

Using Experts in Municipal Contract Negotiations

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Background

Starting over 40 years ago and by 1977, at least 34 states had enacted legislation allowing their counties, cities, townships and other municipalities to negotiate contracts with their labor unions, including: Alabama, Alaska, Connecticut, Delaware, Hawaii, Indiana, Iowa, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming (William and Mary Law Review, 1977). By 2012, Idaho, Illinois and other states had joined them (Malin, 2012). More recently, Sanes and Schmitt (2014) state that North Carolina, South Carolina, Tennessee and Virginia forbid firefighters or police officers from bargaining collectively with their employers, and Georgia forbids police officers from doing so. They add that Idaho, Tennessee, and Wisconsin now severely limit collective bargaining. While at least 43 states have introduced legislation to stop such municipal employee collective bargaining (Nack, Childers, Kulwicz, and Ibarra, 2019), most states continue to permit such collective bargaining (Sanes and Schmitt, 2014).

Many states require such labor contracts to focus primarily on the municipality's "ability to pay" issues for both direct and indirect economic matters. Many states also require police, fire fighters, prison guards, state troopers, physicians working in prisons, and other public safety employees to exchange the right to strike for binding arbitration, based primarily on the "ability

to pay" issue. We use a Michigan arbitration case study as a lens to study "ability to pay" issues; suggest general concepts applicable to other states with similar criteria; and provide generalizable, useful information for many other types of valuation issues.

We note that Rhode Island (<http://webserver.rilin.state.ri.us/Statutes/TITLE28/28-9.4/28-9.4-11.HTM>), Delaware (<https://delcode.delaware.gov/title10/c057/index.shtml>), Pennsylvania (<https://www.pml.org/advocacy/binding-arbitration-reform-act-111/>) and other states have laws similar to Michigan's. But actual demand for arbitrators seems hard to measure, as we found no reports of such demand on the Internet—probably because no central authority measures and reports them.

Per Anderson (1973), the Michigan Policemen's and Firemen's Compulsory Arbitration Public Act (PA) 312 became effective in 1969 after several police officers and firefighters work stoppages threatened public safety. The law arose from nearly four years of study by a Governor-appointed commission that used an impartial arbitration panel to settle labor disputes between public safety employees and municipalities in order to maintain critical public safety services.

Most Michigan labor negotiations between public safety employees and municipalities are settled without using binding arbitration. But for the few cases each year where an impasse arises, PA 312 offers a fair and transparent process for all parties to present their last, best offers to an impartial arbitration panel. The panel then holds a hearing and considers the facts presented—especially the municipality's ability to pay—to determine which side's final offer to accept. Since the panel can only accept one side's offer, the union and the municipality each should offer reasonable economic options.

While Malloy (2003) shows that the contract negotiation process continues to work well for the taxpayers, unions and all other concerned parties, no study has yet detailed the process, especially the expert witnesses' roles in providing ability-to-pay information. Forensic and other accountants also can apply many of the techniques described below in presenting information to juries and arbitrators—and perhaps in serving as arbitrators themselves.

Overview of Governmental Financial Reporting

Both the municipality's and the union's financial experts focus on the contents of the Comprehensive Annual Financial Report (CAFR), i.e., independent auditor-attested financial statements that comply with U.S. Governmental Accounting Standards Board (GASB) accounting disclosure, reporting and statistical requirements (e.g., GASB no. 44, 2004). The *Codification of Governmental Accounting and Financial Reporting Standards* annually reports updated GASB standards. The U.S. government, via the Federal Accounting Standards Advisory Board (FASAB) also adheres to GASB standards.

CAFR reports—which are usually readily available on the municipality's website—contain the detail needed to assess a municipality's financial health. Exhibit I shows the general content of most CAFR Reports, placing in bold the title and underlining each reporting section. Next, Exhibit II explains some key items appearing in Exhibit I, denoted in bracketed capital letters. Exhibit III shows which parts of such CAFR details to place in the "Expert Report" that we will later describe.

Since much of a municipality's ability to pay focuses on the CAFR's General Fund balances, expert witnesses should master the contents of the Government Finance Officers Association's (GFOA, 2015) *Fund Balance Guidelines for the General Fund*. This publication recommends municipalities: (1) provide broad guidance on how to direct its resources to replenish fund balances that fall below management-prescribed levels; (2) consider the predictability of net future cash flows to manage unrestricted and other fund balances; and (3) explain large changes of such balances, presumably in its CAFR. Moreover, expert witnesses should focus on the CAFR areas that most impact the municipalities' financial strength, which include:

- Management Discussion and Analysis could denote major changes in its economy, such as factory closings.
- The Balance Sheet shows changes between restricted and unrestricted General Fund Fund Balances.
- Proprietary Funds should indicate the municipality's financial business strength, as adding resources to its Downtown Development Authority.
- Budget Comparison Schedule - General Fund indicates the municipality's expected future health; and
- Schedules of Pension Contributions and of Other Postemployment Benefit [OPEB] Funding Progress focusing on the municipality's major long-term obligations.

Importantly, the expert witness should master the CAFR's details, especially to face cross-examination questions developed by the municipality's audit firm, whose staff generally are experts in fund accounting and their client's specific economic conditions.

Experts' Reports and Testimony

The Expert's Role

Unlike fact witnesses, expert witnesses can provide conclusions in their areas of expertise, but face *voir dire* (preliminary judge or opposing counsel witness examinations) and Daubert (initiated by the opposing counsel and requiring the expert to show that the methodology and reasoning used are scientifically valid and apply to the facts of the case) challenges. Thus, experts should show their background in auditing municipalities, teaching governmental accounting, testifying in similar cases, and writing articles on these topics; and submit other examples of their expertise in the municipal. We have seen several very embarrassing examples of arbitrators not permitting such testimony from unqualified expert witnesses. For example, some of them had little understanding of (1) the importance of changing pension and OPEB assumptions; (2) why the municipality moved vast sums of cash from the unrestricted to restricted General Fund Accounts; and (3) the content of the municipality's Standard & Poor's or Moody's analyses of the municipality's financial health.

Experts also must support their prior testimony on similar cases. For example, they should normally not claim in one case that a certain set of financial ratios indicates a “strong” set of financial balances and in a later case claim that a similar set of numbers indicates a “weak” set of such balances. To maintain such consistency, experts generally work solely for either the municipality or the unions—but not for both—unless serving as a fact finder for both parties.

Because both sides use competent expert witnesses, each CPA can be a client advocate without breaking AICPA independence rules. Municipal independent auditors, while performing their audit duties, normally attain much financial expertise about their client’s economic status, making them ideal candidates to represent the municipality in arbitration matters. In turn, the union generally engages competent, experienced experts who can provide excellent summary reports and withstand grueling cross-examination. These experts must review carefully the current and several prior years’ CAFR-audited financial information, plus such other key information as budgets, actuary reports, and Internet-posted information (e.g., the municipality’s dashboards, long-term goals and reports on internal control). While auditor fees for such matters normally is part of total audit fees or set at a pre-determined hourly rate, the unions’ experts’ fees are usually negotiated individually. For instance, our hourly fees, which range from \$250–\$350 for “research” time and 50% more for “testimony” hourly rates, are often capped at pre-set limits that require the union’s specific authorization to exceed.

The arbitration process has both sides’ (i.e., municipality and union) attorneys provide copies of their expert accountants’ reports. Each side’s attorneys provide interrogatory questions, including requests for further information. Both sides normally split the arbitrator’s, court stenographer’s, and other related fees, but each side pays its own experts’ fees. Each side makes a “last and final” offer on each direct and indirect economic issue (e.g., salary, gun allowance and seniority rules). Similar to professional baseball and basketball negotiations, the arbitrator cannot “split the baby;” i.e., the arbitrator must accept only one side’s final offer for each negotiated item.

Here is an interesting anecdote regarding this process. Several years ago, a union president asked one of the authors how large a salary request to place in the union’s final offer. The president stressed that he had never before (or since) responded to such a specific request. Knowing that the city’s weak financial position would likely cause the arbitrator to reject a substantial wage increase in the near future, the expert said to ask for 0% for years 1 and 2, and 6% for year 3. The union president said that doing so would cause his members to find a new president. He then requested instead a 6% for each of the three years of the contract, while the city requested 0% for all three years. The arbitrator indeed accepted the city’s offer. Years later at a social event, the expert saw the arbitrator who said (confidentially) that she would have accepted the union’s (0%; 0%; 6%) offer. The union members later reelected their president, exemplifying “winning the battle, but losing the war.” The members sacrificed a reasonable contract in order to wage a losing fight for an untenable one.

How to Prepare the Union Expert’s Report

This section discusses the content of a union expert’s economic financial reports for accountants, economists, and others to apply when serving as municipal financial experts. Again, forensic accountants also can apply the municipal financial/operational details, logic and formats discussed herein to private sector valuations. The expert should first obtain and read carefully current and a few prior years of CAFR data. Manually adding this data into an Excel spreadsheet helps to summarize this data, grasp how the municipality accumulates its data, and find inconsistencies.

For example, the GFOA (2015) suggests that all municipalities maintain an unrestricted budgetary fund balance in their general fund (GF) of at least two months (i.e., 16.67%) of regular GF operating revenues or regular GF operating expenditures, a percentage called the “gold standard.” Performing this data input led one of us to detect that a city had moved such “normal” activities as “Reserves for Brownfields” and “Reserves for Future Construction” from its unrestricted to reserved GF balances. The master Excel file that formed much of the final report highlighted this inconsistency and made this issue a key point for the city’s auditors to defend.

The first section of the Expert Report uses the master Excel file that includes the key topics shown in Exhibit 3. Later sections of the Expert Report—beyond the Excel file—focus on such matters as the following:

- Key disclosures from prior year CAFR reports (e.g., from the MD&A sections)
- Analyses of Actuarial Pension and OPEB Reports (e.g., discussing their Normal Costs, AAL and UAAL balances, Employee Payments, and Overall Funding Status)

- Articles from the popular press regarding the entity's economic health, using such items as major banks' summaries of the area's economic index, plus Standard and Poor, Dun and Bradstreet, Fitch and other rating agency reports. Arbitrators often place much value on such outside, independent data that focus on changing bond ratios.

Constructing the Expert Report requires compiling, reviewing, and locating inconsistencies within a large amount of detailed financial data, a process to which forensic accountants are well-accustomed. Finally, while such factors as past surpluses/deficits, current cash reserves, future economic forecasts, and the funding status of pension and OPEB balances all can impact the Expert Report, specific economic conditions play such a dominant role in developing such conclusions that no one set of factors applies to all municipalities.

Conclusion

Accountants, economists, and other professionals can add much value to the collective-bargaining process by determining and reporting on a municipality's economic health, especially during and after the coronavirus pandemic. There will be huge pressures on municipalities and possible bankruptcies. After all, providing this information helps the municipality pay the union members "reasonable" compensation and other benefits, while effectively using taxpayer funds. Given the breadth of financial data relevant to determining a municipality's ability to pay, forensic accountants who are knowledgeable about municipal accounting are well-suited to perform this task.

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Exhibit I:

Outline of Elements of Typical Comprehensive Annual Financial Reports (CAFR)

Introductory Section

Letter of Transmittal [A]
GFOA Certificate of Achievement [B]
Organization Chart
List of Principal Officials

Financial Section

Independent Auditor's Report [C]
Management's Discussion and Analysis [D]

Basic Financial Statements

Government-Wide Financial Statements: [E]
Statement of Net Position (Balance Sheet) [F]
Statement of Activities (Income Statement)

Fund Financial Statements: Governmental Funds

Balance Sheet [G]
Reconciliation of the Balance Sheet to the Statement of Net Position
Statement of Revenue, Expenditures, and Changes in Fund Balances
Reconciliation of the Statement of Revenue, Expenditures, and Changes in Fund Balances to the Statement of Activities

Proprietary Funds [H]

Statement of Net Position
Statement of Revenue, Expenses, and Changes in Net Position
Statement of Cash Flows

Fiduciary Funds [I]

Statement of Fiduciary Assets and Liabilities

Notes to Financial Statements [J]

Required Supplemental Information [K]

Budgetary Comparison Schedule - General Fund
Budgetary Comparison Schedule - Major Special Revenue Funds
Note to Required Supplemental Information
Schedule of Changes in the Net Pension Liability and Related Ratios
Schedule of Pension Contributions
Schedule of OPEB Funding Progress

Other Supplemental Information

Non-Major Governmental Funds [L]:
Fund Descriptions
Combining Balance Sheet
Combining Statement of Revenue, Expenditures, and Changes in Fund Balances
Special Assessment Schedules - Combining Balance Sheet
Special Assessment Schedules - Combining Statement of Revenue, Expenditures, and Changes in Fund Balances
Budgetary Comparison Schedule - Non-Major Governmental Funds

Fiduciary Funds

Fund Descriptions
Combining Statement of Assets and Liabilities
Schedule of Changes in Assets and Liabilities

StatisticalSection

Description of the Statistical Section

Financial Trend Information [M]

Net Position by Component
Changes in Governmental Net Position
Changes in Business Type Net Position
Fund Balances - Governmental Funds
Changes in Fund Balances - Governmental Funds

Revenue Capacity Information [N]

Taxable Value and Estimated Actual Value of Taxable Property
Direct and Overlapping Property Tax Rates
Principal Property Taxpayers
Property Tax Levies and Collections

Debt Capacity Information [O]

Ratios of Outstanding Debt
Ratios of General Bonded Debt Outstanding
Direct and Overlapping Governmental Activities Debt
Legal Debt Margin

Demographic and Economic Information [P]

Demographic and Economic Statistics
Principal Employers

Operating Information [P]

Full-time Equivalent Government Employees
Operating Indicators
Capital Asset Statistics

Exhibit II:
Explanations of Key Elements of the CAFR that Appear in Exhibit I

- A. Summarized municipality financial status, signed by its supervisor, clerk and other key leaders
- B. The Government Finance Officers Association's (GFOA) Executive Director issues an Excellence in Financial Reporting certificate when the municipality's independent auditor issues an unqualified opinion.
- C. Similar to non-municipal accounting, the independent auditors can qualify their opinions, add explanatory paragraphs, or issue adverse opinions or disclaimers of opinion.
- D. This analysis includes comparing several years of governmental- and business-type balance sheet and income tax activities, major acquisitions and disposals of capital assets, and the levels of restricted and unrestricted funds.
- E. This section separates and totals Governmental and Business-type Activities and discloses separately such Key Component Units as Downtown Development or Wetland Activities.
- F. Net Position, akin to Owners' Equity, represents a critical, non-contractually committed component of the municipality's *ability to pay*; its components include such restricted components as Balances for Future Construction and Brownfield Remediation—which the municipality can change—and the remainder is unrestricted.
- G. This set of Balance Sheets includes the General Fund (i.e., the source of normal employee wages and benefits), Taxpayer approved millages (e.g., for Police and Fire Services), Non-major Funds (e.g., Library Fund Millages) and Total Governmental Funds.
- H. Propriety Funds are business-like funds, such as enterprise funds (that provide citizen services for a fee, such as a swimming pool or ice skating arena) and internal service funds (that provide other departments such services as processing payroll on a cost-reimbursement basis).
- I. Fiduciary funds contain governmental resources that it does not own, such as its employee's Pension Plan Trust, Investment Trust Funds, and Custodial Funds.
- J. The municipality's footnotes contain such critical information as its accounting policies, purchases of long-term assets, schedule of liabilities, lease obligations and defined contribution pension and other post-employee benefit obligations (OPEB), listed separately for each class of employee (e.g., police, fire fighter, general employee, and supervisory personnel).
- K. Since most municipalities have huge pension and OPEB obligations, this footnote provides important information in measuring the entity's short-, medium, and long-term financial solvency, and, therefore, its ability to pay.
- L. Non-major funds include analyzing police, fire fighting, library and other taxpayer-approved budgetary funds.
- M. These schedules contain trend information showing changes in the municipality's financial performance and well-being over time, disclosing, for example, Governmental net investments in capital assets, restricted, and non-restricted net balances; business-type investments in capital assets, plus the total balances in Primary Governmental Activities.
- N. Revenue Capacity Information provides historical information about the municipality's residential, commercial, industrial, personal property and other tax-based values; its tax/millage rates; and actual market values. Many states use two tax bases—an historically-based (with limited increases in value) one for current owners and another market-based for new owners.
- O. Debt Capacity includes information of General Obligation Bonds, Special Assessment Bonds, and Capital leases for both Governmental and Business-Type Activities; total governmental debt; Total Residential Personal Income; Total Population; and Total Debt Per Capita. Since many states cap the allowable debt per capita, these data provide important ability to pay criteria.
- P. Such Demographic and Economic Information as the number of employees working for the municipality's principal employers and such Operating Information as the number of full-time equivalent police, fire fighting and other types of employees show key ability to pay information.

Exhibit III:

Contents of the Master Excel File

- Management Discussion and Analyses (MD&A) of Governmental and Business-type activities as Current and Other Assets, Capital Assets, Total Long-Term and Other Liabilities, and Assets Invested in Capital Assets-Net of Related Debt.
- Restricted and Unrestricted Net Assets, Program Revenue and Expenses.
- Charges for Services, Operating Grants & Contributions, Capital Grants and Contributions, General Revenue, Property Taxes, State-Shared Revenue, Investment Earnings, Franchise Fees, Other Revenues, Interest on Long-Term Debt.
- General Revenues, Property Taxes, State-Shared Revenues, Investment Income, Gain on sale of fixed assets, Cable Franchise Fees, Program Revenue, Other Misc. Income.
- Business-Type Activities, such as Current Assets, Capital Assets, Current and Long-Term Liabilities, Restricted and Unrestricted Net Position, Operating Income (Loss) before Depreciation, Nonoperating Revenues (Expense), and Capital Contributions.
- Governmental Activities Balance Sheet for General and Other Funds of such assets as Cash and Cash Equivalents, Receivables, Due from Governmental Units, Internal Balances, Assets Held for Resale, Net Other Postemployment Benefit (OPEB) Assets, Capital Assets, Not Subject/Not Subject to Depreciation, Amounts Due to Other Governmental Units, Compensated Balances Due/Not Due Within One Year, Deferred Outflows of Resources, Assets Restricted for Police & Fire Service; Safety Path Millage; Public Access Programming; Debt Service; Expendable Cemetery Permanent Funds; Public Access Studio Capital Projects; and Unrestricted Funds.
- GF (Net) Balance: End of Year, Unassigned GF Fund Balance, GF Expenditures, Ratio of GF Unassigned Fund Balance to GF Expenditures.
- Other Governmental Funds Balance Sheets, such as the Police Millage Fund, Fire Millage Fund, Library Fund, Safety Paths Fund.
- Proprietary Funds Balance Sheets, such as the Water Fund and Sewer Funds Special Assessments, Customer Usage Receivable, and Due from Other Governmental Units, Invested in Capital Assets, Net of Related Debt, Governmental Activities, Capital Charges and Tap-In Fees, and Unrestricted Net Assets.
- Data from CAFR Footnotes, such as Millage Rates, Millage Revenues Generated, Building Permit Revenues, Development Rights, Yearly Accumulated Depreciation, Depreciable Capital Assets, Interest Due within Five Years, Accumulated Long- and Short-Term Employee Benefits Due, Pension and OPEB Costs and Liabilities; and such key calculations as assumed and actual rates of returns on pension assets, projected inflation, wage inflation factors, remaining amortization periods, actuarial value of Plan Assets, Actuarial Accrued Liability (AAL), Unfunded AAL (UAAL), Covered Payroll, UAAL/Covered Payroll, and active/inactive plan members.
- Compare Budgeted to Actual Expenditures for GF Property Tax, Revenues, and Key Budget Variances.