

FINANCE COMMITTEE MINUTES

January 13, 2005

The Finance Committee of the City of Mesa met in the lower level meeting room of the Council Chambers, 57 East 1st Street, on January 13, 2005 at 10:42 a.m.

COMMITTEE PRESENT

Tom Rawles, Chairman
Janie Thom
Claudia Walters

COUNCIL PRESENT

None

STAFF PRESENT

Debra Dollar

1. Discuss and consider accepting the Comprehensive Annual Financial Report of the City of Mesa for the fiscal year ended June 30, 2004.

Financial Services Director Bryan Raines addressed the members of the Finance Committee and introduced Greg Lee, senior manager for Deloitte & Touche, and John Hunter, a partner with the firm. He expressed appreciation to Controller Kathy Pace and Assistant Controller Doug Yeskey for their efforts and hard work in connection with the preparation of the City's Comprehensive Annual Financial Report.

Mr. Hunter highlighted a variety of materials provided for the Committee's review including the Comprehensive Annual Financial Report, an audit opinion generated by his firm, a management letter for the year ended June 30, 2004, and the November 9, 2004 Audit Committee letter (addressed to the Finance Committee). He stated that during the audit process, he has had the opportunity to work closely with City staff and acknowledged their professionalism and experience in this regard.

Mr. Hunter provided a brief overview of his firm's Audit Committee letter to the City of Mesa relative to the following items: that Deloitte & Touche are independent accountants with respect to the City of Mesa; Deloitte & Touche's responsibility under generally accepted auditing standards and government auditing standards; audit adjustments; significant accounting policies; disagreements with management; consultation with other accountants; major issues discussed with management prior to retention; difficulties encountered in performing the audit; and other material written communications. (See Attachment 1.) He concluded his remarks by noting that this is his firm's fifth and last year serving as independent accountants for the City of Mesa and expressed appreciation for the professional relationship he has enjoyed in that capacity.

In response to a question from Committeemember Walters, Mr. Hunter stated that Sarbanes-Oxley legislation does not relate to government at this time. He noted that there have been discussions that sooner or later it could affect entities receiving Federal funds such as nonprofit organizations, governmental entities and universities.

Committeemember Thom commented that she did not have sufficient time to review all of the materials contained in the packet and is not prepared to ask any questions at this time.

Discussion ensued relative to the "observation, recommendation and management's response" with regard to the Oversight of Federal Grant Programs (as contained in Exhibit 1 of the packet).

It was moved by Committeemember Walters, seconded by Committeemember Thom, to recommend to the Council that the Comprehensive Annual Financial Report of the City of Mesa for fiscal year ended June 30, 2004, be approved.

Carried unanimously.

2. Discuss the status of the City of Mesa's Investment Program including investments in the State of Arizona's Local Government Investment Pool.

SEE ADDENDUM "ATTACHMENT A" FOR CORRECTION

Financial Services Director Bryan Raines reported that during the past year's budget hearings, the Council had requested that staff provide a status report on the City's investment program. He introduced Controller Kathy Pace and Assistant Controller Doug Yeskey to the Committee.

Mr. Yeskey explained that the rise in interest rates in the fourth quarter of 2004 was the impetus that led the City to start investing outside of the Local Government Investment Pool (LGIP). He advised that the pool is sponsored by the State Treasurer's Office and contains United States government backed securities. Mr. Yeskey stated that for the last three years, all of the City's investments have been placed within the LGIP, but commented that investments outside of the LGIP have occurred in the past as well.

Chairman Rawles indicated that the Committeemembers have read the City Council Report and stated that it was unnecessary for staff to provide a lengthy presentation relative to this issue.

Committeemember Walters commented that on various occasions, the City has invested considerably less money in the LGIP than it currently has invested. She noted that Mesa lost a significant sum of money from the LGIP under the previous administration at the State Treasurer's Office and questioned whether municipalities have withdrawn or are in the process of withdrawing their investments from the pool. Committeemember Walters further stated that the suggestion was made to her that if Mesa pulled out of the LGIP, it would harm smaller cities investing in the pool, but said she hopes those individuals who make Mesa's investments are doing so based on what is in the best interest of the City.

In response to a series of questions posed by Committeemember Walters, Ms. Pace clarified that Mesa has invested more money in the LGIP than any other municipality in Arizona; that since the beginning of the current fiscal year, the City has withdrawn \$15 million from the LGIP and invested those funds in the Federal Home Loan Bank and the Federal Farm Credit System;

that because of a shift in various job assignments within his division, Mr. Yeskey is now able to devote more time to the City's investment program; that Mr. Yeskey is working with an outside consultant, Larry Woolf (a former City employee with over 30 years of investment experience), to solicit input and guidance with regard to the City's investment program; that Mr. Woolf is not compensated by investment firms for specific recommendations he makes to the City, but rather is paid an hourly salary for his services; that Scottsdale and Chandler employ firms to make the investments for those municipalities; and that citizens can access the City's website to view a status report of Mesa's investment program.

Chairman Rawles stated that from his perspective, he does not think it is appropriate or necessary for the Council to be involved in the decision-making process with regard to the City's \$15 million investments outside the LGIP. He noted, however, that when staff withdraws funds from the LGIP to make such investments, it would be appropriate for them to apprise the Council of such action.

In response to Chairman Rawles' comments, Ms. Pace explained that in the past, the Council was provided with monthly investment reports, but said that staff discontinued the practice when all of the City's investments were placed in the LGIP. She assured the Committee that staff intends to reinstitute the distribution of monthly investment reports to the Council.

Chairman Rawles recounted an incident when he was hired to serve as a local government expert with regard to the Orange County, California bankruptcy case. He stated that as a result of that experience, he learned the importance of elected officials being aware of the investment programs of their respective communities.

In response to a question from Committeemember Thom, Ms. Pace clarified that prior to the City withdrawing \$15 million from the LGIP to invest outside the pool, staff did not consult with any investment experts other than Mr. Woolf. She stated that the decisions were made based on staff's analysis of various investment documentation, as well as input and recommendations from Mr. Woolf.

Committeemember Thom commented that she recently obtained information that during Mr. Woolf's tenure as a City of Mesa employee, he also served as a consultant for the City of Chandler. She stated that in addition, it is also her understanding that Mr. Woolf recommended that Chandler withdraw funds from the LGIP and invest them elsewhere, which resulted in substantial losses for the municipality. Committeemember Thom suggested that before staff makes any further investments with the assistance of Mr. Woolf, that they first solicit input from other financial consultants.

Discussion ensued relative to the fact that the Federal Home Loan Bank and the Federal Farm Credit System are United States government sponsored entities; that although the Federal government does not directly guarantee these securities, it is commonly accepted that the government would step in before a default occurred on either of the enterprises; and that the main source of funds for Mesa's investments are Quality of Life funds, utility revenues, restricted trust funds, bond proceeds, and funds set aside for debt service payments.

In response to a question from Committeemember Thom, Ms. Pace advised that staff would continue to withdraw money from the LGIP if it was determined to be in the best interest of the

City of Mesa to do so. She added that pending management approval, staff would notify the Council of such future transactions.

Committeemember Walters clarified that an individual she had spoken with concerning this issue was not alleging that Mr. Woolf worked for Chandler while he was a full-time employee of the City of Mesa. She commented that Mr. Woolf now serves as a consultant for several cities, and emphasized that she has no reason to believe that he was anything but a loyal employee during his tenure with the City.

Chairman Rawles expressed appreciation to staff for their presentation.

3. Discuss the status of the Tax Audit & Collections' project for the collection of Privilege (Sales) Tax on the Rental of Real Property.

Audit and Collection Supervisor Roger Okin and Assistant City Attorney II Alfred Smith addressed the Committee relative to this agenda item. Mr. Okin reported that staff has become aware of the fact that various Councilmembers have received inquiries from Mesa residents regarding a project initiated by staff to identify unlicensed residential properties within the City. He explained that today's presentation is to provide the Committee with background information relative to the privilege (sales) tax on the rental of real property and to respond to any questions the members may have.

Mr. Okin referred to a January 10, 2005 memo, copies of which were distributed to the Committee, and provided a brief overview of the document. (See Attachment 2.) He stated that since 1967, the City has imposed the privilege (sales) tax on income received from the rental of real property; that all commercial rentals within the City are subject to the tax, and that only those residential units where either the owner owns three or more units within the State or owns a commercial property plus one or more residential units are subject to the City tax; and that in 1997, the State of Arizona phased out the privilege (sales) tax on the commercial rental of real property and has never imposed such a tax on residential rental income.

Mr. Okin explained that in 2003, the Tax Audit staff initiated a project to identify unlicensed residential properties within the City. He stated that the research for the project took several months to complete and consisted of matching the Maricopa County Assessor's records to real estate databases and the City's tax and licensing system in order to identify properties that were not properly licensed (1600 properties were identified). Mr. Okin noted that due to limited staff resources, the project has been conducted in phases, with Phases 1 and 2 completed in 2004, and a third phase that has just begun.

Discussion ensued relative to the fact that the City Tax Code allows for a tax assessment back to the property acquisition date, but as a matter of management policy, staff is only going back six years; that per the Tax Code, transactions between affiliated companies or persons are subject to the privilege tax in the same manner as transactions between unaffiliated companies or persons; that in those instances where no money is actually changing hands or where the income is not indicative of market value, the City would determine market value and levy the tax on that amount which represents what the gross income would be between unrelated parties; that all cities in Arizona have adopted the Model City Tax Code, upon which the Mesa Tax Code is based; and that most cities tax rental properties in the same manner as the City of Mesa.

Mr. Okin further commented that every four to five years, the Audit staff has conducted a similar collections project. He stated that Mesa has a vast majority of compliance with regard to the payment of privilege (sales) tax, and added that there is only a small percentage of property owners who are not in compliance.

Mr. Okin concluded his remarks by noting that when the City conducts an audit and issues an assessment to an individual, the taxpayer has 45 days in which to pay the assessment or to file a protest. He explained that a hearing officer hears all protests, and if the individual disagrees with the hearing officer's decision, he or she may appeal to the Superior Court.

Further discussion ensued relative to the fact that during fiscal year 2003/04, the City generated \$13.4 million in tax revenue, the majority from the rental of residential and commercial real property; that as of October 31, 2004, staff had issued assessments totaling approximately \$309,000, of which \$160,000 has been paid; that during this project, staff identified a number of commercial properties that were not properly licensed, and upon completion of researching the properties, it is anticipated that an additional \$200,000 in assessments would result.

Chairman Rawles requested that staff provide the Committee a cost analysis regarding the amount of staff resources being expended to target the small percentage of property owners not in compliance and comment on whether the audit project is truly cost effective. He commented that although he does not want individuals to avoid their tax responsibilities, if the project is costing the City more in staff time to address the small percentage of noncompliance assessments as compared to the assessments being generated, it would be appropriate for the Council to be aware of that fact.

In response to a series of questions from Committeemember Thom, Mr. Okin highlighted the manner in which staff deals with property owners if the City has obtained inaccurate information from the County Assessor's Office; the basis upon which an assessment is issued; and an explanation of Section 5-10-445.1 of the City Tax Code.

In response to a series of questions from Committeemember Thom regarding two cases in which the property owners experienced similar factual scenarios, but realized different outcomes relative to their tax assessments, City Attorney Debbie Spinner advised that it would be inappropriate for Mr. Okin to respond to such questions due to confidentiality issues. She added that the Finance Committee meeting would be an improper venue in which to discuss the specifics of the two cases.

Chairman Rawles concurred with Ms. Spinner's opinion and encouraged staff to meet privately with Committeemember Thom concerning her inquiries.

Ms. Spinner stated that staff would attempt to respond to Committeemember Thom's questions, but expressed concerns regarding the disclosure of confidential information, including taxpayer information, on a one-on-one basis with Committeemember Thom.

Additional discussion ensued relative to the fact that assessments are sent to property owners based upon information obtained via various databases and not because such individuals addressed the City Council during Council meetings or filed a legal action against the City; and that if the property owner fails to respond to certified letters issued by the City (up to three

letters), the Tax Code allows Mesa to issue an estimated assessment against the individual at that time.

Chairman Rawles thanked staff for the presentation.

4. Adjournment.

Without objection, the Finance Committee Meeting adjourned at 11:38 a.m.

I hereby certify that the foregoing minutes are a true and correct copy of the minutes of the Finance Committee meeting of the City of Mesa, Arizona, held on the 13th day of January 2005. I further certify that the meeting was duly called and held and that a quorum was present.

BARBARA JONES, CITY CLERK

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addendum
attachments (2)

ADDENDUM

ATTACHMENT "A"

"I would like to correct some statements that I made during a Finance Committee Meeting on January 13, 2005.

During that Committee Meeting I made comments regarding Larry Woolf and his employment with the City of Mesa; consulting work that Larry performed for the City of Chandler; Larry's involvement in Chandler's decision to remove funds from the Local Government Investment Pool; and advice I thought he provided to invest those funds in other investments. Those comments were based on information that had been provided to me by State Treasurer Dave Petersen. I have since learned that I misinterpreted this information.

I have received a letter from Mr. Woolf and a letter from Pat Walker, the Management Services Director for the City of Chandler.

Based on this information, I would like to correct the record by stating that:

1. Mr. Woolf was not compensated by the City of Chandler as a consultant during his employment for the City of Mesa.
2. Mr. Woolf was not, in any way, involved in Chandler's decision to move money from the LGIP into other investments.

Mayor, I apologize for this error and I would like to make a motion that the January 13, 2005 Finance Committee Minutes reference this statement. This will ensure that anyone reading the minutes will also have an opportunity to read this correction."

Deloitte

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November 9, 2004

Finance Committee
City of Mesa
20 East Main Street, Suite 350
Mesa, Arizona 85211

Dear Finance Committee Members:

We have audited the basic financial statements of the City of Mesa (the "City") as of and for the year ended June 30, 2004 and have issued our report thereon dated November 9, 2004.

Our professional standards require that we communicate at least annually with you regarding all relationships between Deloitte & Touche LLP, the member firms of Deloitte Touche Tohmatsu and their respective affiliates (collectively the "Deloitte Entities") and the City that, in our professional judgment, may reasonably be thought to bear on our independence. We have prepared the following comments to facilitate our discussion with you regarding independence matters arising since November 21, 2003, the date of our last letter.

We are not aware of any relationships between the Deloitte Entities and the City that, in our professional judgment, may reasonably be thought to bear on our independence.

We hereby confirm that as of November 9, 2004 we are independent accountants with respect to the City, within the meaning of the Government Auditing Standards Amendment No. 3.

Other Matters

We have prepared the following comments to assist you in fulfilling your obligation to oversee the financial reporting and disclosure process for which management of the City is responsible.

Our Responsibility under Generally Accepted Auditing Standards and Government Auditing Standards

Our responsibility under auditing standards generally accepted in the United States of America and Government Auditing Standards have been described to you in our engagement letter dated April 24, 2004. As described in that letter, those standards require, among other things, that we obtain an understanding of the City's internal control sufficient to plan the audit and to determine the nature, timing and extent of audit: procedures to be performed. We have issued a separate report to you, also dated November 9, 2004, containing our comments on the City's internal control.

Management Judgments and Accounting Estimates

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and on assumptions about future events. Significant accounting estimates reflected in the City's 2004 basic financial statements include estimates to determine the valuation of allowances for doubtful accounts, inventory reserves and liabilities incurred but not reported. During the year ended June 30, 2004, we are not aware of any significant changes in accounting estimates or in management's judgments relating to such estimates.

Audit Adjustments

During our audit procedures we did not note any audit adjustments that we believe would have a significant effect on the financial statements, either individually or in aggregate.

There were no uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented, as all misstatements detected in our audit have been corrected by management.

Our audit was designed to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. In addition, we are obligated by generally accepted auditing standards to inform you of any adjustments arising from the audit that could, in our judgment, either individually or the aggregate, have a significant effect on the City's financial reporting process. All proposed audit adjustments (whether recorded or uncorrected) were reviewed with management and were determined, individually or in the aggregate, not to have a significant effect on the financial reporting process.

Significant Accounting Policies

The City's significant accounting policies are set forth in Note 1 to the City's 2004 basic financial statements. During the year ended June 30, 2004, there were no significant changes in previously adopted accounting policies or their application.

Disagreements with Management

We have not had any disagreements with management related to matters that are material to the City's 2004 financial statements.

Consultation with Other Accountants

We are not aware of any consultations that management may have had with other accountants about auditing and accounting matters during 2004.

Major Issues Discussed with Management prior to Retention

Throughout the year, routine discussions regarding the application of accounting principles or auditing standards were held with management in connection with transactions that have occurred, transactions that are contemplated or reassessment of current circumstances. In our judgment, such discussions were not held in connection with our retention as auditors.

Difficulties Encountered in Performing the Audit

In our judgment, we received the full cooperation of the City's management and staff and had unrestricted access to the City's senior management in performance of our audit.

Other Material Written Communications

A listing of those written communications that we believe constitute other material written communication between management and us related to the audit for the year ended June 30, 2004 is below. For those communications previously provided to you, we have indicated the date you were provided with such communication. For those communications not previously provided, a copy of such communication has been attached to this letter.

- Management Letter for the year ended June 30, 2004 is attached to this letter.
- Management Representation Letter for the year ended June 30, 2004 is attached to this letter.
- Engagement Letter for the year ended June 30, 2004 is attached to this letter.

This report is intended solely for the information and use of the Finance Committee of the City Council, management and others within the City and is not intended to be and should not be used by anyone other than these specified parties.

Yours truly,

Deloitte & Touche LLP

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MEMO

January 10, 2005

TO: Mike Hutchinson, City Manager

THROUGH: Bryan Raines, Financial Services Manager

FROM: Roger Okin, Audit & Collection Supervisor

SUBJECT: Privilege (Sales) Tax on the Rental of Real Property

A. History

The City has imposed the privilege (sales) tax on income received from the rental of real property since 1967. The tax applies to both residential and commercial rental income. The current tax rate is 1.5%. All commercial rentals within the City are subject to the tax. Only those residential units where either the owner owns 3 or more units within the State or owns a commercial property plus one or more residential units are subject to the City tax.

The State of Arizona phased out the privilege tax on commercial rental of real property in 1997. The State never imposed their privilege tax on residential rental income.

Maricopa County imposes a 0.5 % privilege tax on commercial rental income. There is no County tax on residential rental income.

During fiscal year 03/04, the rental category generated \$13.4 million in tax revenue. Although this category includes tax revenue from hotel/motel activities and the rental of real property, the bulk of the revenue is from the rental of residential and commercial real property. The rental category in FY 03/04 accounted for approximately 13% of total City tax revenue.

B. Residential Rental Project

In mid 2003, the Tax Audit staff initiated a project to identify unlicensed residential properties within the City. The research for this project took several months and consisted of matching Maricopa County Assessor records to real estate databases and the City's tax and licensing system in order to identify those properties which were not properly licensed.

As a result of staff research, approximately 1,600 properties were identified potentially as not being properly licensed. According to County Assessor records, these properties were owned

by 611 different owners. In March 2004, Phase I of the project began with the mailing of 217 letters. (Due to limited staff resources, the project has been done in 3 phases) In August 2004 Phase II began with the mailing of 394 letters. Staff is currently beginning Phase III. As of October 31, 2004, assessments totaling approximately \$309,000 have been made of which approximately \$160,000 has been paid. In addition, as a by-product of the residential research, a number of commercial properties were also identified as not being properly licensed. When research on these properties is completed, it is expected that additional assessments of approximately \$200,000 will result. Our office is currently studying the possibility of initiating a commercial rental project next fiscal year to be conducted in a manner similar to the residential project.

Although the City Tax Code allows for assessment of tax back to property acquisition date, it has been the City policy in past rental projects and in the current project to only go back as far as six years. In addition, if taxpayers are cooperative in providing the necessary information to get in compliance, penalties will be waived. (Interest will still be applicable)

C. Related Party Transactions

Under the Mesa Tax Code, transactions between affiliated companies or persons are subject to the privilege tax in the same manner as transactions between unaffiliated companies or persons. These types of transactions are commonly found in the rental of real property. Some of the common transactions between affiliated parties are as follows:

Individual leasing to their 100% owned corporation.

Trust of which the individual is the trustee leasing to the individual's 100% owned corporation.

LLC of which the individual is a member leasing to the individual's 100% owned corporation.

In cases where no money is actually changing hands or where the income is not indicative of market value, the City will determine market value and levy the tax on that amount which represents what the gross income would be between unrelated parties. In these cases, consideration must be shown to exist which represents a benefit or gain to the seller or lessor. For example, a 100% owned lessee corporation paying the mortgage payment and property taxes on behalf of an individual owner lessor. In this case, consideration has been received by the individual owner lessor in the form of payments made on their behalf resulting in a taxable transaction.

D. Summary

The provisions discussed above are all part of the Model City Tax Code, upon which the Mesa Tax Code is based. All Arizona cities follow these code provisions. The City's audit staff historically has conducted research in this area every 4-5 years. Similarly, most of the large self-administered cities in the State also are actively pursuing unreported rental transactions, including those between related parties.