Systems, Inc., identified the following problems:

"Lack of Controls -- Control totals, document number checks, and other controls on the flow of documents and transactions are virtually nonexistent.

"Lack of Auditing -- Although the Comptroller's Office is supposed to conduct audits of payroll

payments, current audits are limited in scope. The tight schedule that most payrolls operate on demand that everyone focus on obtaining the proper signatures and moving the paper rather than look at what is being transacted.

"Refunds -- Not only is refund processing cumbersome but refunded amounts are not included on most reports including the recaps which show fiscal year expenses by budget line.

"Budget Control -- Despite the elaborate procedures for checking current payroll expenditures against prorated appropriations, Central Payroll's current control methods do not catch all budget overruns before the checks are released.

"Payroll Processing Delays in the Agencies -- For a variety of reasons, large transaction delays and backlogs often occur in agency payroll divisions. Retroactive collective bargaining payments, for example, often take as much as six months before the payroll clerk gets around to computing the amount due and submits the transactions."

It was recognized by city and contractor officials that complete and accurate payroll information was essential to improve the financial management of the city and to produce accurate financial statements. As a result, the city's initial plan for the new budgeting and accounting system included a payroll subsystem. The original plan provided for the payroll subsystem to be implemented on July 1, 1977, with the rest of the system.

During our review, city officials had informed us that they would implement only part of the payroll subsystem on July 1, 1977, and would defer the remainder of the subsystem until January 1, 1978. They said this was necessary because the subsystem could not be completed by July 1, 1977.

The decision to defer implementing part of the payroll subsystem would require the city to continue using information produced, at least partially, by the existing payroll system until January 1, 1978. Although the city planned to make some improvements in the existing system, we questioned whether the improvements would enable the system to produce complete and accurate information. In our view, accurate payroll information probably would not be produced until January 1, 1978, and as a result, the financial statements produced by the city for the year ending June 30, 1978, may be inaccurate.

City officials stated that the existing payroll system will be improved prior to July 1, 1977, and as a result, the city should have auditable payroll records for the year ending June 30, 1978. They said that they would consider limiting the audit if it appears that the records will not be auditable.

The auditability of the records should not be the only basis for determining whether to audit information produced by the existing payroll system. We believe that the decision should consider the relative accuracy of the records. If the information produced by the existing payroll system after July 1, 1977, is grossly incomplete or inaccurate, the cost of the audit could be prohibitive.

Enterprise and intragovernmental service funds have not been established

The city has not established enterprise and intragovernmental service funds even though such funds are necessary to receive an auditor's unqualified opinion on the city's financial statements.

The principles of governmental accounting and reporting issued by the National Council on Governmental Accounting require establishing (1) enterprise funds to account for the financing of services to the general public where all or most costs involved are paid in the form of charges to users and (2) intragovernmental service funds to account for the financing of special activities and services performed by a designated organization unit for other units within the same governmental jurisdiction. An auditor ordinarily will not give an unqualified opinion on the financial statements of a municipality which has not complied with this principle.

City officials informed us that they were unable to include enterprise and intragovernmental service funds in the design of the new budgeting and accounting system because of the limited time available to develop the system.

On June 8, 1976, city officials requested authorization from the Municipal Assistance Corporation for the City of New York to defer establishing enterprise and intragovernmental service funds until July 1, 1979. The reason for this action may be found in the law creating the corporation, which states that the city and the corporation are to

"formulate a mutually acceptable method of phasing
* * * adjustments into such accounting system over
such reasonable period, not exceeding ten years,
as the corporation may determine to be appropriate
* * *."

The corporation approved the city's request on October 29, 1976.

We are aware of at least three city operations which should be accounted for as enterprise funds: Mitchell-Lama housing, water and sewer systems, and off-street parking.

The city has numerous operations which should be administered as intragovernmental service funds. At the request of the city, Touche Ross & Co. made a study of the services performed by the Municipal Services Administration and recommended that the following be accounted for as intragovernmental service funds: gas and electricity purchasing, building maintenance, repair shops, municipal telephone service, motor pool, leased space, and data processing.

The city will be unable to receive an auditor's unqualified opinion on its financial statements until enterprise and intragovernmental service funds have been established.

City officials stated that they expect the audit for fiscal year 1978 to be for the purpose of determining whether the city complied with the accounting directives issued by the State Comptroller rather than for the purpose of determining whether the financial statements fairly present the city's financial position and results of operations in conformity with generally accepted accounting principles. The city is not required, they say, to comply with the accounting directives requiring enterprise and intragovernmental service funds because it has been authorized to defer the implementation of those directives until July 1, 1979.

No comments were made on the objective of the audit to be performed for the year ending June 30, 1979. Of course, the financial statements for that year also will not fairly present the city's financial position and results of operations in conformity with generally accepted accounting principles if the city does not establish enterprise and intragovernmental service funds on July 1, 1978.

The city had not requested the Treasury Department to approve its decision to defer establishing enterprise and

intragovernmental service funds even though such authorization appears to be warranted. In this regard, the credit agreement requires the city to establish an accounting system for the fiscal year beginning July 1, 1977, that is in accordance with the accounting principles in the State Comptroller's Uniform System of Accounts for Municipalities, as modified by the State Comptroller in consultation with the city. These principles require the establishment of enterprise and intragovernmental service funds and, therefore, the city's failure to provide them would apparently constitute a violation of the terms of the credit agreement.

Financial statements for the Capital
Projects Fund will be inaccurate

The financial statements for the Capital Projects Fund will be inaccurate for a few years because of erroneous data accumulated prior to July 1, 1977.

The principles of governmental accounting and reporting issued by the National Council on Governmental Accounting require financial statements for capital projects funds to contain cumulative financial information about each project. Most capital projects require several years to complete, and therefore much of the information contained in the statements will have been accumulated in prior years.

City officials plan to defer inclusion of the Capital Projects Fund in the new budgeting and accounting system for 2 or 3 years because of the limited time available to design the system. They recognized that the existing accounting system was not producing complete and accurate data, however, and requested Touche Ross & Co. to improve the accounting system presently operated by the Comptroller's office so that it could produce reliable accounting information for the Capital Projects Fund.

City and contractor officials said that the Comptroller's accounting system is basically a good system, and they believe it will produce complete and accurate information starting July 1, 1977. However, the financial information accumulated prior to July 1, 1977, will not be corrected.

In addition to the errors caused by weaknesses in the accounting system, through the years the city has charged millions of dollars of expenses to the Capital Projects Fund which should have been charged to the General Fund. Although the city will charge such expenses to the General Fund after

July 1, 1977, the financial statements for the Capital Projects Fund will continue to be distorted by the expenses erroneously charged in prior years.

City officials said that accounting data accumulated prior to July 1, 1977, could not be corrected because there was no way to verify the accuracy of the amounts which had been recorded. Missing information needed to verify the records' accuracy will prevent an auditor from performing an essential audit procedure. Therefore, we believe that until projects for which large amounts of costs were accumulated prior to July 1, 1977, have been completed, a meaningful audit of the Capital Projects Fund will not be possible.

Financial statements will not contain
a statement of general fixed assets

City officials do not plan to establish monetary control over the city's general fixed assets until July 1, 1979. As a result, the city will not be in a position to receive an auditor's unqualified opinion on the financial statements until fiscal year 1980.

In its industry audit guide for State and local governmental units, the American Institute of Certified Public Accountants said that a statement showing general fixed asset balances at the statement date is necessary for presentation of financial position. Although the inclusion of certain improvements other than buildings (e.g., streets, bridges, curbs, drainage systems, lighting systems) in the statement is optional, a certified public accountant is not to give an unqualified opinion on the financial statements of a municipality if they do not include a statement disclosing the value of the fixed assets.

The city has not maintained accurate records of its fixed assets and therefore will not have the information needed to prepare a statement of general fixed asset balances until it conducts a physical inventory of all such assets and establishes their value. A city official informed us that they will not make such an inventory at this time because it would require an exorbitant amount of personnel resources.

On June 8, 1976, city officials requested the Municipal Assistance Corporation for the City of New York to authorize them to defer the recording of new assets until fiscal year 1978 or 1979, and to defer the development of an inventory of

existing assets for approximately 3 years. The corporation approved the city's request on October 29, 1976.

City officials stated that they expect the audit for fiscal year 1978 to be for the purpose of determining whether the city complied with the accounting directives issued by the State Comptroller, rather than for the purpose of determining whether the financial statements fairly present the city's financial position and results of operations in conformity with generally accepted accounting principles. Therefore, they believe that the absence of a statement of general fixed asset balances in the city's financial statements for fiscal year 1978 will not result in an auditor's qualification of the city's financial statements. The city did not comment on the financial statements for fiscal year 1979, which also will not include a statement of fixed asset balances under the city's present plan.

The city had not requested the Treasury Department to approve its decision to defer establishing monetary control over fixed assets even though such authorization appears to be warranted. In this regard, the credit agreement requires the city to establish an accounting system for the fiscal year beginning July 1, 1977, that is in accordance with the accounting principles contained in the State Comptroller's Uniform System of Accounts for Municipalities, as modified by the State Comptroller in consultation with the city. These principles require the establishment of monetary control over fixed assets and, therefore, the city's failure to provide them would apparently constitute a violation of the terms of the credit agreement.

CONCLUSIONS

Unless some terms of the credit agreement between New York City and the Treasury are waived or amended, the city will be in 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.

New York has been making great progress in its systems design work, and accordingly, we believe that Treasury should reexamine the agreement. If it deems it necessary for orderly and effective completion of the work, Treasury should authorize the city to do the following:

- Defer implementing portions of the payroll subsystem for a reasonable period and, if necessary, defer the encumbrance control subsystem.
- Defer for a reasonable period the implementation of those aspects of the system for which training will be inadequate on July 1, 1977.
- Limit the audit of the financial statements for the year ending June 30, 1978, to that financial information which the city determines to be reasonably complete and accurate, even if it would not result in an auditor's opinion. Such an audit would give the city confirmation that the implemented aspects of the new system are operating properly, but would save the expense of auditing data that is known to be inaccurate. State and city auditors should continue to audit internal controls of all the city's accounting systems to identify areas requiring corrective action.
- Defer implementing enterprise and intragovernmental service funds until July 1, 1978.
- Exclude the Capital Projects Fund from audits of the city's financial statements until most of the projects for which large costs were accumulated prior to July 1, 1977, have been completed.
- Defer establishing monetary control over fixed assets until fiscal year 1979.

RECOMMENDATION

We recommend 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 when needed to complete the work in an orderly and effective manner.



STATE OF NEW YORK
DEPARTMENT OF AUDIT AND CONTROL
270 BROADWAY, NEW YORK CITY

ARTHUR LEVITT
STATE COMPTROLLER

November 9, 1976

IN REPLYING REFER TO

U.S. General Accounting Office
26 Federal Plaza
New York City, New York 10007

ATTN: Mr. Edward Hefferin, Project Manager

Dear Mr. Hefferin:

The purpose of this letter is to offer my office's comments on certain aspects of the draft report "GAO Observations ON NEW YORK CITY'S EFFORTS TO IMPROVE ITS ACCOUNTING SYSTEMS," (B-185522), issued by the GAO recently. These comments supplement the lengthy telephone discussions I had with Mr. Jim Oliver before issuance of the draft.

[See GAO note page 24]

Mr. Edward Hefferin
November 9, 1976
Page 2

[See GAO note page 24]

b. Page 2 of the draft notes the GAO's unawareness of any comprehensive listing of the numerous weaknesses in the City's accounting system. Your attention is respectfully drawn to State Comptroller Levitt's report of September 30, 1976 summarizing the accounting system directives (ASD's) for New York City issued by his Metropolitan Area Office (Audit Report NYC-44-77; copy attached). While not a comprehensive listing, this report does address itself to the major problem areas. It sets forth the relationship between the accounting system directives, which intended to conform the City's accounting to generally accepted accounting principles for municipalities, and the basic system weaknesses, as well as their effect, which led to the need for the ASD.

[See GAO note page 24]

Mr. Edward Hefferin
November 9, 1976
Page 3

draft report notes that the City's financial statements for the year ending June 30, 1978 will probably be inaccurate because the new payroll/personnel subsystem will only have been in operation for half a year. It is not illogical to further conclude that the GAO believes such inaccuracies will have a material effect on the expression of an auditor's opinion.

We have no basis at this time for such a conclusion. One must first define "material" to evaluate what condition or degree of conditions might cause a disclosure comment or qualification of the financial statements. There are no formal guidelines in this respect for municipalities in line with the practices which have developed in the private sector. Materiality is a concept which cannot be precisely defined because it is highly dependent upon judgment. The primary question is whether a condition is such that it must be accounted for to prevent the financial statements from being misleading. Do you measure any proposed degree of inaccuracy with the overall budget, the overall City payroll, the payroll within a particular fund, or by its net effect on fund surplus or deficit? In any event, inaccuracies which are not deemed significant will not affect the financial statements although they would probably be discussed in a management letter accompanying the audit report. To illustrate the extent of this problem, approximately .1% of payroll expenditures in New York City would approximate \$3.5 million based on a gross payroll of \$3.5 billion. If this were decided as the measure of materiality only inaccuracies projected at more than such amount would affect the financial statements. We in the State Comptroller's audit unit are presently studying this matter of what materiality shall be with reference to the City's financial statements. The matters arose with reference to adjustments which should be taken in as part of the current year's operations, or should be recorded in the fund balance account.

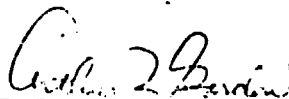
Moreover, the City is obviously going somewhat slower in changes to its present payroll system than in other areas to ensure its continued ability to render the primary service of being able to prepare and distribute pay checks when due.

e. Page 24 of the draft discusses the Intragovernmental Service fund. The establishment of such a fund is optional on the part of the City. We definitely recommended it but its lack of implementation will not result in a lesser auditor's opinion as all the requisite transactions would still be in the general fund and subject to audit. With respect to the Enterprise Fund, City officials have requested the permission of MAC to defer implementation. Such approval is within MAC's legal authority.

Mr. Edward Hefferin
November 9, 1976
Page 4

I hope the above comments will be of help in the finalization of your report.

Very truly yours,



Arthur N. Gordon, Director
Metropolitan Area Office

ANG/td
Enc.

GAO note: Deleted comments relate to material contained in the draft report which has been revised or which has not been included in the final report.



THE CITY OF NEW YORK
Office of the Mayor and Office of the Comptroller
NEW YORK, N.Y. 10007

November 23, 1976

Mr. Francis X. Fee
Regional Manager
New York Regional Office
U.S. General Accounting Office
26 Federal Plaza
New York, NY 10007

Dear Mr. Fee:

On behalf of the Office of the Mayor and the Office of the Comptroller of the City of New York, we are transmitting the enclosed statement entitled "City of New York Statement on the Integrated Financial Management System Project." It represents the City's official response to the GAO's proposed report to the Congress on "GAO's Observations on New York City's Effort to Improve Its Accounting Systems."

If you have any questions please do not hesitate to contact either one of us.

Sincerely,

A handwritten signature in dark ink, appearing to read "S. A. Clifford".

Steven A. Clifford
Office of the Comptroller
Co-Director, IFMS Project

A handwritten signature in dark ink, appearing to read "D. G. Woodbridge".

David G. Woodbridge
Office of the Mayor
Co-Director, IFMS Project

City of New York
Statement on the Integrated Financial Management System Project

November 22, 1976

The City has reviewed "GAO Observations on New York City's Effort to Improve Its Accounting System" and finds it, in general, to be an objective and perceptive assessment of the progress to date, future plans, and potential problems.

The Credit Agreement between the City and the Federal Government requires the City to "...pursue with diligence the design and implementation of (a) new accounting system and ... that by July 1, 1977 the City will have established an accounting system which will establish adequate records and controls which would enable an auditor to perform an annual audit and render an opinion thereon."

The City's compliance to date and continuing commitment towards these goals is confirmed by GAO's statement that:

The City and its contractors have made remarkable progress toward the implementation of a new accounting system by July 1, 1977, the date mandated by the State of New York and the Treasury Department. In the 9 months since the first contracts were awarded, the accomplishments of the City and its contractors far exceed those which would normally be expected in such a complex system development effort.

The progress to date does not necessarily assure continued performance at the same high level since each phase of the Project differs; many of the most intricate phases of the Project lie ahead. The City appreciates the concerns of the GAO and expects in a systems project of this magnitude to experience implementation problems and to continue training efforts for some time after conversion. Nonetheless, the City believes it will meet the two major objectives of IFMS. They are to:

- Improve financial management and controls at all levels in the City;
- Install auditable budget and accounting systems which are in accord with the Accounting System Directives issued by the State Comptroller pursuant to the legislation which created the Municipal Assistance Corporation.

In order to meet these objectives, the following steps will be taken:

- In the event that some or all of IFMS is delayed, bridging procedures will be developed which should enable the City to maintain its records in a manner that fulfills the objectives. These procedures will include but not be limited to:
 - enhancements to the current accounting system to strengthen its control capability, to improve its auditability, and to make it compatible with the new budget format;
 - new modules for the current payroll system to enable it, on a short-term basis, to meet the requirements of the new standards.
- The new payroll system will be implemented during FY1978 rather than as of July 1, 1977. This should enable orderly implementation of a most complex business application and ease the impact of IFMS implementation on the user agencies.
- Consideration will be given to advantages and disadvantages of delaying the implementation of the Encumbrance Control System. A benefit would be to facilitate IFMS implementation in the user agencies. But, system development would not be eased.
- In the near future, the Mayor will hold a cabinet meeting to remind all Administrators and Commissioners of the importance to the City of the successful implementation of IFMS and to emphasize the need for their active participation and cooperation.

- The successful staffing of the Financial Information Services Agency may be accomplished by using "facilities management/turn key" methods if hiring efforts are not successful. It should be kept in mind that the original intent was to transfer people from the Office of Management and Budget and the Comptroller's Office data center operations to FISA. This is proving not to be feasible because of the intense pressure on these operations by the current need for financial information. By using the "facilities management/turn key" method, FISA will be able to begin operating on time and protect the FISA jobs for personnel currently on staff in OMB and the Comptroller's Office.
- The City will arrange to have extensive follow-up training, technical support and other supplementary procedures in order to facilitate IFMS operations during the start-up period.

The City is prepared to allocate the resources needed to take these steps.

As to the City receiving an opinion on its financial statement for FY 1978, there are a number of points to be covered.

Based on the steps outlined above, the City should have auditable records. The GAO recommendation that only those portions of the records maintained by IFMS be audited will be considered if it appears that the City cannot meet its goal of having auditable records. As to the General Fund in which most of the City's activities are reflected, the potential problems appear, at this time, to be minimal.

The City intends to issue financial statements for FY 1978 which are in accordance with the Accounting System Directives issued by the State Comptroller pursuant to the legislation which created the Municipal Assistance Corporation. The City also expects the audit opinion to be based on these ASDs which some may consider to be at variance with generally accepted accounting principles for municipalities. It should be noted that MAC, pursuant to the legislation which created it, has given the City permission to delay three requirements of the ASDs. They are budgeting and accounting for water and sewer operations as an enterprise fund, budgeting and accounting for the operations of the Municipal Services Agency as an intragovernmental service fund, and the establishment of a fixed asset group of accounts. If new problems of a similar nature should arise, the City would seek relief from MAC. At this time, problems are not anticipated.

The City realizes that it will be difficult if not impossible for it to receive a clean opinion on its FY 1978 financial statements. However, it does not believe that the various potential problems preclude the receiving of an opinion. This in itself will be a giant step forward which will do much to restore creditability in the City's fiscal structure.

The drawbacks of the time requirement for IFMS implementation are obvious; however, the benefits should be considered. It gives all concerned in the City a sense of urgency and discipline which would not be obtainable if implementation were delayed by a year. This has been an important factor in the success to date in what the City believes will be a continuing success story.