City of Albuquerque

P.O. BOX 1293 ALBUQUERQUE, NEW MEXICO 87103

Office of Internal Audit

Martin J. Chavez, Mayor

September 10, 2002

Internal Audit Committee
City of Albuquerque
Albuquerque, New Mexico

Audit: Risk Management Division
Department of Finance and Administration
Land Acquisition
02-135

FINAL

INTRODUCTION

In 1984 the City of Albuquerque (the City) closed a landfill on the north side of the City known as the Los Angeles landfill. In 1995 the City's Environmental Health Department (EHD) was notified that methane gas was polluting privately owned property adjacent to the landfill. On September 3, 1999 the City was notified that a real estate developer (the developer) who owned property adjacent to the Los Angeles landfill had filed a claim against the City for damages as a result of methane contamination to his property.

In November of 1999 the City entered into a settlement agreement with the developer related to damages from methane contamination of land adjacent to the City's Los Angeles Landfill. The settlement agreement called for the City to pay the developer quarterly easement payments from February of 2000 to April of 2001 to not develop the property while the City attempted to remediate the property. Total easement payments for this period of time totaled $707,045. If the City could not remediate the property within the allotted time, the settlement agreement allowed the City to purchase the property from the developer at its fair market value without the contamination. In June 2001, the City purchased the property from the developer for $3,375,351.

The Office of Internal Audit performed a special audit of land acquisition related to the Los Angeles landfill settlement agreement in the Risk Management Fund. As a part of completing our audit, the Office of Internal Audit relied on data provided by real estate appraisers and experts in landfill gas extraction covering the subject property. That data is incorporated into this report and is an integral part thereof.

Our fieldwork was completed on July 19, 2002. We have based this report on our examination of activities through the completion date of our field work and it does not reflect events after that date.

Our audit was conducted in accordance with Government Auditing Standards, except Standard 3.33, which requires an external quality review.

SCOPE

Our audit did not include an examination of all the functions, activities and transactions in the Risk Management Fund. Our audit was limited to the following areas:

- To determine if land acquired from the Los Angeles landfill settlement was recorded in the City's general ledger appropriately.
- To ensure compliance with pertinent statutes, ordinances, policies and Generally Accepted Accounting Principles.
- To verify that any related remediation liabilities associated with the settlement agreement on the Los Angeles landfill have been appropriately recorded.

FINDINGS

The following finding concerns areas that we believe would be improved by the implementation of the following recommendations.

1. THE DEPARTMENT OF FINANCE AND ADMINISTRATIVE SERVICES SHOULD FOLLOW GENERALLY ACCEPTED ACCOUNTING PRINCIPLES.

Internal Service funds are used to account for operations that are financed and operated in a manner similar to private business or where the City has decided that the determination of revenues earned, costs incurred, and net income is necessary for management accountability. In the Internal Service funds category the City maintains a Risk Management Internal Service Fund (the Risk Management Fund) that is used to account for the costs of providing workers' compensation, tort and other claims insurance coverage to City Departments. The Risk Management Fund provides resources so that the City can be a self-insured entity.

On September 3, 1999, the City was notified that the developer who owned property adjacent to the Los Angeles landfill had filed a claim against the City for damages as a result of methane contamination to his property. In the fiscal year ended June 30, 2001, the City purchased part of the methane contaminated property as the result of a settlement agreement. The purchase price was $3,375,351which was the estimated fair market value as if no contamination existed on the property. In fiscal year 2001, as reflected in the City's Comprehensive Annual Financial Report (CAFR), the City recorded the property as an asset in the balance sheet of the Risk Management Fund at $3,375,351. No related remediation liabilities were recorded in the CAFR and a footnote stating that the City is responsible for remediation of the property was not made. DFAS management reports that they requested the City's external auditors to look at the way the property was classified. However, an examination of the external auditors' workpapers revealed that they were not provided complete information on the issue, and as a result no adjustments were made.

On May 18, 2001, the City obtained an independent appraisal of the property. According to the appraisal, the property had a fair market value of $1,930,000 with the methane contamination. On June 30, 2001, the City's CAFR should have reflected the property at this reduced value. The remaining $1,445,351 ($3,375,351 settlement agreement less $1,930,000 appraised value) should have been charged as an expense in the Risk Management Fund. Table 1 shows the balance sheet in the Risk Management Fund as presented in the June 30, 2001 CAFR compared to a correct balance sheet in accordance with Generally Accepted Accounting Principles (GAAP):

Table 1 – June 30, 2001 Risk Management Fund Balance Sheet

	As presented	Corrected in accordance with GAAP
ASSETS		
Current assets		
Cash, investments, and accrued interest	$19,260,870	$19,260,870
Receivables	1,625	1,625
Total current assets	19,262,495	19,262,495
Property and equipment		
Land	**3,375,351**	**1,930,000**
Improvements	46,465	46,465
Equipment	219,492	219,492
	3,641,308	2,195,957
Less accumulated depreciation	206,323	206,323
Net property and equipment	3,434,985	1,989,634
TOTAL ASSETS	$22,697,480	$21,252,129

LIABILITIES AND FUND EQUITY

Current liabilities		
Accounts payable	$231,058	$231,058
Accrued employee compensation and benefits	208,845	208,845
Current portion of claims and judg. payable	11,079,498	11,079,498
TOTAL CURRENT LIABILITIES	11,519,401	11,519,401
Long-term liabilities		
Claims and judg. payable excl. current portion	22,732,934	22,732,934
TOTAL LIABILITIES	34,252,335	34,252,335
Fund equity		
Contributed equity	18,181	18,181
Retained deficit	**(11,573,036)**	**(13,018,387)**
Total fund deficit	(11,554,855)	(13,000,206)
TOTAL LIABILITIES AND FUND EQUITY	$22,697,480	$21,252,129

The following is a summary of pertinent accounting principles and regulations as they relate to this transaction:

A. Assets, as defined by the Financial Accounting Standards Board (FASB) Concept Statement No. 6, are "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." This concept statement concludes that an asset should be recorded at its fair market value at the time the asset is purchased. According to information obtained from the City's independent appraiser, the developer had the asset offered for sale. However, as a result of the methane contamination, the property was removed from the market. The independent appraiser, taking into consideration remediation requirements from an independent landfill gas extraction engineering firm, concluded that the fair market value of the property was $1,930,000. This property should have been recorded at this amount in the June 30, 2001 CAFR. Recording property in excess of its fair market value at the time of purchase is not in compliance with FASB Concept Statement No. 6 and overstates the value of the property. This makes the City at risk of issuing misleading financial statements.

B. FASB Statement No. 5, Contingencies, states, "An estimated loss from a loss contingency shall be accrued by a charge to income if *both* of the following conditions are met:

1. "Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements…

2. "The amount of loss can be reasonably estimated."

There appears to be some disagreement among the City's independent landfill gas extraction expert and EHD as far as the best method to remediate the property. As a result, the amount of remediation costs in this case cannot reasonably be estimated and therefore, an accrued loss representing future remediation expenses cannot be recorded.

FASB Statement No. 5 further requires that if no accrual is made for a loss contingency because one or both of the conditions listed above are not met, or if an exposure to loss exists in excess of the amount accrued when there is at least a reasonable possibility that a loss or an additional loss may have been incurred a footnote disclosure should be made. The disclosure should indicate the nature of the contingency or a statement that an estimate of the loss cannot be made. There was not a footnote disclosure in the June 30, 2001 CAFR relating to potential remediation liabilities associated with the subject property.

C. As part of the settlement of the claim with the developer, the City acquired and recorded the land as an asset in its general ledger. Governmental entities may not be allowed to hold land that the governmental entity does not intend to use. Article VIII, Section 4 of the New Mexico Constitution states, "…All public money not invested in interest-bearing securities shall be deposited in national banks in this state, in banks or trust companies incorporated under the laws of the state, in federal savings and loan associations in this state, in savings and loan associations incorporated under the laws of this state whose deposits are insured by an agency of the United States and in credit unions incorporated under the laws of this state or the United States to the extent that such deposits of public money in credit unions are insured by an agency of the United States, and the interest derived therefrom shall be applied in the manner prescribed by law. The conditions of such deposits shall be provided by law." Land is not an interest bearing security. DFAS management should obtain a legal opinion as to the legality of holding land as an asset. If it is determined that a governmental entity cannot hold land as an asset without any intended use, the property should be reclassified as an expense in the City's general ledger.

D. As reported in the June 30, 2001 CAFR, the Risk Management Fund had a deficit Fund Balance of $11,573,036. If the land is adjusted to actual amounts as shown in Table 1 above, the Fund Balance deficit will increase. Recording the settlement transaction may not be appropriate since the Risk Management Fund had a deficit balance at June 30, 2001.

RECOMMENDATION

DFAS should follow GAAP. The property recorded at $3,375,351 in the CAFR should be adjusted to $1,930,000 in accordance with the appraisal received, and the June 30, 2001 CAFR should be corrected. In addition, a footnote should be added to the CAFR disclosing the potential liabilities associated with the remediation of the property in accordance with FASB Statement No. 5.

DFAS management should obtain a legal opinion as to the legality of holding land as an asset. If it is determined that a government cannot hold land as an asset without any intended use, the property should be reclassified as an expense in the City's general ledger.

DFAS management should also consider either increasing the funding to the Risk Management Fund or reclassifying the settlement expenses to another appropriate fund in order to ensure compliance with the pertinent statutes and policies over self insured entities.

EXECUTIVE RESPONSE FROM DFAS

"The property will be recorded in the general ledger and CAFR in accordance with GAAP.

"Risk Management already has in place an approved five year Deficit Recovery Plan."

CONCLUSION

By implementing this recommendation, DFAS will better fulfill its responsibility to implement professional accounting standards and the pertinent statutes and policies in an effective manner.

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Senior Auditor

REVIEWED and APPROVED:	**APPROVED FOR PUBLICATION:**
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Debra D. Yoshimura, CPA, CIA Internal Audit Officer	Chairman, Audit Committee

SPECIAL AUDIT REPORT

OF THE

DEPARTMENT OF FINANCE & ADMINISTRATIVE SERVICES

RISK MANAGEMENT DIVISION

LAND ACQUISITION

REPORT NO. 02-135

CITY OF ALBUQUERQUE
OFICE OF INTERNAL AUDIT