



**Report on Investigation of General Fund Cash Reserves
and Projected Fiscal Year 2015 - 2016
Revenues/Expenses for the City of Hawthorne**

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Vasquez
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Arnold Shadbeh
Interim City Manager
City of Hawthorne
4455 W. 126th Street
Hawthorne, CA 90250

Dear Mr. Shadbeh:

Vasquez & Company LLP (Vasquez) is pleased to present the results of our engagement to assist the City in its efforts to promote clarity and transparency regarding the City of Hawthorne's financial condition.

Scope and Objectives

The scope of our study was to investigate certain records and transactions of the City's Finance Department for the purposes of clarifying the City's sources and uses of General Fund cash during the year ended June 30, 2015 and the General Fund cash balance at June 30, 2015. We also considered claims against the City's cash balance during the past few years. The City's proposed General Fund budget for fiscal year 2015 - 2016 as of August 15, 2015 was reviewed for purposes of calculating the expected Cash Balance (Deficit).

The primary objective associated with the study was to provide an understanding and assurance as to the status of the cash balance of the General Fund as of June 30, 2015, and the disposition of the cash balance of the General Fund which was reported in the June 30, 2014 audited financial statements to be \$10,707,046.

Approach

In order to accomplish the project objectives we performed research and investigatory procedures including the following:

1. Obtained the detail of general ledger transactions for the City's General Fund for the fiscal year 2014 - 2015.
2. Sorted cash transactions by account code to develop a summary of cash sources and uses.
3. Performed analytical procedures on fiscal year 2014 - 2015 revenues and expenditures, comparing recorded amounts to prior year and estimates as reflected in the annual operating budget.
4. Researched certain transactions, based on pre-defined criteria, to validate or clarify the nature of the transaction.



5. Reviewed July and August 2015 revenue and expenditures information as necessary to evaluate accruals for unpaid liabilities and uncollected revenues for proper recording in fiscal year 2014 - 2015.
6. Reviewed bank reconciliations supporting the recorded cash balances as of June 30, 2015 and July 31, 2015.
7. Reviewed City's Cost Allocation Plan for unusual or improper allocations of costs to or from the General Fund.
8. Conducted interviews with City management and staff within the Finance Department as considered necessary to understand revenue and expenditure accounting practices.
9. Reviewed projections underlying the proposed fiscal year 2015 - 2016 General Fund budget.
10. Developed a report and presentation materials to clearly present the cash sources and uses for fiscal year 2014 - 2015, the ending cash balances and reserves against those balances as of June 30, 2015, and the projected ending cash balance as of June 30, 2016.
11. Reviewed previous years Audited Financial Reports (CAFRs).

Study Results

The study found that the City's financial condition has worsened subsequent to fiscal year 2013 - 2014 primarily because certain anticipated funding sources did not materialize and unplanned expenditures occurred. In fact, the cash available to finance the fiscal year 2015 - 2016 General fund budget is only approximately \$4.1 million which represents the Operating Cash Balance. The City's Rainy Day Fund of \$4 million is invested in LAIF and MBS. The Operating Cash Balance of \$4.1 million is sufficient to fund only about three (3) weeks of operations.

A summary of the fiscal year 2013 - 2014 financial condition, major financial events occurring in fiscal year 2014 - 2015, and projected future events expected to occur in fiscal year 2015 - 2016 which will impact the June 30, 2015 financial position are summarized below. Unless otherwise stated, all fund balances, revenues and expenditures relate solely to the City of Hawthorne General Fund.

Fiscal Year 2013 - 2014 Fund Balances and Cash Position

The City concluded fiscal year 2013 - 2014 with a General Fund Cash Balance amounting to \$10,707,046.

At June 30, 2014, substantial liabilities existed that the City would be required to pay primarily from the General Fund, even though, in accordance with generally accepted accounting principles, those liabilities were not reflected in the General Fund. These liabilities included the Insurance Reserve Fund deficit net position (liabilities in excess of assets) of \$6.4 million, the liability for Other Post-Employment Benefits amounting to \$49.7 million at June 30, 2013 (most recent valuation available), and the unfunded pension liability of \$39.2 at June 30, 2013 (most recent valuation available).

It was with this cash balance and the outstanding claims against it that the City entered into fiscal year 2015.



Fiscal Year 2014 - 2015 Operating Results

The City began fiscal year 2014 - 2015 with a General Fund budget that proposed Expenditures of \$62.6 million balanced by estimated Revenues of \$59.4 million and General Fund reserves of \$3.1 million. The Annual Budget Document disclosed (in the Revenue Detail Section) that, included in Proposed Revenue amounts for fiscal year 2014 - 2015, was \$3,067,027 from the unassigned fund balance residual.

As of August 31, 2015, after the City recorded all known year-end adjustments for matters such as uncollected receivables, interfund loan, accrued payroll and payables owed to vendors, the City reported actual Revenues for fiscal year 2014 - 2015 of \$58.7 million while actual Expenditures totaled \$61.9 million. This deficit of \$3.2 million is substantially financed by General Fund cash reserves.

Additional revenue sources were contemplated by management which may have allowed the City to avoid spending the General Fund Reserves; however, the approved budget did not identify and include these revenue sources, but rather provided funding from the \$3.1 of General Fund Reserves.

Fiscal Year 2014 - 2015 Fund Balance and Cash Position

The City concluded fiscal year 2014 - 2015 with a General Fund Operating Cash Balance amounting to \$4.1 million and a Rainy Day Fund of \$4 million. Therefore, the City's Operating Cash *available for appropriation* is only \$4.1 million which represents less than one month's operating costs and is well below recommended levels.

Fiscal Year 2015 - 2016 Reserves and Operating Projections

The City's Finance Department is projecting General Fund revenues for fiscal year 2015 - 2016 to be approximately \$59 million. This may be compared to 2015 revenues of \$58.7 million, or a .05% increase from 2015. We reviewed the projections and supporting documentation underlying the most significant revenue categories and found them to be reasonable and supported by third-party information sources.

General Fund expenditures are projected to be approximately \$65.2 million, assuming a "business as usual" scenario. This may be compared to 2015 expenditures of \$61.9 million, which is a 5.3% increase. The primary reason for this increase in expenditures is increasing PERS costs for employee pension and medical costs as well as salary step increases.

The projected revenues of \$59 million will not be sufficient to finance estimated expenditures of \$65.2 million. It is this projected \$6.2 million deficit that has prompted management to seek significant cost reduction measures.

Accordingly, City management is evaluating options to reduce costs by \$6.2 million on an annual basis. Because one-fourth of the year (3 months) will likely have passed before substantial cost saving measures can be implemented, the City will only realize a portion of the annual savings potential. Therefore, even if the City implements budget reduction measures immediately, the City will continue to spend down Cash Reserves in fiscal year 2015 - 2016.



Outlook For the Future

The City has recently balanced its budget by including General Fund Reserves as a financing source. The budgets for fiscal years 2013 - 2014 and 2014 - 2015 reflect deficit spending, as shown below:

Fiscal Year	Reserves Used To Balance the Budget
2013 - 2014	\$1.5 million
2014 - 2015	\$3.2 million

As discussed above, the proposed 2015 - 2016 budget reflects spending an additional \$6.2 million of General Fund Reserves in order to finance the \$6.2 million deficit. Because the City considers \$4 million of Cash to be its Rainy Day Fund, and thus unavailable for appropriation for normal operations, the draft budget would have the City spending cash reserves which it will not have on hand.

If the City spends its cash reserves pursuant to the above projection, the General Fund Cash Balance will be substantially depleted if not exhausted.

Further, not only must the City manage the threat of declining Cash Reserves, it also faces additional costs not presently recorded in the General Fund, but ultimately to be paid, at least substantially, by the General Fund. These include:

- Insurance Fund Deficit (liabilities in excess of assets) of \$6.4 million
- Escalating retiree medical care costs (Other Post-Employment Benefits) with an unfunded liability of \$49.7 million at June 30, 2013 (most recent valuation available)
- Escalating pension costs, with an unfunded pension liability of \$39.2 at June 30, 2013 (most recent valuation available)
- Pension Obligation Bonds with escalating annual debt service payments.

The City's General Fund Balance is not sufficient to finance these increasing costs, and any worsening of the financial condition caused by operating deficits will place the City in an even more precarious financial position.

Conclusion

We have appreciated the opportunity to assist the City in its efforts to clarify the City's financial position, explain historical data contributing to current conditions, and focus stakeholders on the challenges facing the City in fiscal year 2015 - 2016 and beyond. We are available to discuss this investigation and our findings upon request.

VASQUEZ & COMPANY LLP

Margaret J. McBride
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