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IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, CHANCERY DIVISION

City of Chicago,

Plaintiff,

v.

City of Harvey, Village of Homewood, Village of Hazel Crest, Village of Posen, Village of Dixmoor, Village of East Hazel Crest,

Defendants.

Case No. 12 CH 44855

Hon. Anna M. Loftus

FORENSIC ACCOUNTANT'S CONCLUDING REPORT

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I. EXECUTIVE SUMMARY OF G&P'S CONCLUSIONS REGARDING HARVEY'S USE OF ITS WATER FUNDS AND HARVEY'S OVERALL FINANCIAL CONDITION.

Michael D. Pakter[1] and Gould & Pakter Associates, LLC[2] (collectively "G&P"), as forensic accountants for Robert P. Handler, the Court-appointed Receiver in this matter ("Handler" or "Receiver"), submits this final report as to its scope of work, procedures, findings and recommendations (the "Report"). In conducting its forensic investigation, G&P focused its efforts on two primary issues: (i) tracing the historic use of the City of Harvey, Illinois' ("Harvey" or the "City") Water Funds[3] to determine whether such funds were used for non-water purposes[4] or non-Harvey purposes, and (ii) assessing Harvey's overall financial condition, financial practices, procedures and internal controls to determine if improvements could be made to benefit Harvey's Water Fund in the future. Below is a brief description of G&P's conclusions.

A. Harvey Used Water Funds for Non-Water Expenses, but No Evidence Was Found of Water Funds Being Used for Non-Harvey Expenses.

Historically, Harvey used its Water Fund for non-water expenses and, in doing so, transferred millions of dollars of Water Funds to its General Fund and (to a lesser extent) other non-water Funds (*see* Section III.C. *infra* for a description of Harvey's Funds). Based on the most current data available, Harvey's General Fund is indebted to Harvey's Water Fund in the amount of $31.6 million.[5] Many of these transfers occurred while Harvey was prohibited from making such transfers per the terms of a Consent Decree that Harvey entered into with Chicago.[6] G&P found no evidence that anyone working at or on behalf of Harvey stopped, prevented or voiced any objection to such transfers.

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[1] As described further in his professional profile attached as Exhibit 1, Mr. Pakter has more than 40 years of experience in accounting and forensic accounting, business economics and financial investigations in numerous industries and diverse engagements. He has participated in public hearings and alternative dispute resolutions, submitted expert reports in several jurisdictions and testified in arbitrations, regulatory proceedings and litigated disputes. State, Federal and Bankruptcy Courts have recognized Mr. Pakter as an expert in accounting, financial analysis, forensic accounting and financial investigations.

[2] Gould & Pakter Associates, LLC is a certified public accounting firm that, among other services, provides financial forensics, commercial litigation services, financial investigations and financial analysis of disputes, calculates economic damages, values closely held businesses for litigation, traces undisclosed assets and analyzes financial transactions and balances; determines sources of funds used to acquire assets, and reconstructs incomplete accounting and financial information.

[3] Unless otherwise defined herein, capitalized terms used in this Report have the same meaning as in this Court's August 4, 2017 order appointing the Receiver, which is attached as Exhibit 2.

[4] The terms "non-water purposes" and "non-water expenses" as used in this Report mean purposes and expenses unrelated to the operations of Harvey's Water Department.

[5] Exhibit 3 (excerpt of Harvey's Annual Financial Report for Fiscal Year Ended 2017 through the "Basic Financial Statements" section) at 44. The full 2017 AFR is available as of 2-1-19 at http://warehouse.illinoiscomptroller.com/ (search for "Harvey").

[6] It has been argued that Harvey was also prohibited by Illinois' law from making these transfers. Such legal analysis is beyond the scope of this Report.

Because significant Water Funds were transferred to, and spent from, Harvey's General Fund, a complete investigation into the use of Harvey's Water Funds necessarily involved investigating Harvey's citywide expenditures. In doing so, G&P found no evidence of misappropriation of Water Funds or any Harvey funds for non-Harvey purposes.

To reach this conclusion, among other financial analyses, G&P performed a targeted analysis of Harvey's seven largest expenditure categories that comprise 92% percent of Harvey's expenditures. Those expenditure categories are payroll, water purchases, insurance, debt service, maintenance, claims against Harvey ("Claims"), legal and professional costs and other operating expenses.[7] G&P also performed a detailed invoice review of Harvey's significant vendors, which confirmed valid Harvey expenditures.

Additionally, G&P reviewed specific allegations made by Chicago's forensic accounting expert retained in this matter, Ronald Cote ("Cote"), that approximately $8.73 million of Water Revenue was not deposited into Harvey's Water Fund, and that Harvey's money may have been used for non-Harvey expenses. After closely reviewing Cote's allegations, G&P found Cote misunderstood certain facts and/or did not have access to all necessary information and, accordingly, his observations of non-Harvey expenses were incomplete. G&P's testing noted that, in aggregate, all Water Revenue deposits were included in Harvey's deposits taken as a whole. Cote was correct, however, in concluding that Water Funds were not all deposited into Harvey's Water Fund and were used to pay non-water expenses.

B. Harvey Should Create a Robust, Functional and Reconstituted Finance Committee Supported by a Non-Voting Finance Committee Advisory Board, Which Should Improve Harvey's Overall Financial Condition, Financial Accountability, Financial Practices, Procedures and Internal Controls.

Factors contributing to Harvey's use of Water Funds to pay for general expenses while water-related expenses remained unpaid included (i) its overall distressed financial condition; (ii) its deepening insolvency; (iii) a general lack of financial accountability, and (iv) insufficient financial practices, procedures and internal controls. Harvey did not have and does not have enough revenues, including Water Revenue, to make payroll and to pay ongoing citywide expenditures and obligations and, accordingly, historically has resorted to using Water Funds to do so before paying all water-related expenses.

In Fiscal Year Ended ("FYE") 2017, Harvey spent $120 in expenditures for every $100 it took in in revenues[8] (an observation generally consistent with prior fiscal years).[9] Harvey's overall distressed financial condition and its deepening insolvency taken together with a general lack of appropriate financial accountability and inadequate financial practices, procedures and internal controls stands as a continued threat to the Water Fund in that it perpetuates the risk of Harvey using Water Funds to make payroll and to pay ongoing citywide expenditures and

[7] For Fiscal Years Ending 2011-2018, the breakdown is as follows: Payroll (32%); Water (21%); Debt service (11%); Claims/Legal/Other Professionals (9%); Insurance (7%); Other Operating Expense (7%), and Maintenance (5%).

[8] Harvey's Comptroller, Louis Williams, noted that Harvey's revenues have decreased due to significant declines in real estate tax collections, in turn caused by abandoned and vacant homes.

[9] Exhibit 4 (G&P's Analysis of Net Position for FYE 2009-2017).

obligations. Harvey's financial distress and deepening insolvency are likely to continue unless Harvey adopts appropriate levels of financial accountability and implements better financial practices, procedures and internal controls.

G&P's most pressing and encompassing recommendation is for Harvey to have a robust, functional and reconstituted Finance Committee, supported by a strong non-voting Finance Committee Advisory Board that should include committed, talented and knowledgeable community and business leaders, bankers, finance and/or accounting professionals as well as a representative from Lauterbach & Amen, LLP, Harvey's external, independent auditor ("Harvey's Auditor")[10]. The newly reconstituted Finance Committee should engage in a more consistent review of Harvey's overall financial condition, financial accountability, financial practices, procedures and internal controls and consider several changes thereto, including, but not limited to:

a) reestablishing an appropriate level of financial accountability regarding all financial matters;
b) implementing best practices regarding Harvey's finances, budgets, policies, procedures and internal controls;
c) taking steps to turn around Harvey's overall financial condition and reverse Harvey's deepening insolvency;
d) increasing Harvey's water and other revenues and decreasing Harvey's expenditures;
e) selling some of Harvey's vacant land and maintaining its capital assets currently in use;[11]
f) analyzing whether regional police and fire department and other municipal shared service partnerships could save Harvey money;
g) hiring a new Human Resources Manager ("HR Manager") and determining whether Harvey has the correct employee headcount in all departments;
h) analyzing whether Harvey could restructure some or all of its highly compensated outsourced consultant positions, for example by (i) hiring a full time Comptroller supported by full time Finance Department staff, and (ii) reviewing its Corporation Counsel arrangement;
i) developing and implementing risk mitigation strategies that could reduce Claims;
j) improving Harvey's vendor acceptance and invoice approval processes;
k) investigating and resolving interfund indebtedness, and
l) implementing several long-neglected recommendations included on a recurring basis in the management letter comments ("MLCs") raised by Harvey's Auditor.

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[10] AICPA Ethics Interpretation 1.275.015 (Member on Advisory Board) states that an auditor's independence would generally not be impaired if the responsibilities of the advisory board are in fact advisory in nature and the advisory board has no authority to make nor does it appear to make management decisions on behalf of the independent auditor's attest client.

[11] Harvey's Auditor has recommended that Harvey have an outside appraisal firm perform a physical inventory and valuation of all of Harvey's capital assets and has noted that Harvey does not have a formal capital asset policy to provide guidance on the financial aspects and stewardship of its capital assets. *See* Exhibit 5 (excerpts of Harvey's Auditor's Management Letter for FYE 2017) at MLC 4.

While G&P acknowledges that some of its procedures, findings, conclusions and recommendations relate to Harvey generally versus the Water Fund specifically, G&P believes these recommendations benefit the Water Fund too. This is because as Harvey's overall financial condition improves the risk of improperly utilizing Water Funds decreases.

Additionally, improvements in Harvey's financial condition, financial accountability and financial practices, procedures and internal controls will help the General Fund repay the $31.6 million[12] owed to the Water Fund, and will provide the Water Fund and Harvey with additional opportunities to reorganize their finances, including through potential bond offerings.

Only the Receiver's appointment[13] ended Harvey's practice of using Water Funds to make non-water payroll and to pay ongoing citywide expenditures while water-related expenses remained unpaid. Because Harvey has not sufficiently addressed its underlying financial distress that led to such use of Water Funds, the risk remains that ending the Receivership without building the necessary safeguards around Harvey's Water Funds will result in Harvey resuming this practice.

II. G&P'S APPOINTMENT.

A. Harvey and Chicago Entered into a Consent Decree to Resolve Their Dispute Regarding Harvey's Unpaid Water Bills.

Harvey purchases its water from the City of Chicago ("Chicago") and sells it to Harvey's residents, businesses and the downstream municipalities of the Villages of Homewood, Dixmoor, Hazel Crest, Posen and East Hazel Crest (collectively the "Downstream Municipalities").

In 2012, Harvey fell behind on its water bill payments to Chicago, and Chicago sued Harvey in the Circuit Court of Cook County to collect the outstanding amount.[14] The Court entered summary judgment against Harvey in the amount of $23,303,339.02, and afterwards the parties settled the case via a Consent Decree entered on January 20, 2015.[15]

The Consent Decree laid out terms by which Harvey would pay Chicago for its outstanding water bills, and contained restrictions on how Harvey could use the money generated by its sale of water until Chicago had been repaid.[16] Specifically, all money generated by

[12] The Comptroller believes that the $31.6 million significantly overstates the amount owed to the Water Fund, as the Water Fund had not historically been charged its full and fair share of citywide expenditures. G&P recommends that the Comptroller and the reconstituted Finance Committee identify necessary adjustments in this regard.

[13] The Receivership is ongoing as of the date of the Report, and the Receiver and the Receiver's Counsel continue to investigate matters. Should anything material arise, G&P reserves its right to supplement the Report as warranted, and to seek any leave of Court to do so.

[14] Exhibit 6 (July 19, 2017 Court Order) at 2.

[15] *Id.* at 2-3; *see* Exhibit 7 (the Consent Decree, without its exhibits).

[16] Exhibit 7 at ¶¶ 5-6.

Harvey's waterworks system was to be deposited into Harvey's Water Fund,[17] and could only be used to pay water-related expenses while water-related expenses remained unpaid.[18]

B. Harvey Violated the Consent Decree, Leading the Court to Appoint a Receiver, Who Retained G&P as Forensic Accountant.

On July 19, 2017, Chicago filed a Motion to Declare Transactions Relating to City of Harvey's Water Account "Unauthorized Transactions" under the Consent Decree and for Appointment of a Receiver as an Independent Monitor (the "Receivership Motion"), alleging Harvey had violated the Consent Decree by, *inter alia*, using money for non-water expenses while Harvey's debt to Chicago for the purchase of water remained unpaid.

The Receivership Motion was supported by the sworn declaration of Cote[19], who concluded, among other things, not only that transfers from the Water Fund to the General Fund occurred in violation of the Consent Decree, but also that millions of dollars of Water Revenue were not deposited in Harvey's Water Fund, and certain unauthorized transactions occurred that might not indicate any apparent Harvey business use. Chicago asked the Court to find that Harvey violated the Consent Decree and to appoint a Receiver to manage Harvey's Water Fund and ensure Harvey's compliance with the Consent Decree.

The Court granted Chicago's Motion[20] and, on August 4, 2017, the Court entered an order (the "Receivership Order") appointing Handler as Receiver of, *inter alia*:

> all monies generated by [the City of Harvey, Illinois'] waterworks system at any time, wherever such monies are located and however they are held ("Water Revenue"), including all Water Revenue located in or required to be deposited in a segregated bank account under applicable law or any order of this Court at any time (the "Water Fund" and the funds therein the "Water Funds") and all Water Funds and Water Revenue located in any Harvey accounts which have been commingled with other funds….[21]

Among other things, the Receiver was authorized to investigate the historic use of Water Funds for any improprieties and to implement internal controls to preserve Water Funds and help protect them from future misuse.[22] The Receiver was permitted to hire professionals to assist him with these and other duties, and retained G&P to serve as his forensic accountant.[23]

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[17] The Comptroller noted that it is often not practical and/or possible to deposit all Water Revenue into the Water Fund because Harvey residents only receive one bill for water and non-water bills and most cities deposit water funds into pooled disbursement bank accounts.

[18] Exhibit 7 at ¶¶ 5-6.

[19] At the time of his engagement by Chicago, Cote was a Managing Director within the Forensic Advisory Group of Grant Thornton LLP.

[20] Exhibit 6 at 18-20.

[21] *See* Exhibit 2 at § 1.1.

[22] *E.g.*, *Id.* at § 1.6 (m).

[23] *Id.* at § 3.1.

III. G&P'S SCOPE OF WORK & INVESTIGATIVE PROCESS.

A. G&P Defined and Refined Its Scope of Work Based on the Receivership Order and Meetings with the Receiver and the Receiver's Counsel.

G&P's scope of work was defined and refined through a combination of the matters identified in the Receivership Order,[24] Handler's July 26, 2017 letter to the Court[25] and meetings with the Receiver and Fox Swibel Levin & Carrol LLP, the Receiver's legal counsel ("Receiver's Counsel")[26].[27] G&P focused its efforts on tracing the use of Water Funds after they were transferred to the General Fund to determine where and how all funds were spent and if they were used improperly, and assessing Harvey's overall financial condition, accountability, practices, procedures and internal controls to determine if improvements could be made to benefit Harvey's Water Fund. To do so, G&P performed the procedures documented in this Report.[28]

G&P performed its work using peer reviewed and/or generally accepted accounting, financial analysis, forensic accounting and/or investigative methodologies routinely used by professionals performing forensic accounting, financial investigations and similar consulting engagements. G&P was guided by the standards contained in the AICPA Code of Professional Conduct and Bylaws including, but not limited to, ET §1.300.001, the General Standards Rule.

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[24] *Id.*

[25] *See* Exhibit 8 (Handler's July 26, 2017 letter to the Court, without its exhibits).

[26] While G&P acknowledges the assistance of the Receiver and the Receiver's Counsel in drafting certain portions of this Report, this Report and all opinions expressed and conclusions reached herein, as well as the procedures performed as the basis for such conclusions and opinions are solely those of G&P. G&P's reports, analyses and conclusions herein are exclusively for use in connection with the captioned litigation and cannot be used for any other purpose (or by any other person or entity other than the Court, the Receiver or the Receiver's Counsel) without G&P's and the Receiver's prior written consent. Other than required by law, any summaries of or references to G&P's work prepared by the Receiver, the Receiver's Counsel or any other person are subject to G&P's prior review and written approval.

[27] G&P's Forensic Accountant's Status Report to the Court dated August 1, 2018 summarized G&P's scope of work as follows: (a) analyze and verify the Receiver's position that, from at least FYE 2010 to FYE 2017, Water Fund revenues were used, in part, to fund Harvey's General Fund and pay for Harvey's non-Water operations; (b) analyze, to the extent deemed cost-beneficial, using risk-based investigative approaches, the nature, timing and extent of Harvey's disbursements to vendors for FYE 2010 through FYE 2018; (c) evaluate the completeness of Water Fund revenue records for FYE 2010 through FYE 2018; (d) investigate and analyze any financial claims made by or against the Water Department, and (e) assist the Receiver in identifying, developing and implementing improvements in Harvey's internal financial controls, policies and procedures.

[28] G&P's engagement by the Receiver did not and does not obligate G&P to prepare, audit, review, compile or file financial statements or income tax returns. While G&P's procedures may have included preparing and/or analyzing financial statements or portions thereof, G&P's procedures are not intended to and do not constitute the presentation of financial statements under the jurisdiction of AICPA, SEC or PCAOB standards, nor does G&P's work constitute an attestation, audit, examination, review, compilation or preparation engagement under those professional standards.

B. G&P Assembled the Financial and Non-Financial Information and/or Documentation Necessary to Perform Its Scope of Work.

To perform its scope of work, G&P needed to collect the necessary financial information from Harvey. This proved time-consuming because Harvey had maintained separate and distinct financial reporting databases during the period analyzed that made assembling all the information difficult. Specifically:

- For FYE 2010-2013, Harvey maintained its accounting books and records on an IBM AS 400 server. Portions of Harvey's accounting books and records for those fiscal years were downloaded in Notepad format, requiring manual data entry of Expenditure Ledger[29] information into Microsoft Excel to enable the performance of G&P's forensic accounting procedures.
- For FYE 2014-2016, Harvey maintained its accounting books and records using ACS Financial. Portions of Harvey's accounting books and records for those fiscal years were downloaded in PDF format, without vendor totals, requiring manual data entry of Expenditure Ledger information into Microsoft Excel to enable the performance of G&P's forensic accounting procedures.
- For FYE 2017-2018, Harvey maintained its accounting books and records using BS&A software (a software package used by local governments). Harvey's accounting books and records for those two fiscal years were downloaded directly into Microsoft Excel to enable the performance of G&P's forensic accounting procedures.
- Louis Williams, Harvey's Comptroller (the "Comptroller") employed QuickBooks accounting software to control the process of completing the accounting books and records for finalizing the FYE 2010-2015 annual independent audits of Harvey's Annual Financial Statements included within Harvey's Annual Financial Reports.

C. G&P Obtained an Understanding of Harvey's Fund Accounting Systems and Analyzed the Water Fund Revenues Used to Fund Harvey's Payroll and General Operations.

The FYE 2017 Annual Financial Report ("AFR") reports that Harvey uses the following fund types:[30]

- Governmental Funds; focused upon determination of financial position and changes in financial position rather than upon net income; the following describes Harvey's governmental funds:

[29] As used herein, the term "Expenditure Ledger" includes expenditure ledgers, check registers and expense ledgers.

[30] *See* Exhibit 3 at 23-25.

- General fund; the general operating fund of Harvey, used to account for all financial resources except those required to be accounted for in another fund.
- Special revenue funds; used to account for the proceeds of specific revenue sources that are legally restricted to expenditures for specified purposes, for example the Motor Fuel Tax Fund used to account for the operations of street maintenance programs and capital projects authorized by the Illinois Department of Transportation.
- Debt service funds; used to account for the accumulation of funds for the payment of principal and interest on Harvey's long-term debt.
- Capital projects funds; used to account for financial resources to be used for the acquisition or construction of major capital facilities; for example, Harvey's Economic Development Fund.

- Proprietary Funds; focused upon determination of operating income, changes in net position, financial position, and cash flows; the following describes the proprietary funds of the City:
  - Enterprise funds; required to account for operations for which a fee is charged to external users for goods or services; for example, the Water Fund is used to account for the provision of water to the residents of the City. All activity necessary to provide such services is accounted for in this fund including, but not limited to, administration, operation, maintenance, financing and related debt service and billing and collection.

    The Water Fund also accounts for all the operations of the water system. Water is purchased from the City of Chicago. The spread between purchase and sale rates is intended to finance the operations of the utility system, including labor costs, supplies, and infrastructure maintenance.

    The City of Harvey intends to run the Water Fund at a breakeven rate. Periodically, there will be an annual surplus or draw down due to timing of capital projects. The deficit in the Water Fund during Fiscal Year Ended 2017 was $4,509,475, while Fiscal Year Ended 2016 reported a surplus of $2,284,085.
  - Fiduciary Funds; used to report assets held in a trustee or agency capacity by the City for others and therefore are not available to support City programs.
  - Pension trust funds; used to account for assets held in a trustee capacity by the City for pension benefit payments; for example, the Police Pension Fund and the Firefighters' Pension Fund account for the accumulation of resources to pay retirement and other related benefits for members of the City's Police and Fire Departments.

G&P analyzed whether, prior to the Receiver's appointment, during the period FYE 2010-2017, Harvey used Water Revenue, in part, to fund Harvey's General Fund and to pay for Harvey's non-water expenses while water-related expenses remained unpaid. G&P reviewed and analyzed Harvey's AFRs in this respect and tested transfers from Harvey's Water Fund to its General Fund.

D. G&P Analyzed the Nature, Timing and Extent of Harvey's Disbursements.

To confirm Harvey expenditures were for Harvey purposes, G&P analyzed, to the extent deemed cost-beneficial, using risk-based and materiality-based forensic accounting investigative approaches, the nature, timing and extent of Harvey's disbursements to vendors for FYE 2010-2018.[31] This involved examining Harvey's accounting books and records and obtaining an understanding of its AFRs for the relevant period; documenting the dollar amounts and percentages of total annual expenditures to Harvey's largest vendors; focusing forensic accounting investigative efforts on the seven largest expenditure categories; identifying and reporting any misappropriated, unauthorized and/or questionable transactions of a material nature;[32] and investigating the transactions and/or account balances enumerated in the February 8, 2017 Declaration of Ronald Cote ("the Cote Declaration").

G&P assessed the risk of a lack of completeness of Water Fund revenue for FYE 2010-2018. This involved evaluating the completeness of historical water revenues analytical review procedures performed by Harvey's Auditor for FYE 2009-2017 and investigating the assertions made in the Cote Declaration for the period January 2015 to August 2016.[33]

G&P investigated claims made by or against the Water Department or Harvey. This involved documenting the annual dollar amounts paid by Harvey for the settlement of Claims and confirming the absence of claims by or against the Water Fund other than those disclosed in Harvey's FYE 2017 AFR or those pursued by the Receiver.

G&P developed recommendations regarding the necessary improvements in Harvey's overall financial condition, financial accountability, financial practices, procedures and internal controls.[34] G&P reviewed the MLCs and internal control recommendations identified in the Management Letters issued by Harvey's Auditor; reviewed the status of internal control

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[31] At times, narrative discussion of financial analyses may contain amounts and/or percentages that are approximate and/or rounded for presentation. In any accompanying schedules and/or charts, amounts and/or percentages may have been rounded and/or may contain rounding adjustments.

[32] Materiality is a concept or convention within auditing and accounting relating to the importance/significance of an amount, transaction, omission or discrepancy. G&P used the materiality concept as its meaning is used in AICPA, NACVA and/or ACFE professional standards. For example, the objective of an audit of financial statements is to enable the independent auditor to express an opinion on whether the financial statements are prepared, in all material respects, in conformity with an identified financial reporting framework such as GAAP. Materiality has qualitative and quantitative elements and is subject to the concepts of professional judgment. G&P was guided by professional literature and professional judgment regarding consideration of issues of risk and/or materiality. Considerations of risk and materiality affected G&P's determination of the nature, timing and extent of investigative procedures to be performed. G&P considered the issues of risk and materiality, among other matters, when designing the nature, timing, and extent of its procedures and in evaluating the results of those procedures.

[33] G&P did not test the historical water rates charged by the Harvey Water Department to Harvey residents, to businesses and to the Downstream Municipalities, as the Receiver is pursuing those issues.

[34] While G&P's scope of work included assisting the Receiver in identifying improvements in Harvey's overall financial condition, financial accountability, financial practices, procedures and internal controls, G&P believes implementing these improvements is ultimately the province of and best achieved by Harvey's reconstituted Finance Committee, supported by a Finance Committee Advisory Board.

deficiencies enumerated in the Cote Declaration; identified best practices in vendor approval and disbursement procedures, and identified the extent to which the Mayor, the current Finance Committee and/or the Comptroller had not implemented necessary improvements in Harvey's financial practices, procedures and internal controls since July 2014 (when the current Comptroller was hired).[35]

E. G&P Identified Deficiencies in Harvey's Financial Practices, Procedures and Internal Controls.

Working closely with the Receiver, the Receiver's Counsel, eTERA (the Receiver's Court-approved e-discovery vendor), Harvey's Auditor and Harvey's Comptroller,[36] G&P assembled significant portions of Harvey's accounting books and records for FYE 2010-2018.[37] Attached as Exhibit 9 is a detailed list of the information and/or documentation G&P gathered, the more significant items of which are listed below:

- Harvey's General Ledgers, Expenditure Ledgers, Disbursement Journals, Journal Entry Histories, Account Activity by Vendor, Revenue Ledgers and Trial Balances, bank statements, wire transfers, Purchase Requisitions, vendor invoices and statements;
- For FYE 2009–2017, Harvey's AFRs, Auditor's Management Letters and MLCs and portions of the Auditor's working papers;
- Third Party Claims Administrator ("TPA") Contracts (2010-2018) and TPA Claims analyses (2009-2018);
- Transcripts of the tape-recorded Minutes of a Finance Committee meeting held on March 4, 2004 and on August 2, 2011;
- Transcripts of the depositions – taken by Receiver's Counsel – of Bettie Lewis (taken on December 18, 2018); Dreina Lewis (taken on December 20, 2018); Lamond Cliff Taylor

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[35] The following was not included in G&P's scope of work: pursuing legal fact discovery through compelled document production and deposition testimony; assessing or verifying the water rates charged by Harvey to its residents, businesses or downstream municipalities; procedures performed by Harvey's Auditor as part of its annual audit engagements (including but not limited to reviewing Harvey's annual expenditures on capital asset acquisitions); vendor, invoice or disbursement review when the underlying documents were unavailable or amounts involved were, in G&P's judgment, relatively immaterial and/or without risk given Harvey's finances as a whole; assessing the fair value and/or market pricing of goods and services purchased by Harvey, and investigating issues related to the U.S. Securities and Exchange Commission ("SEC") June 2014 complaint against the former comptroller Joseph Letke for allegedly misleading investors in relation to Harvey's 2008, 2009 and 2010 bond offerings.

[36] G&P gratefully acknowledges the significant assistance provided by Harvey's employees and consultants. G&P is especially appreciative of the significant time and effort contributed by Harvey's Comptroller, and Matt Beran on behalf of Harvey's Auditor.

[37] G&P was able to rely on Harvey's Expenditure Ledgers (and similar documents) by reviewing and analyzing the "audit trail" employed by Harvey's Auditor to incorporate those Expenditure Ledgers into its audit efforts and audit work papers and employ them as part of Harvey's accounting books and records to create the audited AFRs.

(taken on December 19, 2018); Michael Castro (taken on November 14, 2018), and Mayor Eric Kellogg (taken on January 14, 2019);

- Various Receiver Reports and Court Orders;
- Various extracts of Harvey's accounting books and records, including payroll and wage information and/or documentation, health insurance work sheets, business insurance policies and/or other data and financial analyses provided by the Comptroller;
- Research on local government shared service best practices, and
- Various other correspondence, emails and/or documents.

eTERA stored and hosted much of the documents collected, whether originally obtained in electronic or in hard copy form, in a digital e-discovery electronic document management database called "Relativity." The Relativity database eventually grew to over 200,000 documents. To ensure cost-effectiveness, Receiver's Counsel disseminated specific search terms to be used to narrow the documents reviewed, which greatly reduced those documents, allowing G&P to focus its efforts on areas of greatest risk and materiality.

Attached as Exhibit 10 is a detailed list of G&P's procedures performed. Listed below are the most significant of G&P's procedures:

- Assembled a sequential record of Harvey's accounting books and records from FYE 2010-2018 that facilitated G&P's forensic accounting investigative procedures, with special emphasis on the audit trail from Harvey's annual Expenditure Ledgers to its AFRs, and established an infrastructure to assemble, preserve, review, and analyze Harvey's accounting books and records for that period;
- Obtained an understanding of the processes relating to Harvey's disbursements; developed a methodology for identifying and reviewing disbursements; established risk-based and materiality-based forensic accounting investigative approaches to be applied to Harvey's disbursements, by vendor, and identified vendors to be subjected to invoice reviews, analytical reviews or no reviews based on risk and materiality thresholds, and investigated disbursements to approximately 180 vendors to consider if the vendor existed, the reasonableness of the amounts paid, and the operating effectiveness of the internal controls applied;
- Investigated the significant percentage of Harvey's disbursements concentrated in the seven largest expenditure categories, including obtaining and analyzing Claims reports prepared and maintained by the TPA for the ten-year period FYE 2009-2018; analyzing the number of personnel by department for FYE 2012-2018; analyzing FYE 2018 payroll expenses by department, and performing additional procedures regarding other large expenditure categories, and
- Conducted research into cost-savings and other benefits to a city through shared service partnerships with other cities, including ambulance services; enterprise zones; joint fire, EMS and fire protection projects, and police services agreements.

IV. G&P'S SPECIFIC FINDINGS REGARDING HARVEY'S USE OF WATER FUNDS.

A. Harvey Consistently Transferred Water Funds to Harvey's General Fund, Creating a $31.6 million Debt from the General Fund to the Water Fund.

Prior to the Receiver's appointment, Harvey generally acknowledged that Water Funds had been transferred to the General Fund to cover Harvey's budgetary shortfalls.[38] To verify the existence of such transfers, and to better understand their scope, G&P selected for testing a period from early 2015 to early 2017 in order to trace Water Fund transfers to their destination. G&P's work was only a test, as G&P could not locate documentation for all wire transfers.

G&P's analysis indicated that Harvey transferred approximately $6.16 million from its Water Fund accounts to its other accounts. These transfers were recorded as being made for the purpose of funding payroll, health and other insurance, accounts payable, bond payments and "urgent settlements."

G&P's testing confirmed that Harvey repeatedly moved money from its Water Fund to its non-water Funds while an outstanding balance for water purchases existed between Harvey and Chicago.[39] The wire transfers G&P tested were requested by the Comptroller and approved by Nancy Clark (Harvey's City Clerk) or Gloria Morningstar (Harvey's Treasurer).

Harvey's Water Fund transfers in this period were not all outgoing. From early 2015 to early 2017, Harvey transferred $3.9 million from non-water accounts to the Water Fund. Some transfers were made to repay monies that had been taken out for non-water purposes. Others represented transfers of water fund deposits into other bank accounts used for water bill payments, and transfers to facilitate Harvey making payments on its water obligations to Chicago.

In addition to testing interfund wire transfers from FYE 2015-2017, [40] G&P analyzed interfund balances from FYE 2009- 2017, and found that the amount due from the General Fund to the Water Fund grew over time as follows (only FYE balances are shown below):

- 2009 - $9.4 million
- 2010 - $9.5 million
- 2011 - $13.4 million
- 2012 - $15.1 million
- 2013 - $20.6 million
- 2014 - $26.8 million
- 2015 - $29.4 million
- 2016 - $26.5 million
- 2017 - $31.6 million

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[38] *See* Exhibit 6 at 18.

[39] A detailed list of Water Fund transfers in this period is attached as Exhibit 11.

[40] G&P did not trace, on a test basis, the transfers between Harvey's Debt Service Fund and Harvey's Water Fund because the Interfund Balance was zero by FYE 2017.

As the incoming transfers to the Water Fund were less than outgoing transfers from the Water Fund, the net effect on the Water Fund's balance was negative.

In addition to owing the Water Fund money, the General Fund owed other Funds the following amounts as of FYE 2017:

- TIF II Center Street Fund - $6.5 million
- Capital Projects Fund - $4.1 million
- Non-Major Governmental Fund – $3.3 million
- TIF I Dixie Square Fund - $2.3 million
- Firefighters Pension Fund - $1.5 million
- Non-Major Business Type Fund - $1.4 million
- Police Pension Fund - $1.3 million
- Debt Service Fund - $1.2 million

The General Fund's indebtedness to other funds is relevant because it indicates that the General Fund's ability to repay the Water Fund will be impacted by the General Fund's debt to non-Water Funds.

G&P confirmed Harvey's longstanding financial practice of transferring money from its Water Fund to its General Fund each year since at least FYE 2010 up to when the Receiver was appointed in 2017. This financial practice created a sizable debt from the General Fund to the Water Fund of $31.6 million based on the most recently available data. While the debt to the Water Fund represented the General Fund's greatest interfund debt, the General Fund also received money from other Harvey Funds, creating additional debts to those funds.

Harvey's Auditor noted that Harvey's financial condition had continued to deteriorate, causing the City to borrow from its other funds, including the Water Fund, to meet its obligations. G&P recommends that the reconstituted Finance Committee (*see* Section V, *infra*) review Harvey's cash flows and create, implement and follow through on a long-term plan to repay those borrowings.

B. G&P Found No Evidence that Water Funds were Used for Non-Harvey Purposes.

After establishing that Water Funds were transferred to non-water Funds, G&P investigated how Harvey money was used irrespective of the Funds they were held in. This included investigating Water Fund disbursements made directly from the Water Fund; disbursements made from non-water Funds that received transfers of Water Funds, and disbursements from other Funds.

In determining whether Water Fund money had been misappropriated for non-Harvey purposes, G&P independently analyzed Harvey's largest expenditures and performed targeted investigations of supporting documentation to determine if the expenditures were for valid Harvey purposes, and analyzed in detail allegations of Water Revenue not deposited in Water Fund bank accounts and specific instances of possible misappropriation of Harvey funds that Cote had observed prior to the Receivership.

i. After tracing Harvey's biggest expenditures for FYE 2011-2018, G&P independently found no evidence of expenditures unrelated to valid Harvey functions.

In order to determine how Water Funds were used, regardless of whether they were paid out of the Water Fund or a non-water Fund, G&P examined Harvey's citywide expenditures from FYE 2011–2018. In doing so, G&P found that the following seven largest expenditure categories consumed over 92% of Harvey's treasury:[41]

- 32% of funds were spent on payroll.
- 21% of funds were spent on purchases of water from Chicago.[42]
- 11% of funds were spent on debt service.[43]
- 9% of funds were spent on Claims, including settlements, Claim-related expenditures and defense attorneys' fees.
- 7% of funds were spent on insurance.
- 7% of funds were spent on other operating expenses (fines and penalties, bank and credit card fees, technology, postage, and printing).
- 5% of funds were spent on maintenance of infrastructure.

In addition to identifying Harvey's largest expenditures, G&P investigated payments to Harvey's larger vendors in order to determine, on a test basis, whether they were valid. In general, G&P reviewed vendors for FYE 2010-2018 that were paid $10,000 or more in any fiscal year, and focused on, among other things whether (i) the vendor existed; (ii) whether the vendor's hiring was approved by the proper Harvey authority; (iii) Harvey had vendor invoices providing documentary support for the expenditure; (iv) Harvey had a written contract with the vendor; (v) a proper Purchase Requisition[44] form was executed to authorize payment; (vi) the vendor had any conflict-inducing relationship with Harvey employees; (vii) the invoice (if one existed) appeared genuine on its face, and (viii) whether the goods or services paid for were actually delivered or performed.

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[41] *See* Exhibit 12 (G&P's Analysis of Seven Largest Expenditure Categories). G&P sourced its "concentrations" data from Harvey's trial balances. The data G&P used and the financial analysis G&P presented does not (and is not intended to) tie directly to Harvey's AFRs for several reasons including that G&P's financial analyses in this context ignored interfund transfers and/or due to/due from balances; G&P's categorization of expenses were made on a functional/operational basis vs. categorizations governed by governmental GAAP (required in published AFRs), and G&P's financial analyses did not necessarily account for the necessary year-end audit adjustments made by the Auditor. G&P believes that a detailed reconciliation of such year-end adjustments was not needed for purposes of its forensic accounting investigation and, accordingly, did not perform such a reconciliation.

[42] All monies owing by Harvey to Chicago have been accrued in Harvey's accounting books and records.

[43] G&P extracted Harvey's debt service requirements to maturity from Harvey's FYE 2017 AFR.

[44] A Requisition is a form used to request that an invoice be approved for payment.

Overall, G&P found no evidence of fraud. However, G&P identified several deficiencies with Harvey's vendor approval and invoice payment practices, procedures and internal controls. For example, G&P found that the vast majority of vendors had and have no written agreements with Harvey as to the scope or cost of their work. It is considered a best practice to have written contracts with all material vendors after they have been subject to independent vetting processes. G&P found that the Purchase Requisition forms for payment of invoices were not always signed by any party having approval authority for Purchase Requisitions, making it possible for unauthorized payments to have been made. G&P also found a general lack of clarity surrounding vendor approval and retention and invoice authorization processes.

Harvey's invoice approval process extensively and significantly relies on the Comptroller and/or Dreina Lewis (the "Mayor's Assistant")[45] to (i) ensure that (a) only valid invoices are paid; (b) the vendor exists; (c) proper goods and/or services were provided, and (d) no invoices are paid more than once (employing the BS&A software); (ii) identify ways of reducing costs; (iii) make the tough decisions about which vendors get paid and which vendors do not get paid during periods of illiquidity, and (iv) make numerous other decisions regarding Harvey's vendors and invoices.

It does not appear that either the City Council or the Finance Committee reviews the actual invoices upon which vendors are paid (although specific invoices can be requested from the Comptroller). The City Council merely authorizes payments based on a list of vendor names and payment amounts without reference to underlying supporting documentation (assuming such exists). It is not clear whether the City Council always receives such list before or after the invoices are paid.[46] It also is not clear how invoices were authorized for payment between April 25, 2016 and January 23, 2017 when Harvey did not conduct City Council meetings.[47]

Harvey's Auditor noted that Harvey's processes of approving its expenditures, including significant expenditures, were not consistent and led to significant transactions being approved outside of a City Council meeting.[48] Harvey's Auditor recommended that Harvey review its entire expenditure approval processes and create a policy that ensures adequate approvals, with all necessary supporting documentation evidencing the approval and transparency of transactions.[49] Harvey has not yet followed this recommendation. G&P recommends that

[45] *See* Exhibit 13 (excerpts of D. Lewis Dep. Tr.) at 35:15-24; *see also* Exhibit 14 (excerpts of E. Kellogg Dep. Tr.) at 46:4-51:3.

[46] The Comptroller believes it is not practical and/or necessary for the City Council (or the Finance Committee) to be provided copies of vendor invoices and/or to review vendor invoices and that such steps are not performed at other municipalities.

[47] *See* Exhibit 5 at MLC #27 ("Without those council meetings, the City is not able to conduct formal government business, including but not limited to, planning for the budget, property tax levy, any potential bond refunding or issuance, and approving vendor payments."); *see also* Exhibit 14 (excerpts of E. Kellogg Dep. Tr.) at 27:20-10, 66:14-22.

[48] *See* Exhibit 5 at MLC #4.

[49] *Id.*

Harvey's reconstituted Finance Committee be tasked with implementing best practices for approving the engagement and retention of vendors and authorizing payment of invoices.

While G&P did not identify any fraudulent invoices, it has (like Harvey's Auditor) identified a system that has the inherent risk of effecting payments to unauthorized vendors and/or for unapproved invoices. Moreover, implementation of a more formal, written, consistent and verifiable review process, including fully vetting vendors and engaging in competitive bidding, would not only reduce the risk of improper payments or overpayments to vendors, but would create opportunities for Harvey to reduce its total expenditures.

ii. Cote's observations about Water Revenue deposits and non-water expenses were incomplete.

Prior to the Receivership and G&P's resulting engagement, Chicago hired Cote as its forensic accounting expert in the underlying litigation between Chicago and Harvey. Chicago engaged Cote to (i) verify that Harvey billed its water customers accurately; (ii) verify Harvey recorded all cash receipts collected in the ledger specific to water payments and deposited the cash receipts in the Water Fund; (iii) assess whether expenditures of water-related cash were for the purpose of water or the operation of Harvey's Water System, and (iv) note any financial activity or reporting relevant to the ongoing financial condition of the Water Fund.[50]

Cote, in his role as Chicago's expert, ultimately submitted three declarations. His first declaration, the Cote Declaration, is the most relevant for purposes of G&P's investigation. Cote's analysis was limited in scope because he did not have access to all relevant financial records.[51] Nevertheless, based on the records he was able to review, he made several adverse observations about Harvey's use and management of its Water Fund.

G&P confirmed that many of Cote's observations were correct. Cote correctly found that Harvey did not directly deposit all Water Revenues into Harvey's Water Funds and that Harvey had used Water Revenue to pay for non-water expenses, such as citywide payroll, while water-related expenses remained unpaid, including Harvey's debt to Chicago for the purchase of water.[52] Cote's observations regarding suspected misappropriation of Harvey funds, however, were incomplete and/or unfounded.

Cote identified what appeared to be \$5.98 million of Water Revenue billed between January and December 2015, and \$2.75 million of Water Revenue billed between January and August 2016, that was not deposited into Harvey's Water Fund.[53] Cote did not determine where and/or if this approximately \$8.73 million of Water Revenue had been deposited. G&P has determined that Cote was correct to conclude that not all Water Revenue was deposited into Harvey's Water Fund. However, G&P's testing noted that, in aggregate, all Water Revenue deposits were included in Harvey's deposits taken as a whole.

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[50] Exhibit 15 (Cote Declaration) at ¶ 3.

[51] *Id.* at ¶¶ 5 & 8.

[52] *Id.* at ¶¶ 21 & 35-44.

[53] *Id.* at ¶¶ 18-19.

G&P determined that, from January 20, 2015 to August 4, 2017, Harvey deposited water-related cash receipts from customers directly into its Pooled Disbursement Account – a practice that did not comply with the Consent Decree. The cash deposits that Cote used excluded cash deposits into non-Water Fund bank accounts and the risk existed that there might have been a failure to deposit Water Revenue into any Harvey bank accounts. Accordingly, G&P considered whether there was a failure to deposit Water Fund payments into any Harvey bank accounts and concluded that was not the case.

Cote did not identify in his report the Utility Billing System reports he relied on. As G&P did not receive Cote's detailed working papers, G&P independently analyzed whether there was a risk that $8.73 million of Water Revenues could have not been deposited in the period identified by Cote. G&P concluded that such risk was remote, by performing the following procedures:

- G&P extracted from the Cote Declaration the monthly water billings per Harvey's Utility Billing Reports as reported by Cote noting, for FYE 2016, the total of such water billings was $15.762 million.
- G&P extracted the monthly water billings based on Harvey's Utility Billing Reports that appeared in Harvey's Revenue Ledger for FYE 2016 noting that, for FYE 2016, the total of such water billings in the Revenue Ledger based on the Utility Billing Reports was $15.884 million.
- G&P believed these annual totals were sufficiently close to continue its analyses.
- By review and analysis of Harvey's FYE 2016 Revenue Ledger, G&P determined that all Harvey revenues, for all funds, for FYE 2016, were accounted for in total by deposits into all Harvey's bank accounts.[54]
- G&P determined that all Harvey bank accounts were reconciled at FYE 2016 and, accordingly, that such reconciliations tied the account balances per Harvey's FYE 2016 Revenue Ledger to Harvey's external bank statements[55].

Accordingly, G&P was able to conclude that FYE 2016 water billings were reconciled to Harvey's audited AFRs and the risk of misappropriation of $8.73 million of water revenues was remote. However, G&P could only analyze the period May 1, 2015-April 30, 2016, as this was the only consecutive twelve-month period that G&P had both the documentation from the Cote Declaration and from Harvey's audited accounting books and records.

Cote identified eight payments totaling more than $10,000 (including to Kay Jewelers, to Kohl's Department Store and to a Section 529 education fund) that "were made from the Water Fund Account that were not water-related, and have no apparent business use for the operation of a water utility."[56]

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[54] G&P confirmed this both with Harvey's Auditor and the Comptroller.

[55] G&P confirmed this both with Harvey's Auditor and the Comptroller.

[56] Exhibit 15 at ¶¶ 24 & 25.

G&P's review and analysis of the relevant bank accounts and Harvey's Finance Department's communications with Harvey's bank revealed that unknown parties (not identified as ever having had any relationship to Harvey) attempted to defraud Harvey by effecting false charges to Harvey's bank accounts, and that Harvey's Comptroller and Finance Department had acted effectively to prevent the attempted fraud. These actions resulted in Harvey's bank reversing the fraudulent transactions. Thus, these eight transactions seem to indicate attempted fraud perpetrated on Harvey, not by Harvey.

Cote further identified a purportedly improper transaction with a vendor named, "Let's Kiss & Makeup." Cote asserted the business purpose of this disbursement was not readily apparent because the vendor was a skin care service in Markham, Illinois.[57] G&P's analysis revealed that Harvey had acquired a Utility Tractor at a bargain price used for Harvey's purposes. The seller had requested payment be issued to "Let's Kiss & Makeup," his wife's business. G&P's review and analysis noted the relevant Harvey Purchase Requisition had been completed properly and authorized; the Street Department had properly issued a Purchase Requisition, and the documentation included a detailed invoice.[58] The Comptroller confirmed the Utility Tractor was in use in Harvey's Street Department. Accordingly, G&P concluded that this was not an improper transaction.

G&P located no evidence that Harvey's Water Revenue was not deposited in Harvey's accounts or that it was used for non-Harvey purposes. This is not to say that Harvey Water Funds were always properly used, as G&P has confirmed (and Cote correctly noted) Harvey's longstanding practice of depositing Water Funds in the Pooled Disbursement bank account (a practice that ended with the Receiver's appointment) and using Water Funds to pay non-water expenses while water-related expenses remained unpaid.

V. G&P'S FINDINGS AND RECOMMENDATIONS REGARDING HARVEY'S OVERALL FINANCIAL CONDITION, FINANCIAL ACCOUNTABILITY, FINANCIAL PRACTICES, PROCEDURES AND INTERNAL CONTROLS.

Section IV above discussed Harvey's historical use of its Water Funds and General Funds from FYE 2010-2017. Equally important is the issue of the preservation and management of Harvey's Water Funds going forward, so that Harvey, and those who interact with Harvey for the purchase of water, do not have to be concerned about whether Water Funds will be properly managed and/or available to pay water expenses.

Only the Receiver's appointment ended Harvey's continual practice of using Water Funds to make payroll and to pay ongoing citywide expenditures and obligations while water-related expenses remained unpaid. As Harvey's overall financial condition, deepening insolvency and the financial distress that led to the use of Harvey's Water Funds for non-water purposes has not been addressed, the risk remains that ending the Receiver's appointment without implementing the necessary safeguards around Harvey's Water Funds could result in Harvey resuming the improper practice of using Water Funds to make payroll and to pay ongoing citywide expenditures and obligations while water-related expenses remain unpaid.

[57] Exhibit 16 (Second Supplemental Declaration of Ronald Cote, without its exhibits) at ¶ 19.

[58] *See* Exhibit 17.

Improving Harvey's overall financial condition, financial accountability, financial practices, procedures and internal controls could mitigate that risk and help the Water Fund going forward by (i) lessening the risk of Harvey's management utilizing the Water Fund to pay for non-water expenses while water-related expenses remain unpaid, and (ii) increasing revenues and reducing expenditures to make it easier to preserve Water Funds and for the General Fund to repay the Water Fund the $31.6 million owed.

G&P is sympathetic to Harvey's overall financial condition and recognized the historical circumstances that resulted in Harvey utilizing the Water Fund to make payroll and to pay ongoing citywide expenditures while water-related expenses remained unpaid. Notwithstanding, it is essential and possible that Harvey take steps to reverse its deepening insolvency.

With an eye toward these issues, G&P recommends several improvements to Harvey's overall financial condition, financial accountability, financial practices, procedures and internal controls based on G&P's forensic accounting investigation. Crucially, irrespective of the Receiver's continued appointment, all G&P's recommendations can and should be addressed by Harvey establishing a robust and reconstituted Finance Committee, supported by a Finance Committee Advisory Board.

A. Harvey's Overall Financial Condition Is Worsening but Could Be Improved.

To best understand the pressures that caused Harvey to use its Water Revenue to pay for non-water expenses, and to properly assess and evaluate the risk of such pressure continuing, it is essential to review Harvey's overall financial condition and deepening insolvency and understand why it needs appropriate financial accountability, financial practices, procedures and internal controls.

From FYE 2009-2017, Harvey's annual revenues, expenses and excess of expenses over revenues were as follows ($000):

FYE	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenues	34,850	33,322	33,066	35,737	38,214	40,759	44,895	47,719	48,994
Expenses	54,829	41,199	39,491	43,032	45,014	49,069	53,802	53,066	58,744
	(19,979)	(7,877)	(6,425)	(7,295)	(6,800)	(8,310)	(8,907)	(5,347)	(9,750)

FYE accumulated deficits have worsened from approximately $34 million in FYE 2009 to over $150 million in FYE 2017.[59] During FYE 2009-2017, Harvey's total assets increased from approximately $40 million to approximately $55 million, while its total liabilities have increased from approximately $74 million to more than $200 million. Annual deficits continually worsen the accumulated deficits, hence a deepening insolvency.[60] By FYE 2017, Harvey had "an accumulated unassigned deficit in the General Fund of $55,609,732…which has resulted from operating deficits over the last several years."[61]

[59] The Comptroller noted that FYE 2017 deficits are primarily being driven by the legacy pension obligations and the recording of fines and penalties on water obligations due Chicago.

[60] *See* Exhibit 4.

[61] *See* Exhibit 3 at 2.

This distressed financial condition and deepening insolvency continues to increase the risk that Water Funds again will be used for the benefit of Harvey's general payroll and to pay ongoing citywide expenses while water-related expenses remain unpaid (and at the expense of the Water Department's critical needs).[62] Hence, improving Harvey's overall financial condition, financial accountability and financial practices, procedures and internal controls will likely help the Water Fund while stemming Harvey's deepening insolvency.

Harvey's FYE 2017 AFR noted Harvey is at risk of not having enough cash available to pay its current operations and debt service. The Harvey FYE 2017 AFR noted:

> Liquidity risk is the risk of not having sufficient liquid financial resources to meet obligations when they come due. The City faces significant risks threatening its ability to generate cash from revenues sufficient to pay operating expenditures and debt service. Four of the City's largest revenue streams, distributable state aid, property taxes, municipal income taxes, and municipal sales taxes, are especially susceptible during times of major economic downturns and have declined in recent years. Also, the number of residents leaving the City and home foreclosures has adversely impacted City property valuations and property and income tax collections. Further stressing the City's liquidity are legacy costs such as pension retirement benefits and debt service. As the City's tax base and revenues decline, the legacy costs become an increasing percentage of the General Fund budget, reducing funding available for essential services such as public safety.

Harvey's Auditor's FYE 2017 Management Letter noted that Harvey did not pay in full its bond payments for several bonds when due; neither the Police Pension Fund nor the Firefighters' Pension Fund was being funded in accordance with actuarial recommendations; Harvey has not been funding the Police Pension Fund and the Firefighters' Pension Fund for their portion of personal property replacement taxes, and Harvey has used restricted TIF and Motor Fuel Tax dollars to sustain its general operations (as these funds are restricted for specific purposes they should not be used for general operations). Harvey has an obligation to pay these bonds with the property taxes it collects from its levy each year on their due dates.[63]

Harvey's Auditor's FYE 2017 Management Letter noted further that expenditures out of the General Fund have been causing Harvey to borrow from its other Funds to meet its obligations; other obligations for the City have been building up with no payments being made, and the consequences of revenues consistently being less than expenditures will lead to further downgrading of Harvey's credit rating (which, in turn, will result in more difficulty in obtaining loans and require borrowing at higher interest rates).

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[62] As noted in the Receiver's Report for the period ending October 31, 2018, the Receiver has invested over $1 million in Water Funds towards capital improvements and repairs, which were necessary to maintain and improve the reliability and safety of Harvey's water-related assets. It is possible these funds would not have been so utilized had the Water Fund remained under Harvey's control.

[63] Exhibit 5 at MLC # 25.

B. The Receiver Has Taken, and Harvey Can Take, Several Steps to Directly Increase Water Revenue.

Harvey can benefit the Water Fund going forward by increasing its collection of Water Revenue and the water rates billed to Homewood. The Receiver has already done many things to that end.[64] For example, the Receiver has begun (and Harvey should continue) to review major industrial accounts to verify meters are properly registered and billed, and repair and invest in its water system to extend the long-term viability and reliability of its infrastructure. G&P recommends that these practices remain in place following the Receiver's discharge and that the reconstituted Finance Committee be tasked with follow-up in this regard.

In addition to the above procedures, the Receiver has stressed the following practices that, when performed on a consistent basis, should result in lowering non-revenue water and increasing the long-term reliability and viability of the water system:

- Harvey should review major industrial accounts to verify that meters are properly registered and billed.
- Harvey should secure competitive quotations from vendors and pay water-related invoices within terms to take advantage of vendor discounts and avoid late fees.
- Harvey should maintain a regular practice of repairs to and investments in its water system to extend the long-term viability and reliability of its infrastructure.
- Harvey should continue to work to reduce "lost water" due to faulty meters and/or leaks in the water system.
- Harvey should have leak surveys performed annually by an outside professional firm investigating main line and fire hydrant leaks, followed by an action plan to carry out repairing leaks within the system in a timely manner.[65]
- All major water meters one inch and above should be tested every two years and recalibrated when noted by a professional outside organization. Water meters six inches and above should be tested and recalibrated annually by an outside professional meter organization.

[64] Among other things, the Receiver has invested Water Funds in new meters for approximately 25% of Harvey's commercial customers and eight out of nine of Downstream Municipality customers. Installation of new meters increases the accuracy of measuring water sold to the commercial accounts, resulting in increased billings for such customers by an average of 60%. The Receiver has moved aggressively to collect water bills from large and delinquent commercial customers, which has netted approximately $750,000. Further, the Receiver has invested in repairs to address long-standing leaks in the water system, which has reduced the amount of "lost water" or non-revenue water, and lowered Harvey's cost of acquiring water from Chicago by 7.6% of annual total revenue. The Receiver's efforts in these areas are detailed further in the Receiver's reports periodically filed with this Court.

[65] Minor leaks can be repaired in-house; major repairs should be performed by an outside industrial repair organization after approval of a competitive bid. The leak survey should be performed at least annually, the Receiver encourages that it should be performed semi-annually until the system shows minimal detected leaks.

- The five water reservoirs within the City of Harvey Water System should be inspected every two years for leaks and/or containment erosion.
- Harvey's billing system should implement a self-check summary protocol for water rates by category before the billing file is sent to the mailer. This will ensure against improper water rates billed by customer category.

The Receiver has engaged in discussions with the Downstream Municipalities in an effort to create a uniform and reasonable rate structure. Currently, four of the Downstream Municipalities are being serviced by Harvey without a current contract. The fifth municipality – Homewood – is serviced under an agreement that is not due to expire until December 16, 2022. The Downstream Municipalities combined use approximately 65% of Harvey's water, with Homewood accounting for 55% of that usage or 35.75% of the overall total. However, each of these Municipalities is charged a different rate.

Water rates to the Downstream Municipalities range from a low to the Village of Homewood of $.0325 per cubic foot to a high of $.0536 per cubic foot to the Village of Dixmoor. After allowing for a system water loss of approximately 14.1%, Harvey's effective cost of water purchased from Chicago is $.034 per cubic foot. As a result, because of the rates under the Homewood contract, Harvey is currently selling its water to Homewood at a significant monetary loss. Exhibit 18 hereto shows Harvey's actual costs for delivering water to the Downstream Municipalities, and the net profit or loss to Harvey for making that water available to each of them.

The Receiver and Homewood are in negotiations regarding Harvey's failure over the past five years to charge (and Homewood's failure to pay) higher water rates due to inflation and higher energy costs incurred in delivering water to Homewood. These negotiations have been underway since the Receiver made a demand on Homewood to pay higher charges or face a lawsuit seeking to collect such charges.[66] The Receiver proposed a new rate to the Downstream Municipalities and engaged in lengthy good faith negotiations with the Downstream Municipalities relating to proposed terms for a single global water contract.[67]

C. Harvey Can Take Several Steps to Decrease Its Citywide Expenditures.

i. Harvey should reconstitute and formalize its Finance Committee and strengthen that Committee's oversight role.

Before Harvey's reconstituted Finance Committee can implement best financial practices, procedures and internal controls, it must establish its members and properly document its mission statement and form the non-voting Finance Committee Advisory Board.

[66] The Receiver also offered to settle such claims in the event Homewood, along with the other Downstream Municipalities, agrees to be a party to a revised water services contract at an appropriate rate.

[67] These negotiations, however, have stalled. One of the objections by the Downstream Municipalities is that a water rate study has not been done to determine a new rate. As a result, with the Court's approval, the Receiver engaged a water rate expert, and that water rate study is currently underway.

In general, a municipal finance committee either sets and approves the city's budget or makes recommendations to the city council on the final budget. Municipalities commonly have finance departments with paid staff who act on the budget that the finance committee sets, but the committee usually serves as a watchdog to ensure the money is being handled as directed. Some meet as often as once a week to go over revenue and expenditures and compare them with budget projections, while others might meet periodically during the year to set the budget, to review the results of the annual financial audit and AFRs, and to implement any recommendations by the municipality's auditor.

Based on G&P's interviews of Harvey Aldermen, G&P's reading of the transcripts of only two Finance Committee meetings, and G&P's other forensic accounting investigative procedures, it appears that Harvey's Finance Committee does not follow best practices. An Alderman interviewed noted that the Finance Committee has not met since before 2015; another Alderman interviewed noted that it had not met for eight months or so. In any event, as best G&P can tell, Finance Committee meetings are not a regular event. G&P found what represented to be typed transcripts of Finance Committee meetings only for the March 4, 2004 and August 2, 2011 meetings. It was represented to G&P that the Finance Committee tape records all its meetings, but that the tape recorder does not always work well.[68] G&P understands that all the tape recordings currently are maintained by Alderman Nesbit.

G&P found no written indication of the current Finance Committee's duties or any citywide policies or guidelines that the current Finance Committee enacted. G&P found no evidence that the Finance Committee has acted to address Harvey's overall financial condition and deepening insolvency nor concerned itself with important issues regarding Harvey's financial accountability, financial practices, policies and internal controls. From time to time, individual Aldermen may obtain financial information from the Comptroller and/or share ideas with the Mayor and/or the Comptroller. As an authoritative body, however, Harvey's Finance Committee appears largely uninvolved with Harvey's numerous financial problems.

G&P recommends that, in turning around Harvey's current distressed financial condition and deepening insolvency, and implementing appropriate financial accountability, financial practices, policies and internal controls, Harvey's reconstituted Finance Committee meet monthly and keep detailed, typed minutes of each of its meetings, timely posted to Harvey's website. G&P recommends that Harvey's Finance Committee engage outside financial experts for advice and create a strong non-voting Finance Committee Advisory Board comprised of persons committed to Harvey's best interests, including those with no conflicts of interest and suitable finance, banking, accounting and/or auditing backgrounds.

Harvey needs to, over time, reduce its deficit of liabilities in excess of assets (currently more than $150 million). That should be the focus of the reconstituted Finance Committee, supported by its Finance Committee Advisory Board. Similarly, the reconstituted Finance Committee should explore all ways to reduce Harvey's annual operating deficits of approximately $10 million by increasing Harvey's revenues and reducing its expenses.

[68] *See* Illinois' Open Meetings Act, 5 ILCS 120/2.06(a) ("All public bodies shall keep written minutes of all their meetings….").

Harvey's reconstituted Finance Committee should investigate the causes of all Fund deficits and adopt appropriate future funding measures. The reconstituted Finance Committee should (i) investigate the causes of over-budgeting in any Funds and adopt appropriate future funding measures; (ii) investigate each interfund receivable/payable outstanding, and (iii) determine the origins of the transactions that created the deficits and if and when the repayments are likely to occur.[69]

As discussed below, once reconstituted, the Finance Committee should prepare one or more formal reports to Harvey's City Council recommending the implementation of steps to improve Harvey's financial condition and its financial accountability, financial practices, procedures and internal controls. The Finance Committee should follow through on the City Council's actions and directly oversee and monitor its recommendations.

ii. Harvey's reconstituted Finance Committee should review, revise and formalize Harvey's vendor and invoice approval process.

The reconstituted Finance Committee should implement improvements to Harvey's vendor hiring and payment process. For example, most Harvey vendors did not have a current contract with Harvey, including long-term vendors who repeatedly do work for Harvey. G&P analyzed the top 20 vendors and noted only four had contracts.[70]

G&P was unable to establish in all instances who had ultimate authority for vendor approval and retention[71] and whether the Mayor, City Council and/or the current Finance Committee were required to approve the hiring of vendors from whom purchases of products and/or services were expected to exceed an established dollar limit. The Mayor's Assistant testified that while she believed at least three bids were supposed to be obtained for certain vendors, she was unable to say why she believed that or where that policy exists, or which vendors it applied to.[72] G&P has seen no evidence of such a policy having been implemented. While the Comptroller represented to G&P that Harvey did not have bargaining strength with vendors due to a history of late payments and discounted below market rates, G&P, nevertheless, does not believe this obviates the need for implementing better vendor approval and retention process.

G&P recommends that the reconstituted Finance Committee establish written guidelines on vendor procurement, addressing how vendors should be solicited (at least for projects of a

[69] The reconstituted Finance Committee may also consider having the General Fund charge the Water Fund an additional share of citywide expenditures prospectively and/or retroactively to reduce the amounts due to the Water Fund.

[70] Of those 20 vendors, only the following four had contracts: Chicago, Allied Waste Services, W&W Consulting and Harvey's Auditor.

[71] *See* Exhibit 13 (excerpts of D. Lewis Dep. Tr.) at 31:11-32:24; 38:8-18; *see also* Exhibit 14 (excerpts of E. Kellogg Dep. Tr.) at 28:11-38:24; 43:16-44:10 (Harvey's Mayor generally unsure about, or unable to recall, how vendors are selected or if the City Council has to approve or fire them).

[72] *See* Exhibit 13 (excerpts of D. Lewis Dep. Tr.) at 33:1-24.

certain magnitude),[73] who has authority to hire vendors, whether contracts should be required for vendors or projects meeting pre-established criteria, and whether Finance Committee and/or City Council approval should be required before hiring or paying vendors.[74] G&P recommends that the Finance Committee begin development of a Policies and Procedures Manual, including but not limited to addressing these issues.

Harvey's Auditor recommended that Harvey review its entire approval process of expenditures (Claims and non-Claims) and create a system that allows for adequate approvals, support of the approval, and transparency of the transactions.[75] G&P recommends that the reconstituted Finance Committee be provided electronically all claim and non-claim related invoices as well as all claim-related or non-claim-related legal and litigation related invoices.

G&P recommends that the Finance Committee determine specific criteria that a vendor should meet prior to being hired. Such criteria should include reviewing the results of running a credit check on the vendor, establishing there are no conflicts of interest that could affect the vendor's performance or Harvey's interests, and searching for publicly available reviews of the vendor online and through resources like the Better Business Bureau.

As to payment of vendor invoices, all Purchase Requisition forms should be signed by the requestor, certifying that the goods or services ordered (i) were received and were of satisfactory quality, (ii) conformed to the order specifications, and (iii) were chargeable to a budget category for which an overrun was not being incurred. The Purchase Requisition should contain an approval signature from an employee possessing the requisite approval authority.

G&P recommends that Harvey invest in technology that allows it to electronically scan and store invoices for easy access and review by the Finance Committee (or other authorized persons). Currently, many vendor invoices are kept in hard-copy format, which has resulted in missing invoices. Scanning Purchase Requisitions and vendor invoices will enable the Finance Committee to easily review vendor invoices for approval and ensure that there is appropriate supporting documentation prior to approval. Currently, the City Council is given a list of bills to approve at meetings, but is not ordinarily given the underlying invoices or other supporting backup, making it difficult for the City Council to have the context needed to approve payment.

In addition to these overarching issues, the reconstituted Finance Committee should specifically review Harvey's current and/or former arrangements with the following vendors with a view toward increasing control and reducing cost:

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[73] G&P recommends that such contracts be mandatory, at least for any law firms engaged by Harvey (such contracts usually taking the form of an "engagement letter"), and any outside consultants hired by Harvey.

[74] Given Mayor Kellogg's general inability to explain or recall Harvey's vendor hiring or invoice approval processes, and his delegation of such duties to the Mayor's Assistant and Comptroller, G&P does not recommend that ultimate approval for vendor and invoice approval be left with the current Mayor as opposed to the Finance Committee. *See* Exhibit 13 (excerpts of D. Lewis Dep. Tr.) at 38:8-18; *see also* Exhibit 14 (excerpts of E. Kellogg Dep. Tr.) at 28:11-38:24.

[75] Exhibit 5 at MLC # 4.

<u>Allied Waste</u>: Harvey paid Allied Waste (a/k/a Republic Services) approximately $1.65 million in FYE 2018 for waste removal services. G&P was advised by the Comptroller, anecdotally, of the possibility that the rates charged by Allied Waste were excessive and/or above-market. Per the Comptroller, the Allied Waste contract ends in April 2019 and is up for renewal. G&P recommends that the reconstituted Finance Committee obtain multiple, arms-length, competitive bids for Harvey's waste removal services.

<u>Bettie Lewis/Smith Amundsen LLC</u>: Bettie Lewis has served as Harvey's Corporation Counsel since 2003. In 2012, she joined the law firm of Smith Amundsen LLC, which represents Harvey in a variety of legal matters. Smith Amundsen's attorneys other than Bettie Lewis bill Harvey on an hourly basis for their work. Conversely, Bettie Lewis is compensated not on an hourly basis, but by Harvey paying Smith Amundsen a monthly "retainer," which serves as her monthly salary. Currently, that monthly "retainer" is $16,650, equating to $199,800/yr.[76] Because Bettie Lewis does not provide timesheets tracking the hours spent on Harvey's legal matters, neither Harvey nor G&P is able to evaluate the value of her work and whether it is commensurate with the amount of the retainer. G&P has not been able to determine whether the hours Bettie Lewis devotes to Harvey matters are more or less than they were before she joined Smith Amundsen. Accordingly, G&P cannot determine if payment of this "retainer" is an appropriate arrangement, and recommends that the reconstituted Finance Committee reevaluate the current Corporate Counsel retainer arrangement.

<u>Real Municipal Solutions</u>: Up to the vendor's termination sometime in FYE 2019, Harvey paid Real Municipal Solutions a monthly amount of $9,600, i.e. $115,200 annually, purportedly for providing town planning services. Real Municipal's billing to Harvey included the following descriptions: "Planning, Code Enforcement & Economic Development Consulting;" "Operational Revenue Consulting;" and "Consulting." The invoices from Real Municipal routinely reflected a daily charge of eight hours. However, the billing timekeeper was not named. The daily eight-hour charge was variously described in the vendor's invoice using some combination and/or variation of the following wording: "provide direction, administrative assistance, leadership & support for daily departmental functions." While the Mayor's Assistant signed some Purchase Requisitions, most were not signed. G&P has been unable to determine who, if anybody, at Real Municipal provided eight hours of work virtually every day for the period of analysis and, if so, what value was provided to Harvey. The more than $100,000 historically paid annually to this vendor was in addition to the total Planning Department payroll costs of approximately $340,000 annually. G&P was not able to evaluate the cost-benefit of Harvey's now terminated relationship with Real Municipal, or the planning needs of Harvey and, accordingly, recommends the reconstituted Finance Committee evaluate the overall staffing needs of Harvey's Planning Department.

<u>W&W Consulting Group LLC</u>: Harvey paid W&W Consulting Group LLC ("W&W"), which is the Comptroller's company, more than $2.5 million for FYE 2015-2018. G&P recommends the reconstituted Finance Committee evaluate Harvey's arrangement with W&W. This is discussed in additional detail in Section V.C.vii below.

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[76] *See* Exhibit 19 (excerpts of B. Lewis Dep. Tr.) at 6:13-7:8, 40:3-43:6.

iii. Harvey's reconstituted Finance Committee should consider a regional police/fire/paramedic department and other recognized best practices in sharing local government services.

G&P analyzed Harvey's personnel count by department for FYE 2012 to 2018 and found the total number of employees in the Police and Fire Departments was (on average and in FYE 2018) more than 60% of the total number of Harvey employees. G&P analyzed Harvey's FYE 2018 payroll expenses by department and noted more than 70% of the payroll (by dollars) related to the Police and Fire Departments.

The 2016 Journal of Local Government Shared Service Best Practices, prepared by Illinois Lieutenant Governor Evelyn Sanguinetti and dated December 31, 2016,[77] reported to local government officials that the Local Government Consolidation and Unfunded Mandates Task Force had developed specific public policy recommendations to make local government more efficient, effective and streamlined. The report noted 27 shared-service partnerships that represented some of the best examples in Illinois of local governments working together to provide a more effective and efficient local government for their communities by sharing local government services.[78]

Separately, the Chester County Regional Police Study[79] ("the Study") noted that "similar community needs and issues, growing cultural diversity, county-wide drug enforcement issues, growing regional and county-wide traffic problems, fiscal constraints and other substantial issues [had] raised new challenges for municipalities and their police departments." The Study noted that it was often difficult for small agencies with limited resources to positively impact problems faced in their communities; that it had become "necessary in many locations to consider ways to improve police service while stabilizing future costs," and that "[t]he concept of regional policing was one option that many municipalities in Pennsylvania are now exploring."[80]

The Study outlined the advantages of regional police services, including (i) improvements in (a) the uniformity and consistency of enforcement; (b) the coordination of law enforcement services; (c) the recruitment, distribution and deployment of police personnel; (d) training and personnel efficiency; (e) management and supervision, and (ii) reduced costs.[81] The Study outlined the disadvantages of regional police services, including loss of law enforcement services; loss of local control; loss of citizen contact, and loss of position.[82]

The Study found that "[r]egionalization of any public sector service usually results in decreased cost to the individual municipalities involved, if the municipality already provided that

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[77] Available as of 1-30-19 at *https://www.ilcounty.org/file/154/Journal-of-Local-Government.pdf*.

[78] *Id.* at ii.

[79] Available as of 1-30-19 at *https://www.kennettsq.org/wp-content/uploads/2014/10/Chester-County-Police-Study-09-07-14-11.pdf*.

[80] *Id.* at 2.

[81] *Id.* at 5.

[82] *Id.* at 7.

service," and that "nowhere [was] this truer than in the area of law enforcement and police services." The Study found "[t]here are established minimum costs involved in the development and continued funding of any police department. These costs are centered in the police facility, communications, vehicle fleet, office equipment, records system, and administrative services" and that there are "many instances where closely adjoining departments duplicate infrastructure and support services. The duplication of support personnel is also a major consideration." The Study found that "[c]onsolidation result[ed] in decreased individual costs by reducing duplication of infrastructure and support requirements within the service area." The Study cited another study that indicated that, in nine out of ten situations, properly managed, regional departments save an average of 24% when compared to traditional police departments.[83]

The reconstituted Finance Committee should engage in a feasibility study to determine if Harvey and certain contiguous police departments would benefit from the formation of a full-service regional police department to serve multiple communities. The Finance Committee should also engage in a feasibility study to determine if Harvey and certain contiguous fire, ambulance and/or paramedic services would similarly benefit from the formation of a full-service fire, ambulance and/or paramedic department to serve multiple communities. G&P's preliminary research indicates that the formation of a regional fire, ambulance and/or paramedic service may be easier to implement than a regional Police Department would be and could result in increased community service at a lower cost.[84]

iv. Harvey's reconstituted Finance Committee should investigate risk management safeguards to limit Harvey's legal liability to third parties in the future.

Claims against Harvey (including related legal and professional fees) constituted one of the seven largest categories of Harvey's expenditures between FYE 2011 and 2018.[85] Between FYE 1998 and 2018, Harvey incurred expenditures exceeding $21.7 million related to such Claims.[86] While annual expenditures in the Claims category have declined somewhat since peaking at more than $3 million in FYE 2013, this is an area posing significant future risk and exposure to Harvey, especially considering each individual Claim has historically had the potential to cost Harvey $500,000 to $1,000,000.[87]

Harvey's FYE 2017 AFR noted that Harvey is exposed to various risks of loss related to torts; theft of, damage to and destruction of assets; errors and omissions; natural disasters, and injuries to employees. Further, Harvey "has a self-insurance retention of between $75,000 and

[83] *Id.* at 6.

[84] The Comptroller agrees that sharing police, fire, paramedic and other services with other local governments could reduce Harvey's costs.

[85] Exhibit 12.

[86] Exhibit 20 (G&P's Analysis of Claims by Year Filed and by Year Paid).

[87] G&P's analysis of the $21.7 million of claims from FYE 1998-2018 indicated 620 Claims, of which 7 claims cost Harvey between $500,000 and $1,000,000; 10 claims cost Harvey between $250,000 and $500,000, and 40 claims cost Harvey between $100,000 and $250,000.

$100,000 for each general liability and property damage claim based on type of claim," [88] and Harvey's insurance only covers losses after Harvey pays its self-insurance retention for each Claim.

As Claims (including related legal and professional fees) comprised about 5% of Harvey's expenditures, G&P performed additional analyses of the Claims and related legal bills.[89] G&P's procedures focused on reviewing and analyzing annual Claims analyses prepared by Insurance Program Managers Group f/k/a/ Claims One, LLC ("IPMG"), which was Harvey's Third-Party Administrator ("TPA") during the period under analysis.[90] G&P's analyses found that workers' compensation Claims and Claims against Harvey's police were the most expensive Claims during the relevant timeframe.[91]

G&P recommends that the reconstituted Finance Committee pursue risk-mitigation strategies to reduce the risk and/or severity of future Claims, especially worker's compensation Claims and Claims against Harvey police. Such mitigation strategies include developing (possibly in consultation with defense counsel) an enhanced written safety control program, working towards better workplace safety, assigning additional safety enforcement responsibilities to senior management and holding additional safety meetings. As noted in Section V.C.iii above, a regional Police Department could also reduce claims against Harvey's police through increased police training. G&P recommends the reconstituted Finance Committee determine the feasibility of Harvey obtaining additional insurance coverages to reduce the financial exposure posed by its current self-insurance retentions.

Harvey's Auditor recommended that Harvey pay additional attention to Claims and the legal bills associated with the defense of such Claims. Harvey's Auditor noted that historically Harvey's expenditure approval processes were not consistent and significant transactions were approved outside of a City Council Board meeting. Historically, litigation-related invoices were submitted to the TPA and were approved for payment without review and approval by the Finance Department or City Council.[92] G&P understands improvements have been made regarding the processes involving these litigation-related invoices. G&P nonetheless recommends that the reconstituted Finance Committee approve all invoices prior to payment, especially, but not limited to, those relating to Claims and resultant legal bills.

Harvey's Auditor recommended that Harvey review its entire approval process of expenditures (Claims and non-Claims) and create a system that allows for adequate approvals, support of the approval and transparency of the transactions.[93] G&P recommends that the reconstituted Finance Committee be provided electronically all Claim and non-Claim related invoices as well as all Claim-related or non-Claim-related legal and litigation related invoices.

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[88] Exhibit 3 at 52.

[89] G&P's scope of work included reporting Claims that came to its attention. None did during G&P's forensic investigation other than the Claims identified in Harvey's FYE 2017 AFR.

[90] Underwriters Safety has since replaced IPMG as Harvey's TPA.

[91] Exhibit 21 (G&P's Analysis of Largest 15 Claims).

[92] Exhibit 5 at MLC #4.

[93] *Id.*

G&P recommends the reconstituted Finance Committee begin a multi-part review of Claims including, but not limited to, determining the feasibility of Harvey obtaining additional insurance coverages; implementing additional risk mitigation strategies to reduce the nature, timing and extent of Claims, and reviewing all legal, medical and payout disbursements associated with Claims. G&P recommends that the Finance Committee review the status of material pending Claims along with defense counsel's budget for defending such Claims.

v. Harvey's reconstituted Finance Committee should investigate ways to reduce Harvey's pension and payroll costs.

Payroll (including pension) is Harvey's greatest expenditure as a percentage of total expenditures. Harvey's payroll as a percentage of its total expenditures increased from 26% in FYE 2011 to 39% in FYE 2018. Likewise, annual payroll (including pension) increased from approximately $12 million in FYE 2011 to over $20 million in FYE 2018. Such increase was primarily due to additional funding of Harvey's pension obligations in FYE 2016, 2017 & 2018.

Salaries and overtime in FYE 2017 and 2018 were lower than they were in FYE 2015 and 2016. Outside services in FYE 2017 and 2018 had been significantly reduced after peaking in FYE 2016.[94] Full-time and part-time employee headcount in FYE 2018 was lower than in FYE 2012-2017. Harvey currently employs approximately two-thirds less employees than it did at its peak. Harvey currently employs 212 full-time and part-time employees, of whom 137 are Police and Fire Department employees[95].

Notwithstanding citywide efforts to reduce employee headcount and associated payroll costs, G&P nonetheless recommends that the reconstituted Finance Committee engage in a full review of all employee functions, job descriptions, employee staffing levels and citywide needs. The Comptroller noted that employee headcounts have and/or will be additionally reduced due to retirements.

The reconstituted Finance Committee, supported by a Finance Committee Advisory Board, should pay special attention to fringe benefits, especially health insurance copays (single Harvey employees have zero copays) and vacation policies (Harvey employees have up to six-weeks of paid vacation time). Due to a recent lack of liquidity, Harvey temporarily cancelled its dental insurance coverage to save funds, but such coverage has since been reinstated. The Finance Committee should evaluate whether any dental insurance coverage should be provided.

Harvey's Comptroller advised that a full-time HR Manager should be hired to assist the Finance Committee in this analysis, as Harvey has not had an HR Manager for over seven months. G&P recommends that the new HR Manager perform an initial review of all employee functions, organizational charts, job descriptions, employee staffing levels and citywide needs together with an assessment of wages and benefits. The new HR Manager should give attention to Harvey's personnel files, some of which are incomplete, and should convert these files into an

[94] Harvey appears to have expended no personnel training costs in FYE 2016, 2017 and 2018 – a matter requiring additional investigation by the reconstituted Finance Committee and/or new HR Manager.

[95] The Comptroller noted that police and fire employee headcounts were and are the results of Harvey being required to follow certain collective bargaining agreements over which Harvey has limited control.

all-electronic system to better facilitate personnel file organization.[96] Procedures should be established to ensure that employee performance evaluations are performed at least annually and filed in each employee's personnel file.

Harvey's police employees participate in the Police Pension Employees Retirement System, reported as a fiduciary fund. Harvey's firefighters participate in the Firefighters' Pension Employees Retirement System, reported as a fiduciary fund. Harvey's FYE 2017 AFR reported as follows: "[f]urther stressing the City's liquidity are legacy costs such as pension retirement benefits…." The FYE 2017 AFR also noted that the lack of payments to the pension fund had caused the pension funds to file litigation against Harvey. In order to resolve litigation, Harvey was required to increase its funding of the police and firefighter pension. Such expenditures exceeded $3 million in each of FYE 2017-2018, constituting more than 15% of Harvey's total payroll expenses in those years. G&P makes no recommendation regarding Harvey's legacy pension obligations, nor has G&P evaluated additional methods to reduce these costs. G&P recommends the Finance Committee do so.

vi. Harvey's reconstituted Finance Committee should consider restructuring and/or transitioning Harvey's outsourced comptroller and Finance Department arrangement.

At Harvey, too many of the financial policies and procedures normally performed by the Mayor and the City Council (and its committees) have been delegated and/or abdicated to Harvey's outsourced Comptroller. It is not always clear who, if anyone, is currently tasked with certain essential financial functions and citywide financial needs. Currently, many financial decisions are either not made or are made on an *ad hoc* basis.

Since July 2014, Harvey's Finance Department has been staffed primarily with non-Harvey employees, those persons being employed by W&W. Louis B. Williams, W&W's owner, serves as Harvey's outsourced Comptroller. G&P recommends reevaluating this arrangement for two reasons – a control reason and a cost reason.

Regarding control, outsourcing Harvey's Comptroller and Finance Department poses communication, oversight, accountability and staffing risks. After all, the outsourced employees work for (and report to) W&W and not to Harvey. Harvey cannot exercise complete employer/employee control over W&W employees and does not possess employer oversight, authority and control over these Harvey non-employees. They are not subject to Harvey's employment policies and procedures. Harvey would be in a better position to manage and supervise full-time employees versus outsourced employees.

Regarding cost, G&P's review and analysis found that Harvey paid W&W the following amounts in the following years: $512,408 (FYE 2015); $834,810 (FYE 2016); $678,049 (FYE

[96] Harvey's Auditor noted in MLCs (and G&P's procedures confirmed) employee personnel files were not consistent and missing pertinent information that should be kept on file for each employee. Harvey's Auditor recommended that Harvey implement procedures to ensure that each employee's personnel file is organized and includes all necessary information. Typically, personnel files should (but do not always currently) contain a signed application for employment, state and federal withholding forms, additional withholding verification forms, completed tax forms, wage verification and annual performance reviews, and other personnel related information.

2017), and $546,993 (FYE 2018) – a total of $2,572,260 (FYE 2015-2018).[97] W&W employees bill Harvey by the hour and the hourly billing rates were increased at the end of 2015 as follows: Louis Williams from $200 to $250 per hour; one W&W employee from $150 to $200 per hour, and another W&W employee from $80 to $150 per hour. Harvey's Finance Committee should assess whether Harvey would save money by hiring a full time Comptroller and Finance Department staff.[98]

G&P recommends that the reconstituted Finance Committee consider restructuring the outsourced Comptroller and Finance Department arrangement, which would include hiring a full-time Comptroller, a full-time accounts payable clerk and a full-time accounts receivable clerk. After hiring a full-time Comptroller, the Finance Committee may wish to consider adding Louis B. Williams to its Finance Committee Advisory Board.

A new, full-time Harvey Comptroller would serve as Harvey's Chief Financial Officer and be responsible for the administration of all the financial affairs of Harvey, including all of Harvey's funds and financial record-keeping activities. The Comptroller would report directly to the Mayor and be responsible for representing the administration in fiscal affairs before the City Council and the reconstituted Finance Committee. The Comptroller should additionally design and implement safeguards around Harvey's Water Funds such that Harvey could not resume the practice of using Water Funds for non-water expenses while water-expenses are outstanding.

A new full-time accounts payable clerk would work closely with and report to the Comptroller and handle all general administrative needs of the accounts payable section of the Finance Department. The full-time accounts payable clerk would primarily focus on the vendor and invoice issues described throughout this Report, including updating and reconciling the disbursements within Harvey's General Ledger (including payroll processing). The disbursements-related documents should be scanned and maintained electronically to allow review, approval and authorization by the reconstituted Finance Committee.

A new full-time accounts receivable clerk would also work closely with and report to the Comptroller and would handle all general administrative needs of the accounts receivable section of the Finance Department. The full-time accounts receivable clerk would primarily focus on ensuring Harvey collects and deposits all revenues due it. This clerk would resolve unpaid accounts receivable issues, prepare aging reports, place billing and collection calls, maintain a cash receipts journal and update and reconcile General Ledger accounts related to revenues and receivables. Having both a new full-time accounts payable and accounts receivable clerks (as opposed to outsourced personnel) would additionally enhance internal controls related to separation of duties, a critical financial internal control.

Restructuring the outsourced Comptroller and Finance Department, as suggested above, should facilitate improvements in Harvey's overall financial condition, financial accountability,

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[97] In more recent years, 20% of these costs were charged to Harvey's Water Department.

[98] The Comptroller agreed with G&P that restructuring W&W's arrangement would result in savings to Harvey.

financial practices, procedures and internal controls by allowing a fresh look at issues of vendor approvals and invoice authorization and many other of Harvey's Auditor's often-repeated MLCs.

vii. Harvey's reconstituted Finance Committee should establish an appropriate level of financial accountability.

One example of Harvey's general lack of financial accountability is that Harvey's Auditor has been forced to repeat annually since 2015 the bulk of its MLCs because they have been significantly ignored year after year.[99] Even today, the majority of Harvey's Auditor's MLCs have not been addressed.

In a commercial business environment, the Board of Directors and senior management establish appropriate levels of financial accountability by implementing best practices and internal controls. In city government, the appropriate levels of financial accountability should be established by the Mayor, the City Council (and its committees), the Secretary, the Treasurer and/or the Comptroller. At Harvey, too many of the financial policies and procedures normally performed by the Mayor and the City Council (and its committees) have been delegated and/or abdicated to the Comptroller.

Harvey's current Finance Committee appears to be largely absent and/or nonfunctioning. Harvey's Mayor was unable to recall several aspects of Harvey's financial workings, policies and procedures.[100] The Comptroller, an outsourced CPA function, is acting as Harvey's de facto Chief Executive Officer and Chief Financial Officer combined, with responsibility for both management and oversight of all financial functions, lacking only the ability to hire and fire Harvey employees. In the current environment, the quickest and surest way to appropriately reestablish Harvey's financial accountability is to have a reconstituted Finance Committee, supported by a Finance Committee Advisory Board, exercising oversight and control over all financial matters, including a full time Comptroller and Finance Department employees. This is a key issue for Harvey's new Mayor also.[101]

viii. Harvey's reconstituted Finance Committee should consider creating a citywide anti-nepotism policy for approval by the City Council.

Harvey's Auditor noted that Harvey does not have a formal anti-nepotism policy, and that nepotism in the workplace could promote disruption and lack of productivity.[102] The policy should include discussions on relationships in the workplace and how Harvey will maintain and employ individuals with personal relationships to current employees.

G&P agrees with Harvey's Auditor that Harvey should consider development of such a policy, especially because familial relationships already permeate some of Harvey's highest positions. The Mayor's assistant is the Mayor's sister. The Corporation Counsel is her daughter

[99] For example, in all that time Harvey's Auditor has noted that Harvey does not have a Policies and Procedures Manual.

[100] *See*, *e.g.*, Exhibit 14 (excerpts of E. Kellogg Dep. Tr.) at 46:4-51:3.

[101] Harvey has a Mayoral election around April 2019, and Harvey's current Mayor cannot run again due to term limits.

[102] Exhibit 5 at MLC #8.

and the Mayor's niece. G&P recommends that Harvey's Finance Committee create an anti-nepotism policy for presentation to, and approval by, the City Council.

VI. G&P'S CONCLUSIONS.

Historically, Harvey used its Water Funds for non-water expenses and transferred $31.6 million to its General Fund. Many of these transfers occurred while Harvey was prohibited from making such transfers per the terms of a Consent Decree and no one working at or on behalf of Harvey stopped, prevented or voiced any objection to Harvey making such transfers.

Factors contributing to Harvey's use of Water Funds to pay for general expenses, while water-related expenses remained unpaid, included its overall distressed financial condition; its deepening insolvency; a general lack of financial accountability, and certain insufficient financial practices, procedures and internal controls. Generally, Harvey spends $120 in expenditures for every $100 receives in revenues and so it did not have and does not have enough revenues to make payroll and to pay ongoing citywide expenditures and obligations, and thus historically resorted to using Water Funds for such expenses before paying all water-related expenses.

Harvey's overall distressed financial condition and its deepening insolvency taken together with a general lack of financial accountability and insufficient financial practices, procedures and internal controls stands as a continued threat to the Water Fund in that it perpetuates the risk of Harvey using Water Funds to make payroll and to pay ongoing citywide expenditures and obligations while water-related expenses remain unpaid.

Harvey's financial distress and deepening insolvency are likely to continue unless Harvey exercises a greater degree of financial accountability and implements adequate financial practices, procedures and internal controls. Accordingly, G&P's most pressing and encompassing recommendation is Harvey's need for a robust, functional and reconstituted Finance Committee, supported by a strong non-voting Finance Committee Advisory Board. The newly reconstituted Finance Committee should:

- Reduce Harvey's deficit of liabilities over time by reducing Harvey's annual operating deficits through increased revenues and reduced expenses.
- Effect improvements in Harvey's overall financial condition, financial accountability and financial practices, procedures and internal controls.
- End the practice of allowing financial policies and procedures normally performed by the Mayor and the City Council to be delegated to an outsourced Comptroller.
- Adopt best practices in the sharing of local government services.
- Approve risk management safeguards to limit Harvey's legal liability to third parties.
- Seek ways to reduce Harvey's pension and payroll costs.
- Implement improvements to Harvey's vendor hiring and payment process and review certain current arrangements with specific vendors.
- Implement the Harvey Auditor's MLCs including creating for the City Council's approval a citywide anti-nepotism policy.

Improving Harvey's overall financial condition, financial accountability and financial practices, procedures and internal controls could help the Water Fund going forward by lessening the risk of Harvey's management utilizing the Water Fund to pay for non-water expenses while water-related expenses remain unpaid. Increasing revenues and reducing expenditures should make it easier to preserve Water Funds and for the General Fund to repay the Water Fund the $31.6 million owed.

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