



MINNESOTA OFFICE OF THE STATE AUDITOR

PETITION AUDIT

**CITY OF CAMBRIDGE
CAMBRIDGE, MINNESOTA**

JANUARY 1, 1991 - DECEMBER 31, 1995

**JUDITH H. DUTCHER
STATE AUDITOR**

PETITION AUDIT

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PETITION AUDIT

INTRODUCTION

In March 1997, the Office of the State Auditor (OSA) received a petition from the citizens of the City of Cambridge (City) which requested that the OSA perform a financial and compliance audit of the City, in accordance with Minn. Stat. § 6.54, for the period January 1, 1991, through December 31, 1995.

The request was precipitated by the City's present financial condition and the extent of outstanding debt owed by the City. This debt placed the City of Cambridge first among Minnesota cities with populations over 2,500 for the amount of debt owed per capita in 1995. As of December 31, 1995, the City of Cambridge and its component units owed over \$33,000,000 in long-term debt which equates to each citizen living within the City of Cambridge owing over \$6,300. Cities with comparable populations had average debt per capita in 1995 of \$1,200.

Our audit found that the City's current financial condition is perilous. Moreover, our audit found that the financial condition of the City has steadily deteriorated between January 1989 and December 31, 1995. Finally, absent significant change and intervention, the financial condition of the City will continue to deteriorate.

Our major findings related to the City's financial condition include the following:

I. Improper Oversight and Management Issues

- Over the last eight years, the City has experienced a serious decline in its financial position. Indications of this decline include:
 - Numerous funds¹ experienced cash deficits during the period under review.
 - Funds were improperly transferred between various restricted debt service accounts and other unrelated City accounts, in violation of bond covenants and loan agreements.
 - The City failed to conduct operations within its approved budget and its total financial resources. The City's total revenue, including its property tax collections, were insufficient to fully fund its annual operating costs.

¹A fund is a fiscal and accounting entity used to record and segregate specific financial activities with a self-balancing set of accounts.

- The City improperly used warrants as a debt instrument to meet its financial obligations. The use of warrants circumvented the effective oversight of debt issuance or debt management by the City.

II. Improper Oversight and Management of Development Projects

- The City repeatedly found itself involved in development projects that were insufficiently funded because:
 - Estimates of development costs were often woefully inadequate. Cost overruns occurred and change orders were made without proper approval or oversight by the Council.
 - Many property assessments² against developers or homeowners were never certified, were certified for lower amounts, or were certified late. These assessments were needed to support the City's many development projects.
 - Sewer rates, which had been recommended by a consultant retained by the City, and subsequently approved by the Minnesota Pollution Control Agency, were never, in fact, implemented. This violated the loan agreement between the City and the Public Facilities Authority and resulted in critical shortfalls of revenues, necessitating the restructuring of debt obligation to the Public Facilities Authority.
 - Improper transfers from development funds often violated bond covenants and loan agreements.
 - Failure to invest prepaid assessments in financial instruments as required by the bond documents.
 - Use of prepaid assessments for unauthorized purposes.
 - Tax increment revenues³ were either insufficient or were not levied in a timely manner.

²Assessments are a compulsory levy made against certain properties to defray all or part of the costs of a specific capital improvement or service deemed to benefit primarily those properties.

³Tax increment revenues are the incremental increase in tax revenues resulting from the development of an area.

As a result of the above conditions, the City experienced a negative financial impact of \$8,434,166 for the eight-year period under our review. The extent of this shortfall is even greater if lost interest earnings are considered.

The primary causes for these conditions can be attributed to mismanagement by the former City Clerk-Administrator and a lack of adequate oversight by the City Council. The former City Clerk-Administrator failed to insure that there was adequate funding for the many improvement projects that were occurring and the City Council failed to question many of the former City Clerk-Administrator's actions. Given the extent of development taking place in the City of Cambridge, the Council should have been more active in reviewing their progress and ensuring that there was adequate funding available. It appears that some of the City's short-term debt issuances were discussed between the former City Clerk-Administrator and individual Council members. However, the Council should have realized the inappropriateness of such discussions and, collectively, should have been more concerned with the City's overall financial condition.

The above conditions created an environment in which the true financial picture of the City was often masked and mismanagement occurred without being detected. As a result, the City's outstanding debt obligations have increased significantly, while the revenue sources to retire the debt have not been sufficient to meet those obligations.

The financial mismanagement, outlined in detail in the following audit report, has had the following financial impact on the taxpayers of the City.

| | |
|--|-------------------------|
| Improvements to properties that were not assessed | \$ 590,023 |
| Improvements to properties that were only partially assessed | 940,000 |
| Unauthorized bond expenditures | 75,775 |
| Failure to implement user fees | |
| Sewer | 1,500,000 |
| Trunk facilities and storm sewer | 1,148,000 |
| Lost interest due to delayed assessments | 142,000 |
| Cost overruns | 557,025 |
| Certificates in violation of statutory purpose | 1,613,600 |
| Bonds issued to cover debt service shortfalls | 753,734 |
| Inappropriate transfers out of bond funds | 324,538 |
| Unnecessary interest costs | 262,575 |
| Future interest costs | <u>526,896</u> |
| Total | <u>\$ 8,434,166</u> |

The following sections contain details of our findings, together with our recommendations, of the specific areas we were asked to review as part of the petition audit.

FINDINGS AND RECOMMENDATIONS

I. 1992 AND 1995 MINNESOTA PUBLIC FACILITIES AUTHORITY LOANS

Between 1992 and 1995, the City of Cambridge obtained two loans from the Minnesota Public Facilities Authority (PFA) to finance construction and improvements to the City's wastewater system. The loan proceeds totaled \$10,917,224 and are to be repaid from fees collected in the Disposal Utilities Enterprise Fund⁴ at rates approved by the Minnesota Pollution Control Agency (MPCA).

A. General

In July 1992, the City entered into a loan agreement with the PFA to finance construction and improvements to the wastewater treatment facility and interceptor project. The majority of the construction took place between 1992 and 1994, and resulted in total proceeds to the City of \$10,499,371 for the 1992 loan. The 1992 PFA loan agreement required the City to begin repaying the loan in August 1994 and continuing for 20 years until final payment in February 2014.

In July 1995, a second loan agreement in the amount of \$417,853 was entered into between the City and the PFA for financing costs to extend sanitary sewer services along East Trunk Highway 95 to the site of the Wal-mart store. Most of the construction and related engineering costs began and were completed in 1995. Scheduled debt payments for the second loan began in February 1997 and are to continue for 20 years until final payment in August 2016.

In January 1997, the City requested that the PFA restructure the loans by deferring a portion of the principal payments until later dates. This restructuring was needed because of a continuing decline in the City's overall financial condition and insufficient funds in the Disposal Utilities Enterprise Fund from which the loans were to be repaid.

⁴Enterprise funds are funds established to account for operations financed and operated in a manner similar to private business enterprises (for example, water, sewer, or liquor store).

As described in detail below, the need to restructure the PFA loans appears to have been caused by: (1) transfers which were in violation of loan agreements or contrary to Council action; (2) failure to approve and impose sewer rates as required by the MPCA, and failure to review rates on an annual basis; and (3) a cost overrun.

B. Transfers in Violation of Loan Agreements and Council Actions

In reviewing transfers related to the 1992 and 1995 PFA loans, the following items were noted.

1. In December 1995, the City Council approved a \$150,000 transfer from the East Highway 95 Capital Project Fund to the General Fund.⁵ This transfer is in violation of the PFA loan agreement.

The 1995 PFA Project Loan Agreement stipulates that the loan proceeds were to be used, ". . . for the purpose of funding the wastewater treatment project. . . ."

This transfer to the City's General Fund was made possible because the East Trunk Highway 95 project received \$178,626 more in funding than the actual cost of the project. The following summarizes the activity within the East Highway 95 Capital Project Fund in the last three years:

| | |
|------------------------------|-------------------|
| Financing Sources | |
| 1994 - Miscellaneous revenue | \$ 8,000 |
| 1995 - PFA loan proceeds | 417,853 |
| 1996 - Wal-mart payment | <u>378,509</u> |
| Total financing sources | \$ 804,362 |
| Total cost of the project | <u>(625,736)</u> |
| Total Excess Financing | <u>\$ 178,626</u> |

The OSA has concluded that the transfer of \$150,000 came from PFA loan proceeds because the only other major source of financing, the 1996 Wal-mart payment, could not have been the source of excess revenue. This conclusion is based upon the following:

⁵The General Fund is the fund used to account for all financial resources except those required to be accounted for in another fund.

- Pursuant to an agreement between the City and Wal-mart, Wal-mart's share of the project cost was approximately 60 percent of \$625,736, as incurred and recorded entirely in the East Highway 95 Capital Project Fund.
- The \$150,000 transfer occurred in December 1995 and the Wal-mart payment was not received until January 1996.

The majority of the 1995 PFA loan proceeds were received four weeks prior to the transfer. Therefore, we have concluded that the \$150,000 of excess financing transferred to the General Fund was from the PFA loan proceeds.

The 1995 audited financial statements provide that the \$150,000 transfer had been made to the General Fund to "reimburse for expenses" of this project. However, no documentation exists to support this. In fact, based on the final cost analysis of the project as done by the consulting engineers, and with which we concur, all expenses were recorded in the East Highway 95 Capital Project Fund, not the General Fund. Thus, this transfer to the General Fund is in violation of the loan agreement.

Upon completion and analysis of the project, the City did not notify the PFA of the excess funds. In addition to the transfer to the General Fund, the remaining balance of \$28,626 was spent on an unrelated project along the same highway.

If the \$150,000 had not been transferred to the General Fund in 1995 and the \$28,626 had not been spent on an unrelated project, the excess funding would have reduced the 1995 PFA obligation. Instead, future debt payments will be greater than what would have been required, ultimately resulting in increased sewer rates for the citizens of Cambridge.

2. In August 1994, the City Council approved a transfer of \$31,000 from the Interceptor Capital Project Fund (part of the 1992 PFA loan for the wastewater treatment plant project) to the 1993 Wastewater Bonds Debt Service Fund.⁶ This transfer was recorded in the City's internal accounting records consistent with Council approval. However, the 1994 audited financial statements reported a transfer of only \$8,834

⁶A debt service fund is a fund established to account for the accumulation of resources for, and the payment of, general long-term debt principal and interest.

to the 1993 Wastewater Bonds Debt Service Fund, with the remaining balance being reported as \$11,537 transferred to the 1993 Economic Development District #6.4 Debt Service Fund and \$10,629 to the Improvement Bonds of 1993 Carriage Hills Debt Service Fund. Because transfers as reported in the 1994 audited financial statements did not accurately reflect those approved by the City Council, the transfers to the 1993 Wastewater Bonds Debt Service Fund were short by \$22,166

It is not clear why this reporting difference occurred. The 1993 Economic Development District #6.4 and Improvement Bonds of 1993 Carriage Hills Debt Service Funds are unrelated to the interceptor project. Thus, these transfers also violate the PFA loan agreement.

The OSA found no documentation to support the transfers for \$11,537 and \$10,629. This absence of documentation is in violation of the 1992 and 1995 PFA Project Loan Agreements which state that, "for all expenditures of funds made pursuant to this agreement, the Borrower shall keep financial records in accordance with generally accepted accounting principles, including invoices, contracts, receipts, vouchers, and other documents sufficient to evidence in proper detail the nature and propriety of the expenditures."

The transfers above--the \$150,000 to the General Fund, \$11,537 to the 1993 Economic Development District Debt Service Fund, and \$10,629 to the Improvement Bonds of 1993 Carriage Hills, for a total of \$172,166--represent an inappropriate use of PFA loan proceeds. The proceeds from the PFA loan funds were transferred to funds with no relation to the loans' intended use.

We recommend that the City Council discontinue the practice of transferring funds without making sure the transfer complies with the loan agreements. In addition, written support to substantiate the transactions and documentation indicating the necessity for transfers should be recorded in the Council minutes.

We also recommend that the City Council consult with PFA regarding any actions that may be required regarding the PFA loan proceeds that were transferred to other funds.

C. Sewer Rates

In order to receive the 1992 PFA loan, the City's system for establishing sewer rates and billing customers had to be approved by the MPCA. The City retained a consultant at a cost of \$5,100 to develop this system. In

March 1992, the rate and billing system was submitted by the consultant to the Mayor and City Council for approval. Prior to any formal action by the City Council, the plan was sent to the MPCA for review. In April 1992, the MPCA approved the City's system contingent upon a City ordinance enacting the consultant's rate structure and method of application.

The consultant's rate-setting plan was not implemented by the Mayor and City Council. Ordinance No. 262 was passed at a December 1992 City Council meeting establishing sewer rates significantly lower than those proposed by the consultant and approved by the MPCA. Sewer rates were not increased again until April 1997. These actions caused the following to occur:

- Because the City Council did not implement the consultant's rate structure and failed to notify the MPCA of this, the MPCA and the PFA were misled into believing the City Council was taking appropriate steps to establish sewer rates.
- The City Council did not comply with the loan agreement which required it to impose and collect rates, as approved by the MPCA, that would be sufficient in amount to repay the loans.
- Sewer rates were not increased for over four years causing a shortfall in revenues needed to meet the debt service requirements of the 1992 and 1995 PFA loans. If the consultant's rate structure had been followed, we have estimated that at least \$1,500,000 in additional revenues would have been received by the City. The impact would have been an additional \$6 per person per month on their sewer bill from 1993 through 1996. These additional revenues would have provided two years worth of payments on both the 1992 and 1995 PFA loans and would have avoided, or significantly lessened, the 40 to 60 percent increase in sewer rates in 1997.

Based on the City's current financial condition, we recommend the City Council adopt and adhere to a policy for the annual analysis and review of sewer rates to determine the need for future increases. This process may require the City to retain a consultant for assistance in calculating an adequate rate structure. We also recommend the City Council notify the PFA regarding any actions that may be necessary for failing to implement rates as required by the MPCA.

D. Cost Overruns

The interceptor project incurred a cost overrun of \$29,164. This was the result of a \$13,740 supplemental agreement for additional work and \$15,424 in unexplained costs. There is no documentation in the Council minutes that the supplemental agreement was discussed or approved. Although the cost overrun is not material to the total cost of the project, the City Council should have approved the supplemental agreement prior to having the work performed.

We recommend that project cost overruns be justified, documented, and approved by the City Council prior to incurring those costs and making payment.

E. Financial Impact to City Taxpayers

Due to actions previously stated relative to the two PFA loans, the impact to residents of the City of Cambridge is the following:

| <u>Description</u> | <u>Amount</u> |
|---|---------------------|
| Failure to increase rates as required | \$ 1,500,000 |
| Inappropriate transfers | 172,166 |
| Cost overruns | <u>29,164</u> |
| Amount That Will Have to Be Recovered Through Increased Sewer Rates in Future Years | <u>\$ 1,701,330</u> |

II. **GOLDENWOOD - 1989 IMPROVEMENT BONDS AND 1991 IMPROVEMENT BONDS**

The City issued \$4,300,000 of General Obligation (G.O.) Improvement Bonds in 1989 to fund street and utility improvements for the Goldenwood area. Because of cost overruns, change orders, and late certification of assessments, the City was forced to issue \$869,090 of G.O. Improvement Bonds in 1991 to complete the project.

A. General - Effect on City's Debt Load

The area known as Goldenwood was originally platted through Isanti County and consisted of approximately 295 residential lots. The City signed an agreement with Isanti Township on August 29, 1988, to provide for

annexation of the Goldenwood area. As part of this agreement, the City would provide an additional route other than Highway 65 from Goldenwood to the City. This additional route, known as East Rum River Drive South, passes through the development area of East Oaks.

The City submitted the 1989 bond issue for rating by Moody's Investors Service in June 1989. The opinion was returned with a rating of "Baa1." Moody's analysis provided the "Current offerings more than double Cambridge's bonded debt, increasing debt ratio to a high \$3,124 per capita and 9.7% of estimated full value of taxable property." The analysis also indicated that debt service as a percent of expenditures for 1987 was 46.1 percent and 1988 was 53.1 percent. These are both significant amounts.

There are several issues of concern regarding the Goldenwood improvements:

- Additional costs were incurred, primarily to correct landscaping for Goldenwood residents. The need to make these corrections was not documented in the City Council minutes. Some landowners did pay for the additional improvements; however, there is no correlation between the added costs and the amounts that landowners paid.
- The City did not assess all properties that benefited from the improvements. There is no discussion in the City Council minutes as to why those properties were not assessed. The City recovered only 58 percent of the cost of providing improvements to the Goldenwood residents. Thus, the remainder of those costs are being recovered from taxpayers of the entire City.
- Though the City Council never voted on the matter, the former City Clerk-Administrator participated in the decision not to assess East Oaks for City water, sewer, curbing, and lighting at a time when a friend of his owned East Oaks. Subsequently, he received a lot as a "gift" when he and the owner's widow were acting as co-trustees of the owner's family trust. As a result of this transfer and the purchase of a second adjacent lot, the former City Clerk-Administrator received the full benefit of his prior decision not to assess this property.
- The City was in violation of the 1989 Improvement Bond covenants when cash was transferred out of the 1989 Improvement Bond Debt Service Fund. Also, prepaid assessments were not invested in government securities as required by the bond documents. Because of the poor overall cash position of the City, funds were not available to be invested to generate interest earnings. Future property tax levies will have to be increased to compensate for lost interest earnings.

- The City Council did not follow Ordinance No. 172, "Subdivision Ordinance of the City of Cambridge," when the East Oaks preliminary plat was approved. The ordinance provides that the developer shall, at the time the preliminary plat is approved, set aside park land or make a cash payment to the City. The OSA can find no evidence that either of these prerequisites were met.

Each of these areas is discussed in further detail below.

B. Project Costs Benefiting Individual Landowners But Not Assessed

The total cost of the Goldenwood improvements was approximately \$4,914,000. Of these costs, \$383,650 was spent on landscaping for specific residents of the project. These costs were in addition to those already planned for in the construction contract. These costs included:

| | |
|--|-----------------------|
| Sod with topsoil | \$ 33,060 |
| Bituminous driveway mixture | 35,060 |
| Concrete driveways | 67,236 |
| Concrete sidewalks | 13,256 |
| Keystone retaining walls | 104,940 |
| Removal of concrete and bituminous driveways | 71,632 |
| Removal of trees and stumps | 6,665 |
| Additional common excavation | <u>51,801</u> |
| Total | <u>\$ 383,650</u> |

Approximately 93 percent of these costs, or \$356,795, was not assessed and these amounts will have to be recovered through property taxes levied against all properties of the City.

C. Assessments - Properties Under-Assessed, Not Assessed, or Assessed Late

1. The City Council used a proposed cost of \$55 per foot when the Goldenwood improvements were discussed with landowners. However, this amount was significantly less than actual project costs of approximately \$3,593,000, increasing the cost to \$93 per foot. The City eventually applied a flat fee of \$2,090 for sewer and \$1,873 for water because the benefit was the same for each lot. Street improvements would be assessed at \$24.75 per foot. This provided \$2,100,000 in assessments, falling short of actual costs by \$1,493,000.

Due to insufficient amounts being assessed against property owners, the City will recover only 58 percent of the cost of providing sewer, water, and street improvements to the Goldenwood area from assessments to benefited properties. Assessments will not be sufficient to cover the debt service requirements on the project. As a result, the City has had to rely on property taxes to retire the debt not financed through assessments.

2. The City Council planned to certify assessments in 1989 with collections beginning in 1990. However, because the improvement project was extended into 1990, the City chose to certify the assessments a year later, in 1991. The City could have certified assessments prior to the completion of the improvement project. The City lost approximately \$142,000 in interest on assessments due to this delay in certifying assessments.
3. The cost of trunk facilities and storm sewer improvements for this project totaled approximately \$1,148,000. The outside engineer hired by the City for this project strongly recommended an area-wide charge to recover these costs. However, the City Council decided that these costs would be paid with property taxes levied on a City-wide basis, even though the Goldenwood residents were the primary recipients of benefits from this project.
4. The additional route of East Rum River Drive South that the City agreed to construct passes through East Oaks. The East Oaks area was not assessed for any of the street, sewer, or water improvements involved with the construction of East Rum River Drive South. The City could have assessed the East Oaks properties approximately \$154,000, as described below in Section D.

We recommend that the City Council, with the assistance of the City Attorney, consider pursuing assessment, supplemental assessment, or reassessment of the benefited properties.

We also recommend that the City Council consider a user fee for storm sewer use for all future projects. This will provide the City with additional funds for future maintenance and replacement of existing storm sewers.

D. Allegations of Personal Benefit Against Former City Clerk-Administrator

During the course of the OSA audit, several concerns were brought to our attention alleging personal benefits received by the former City Clerk-Administrator for decisions and actions he took while acting in an official capacity.

In 1989, the area now known as East Oaks was owned by a person who was also a close friend (owner) of the former City Clerk-Administrator.⁷ In a trust instrument dated March 1, 1989, the City Clerk-Administrator was named as the co-trustee for the owner's testamentary trust that would receive a part of East Oaks upon the owner's death. Several lots in East Oaks passed directly to the owner's widow. The former City Clerk-Administrator was also appointed to be co-personal representative for the owner's estate in a will executed by the owner.

In a letter dated April 2, 1990, the former City Clerk-Administrator, acting on behalf of the City, entered into an arrangement with the owner's son whereby the city set forth its need for a right-of-way through the East Oaks area and the city agreed not to assess the owner's property which would contain lots along the newly constructed road known as East Rum River Drive South. The City also agreed not to assess the owner's son's residence located on 24th Avenue Southwest.

In the city council resolution passed on April 6, 1990, the city placed a value on the right-of-way to build a road through East Oaks as well as a right-of-way for a bike trail at \$40,000. This council resolution does not mention the agreement not to assess the owner's benefitted property. The value of the assessments given up by the city were \$154,000 based on other assessments made at the time. If the city had taken the roadway by eminent domain⁸ and assessed all of the benefitted property, it would have received \$114,000 in assessments from the owner and an additional \$7,000 in assessments from the owner's son. It appears the city should have exercised eminent domain to acquire the road and bike path right-of-way and assessed the benefits to property owners in the normal fashion. The result of actions taken by the former City Clerk-Administrator, however, was that the owner and his son received the net benefit of \$114,000 and his son received a benefit of \$7,000.

Lots along East Rum River Drive South have city water, city sanitary sewer, city storm sewer, curbing, city lighting, and a city-maintained road, all free of cost. When individual lots in this area are sold (or have been sold), the price of the lot will undoubtedly reflect the value of city improvements on the lots. As previously indicated, the city council did not vote on the decision not to assess this property.

⁷Property was owned in joint tenancy with the owner's wife.

⁸Eminent domain is the power of a government to acquire private property for public purposes.

By August of 1993, the owner had died and the former City Clerk-Administrator and the owner's widow were co-trustees of the owner's family trust. On August 12, 1993, the owner's wife transferred her interest in Lot 1, Block 2 of East Oaks First Addition, to the owner's family trust. On that same day, the owner's widow, along with the former City Clerk-Administrator, transferred title of this lot to the former City Clerk-Administrator from the trust. The former City Clerk-Administrator characterized this transfer as a "gift." The deed tax paid on the transfer from the trust to the former City Clerk-Administrator indicates the fair market value of the lot to be \$30,000.

The former City Clerk-Administrator informed the OSA that he received this lot as a "gift" to thank him for work he had done as personal representative on the owner's estate and as a co-trustee for the family trust. However, this is inconsistent with the closing documents filed for the estate which represented to the court that the co-personal representatives were not paid any compensation from the estate for their work.

It does not appear that the former City Clerk-Administrator had any special training in the area of estates and trusts. He is not an attorney, nor has he performed estate or trust work for any other estate or trust. The former City Clerk-Administrator informed the OSA that he did bill the owner's family trust on two occasions for services at a rate of \$25 per hour. No documentation of these billings were provided to the OSA to date.

On February 1, 1997, a second lot, immediately adjacent to the prior lot, was transferred from the owner's widow to the former City Clerk-Administrator. The price of the lot was \$33,000. According to the former City Clerk-Administrator, he is paying off the \$33,000 at \$200 per month at 0 percent interest. There are no sale documents indicating the terms and conditions of this sale.

Obviously, the former City Clerk-Administrator is free, as a private citizen, to accept gifts. However, receiving gifts from a property owner or the owner's family member who has directly benefitted from the former City Clerk-Administrator's decisions in an official capacity raises the question regarding the nature of these "gifts." Further, the receipt of these two lots, with full city improvements, but without any city assessments, gives the former City Clerk-Administrator the benefit of his prior decisions not to assess the owner's property for the benefits and improvements provided at the expense of the City.

The OSA plans to have this matter reviewed by the Isanti County Attorney.

E. Noncompliance With Bond Covenants

Our review disclosed the following instances in which the City Council violated bond covenants of the bonds issued in 1989.

- The City did not invest as stated in the bond documents. Those documents state prepaid assessments should be invested in U.S. government or guaranteed U.S. agency obligations until such time as the money was needed for debt service payments. Instead, collections of prepaid assessments were pooled with other City funds in a single checking account which allowed the City to cover cash deficits in other funds. Due to this failure to invest the prepaid assessments, future property tax levies will have to be increased because of lost interest earnings.
- Assessments collected from Goldenwood residents were required to be used to retire the 1989 improvement bonds. However, the City used collections from the Goldenwood residents to transfer \$26,004 to the 1978 Improvement Bond Debt Service Fund and \$40,394 to the Wastewater Treatment Improvement Grant Capital Projects Fund. Both transfers violated the bond covenants.

We recommend that the City Council comply with its bond covenants.

F. City in Noncompliance With Park Land Ordinance

The City's Ordinance No. 172, "Subdivision Ordinance of the City of Cambridge § E. Public Sites and Open Spaces," provides the following:

In subdividing land or re-subdividing an existing plat, due consideration shall be given by the subdivider to the dedication or reservation of suitable sites for schools, parks, playgrounds, conservation areas, or other public or semi-public recreational areas or open spaces . . . All new subdivisions having over 10 lots shall dedicate at least 7 percent of the gross area of all property subdivided for public use such as parks and playgrounds.

The subdivider may alternatively make a cash payment to the City of seven percent of the raw land value based on the market value at the time the preliminary plat is submitted. The seven percent is in addition to the property dedicated for streets or other public ways.

The East Oaks developer failed to give seven percent of the gross area or seven percent of the raw land value to the City. The City Council did not address this in the minutes when the preliminary plat was approved. The bike trail is part of the preliminary plat. However, it does not provide sufficient area to comply with the subdivision ordinance and has not been deeded to the City.

We recommend that the City Council determine if any additional land should be set aside or if a cash payment should be made by the developer to comply with the City's ordinance on public sites and open spaces. We also recommend that the bike trail be deeded to the City.

G. Financial Impact to City Taxpayers

The financial impact of various components of the Goldenwood improvements are:

| | |
|---|---------------------|
| Under-assessed or not assessed properties | \$ 1,497,000 |
| Inappropriate transfers | 66,398 |
| Lost interest earnings due to delayed assessment | 142,000 |
| Unrecovered storm sewer and trunk facility costs | <u>1,148,000</u> |
| Amount That May Be Levied As Property Taxes in Future Years | <u>\$ 2,853,398</u> |

In addition, due to the significant number of prepaid assessments not invested, the City Council will have to consider increasing future tax levies to compensate for lost interest earnings on prepaid assessments.

III. 1995 IMPROVEMENT BONDS

The City issued \$995,000 of G.O. Improvement Bonds in 1995 to fund the street improvements for Rum River Oaks and to repay loans from the General Fund to certain debt service funds.

A. General - Questionable Bond Issue

The City annexed the Rum River Oaks area at the request of the developer (noted in the Council minutes of November 11, 1989). Isanti County would not approve the proposed plat due to nonconforming lot sizes. However, the City requirements were considerably less restrictive and the plat was approved. The City Council approved the preliminary plat on December 17,

1990, and stipulated that the park fee of seven percent would be charged on this plat. However, we found no evidence to indicate that a fee was ever paid.

The City's cash position had seriously deteriorated by the end of 1995. The property tax settlement received in early December was not sufficient for the City's cash needs. If the 1995 Improvement Bonds had not been issued, the City would have had a cash deficit of approximately \$125,000 at December 31, 1995.

The bond documents for this bond issue, indicated that \$753,734 of the proceeds would be used for the Rum River Oaks Improvements and \$241,266 for refunding.⁹ The uses of bond proceeds, as shown in the bond documents, did not represent how the proceeds were actually used.

Proceeds from the 1995 Improvement Bonds were actually used as follows:

| | |
|--|-------------------|
| Rum River Oaks improvements | \$ 241,266 |
| Eliminate deficits in the debt service funds for the 1981, 1982, 1984, 1985, and 1987 Improvement Bonds Debt Service Funds | <u>753,734</u> |
| 1995 Bond Issue | <u>\$ 995,000</u> |

It is unclear why amounts presented in the bond documents were not the same as the actual distribution of the bond proceeds. None of the proceeds were used for refunding, and the majority of the cash received was used for cash flow purposes in the City's various funds. The following City actions relative to this project were questionable:

- The City proceeded with construction contracts near the end of the year, a time when many contracts of this nature could not be completed by year-end. In fact, the contractor requested and received an extension on the contract to complete the work in the spring of 1996. It is questionable whether the contract for construction should have been issued near the end of the year or in the spring of the next year. If issued in the spring, however, the bond issuance most likely would have been delayed.

⁹Issuing bonds for "refunding" means that bonds are issued to retire bonds already outstanding.

- Minnesota law requires public approval when issuing debt.¹⁰ An exception to this rule occurs if 20 percent of the cost of the improvement is a special assessment.¹¹ Then, no public approval is required.

The bond documents indicated that \$753,734 or approximately 75 percent of bond proceeds would be used for improvements. However, the City has only assessed \$20,000, or two percent, for special assessments. Therefore, since the vast majority of bond proceeds were used to fund deficits and the City has yet to assess the statutory required 20 percent, the City is currently in violation of Minn. Stat. § 475.58.

We recommend the City pursue obtaining payment of the seven percent park fee. We also recommend that bond proceeds be used in accordance with bond documents. In addition, the City must obtain voter approval for bonds in accordance with the law.

B. Cost Benefit to City Questionable

During 1995, the City proceeded with plans for the development and construction of street improvements in the area known as Rum River Oaks and Rum River Oaks 1st Addition.

It is unclear why the City agreed to issue bonds for this project. The developer agreed that he was responsible for the cost of paving roads in the Rum River Oaks and Rum River Oaks 1st Addition areas. Also, the benefits to the City from this project were insignificant. The modest increases to property values would have only de minimis impact on property taxes collected. The developer benefited from this project because the City incurred the costs of issuing construction contracts and issuing bonds. The developer appears to have incurred no costs for new roads in his development project at this time. The City incurred total construction costs of \$212,340.

¹⁰Minn. Stat. § 475.58.

¹¹Id.

We recommend that future development projects receive a full discussion by the City Council and that such discussions, together with the basis for any decisions made, be documented in the Council minutes. In addition, we recommend that, for future projects, the City Council consider requiring developers to provide escrow deposits prior to commencement of improvements taking place.

C. Assessments Not Certified for 100 Percent of the Improvement Costs

Total costs of the Rum River Oaks improvements were \$212,340. According to the City's bond offering document, and by resolution dated October 16, 1995, 100 percent of the improvement costs were to be assessed against the developer and benefiting landowners of Rum River Oaks and Rum River Oaks 1st Addition. However, our review found the following:

- To date, no assessments have been certified against the 20 properties in Rum River Oaks and Rum River Oaks 1st Addition.
- In addition to the above agreement, the developer submitted a letter to the City Council indicating he would be responsible for payment of assessments on lots already sold in addition to those lots that had not been sold. However, as of December 31, 1996, all of these lots had an unassessed balance of the road improvements totaling \$192,340.
- Assessments totaling \$20,000 against the six other properties that front South Ten Oaks Street and the Rum River were certified to the County Auditor on November 25, 1996, for payable 1997. These assessments could have been certified in 1995 for payable in 1996.

There appears to have been a verbal agreement with the developer to pay \$4,000 per lot at 5.25 percent interest over ten years. However, to date, there is no signed agreement with the developer.

The current Clerk-Administrator is attempting to negotiate an agreement with the developer. If final terms of the agreement are consistent with the verbal agreement calling for \$4,000 per lot, the City will recover only 47 percent of the improvement costs rather than 100 percent that was stipulated in the bond documents. As a result, the City taxpayers will be responsible for approximately \$112,000 of improvement costs, plus the related bond interest.

The City may have some recourse to assess benefited property. We recommend the City Council, in consultation with the City Attorney, consider pursuing assessments, supplemental assessments, or reassessment of the benefited property under Minn. Stat. §§ 429.071 and 429.061, subds. 1 and 2, to recover all or part of the project costs.

D. Financial Impact to City Taxpayers

If the above noted issues are not resolved, the financial impact to the City taxpayers will be the following:

| | Rum River Oaks <u>Improvements</u> | Various Debt Service <u>Fund Deficits*</u> |
|---|--|--|
| Outstanding principal and future interest costs as of December 31, 1996 | \$ 303,080 | \$ 961,210 |
| Collection of future assessments | (26,300) | - |
| Cash (available) or deficit in the related debt service funds | <u>7,056</u> | <u>(9,952)</u> |
| Amount That May Be Levied As Property Taxes in Future Years | <u>\$ 283,836</u> | <u>\$ 951,258</u> |

*This portion of the bonds was issued to cover cash deficits in various debt service funds.

IV. 1994 IMPROVEMENT BONDS AND 1994 STATE-AID STREET BONDS

In August 1994, the City issued \$2,540,000 of General Obligation Improvement Bonds to finance improvements to Fern Street South and Second Avenue Southwest, and \$650,000 in State-Aid Street Bonds for improvements made to Dellwood Street South. Improvements were to be made to the sanitary sewer, watermain, storm sewer, sidewalks, street lighting, bituminous streets, curb and gutter, and landscaping. The debt was to be repaid from a combination of special assessments, property taxes, tax increments, and Municipal State-Aid Street funds.

A. General

This project dates back to 1972 when plans were being developed for services to the Cambridge Community College and for sewer main replacements along Fern Street South. A feasibility report was completed in 1987, and two more studies were completed in 1990 and 1991. These projects were canceled or postponed due, in part, to changes in the college

expansion plans. In February 1992, the final feasibility report was completed for sewer and water service to the college and the improvements to Fern Street South. Again, the actual project was delayed until June 1994, this time due to the decision to incorporate improvements near the Cambridge hospital as part of the overall project. Then in 1994, the City issued the bonds for this project.

B. Under-Assessment Certified by Former City Clerk-Administrator

Although the Bond Record and related documents call for the City to assess \$1,166,404 of the \$2,540,000 bond issue, only \$746,404 was certified by the former City Clerk-Administrator for assessment, resulting in a difference of \$420,000. This difference is a result of the following:

- Tax Increment Financing (TIF) District #6.5 had been created for the purpose of expanding the hospital's facility. From this TIF district, \$220,000 in total tax increment collections are being applied toward repayment of the debt.
- The remaining \$200,000 difference is from the following series of events:
 1. On June 20, 1994, the City Council passed a resolution adopting assessments against HealthSpan in the amount of \$946,404. In addition, six properties along Fourth Avenue Southwest were assessed, each in the amount of \$6,319 for a total of \$37,914. The amounts that were to be assessed to the properties along Fourth Avenue Southwest were based on a letter from the City's consulting engineers, dated June 8, 1994, describing project costs that benefited those property owners. The resolution contained original signatures of both the Mayor and former City Clerk-Administrator.
 2. On July 28, 1994, the City Council adopted a resolution relating to the issuance and sale of \$2,540,000 in General Obligation Improvement Bonds. The Bond Record is structured around \$1,166,404 in special assessments, \$220,000 to come from tax increment collections, and \$946,404 to be assessed against HealthSpan. The six properties along Fourth Avenue Southwest were not included in the assessment portion of the financing plan, even though they were included in the June 20, 1994, Council resolution.

3. On December 2, 1994, the former City Clerk-Administrator certified to the County Auditor the Resolution Adopting Assessment as passed by the City Council on June 20, 1994. The first two pages of the resolution presented to the County Auditor were the same as the June 20, 1994 resolution; however, the third page listing properties to be assessed was not the same. Only HealthSpan was listed as being assessed at \$746,404. This amount was \$200,000 less than the amount originally approved by the Council. The resolution presented to the County Auditor also omitted the six properties on Fourth Avenue Southwest, with assessments totaling \$37,914.

Based on our review of City correspondence, it appears that following the July 28, 1994 issuance and sale of the bonds, the former City Clerk-Administrator was still actively communicating with HealthSpan over terms of the assessment that were contrary to the Council's previous action. The former City Clerk-Administrator stated that individual meetings were held between the former City Clerk-Administrator and Council members regarding the ongoing negotiations to reduce the assessment amount against HealthSpan. A former Council member stated that the reduction in assessments against HealthSpan was due to pressure being placed on the Mayor, and in turn on the Council. The final resolution presented to the County Auditor was not the same as had been approved by the Council nor was it in agreement with amounts used in the Bond Record. As a result, there was deception by the former City Clerk-Administrator regarding amounts to be assessed against HealthSpan. It is not clear why the six properties on Fourth Avenue Southwest were omitted from assessments. While the duties of a City Clerk-Administrator may include negotiating arrangements with businesses and community developers, it is incumbent on that individual to keep the City Council informed on the progress of negotiations. This process of Council approval must be conducted in an open forum and documented in the Council minutes. As significant changes occur, the Council should be updated. Closed door, oral negotiations should not occur.

We recommend that once assessments have been approved by the City Council, they must be certified to the County Auditor in the same amount and in a timely manner. It would be beneficial for the City Council to adopt a policy of reviewing whether the assessments which have been approved by the Council have, in fact, been certified with the County.

Finally, we recommend that the City Council determine if the six properties along Fourth Avenue Southwest could still be assessed. The City Council, in consultation with the City Attorney, should pursue assessments of these properties, if possible.

C. Cost Overruns

- The Fern Street project had costs exceeding original contracts by \$132,213, or 6.7 percent. Of these additional costs, \$29,675 was approved in a supplemental agreement on October 17, 1994. There were no other supplemental agreements, change orders, or related documentation of discussion in the Council minutes for the remaining \$102,538 excess.
- The South Dellwood Street project had costs in excess of original contracts totaling \$7,339. Of the two change orders to the original contract, the second one that increased the contract by \$3,988 was not approved by the Council. It was signed by the former City Clerk-Administrator.

We recommend that prior to incurring costs or making payments on project cost overruns, a change order or supplemental agreement be presented to the City Council for its action and the outcome documented in the Council's minutes.

D. Noncompliance With Bond Covenant

Pursuant to the bond covenants, bond proceeds from the 1994 Improvement Bonds were required to be used for improvements to Fern Street South and Second Avenue Southwest. However, in 1995, the City used these bond proceeds to transfer \$25,000 to the General Fund. This transfer was described in the 1995 financial statements as a reimbursement for project expenses. However, no documentation exists in support of this transfer. This condition results in noncompliance with the bond covenants.

We recommend that the City Council comply with its bond covenants.

E. Contracts

For work performed on Fern Street South, we found the following conditions with payments made to vendors:

- East Central Electric was limited to charge the City \$75,000. We found that the City paid \$75,848 to East Central Electric, \$848 over the apparently agreed-upon amount. No contract or agreement could be located.
- From 1991 through 1996, a surveyor was paid \$36,384. No contract or agreement existed for this work.
- An engineering firm was paid \$17,419. Documentation refers to a contract but, once again, it was not available at the City.
- \$23,462 was paid for paving for which no contract or agreement was completed.

With the recent change in administration, it is possible that some of these agreements were misplaced. However, contracts should have been executed and retained by the City. The purpose of a contract is to make an offer which, upon acceptance, becomes the standard to measure performance against. Issues such as placing a limit on the amount the City would pay for the particular service, the necessity of the service, the quality or standards expected by the City, and other items could have been stipulated in the contracts or agreements.

We recommend that the City Council establish a policy to describe when written contracts are to be obtained, those City officials authorized to enter into contracts on behalf of the City, and a retention policy for these contracts.

F. Financial Impact to City Taxpayers

The above-noted issues on Fern Street South and Dellwood Street South have had the following impact on all residents of the City of Cambridge:

| <u>Description</u> | <u>Amount</u> |
|--|-------------------|
| Reduction in City Council-approved assessments to HealthSpan (\$200,000 less \$47,000 paid by the hospital for sewer and water hook-up fees) | \$ 153,000 |
| City Council-approved assessments never certified | 37,914 |
| Cost overruns | 139,552 |
| Inappropriate transfers | <u>25,000</u> |
| Amount That May Be Levied As Property Taxes in Future Years | <u>\$ 355,466</u> |

V. CARRIAGE HILLS SECOND ADDITION - 1993 IMPROVEMENT BONDS

On November 1, 1993, the City issued \$360,000 in General Obligation Improvement Bonds to finance construction of the storm and sanitary sewers, water, curb and gutter, and street improvements in the area known as Carriage Hills Second Addition. Repayment of the bonds was to be entirely from special assessments.

A. General

Carriage Hills Second Addition was developed by the Carriage Hills Development Corporation. This development included 23 lots along Carriage Lane. The bond documents stated that 100 percent of the costs of the improvements were to be assessed against the benefited properties.

B. Deficient Special Assessments

Documentation exists back to August 10, 1992, regarding agreements by the developer, Carriage Hills Development Corporation, to pay 100 percent of the costs. These costs were to include, ". . . without limitation, construction and engineering and costs associated with the issuance of improvement bonds of the City. . . ."

A year later, on August 16, 1993, the City Council passed a resolution stating that the owners of the property would be assessed 100 percent of the entire costs of the improvements.

Construction, engineering, and related work began shortly thereafter. Total costs for the Carriage Hills Second Addition amounted to \$312,631. In addition to this, \$7,674 was spent on preliminary engineering and grading costs for the area known as Carriage Hills Third Addition, for a total of \$320,305. Of this amount, only \$236,536 was assessed, resulting in deficient assessments of \$83,769.

In determining why the full amount of the Carriage Hills projects was not assessed, the following information was obtained.

- From the August 26, 1992, special Council meeting, the Council minutes indicate that representatives from the Carriage Hills Development Corporation were present to discuss the need for installing utilities along County Road 45 under the future Highway 65 bypass bridge. The Council authorized City staff to work with Carriage Hills Development Corporation to install the necessary sewer and water pipes "at the expense of Carriage Hills Development Company."

In October and November 1993, the former Carriage Hills Development Corporation President and the former City Clerk-Administrator held meetings to discuss financial relief to Carriage Hills Development Corporation for the utility charges totaling \$34,725. Eventually, the former City Clerk-Administrator agreed to reduce future assessment charges to Carriage Hills Development Corporation by \$34,725. This decision was not consistent with previous actions by the Council on this project. It also contradicts the developer's agreement to pay 100 percent of the project's cost.

- On July 20, 1994, a meeting was held with the Carriage Hills Development Corporation President and the former City Clerk-Administrator to determine the final amounts to be assessed; however, this determination was based on outdated information and resulted in a shortfall of \$41,370 in assessments.
- Preliminary engineering and grading costs of \$7,674 for the Carriage Hills Third addition were never assessed. These costs were paid by the City from its Improvement Bonds of 1993 Debt Service Fund. It is not clear why the City paid for these improvements.

The following reconciliation summarizes the above-noted items:

| <u>Description</u> | <u>Amount</u> |
|--|------------------|
| Inappropriate reduction in assessments | \$ 34,725 |
| Out-dated cost estimates | 41,370 |
| Carriage Hills Third Addition costs never assessed | <u>7,674</u> |
| Total Amount of Deficient Special Assessments | <u>\$ 83,769</u> |

We recommend that the City Council explore the possibility of recovering additional assessments from the benefiting landowners in the Carriage Hills Development.

C. Noncompliance With Bond Covenant

Pursuant to bond covenants, bond proceeds from the 1993 Improvement Bonds were required to be used for improvements to Carriage Hills Second Addition. After bond issuance costs were deducted, \$352,663 in bond proceeds were received. Total project costs were only \$320,305, leaving an unspent amount of bond proceeds of approximately \$32,000. In 1993, \$30,000 was transferred from the Carriage Hills Second Addition Capital

Project Fund to the City's General Fund. The City's 1993 financial statements described the purpose of the transfer as administrative and engineering expenses. However, no documentation exists to support these costs. If the transfer had been for administrative and engineering expenses, it should have been included in the amount assessed to the benefited properties. The \$30,000 transfer to the City's General Fund appears instead to have been made to meet general operating expenditures of the City. This condition results in noncompliance with the bond covenants and is indicative of the financial mismanagement through the use of transfers. The excess bond proceeds should have been transferred to the 1993 Improvement Bonds Carriage Hills Debt Service Fund.

We recommend that the City Council comply with its bond covenants and discontinue the practice of making transfers between unrelated funds. If excess bond proceeds are received, they should be transferred to the related debt service fund at the completion of the project.

D. Financial Impact to City Taxpayers

As of April 1997, all but two of the parcels assessed have been paid in full. The results for the taxpayers of the City of Cambridge are the following:

| <u>Description</u> | <u>Amount</u> |
|---|-------------------|
| Outstanding principal and future interest costs at December 31, 1996 | \$ 361,099 |
| Cash on hand as of December 31, 1996 | (138,720) |
| Special assessments collected on three parcels in 1997 | (29,454) |
| Approximate assessments to be collected on remaining two parcels | <u>(21,000)</u> |
| Amount That May Be Levied As Property Taxes in Future Years | <u>\$ 171,925</u> |

VI. CARRIAGE HILLS FIRST ADDITION AND DOWNTOWN PARKING LOT - 1990 IMPROVEMENT BONDS

On June 16, 1990, the City issued \$480,000 in General Obligation Improvement Bonds to finance the construction of street and utility improvements for the Carriage Hills First Addition and construction of downtown parking lot improvements. The bond covenants indicated that approximately \$353,599 would be spent on Carriage Hills First Addition, \$90,000 on parking lot improvements, and the balance on bond issuance and interest costs.

A. General

Carriage Hills First Addition was developed by the Carriage Hills Development Corporation. This development included 39 lots along Carriage Hills Drive. The bond documents stated that 100 percent of the improvement costs for Carriage Hills First Addition and the downtown parking lot were to be assessed against the benefited properties.

B. Assessments

Our review of assessment records found the following:

- The City assessed \$270,765 for the construction and related costs of the Carriage Hills First Addition. This is \$2,000 less than the total improvement costs of Carriage Hills First Addition.
- The City used bond proceeds of \$56,989, originally intended for Carriage Hills First Addition, for improvements to Peterson Park. The bond documents did not mention spending bond proceeds on Peterson Park. The bond documents stated that there would not be a need for any tax levies to retire the debt. However, because the money to improve the park could not be assessed, this money will have to be paid for through future property taxes.
- The City did not construct the parking lot improvements as stated in the bond covenants due to a subsequent decision related to feasibility. Instead, the City utilized \$18,786 of the parking lot portion of the bond proceeds to construct an airport fuel facility. This will have to be paid for through future property taxes.

We recommend that City officials take more care in identifying projects requiring the issuance of debt and in the preparation of the related bond documents. If a portion of the proceeds are to be used for publicly-financed projects such as a park, the bond documents should reflect that situation and be more specific as to related assessments to be applied. Also, the City should have determined, prior to the issuance of debt, if a project was feasible. Finally, the City should never use bond proceeds for purposes other than those stated in the bond documents. Such practices could be viewed as intentionally obtaining capital for other costs that lack funding.

C. Noncompliance With Bond Documents

Our review disclosed the following instances in which the City Council violated covenants of the bonds issued in 1990:

- The City did not invest as stated in the bond documents. Those documents state prepaid assessments should be invested in U.S. government or guaranteed U.S. agency obligations until such time as the money was needed for debt service payments. Instead, collections of prepaid assessments were pooled with other City Council funds in a single checking account which allowed the City Council to cover cash deficits in other funds. Because of this failure to invest the prepaid assessments, future tax levies will have to be increased because of lost interest earnings.
- Bond documents required that bond proceeds from the 1990 Improvement Bonds were to be used for improvements to Carriage Hills First Addition and the downtown parking lot. However, in 1990, \$20,000 was transferred from the Carriage Hills Capital Project Fund to the General Fund and \$974 to the Cambridge Air Show Special Revenue Fund. The General Fund and the Cambridge Air Show Special Revenue Fund have no relationship to activities in the Carriage Hills Capital Project Fund. Both transfers violated the bond documents.

We recommend that the City Council comply with its bond documents.

D. Financial Impact to City Taxpayers

The 1990 Improvement Bonds will be refunded in 1997. However, due to actions previously stated relative to the use of these funds, the impact to residents of the City of Cambridge is the following:

| <u>Description</u> | <u>Amount</u> |
|---|-------------------|
| Outstanding principal and future interest costs as of December 31, 1996 (prior to refunding) | \$ 336,040 |
| Cash available in 1990 Improvement Bonds Debt Service Fund as of December 31, 1996 | <u>(57,571)</u> |
| Amount That May Be Levied As Property Taxes in Future Years | <u>\$ 278,469</u> |

Due to the significant number of prepaid assessments that were not invested, the City Council will have to consider increasing future tax levies to compensate for lost interest earnings on assessments that were prepaid.

VII. GARFIELD STREET - TAX INCREMENT FINANCING DISTRICT #6.4

On November 1, 1993, the City Council issued \$375,000 in tax increment bonds to finance costs of construction for extending Garfield Street from Second Avenue Southeast, north to First Avenue East (Trunk Highway 95). The bond documents state that the debt is to be repaid with future tax increments from Tax Increment Financing District #6.4.

A. General

The Garfield Street project included land purchased, street, curb and gutter, watermain, storm sewer, and related improvements within Tax Increment Financing District #6.4. Of the \$375,000 in bonds issued, the City received \$364,933 in bond proceeds after issuance, legal, and other fees were deducted. These proceeds were used to pay construction costs of \$163,639, engineering fees of \$14,536, land of \$152,866, and miscellaneous costs of \$33,892. Work began in late 1993 and was completed by the end of 1994.

B. Noncompliance With Contracting Laws

The City Council never formally bid or contracted for the work performed by Arcon Construction for improvements made to the Tax Increment Financing District. As far as we are able to determine, City officials thought that since Arcon Construction was already working on another City project, it would be best able to supply the materials and labor needed at the lowest cost. Also, the time involved to proceed through the bidding process was an issue due to the urgency of the project pursued by those businesses within the district. Since Arcon Construction was already working for the City on an unrelated interceptor project, the City Council approved the work through a change order on September 20, 1993. No competitive bidding took place and no contract was signed. The only discussion that took place in the Council minutes was the approval of the change order.

The City Council's failure to bid for work performed by Arcon Construction within Tax Increment Financing District #6.4 violates Minn. Stat. §§ 412.311 and 471.345, subd. 3. These statutes require cities contracting for construction work in amounts greater than \$25,000 to:

- let the contract on sealed bids,
- solicit the bids through public notice, and
- keep the bids on file.

We recommend that the City Council comply with Minn. Stat. §§ 412.311 and 471.345, subd. 3, for future construction work exceeding \$25,000.

C. Cost Overruns

Construction costs totaled \$163,639, exceeding the Council-approved amount by \$4,659. While cost overruns are not unusual, they should receive Council approval and be documented in the Council's minutes. No supplemental agreements or additional change orders were approved by the Council. The cost overrun was apparently paid without questioning its appropriateness.

We recommend that prior to incurring costs and making payments, the additional costs be presented to the Council for approval and be documented in the minutes.

D. Noncompliance With Bond Covenants

In our review of the 1993 Tax Increment Bonds Debt Service Fund and the related Garfield Capital Project Fund, a number of questionable transfers came to our attention.

- Pursuant to the bond covenants, bond proceeds from the Tax Increment Financing Bonds were required to be used to finance improvements within Tax Increment District #6.4. However, a transfer was made in the amount of \$10,000 from the Garfield Capital Project Fund to the City's General Fund in 1993. The 1993 audited financial statements indicated the transfer was for engineering and administrative costs. No documentation exists to support these costs. This condition results in noncompliance with the bond covenants.
- Transfers totaling \$20,907 were made in 1995 to eliminate the deficit cash balance and close out the Garfield Capital Project Fund. This transfer comprised \$1,907 from the Series 1985A Economic Development District #2.3 Debt Service Fund and \$19,000 from the 1993 Economic Development District #6.4 Debt Service Fund. This transfer of \$19,000 could effectively prevent the 1993 Economic Development District #6.4 Debt Service Fund from being able to meet future debt service payments.

The Series 1985A Economic Development District #2.3 Debt Service Fund has no relation to the Garfield Capital Project Fund. The transfer of the \$1,907 appears to have been made out of this unrelated fund because it was one of the few funds available with a well-established

fund balance. Once again, no support exists and no discussion took place in the Council minutes other than identifying the funds involved and amount to be transferred.

The source of the \$19,000 transfer was the project's related debt service fund. Usually at the end of a project, a transfer is not made from a debt service fund to a capital project fund, but rather from the funds left over in the capital project fund to the debt service fund. Since there was a project cost overrun of \$4,659 and a \$10,000 transfer to the General Fund (as previously noted above), a fund deficit occurred in the Garfield Capital Projects Fund by completion of the project in 1995.

We recommend that the City Council comply with its bond covenants and discontinue the practice of making transfers between unrelated funds.

E. Financial Impact to City Taxpayers

The above noted issued on Garfield Street Tax Increment District #6.4 had the following impact on all residents of the City of Cambridge.

| <u>Description</u> | <u>Amount</u> |
|--|----------------------|
| Inappropriate transfers | \$ 10,000 |
| Cost overruns | <u>4,659</u> |
| Amount That May Be Levied as Property Taxes in Future Years | <u>\$ 14,659</u> |

VIII. SHORT-TERM BORROWING THROUGH ISSUANCE OF WARRANTS

Over the past seven years, the City has been in the practice of issuing checks, which the City referred to as "warrants," to obtain needed cash for financing current debt payments and operating expenditures until property taxes are received. The City-issued "warrants" would be presented to the bank, but would not be cashed. Instead, the bank would advance the City cash equal to the value of the "warrants." The bank would hold the "warrants" until notified by the City to charge them against the City's checking account.

It is the OSA's position that the City improperly used the term "warrant." There exists no statutory authority for the City to issue warrants. However, the City is permitted to issue "orders" or checks to pay claims as herein discussed. In this case, the City had no authority to issue checks to the bank and create debt without following the procedures for debt issuance found in Minn. Stat. ch. 475, including the referendum requirement of Minn. Stat. § 475.58.

A. General

The procedures the City used for the issuance of warrants would begin with the former City Clerk-Administrator determining the need for short-term borrowing of cash. A warrant would be issued to the bank. The cash from this short-term borrowing was available to the City to meet general operating expenditures of the City and current debt obligations. The warrant would be uncashed by the bank and serve as the debt instrument. Interest was paid by the City to the bank(s) on a monthly basis. When the City had available cash, the former City Clerk-Administrator would instruct the bank to cash the warrant, thereby paying off the obligation. If the obligation could not be repaid within the six-month life of the warrant, a new one would be issued to replace the stale-dated warrant.

The procedures used by the City to issue checks, which the City erroneously called "warrants," violated several statutes:

- For five years, including 1997, the City issued "warrants" exceeding the dollar amount of outstanding orders and checks allowed by law.
- Checks were not issued pursuant to a claim process as required by statute.

The above two items are discussed in further detail below:

B. "Warrants" (Checks) Exceed Amount Authorized by State Statute

The following is a summary of the checks, issued as "warrants," for the years under audit:

| <u>Year</u> | <u>"Warrants" Issued</u> | <u>"Warrants" the Same</u> | <u>Maximum Outstanding During Paid</u> | <u>Excessive</u> | <u>Interest</u> |
|-------------|--------------------------|----------------------------|--|------------------|-----------------|
| 1991 | \$ 1,250,000 | \$ 1,250,000 | \$ 1,100,000 | \$ 600,520 | \$ 27,400 |
| 1992 | 1,680,000 | 1,680,000 | 1,330,000 | 777,684 | 45,894 |
| 1993 | 1,150,000 | 1,150,000 | 1,150,000 | 486,573 | 56,000 |
| 1994 | 1,200,000 | 1,200,000 | 600,000 | - | 33,288 |
| 1995 | 1,200,000 | 1,200,000 | 200,000 | - | 39,001 |
| 1996 | 1,420,000 | 50,000 | 1,370,000 | 133,092 | 60,992 |

Minn. Stat. § 471.69 limits the amount of orders or checks any statutory city may have outstanding at any given time. This limit is computed as, "the average amount actually received in tax collections on the levy for the three previous calendar years plus ten percent thereof." Applying this limitation to the maximum amount of checks issued as "warrants" in the years 1991 through 1996 results in excessive amounts of checks issued in 1991, 1992, 1993, and 1996, as listed above.

We also noted that the City Council issued an additional \$700,000 in "warrants" in April 1997, resulting in the statutory limit being exceeded by \$833,092.

By consistently exceeding this statutory limit, the City placed itself in the precarious position of not being able to pay off the checks it had issued upon the receipt of taxes. This finally became the situation in 1996 as the City issued an ever increasing number of "warrants." Out of \$1,420,000 in "warrants" issued in 1996, only \$50,000 was repaid. This further jeopardizes the City's financial position when property tax collections must be used to pay off outstanding checks and their related interest, rather than paying for the current debt obligations and general operations of the City.

We recommend that the City Council comply with Minn. Stat. § 471.69. We recommend the City Council discontinue the use of the term "warrants" and issue orders or checks in compliance with the law. If temporary financing is necessary, as determined and approved by the City Council, Minn. Stat. § 412.261 authorizes statutory cities to issue tax anticipation certificates. Tax anticipation certificates would be more applicable for the City's short-term financing requirements.

C. Claims for Expenditures Not Approved by City Council

For the "warrants" issued between 1991 and August 1996, the former City Clerk-Administrator stated that he met with individual Council members to discuss the need to issue "warrants." However, there were never formal discussions or approval of the "warrants" by the City Council in the minutes.

There is no statutory authority for the City of Cambridge to issue "warrants." The City is authorized to issue "orders" to pay claims presented for payment.¹² Each claim must be audited and approved by the City

¹²Minn. Stat. § 412.271.

Council prior to issuance.¹³ For these "warrants," the Board minutes indicate that there were no claims audited or approved by the City Council. In fact, there is no record of the City Council approving issuance of these "warrants."

We recommend that, in the future, the City Council review the manner in which orders are issued to ensure compliance with Minn. Stat. §§ 412.241, 412.271, and 471.38.

D. Financial Impact

From 1991 through 1996, the City paid \$262,575 in interest for "warrants" issued.

IX. CERTIFICATES OF INDEBTEDNESS

There are two statutes that authorize a statutory city, such as Cambridge, to issue certificates of indebtedness: (1) Minn. Stat. § 475.754 permits issuance of this type of debt under certain disaster or emergency conditions; and (2) Minn. Stat. § 412.301 permits the issuance of certificates of indebtedness for the purchase of certain capital equipment. During the period under review, the City Council issued Certificates of Indebtedness by resolutions stating that they were all issued under the emergency or disaster statute, Minn. Stat. § 475.754. The four certificates issued were as follows:

| <u>Date</u> | <u>Amount</u> | <u>Council's Description</u> |
|-------------------|---------------|------------------------------|
| May 5, 1993 | \$ 320,000 | Emergency Certificate |
| June 17, 1994 | 450,000 | Emergency Certificate |
| December 30, 1994 | 600,000 | Certificate |
| September 8, 1995 | 934,000 | Certificate |

A. Statutory Authority

Minn. Stat. § 475.754 provides authority for certificates of indebtedness in case of disasters or emergencies. It states "[i]f in any fiscal year the receipts from taxes or other sources are insufficient to meet the expenses incurred or to be incurred in said year by any city however organized, . . . by reason of any natural disaster or other public emergency requiring the making of extraordinary expenditures, the governing body of any such city may authorize the sale of certificates of indebtedness to mature within three years. . . ."

¹³Minn. Stat. §§ 412.241, 412,271, and 471.38.

- For all four certificates issued, the purposes for issuing the certificates did not meet the requirements of Minn. Stat. § 475.754, except for \$50,000 of the 1995 certificate that was for the July tornado.
- The June 17, 1994, December 30, 1994, and September 8, 1995, certificates have maturity dates longer than three years, in violation of Minn. Stat. § 475.754.

Even if we assume the reference in the Council's resolutions to Minn. Stat. § 475.754 were simply in error, the other statute permitting certificates of indebtedness, Minn. Stat. § 412.30, does not provide authority to issue these certificates. Minn. Stat. § 412.301 authorizes cities to issue certificates of indebtedness for specified types of capital equipment. However, the above-listed certificates issued by the City failed to meet the statutory prerequisites of Minn. Stat. § 412.301 because they were not used to finance capital equipment.

B. Uses of Debt

The City used these Certificates of Indebtedness to finance projects from prior years and, in some instances, used the proceeds for projects not consistent with the stated purpose for which the certificates were issued.

- The 1993 Certificate of Indebtedness' stated purpose was to purchase the South Haven 2nd Additional Final Plat. However, the proceeds were deposited in a capital project fund and used to pay for unrelated costs and transfers to other funds.
- The June 17, 1994, Certificate of Indebtedness had a stated purpose to purchase a fire truck and two maintenance trucks. The City Council approved the fire truck purchase in April 1993. However, at the time of approval, the Council did not have a financing plan. Proper financial planning would have called for determining an appropriate financing source when the purchase was approved. This is another example of how the City proceeded with projects obligating the City prior to determining how they would be financed. Regarding the two maintenance trucks, we could not locate any authorization by the City Council for their purchase.
- The December 30, 1994, Certificate of Indebtedness had a stated purpose for the purchase of 30 acres in the Southeast Cambridge Industrial Area. However, the City issued a warrant on June 27, 1994, and used the proceeds to purchase the land on the same day. The warrant was paid off on December 30, 1994, with the proceeds from

the Certificate of Indebtedness. It again appears that this was done to conceal the declining financial condition of the City, issuing new debt to repay the previously-issued warrant.

- The 1995 Certificate of Indebtedness had the following stated purposes:

| | |
|--------------------------------|-----------|
| July Tornado | \$ 50,000 |
| Senior Activity Center | 70,000 |
| Softball Complex | 143,000 |
| Community Development Center | 295,000 |
| Railroad Crossing Project | 216,000 |
| 2nd Avenue Northwest Watermain | 160,000 |

According to Council minutes, the following projects had been undertaken prior to the issuance of the 1995 Certificate of Indebtedness and without consultation with the City Council:

- The Senior Activity Center had \$50,000 in costs accumulated in 1994.
- The softball complex had a deficit balance since 1991, with a deficit balance of \$244,238 prior to receiving proceeds from the certificate.
- The railroad crossing project had a deficit in 1993.
- The Community Development Center (City Hall) had a deficit in 1994.

We recommend the City consider the method of financing projects at the time the projects are approved. Also, we recommend that the City not issue Certificates of Indebtedness unless authorized to do so by state law. Further, we recommend that the City use the proceeds of debt issues consistent with the stated purpose of the issue.

C. Financial Impact

The September 8, 1995, Certificate of Indebtedness matures in the year 2000. The City has no revenue source other than property taxes to repay this debt. The City Council will have to levy sufficient taxes in the next three years to recover the following:

| | |
|---|-------------------------|
| Outstanding principal and future interest costs at December 31, 1996 on outstanding certificates | \$ 1,530,209 |
| Warrants issued against the debt service fund | 220,000 |
| Promissory note receivable | (60,368) |
| Cash available in the related debt service funds | <u>(76,241)</u> |
| Amount That May Be Levied As Property Taxes in Future Years | <u>\$ 1,613,600</u> |

X. TRANSFERS - GENERAL

For the period under review, the City used a series of cash transfers between City funds to help eliminate the large number of cash deficits. Transfers were routinely made from funds with positive cash balances to funds with negative cash balances. The volume of transfers that occurred was unusual and, in some cases, violated bond covenants and loan agreements.

The financing of cash deficits through transfers from unrelated funds is not the solution to establishing and maintaining sound fiscal management of the City's resources. City officials need to improve their management of existing revenue resources in order to prevent fund deficits from occurring. As can be seen from events in the City, cash transfers are only a temporary solution to an individual fund, but the overall financial condition of the City is not changed. Also, when cash is transferred to the extent as occurred within the City, the true financial position of the City's fund balances cannot be determined. This condition made it difficult for City staff and the City Council to make sound financial decisions.

We recommend that, prior to authorizing transfers between funds, the City Council consider the financial condition of the fund from which the transfer is being made and whether the transfer violates any bond covenants or loan agreements. In the case of the utility funds, when considering whether a real surplus exists, the City Council should consider items such as: future needs of the City's water distribution system; debt that was issued or will need to be issued for construction of the City's water distribution system; maintenance expenditures; and payment of salaries for those paid out of the enterprise fund.

XI. REIMBURSED EXPENSES

The City personnel manual provides for mileage reimbursement and a meal allowance. The manual also states "employees must submit receipts for any request for reimbursement." The City provides a monthly "per diem"¹⁴ of \$475 to the Clerk-Administrator, \$100 to the Economic Development Authority Director, and \$150 to the Zoning Administrator.

- We were unable to locate any authority authorizing the City to establish monthly "per diem payments" other than simply providing additional compensation. There is no authority to make a monthly payment of this type for expenses (other than an automobile allowance under Minn. Stat. § 471.665) without following the Minn. Stat. § 471.38 claim procedures. See Op. Atty. Gen. 161b-12, Aug. 4, 1997.
- City staff indicated that increases in the monthly "per diem" amounts were authorized by the former City Clerk-Administrator, with the last increase in 1991. Minn. Stat. § 412.111 provides that "the Council may . . . fix the compensation of all officers, both appointive and elective, employees and agents, when not otherwise prescribed by law." Based on this statute, the City Council is the only authority that can establish or increase the compensation.

We recommend that the City discontinue "monthly per diem" payments. If the City Council wishes to establish a monthly automobile allowance for officers or employees under Minn. Stat. § 471.665, it must do so by resolution.

We reviewed expense reimbursements for several employees and elected officials for the period January 1, 1994, through December 31, 1996. We found that most reimbursement requests had supporting documentation in the form of receipts or mileage logs.

- However, the reimbursement requests for the former City Clerk-Administrator did not comply with City policy. Of the 26 reimbursement requests of the former City Clerk-Administrator that we reviewed, only one had partial supporting documentation in the form of receipts. The others were hand written on pieces of paper and submitted for payment. As a result, we were unable to ascertain the appropriateness of a substantial

¹⁴The term "per diem" properly refers only to payments made by the day, not to monthly payments. See Op. Atty. Gen. 124a, April 28, 1994. However, because the City called these monthly payments "per diems," we will use this term for the purposes of this report.

number of the former City Clerk-Administrator's expenses because they lacked any supporting documentation. A significant number of reimbursement requests were for meals when meeting with others, such as Council members, the Mayor, department heads, the Economic Development Authority Director, City staff, or individuals that may have business with the City.

Public funds may be expended only for a public purpose (Minn. Const. Art. X, § 1). In Op. Atty. Gen. 63a-2, May 6, 1965, the Minnesota Attorney General held that before a public unit can expend money providing meals to its employees, there must be a showing that it was necessary for the employees to meet at a meal time. Further, in Op. Atty. Gen. 59a-22, November 23, 1966, the Attorney General held there was no authority in state law for a city council to pay the expenses associated with a social event for its employees.

In Op. Atty. Gen. 63a-2, May 6, 1965, City of St. Cloud employees that worked together were going to lunch and since they allegedly discussed city business, they were billing the city for their lunches. In this opinion, the Minnesota Attorney General ruled that public funds could never be expended for staff-on-staff meals because such an expenditure would violate the public purpose doctrine.

We recommend that the City discontinue the practice of reimbursing employees for buying meals for other staff members. Also, supporting documentation in the form of receipts as required by the City's staff manual should be included with the reimbursement request and, in the case of meals, the purpose of the meeting, identities of the attendees, and the necessity of meeting during meal time should be included.

XII. 1993 TAX LEVY AND HOMESTEAD AND AG CREDIT (HACA)

During 1993, the City erroneously recorded \$29,954 of HACA revenue in the Tax Increment Financing (TIF) District #5.1 Townsquare East Debt Service Fund. The revenue should have been recorded in the Improvement Bonds of 1989 Debt Service Fund (Goldenwood). In 1994, TIF District #5.1 Townsquare East Debt Service Fund transferred \$19,000 of the \$29,954 HACA funds to TIF District #2.1 Debt Service Fund, and TIF District #2.1 was closed during 1994.

We recommend that the \$29,954 be repaid from the TIF District #5.1 to the Improvement Bonds of 1989 Debt Service Fund.

XIII. COMMUNICATION WITH CITY COUNCIL MEMBERS

In past years, the City's external auditor communicated primarily with the former City Clerk-Administrator and one Council member. It appears that the external auditor had limited direct communications with the entire City Council through formal entrance and exit meetings. In our opinion, management and compliance letters should be a forum to communicate audit findings and recommendations.

In order for the City Council to fulfill their responsibilities, we recommend that steps be taken to ensure that all members receive sufficient information regarding the financial condition of the City from future auditors.

XIV. PUBLICATION OF FINANCIAL STATEMENTS

Minn. Stat. § 471.697, subd. 1a, requires that the City publish annually a financial report or summary financial report in a form prescribed by the State Auditor, in a qualified newspaper of general circulation in the City, or if there is none, post three copies in three of the most public places in the City, no later than 30 days after the report is due in the Office of the State Auditor. The City did not publish the required financial information during the petition period 1991 through 1995.

We recommend that the City publish annually in the City's official newspaper the required financial information.

XV. EXPENDITURES IN EXCESS OF BUDGET

For the years 1989 through 1996, the City exceeded budgeted expenditures by \$1,189,764. Failing to operate within its established budget contributed to the City's poor financial condition. To effectively exercise budgetary controls, responsibility should be assigned to department heads. Additionally, the City Council should monitor expenditures on a regular basis so they do not exceed budgeted amounts.

We recommend that the City Council assign responsibility to department heads and monitor expenditures on a regular basis so that they do not exceed those budgeted.

* * * * *

As indicated above, the City undertook numerous projects which resulted in a significant amount of debt being accumulated. The financial condition of the City diminished because of financial mismanagement. The revenue sources for various projects were not adequate to recover project costs. Because of this financial mismanagement, the City was forced to use property taxes collected for the general operations of the City to pay debt obligations on those projects that should have been funded through assessments, tax increments, or user fees. Increased interest costs resulted when the City was forced to borrow in order to meet current operating needs. It appears the City Council was reluctant to raise taxes or user fees. If the City Council had been more diligent in addressing the revenue shortfalls through modest increases in taxes and user fees, the City taxpayers would not be experiencing the level of significant tax increases and user fee increases that they are currently experiencing. Only the citizens of the City of Cambridge can determine if the projects undertaken were necessary and worth the price they will have to pay through higher property taxes in future years.

The City Council has begun to address some of the above issues. We encourage the Council to continue to evaluate its financial condition.

JUDITH H. DUTCHER
STATE AUDITOR

GREG HIERLINGER, CPA
DEPUTY STATE AUDITOR