



October 27, 2022
2022-802

City of Hemet—Local High Risk

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

This letter report provides an update on the status of the city of Hemet as a high-risk entity under our high-risk local government agency audit program. In August 2016, we issued our report titled *City of Hemet: Its Ongoing Budget Deficit and Organizational Inefficiency Threaten Its Financial Stability and Delivery of Public Services*, Report 2015-806. In that report, we concluded that issues related to Hemet’s finances and its organizational management placed the city at high risk. In October 2019, we issued a follow-up report that concluded that Hemet remained at high risk. State regulations require that we notify the city and legislative leaders if we determine that a local entity has addressed the areas of risk we have identified and is no longer high risk. In the three years since we issued our follow-up report, Hemet has satisfactorily implemented its corrective action plan. Further, its substantial and sustained progress in responding to the risk factors we identified has addressed or mitigated the deficiencies we described in our August 2016 audit. For this reason, we no longer consider Hemet to be high risk.

As Table 1 shows, our 2016 audit identified two main areas of risk: Hemet’s expenditures continually exceeded its revenues and its organizational management was ineffective and inefficient. During the six years since that initial audit, Hemet has taken steps to satisfactorily address both risk areas. To address its financial risks, it has obtained additional sales tax revenue, increased its general fund balance over four consecutive years, and begun maintaining a substantial general fund reserve. Even though Hemet still has a significant unfunded pension obligation, its revenues are growing faster than its pension obligations and its financial condition has substantially improved. To address its ineffective and inefficient organizational management, the city has conducted strategic planning and made changes to its staffing structure. Although Hemet should take steps to further improve the funding of its fire department and reduce the turnover it experiences in key positions, the city is in a significantly more favorable operational position than it was in August 2016. Further, according to our local high-risk dashboard, Hemet has improved its financial health indicators and is now classified as low risk.

Because Hemet has significantly reduced its risks in the two main areas we identified during our 2016 audit, we are removing our designation of the city as high risk. We will continue to monitor its financial condition—as we do for all California cities—through our local high-risk dashboard. We may subsequently consider whether Hemet should be designated as high risk again if its situation changes and it appears to be at risk of not being able to meet its financial obligations or provide efficient and effective services to the public.

Table 1
Hemet Has Resolved, Addressed, or Partially Addressed All Areas of Risk We Identified

AREA OF RISK	OCTOBER 2019	OCTOBER 2022
<i>Expenditures Continue to Outpace Revenue, Impeding Hemet’s Ability to Meet Its Financial Obligations</i>		
<i>Ongoing budget deficit</i>	PENDING	ADDRESSED
<i>Rising pension costs</i>	PARTIALLY ADDRESSED	PARTIALLY ADDRESSED
<i>Use of city-supported library by nonresidents</i>	NO ACTION TAKEN	RESOLVED
<i>Significant retiree medical costs and unfunded liability</i>	PARTIALLY ADDRESSED	ADDRESSED
<i>Ineffective and Inefficient Organizational Management Negatively Affects Hemet’s Provision of Public Services</i>		
<i>Underfunded fire department</i>	PARTIALLY ADDRESSED	PARTIALLY ADDRESSED
<i>Lack of coordinated approach to promote community engagement</i>	PENDING	ADDRESSED
<i>Inefficient structure of city government</i>	PENDING	ADDRESSED
<i>Turnover of key positions and lack of consistent leadership</i>	PENDING	PARTIALLY ADDRESSED
<i>Inconsistencies in outsourcing maintenance activities</i>	PENDING	RESOLVED

Note: October 2019 is our previous most recent assessment published on our website of Hemet’s progress in addressing its risk areas.

HIGH-RISK AREA #1—Ongoing Budget Deficit

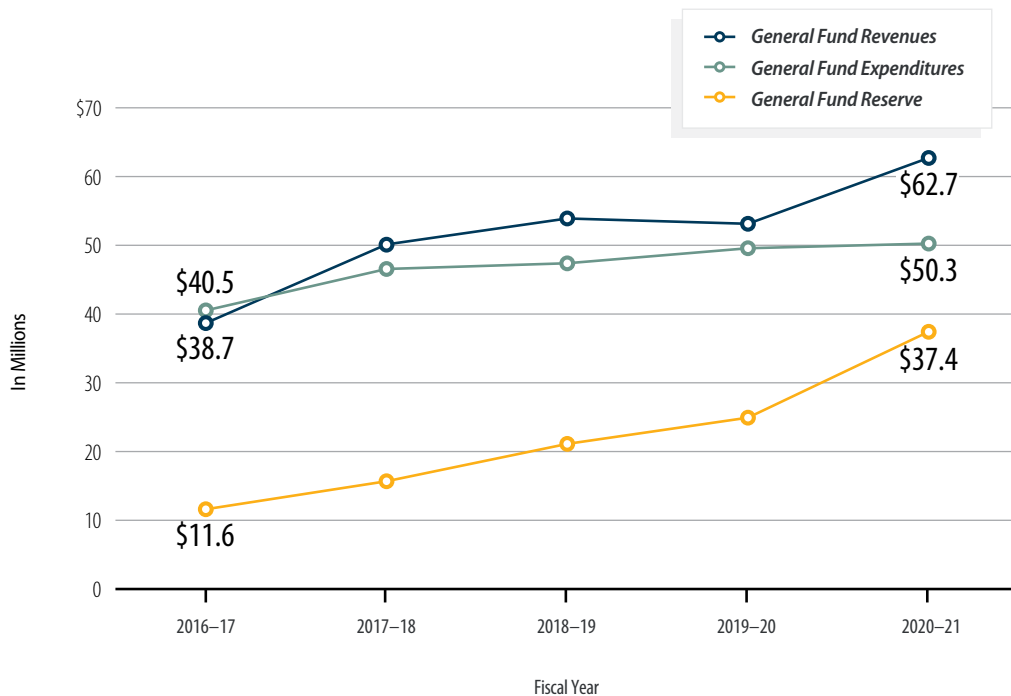
Status: *We conclude that Hemet’s recent fiscal improvement and increased general fund reserve demonstrate that it has addressed this risk area.*

Hemet’s actions in recent years have shown evidence of fiscal control and that it has stabilized its financial condition. Our October 2019 assessment noted that despite an increase in revenue from an additional 1 percent sales tax that voters approved in 2016, the city’s fiscal year 2019–20 budgeted expenditures would have exceeded its revenue had it not relied on transfers from other funds. However, Hemet ultimately received more revenue than it budgeted, and its actual general fund revenue exceeded its expenditures by nearly \$3.6 million in fiscal year 2019–20. The city’s financial position continued to improve during fiscal year 2020–21. The city’s general fund revenue exceeded its expenditures by more than \$12 million, and it had a \$37.4 million general fund reserve at the end of the year, as the figure shows. It was the fourth consecutive year in which the city’s general fund balance increased by more than \$3 million.

Hemet’s reserve policy and current reserve amount exceed best practices. The city’s general fund reserve policy requires it to maintain a general fund reserve equal to 20 percent of its current expenditures, which is higher than the minimum recommendation by the Government Finance Officers Association of 17 percent of regular general fund revenue or expenditures. As of June 30, 2021, Hemet’s unrestricted reserve of \$37.4 million equaled 75 percent of its fiscal

year 2020–21 general fund expenditures, exceeding the minimum its policy requires. In the event of a fiscal emergency, this amount could fund Hemet’s operations for nearly 9 months at its current spending levels.

Figure
By Spending Less Than Its Revenue, Hemet Has Increased Its Reserves



Source: Hemet’s annual financial reports for fiscal years 2016–17 through 2020–21.

Note: From fiscal years 2016–17 through 2018–19, Hemet classified the balance of funds generated through its additional 1 percent sales tax as *restricted*—a classification that is not included in the general fund reserve. In fiscal year 2019–20, the city classified the balance as *committed*—a classification that is included in the city’s general fund reserve. For consistency, the figure above presents the balance as *committed* for all years and thus part of the city’s reserve balance.

Further bolstering its ability to provide services to its residents, Hemet received \$21.7 million under the American Rescue Plan Act (ARPA). The city placed \$10.8 million of these ARPA funds in a special revenue fund in fiscal year 2020–21. These funds are not a part of the city’s general fund reserve and represent additional resources that the city can use in the future. In October 2021, the city polled residents for input on how it should use the funds. The respondents ranked economic assistance, children’s programs, and mental health services as their chief priorities. At a meeting in March 2022, the city council considered these priorities as it allocated its ARPA funds to various projects.

Hemet approved a 15 percent increase in general fund spending in its fiscal year 2021–22 budget. The city’s fiscal year 2021–22 budget projects \$55 million in general fund revenue and \$57 million in expenditures, which could reduce its general fund reserve. However, the city’s actual general fund revenue for fiscal year 2020–21 was nearly \$63 million, or roughly \$8 million

more than it has budgeted for fiscal year 2021–22. Because the city’s general fund balance is larger than recommended, we believe that the higher level of spending Hemet has planned for fiscal year 2021–22 does not represent a significant risk.

HIGH-RISK AREA #2—Rising Pension Costs

Status: We conclude that Hemet has partially addressed this risk area by establishing a trust that, if sufficiently funded, will offset its \$100 million pension liability.

Hemet’s pension liabilities have continued to grow, but its revenue has grown faster, reducing the risk that paying for these liabilities will require the city to reduce services. From fiscal years 2016–17 through 2020–21, Hemet’s pension liability grew an average of 6 percent annually, from \$88 million to \$108 million. However, its government-wide revenue grew at an average of 11 percent annually, from \$65 million to \$94 million. As a result, the ratio of Hemet’s net pension liability to its government-wide revenue—one indicator of a city’s ability to pay its pension obligations and provide services to its residents—improved from 135 percent to 115 percent, meaning that its pension liabilities represent a smaller percent of its annual revenue.

Although this ratio still represents a concern, Hemet has taken steps to reduce the financial risk. Hemet’s city council passed a resolution in February 2022 directing staff to establish a trust for pension and other post-employment benefits (OPEB) stabilization, establishing guidelines for funding the trust using surplus revenues, and devoting an initial amount of \$500,000 from the general fund to open the trust. The guidelines indicate that beginning in fiscal year 2023–24, city staff may contribute 15 percent of a given year’s surplus to the trust. The establishment of a trust is a positive step toward offsetting the city’s costs if the city makes sustained contributions to the trust.

HIGH-RISK AREA #3—Use of City-Supported Library by Nonresidents

Status: We conclude that this risk area has been resolved because there is no longer an urgent need for the city to increase its revenue, and implementing our recommendation would have unintended negative repercussions.

In our 2016 audit, we sought to determine the budgetary impact of various revenue and cost-saving options. We determined that many nonresidents use the Hemet Public Library, and we suggested that the city seek legal guidance on adopting a user fee structure that would charge nonresidents for access to the library’s resources. However, given that the city’s financial condition has since stabilized, the urgent need for the city to take steps to increase its revenue has abated. Further, following our 2016 audit, Hemet provided a letter from the California State Library indicating that establishing a nonresident user fee for library services would not be advantageous to the city or the library. Doing so would disqualify the Hemet Public Library from affiliation with the Inland Library Cooperative System, a cooperative that shares library resources. The California State Library also stated that the Hemet Public Library would become ineligible for reduced cost broadband services and could be required to repay funds it received from certain grants.

HIGH-RISK AREA #4—Significant Retiree Medical Costs and Unfunded Liability

Status: We conclude that Hemet has addressed this risk by reducing its retiree medical costs and placing funds in a trust to begin offsetting its unfunded liability.

One of the significant concerns that prompted the August 2016 audit was Hemet's high costs for medical benefits that resulted from its promise to provide full lifetime medical coverage to eligible retirees whom it hired before 1998. As of January 2015, the city had a significant OPEB liability of \$74 million, and it did not have any assets dedicated to offset its retiree health plan cost liability. However, Hemet has since reduced its net retiree medical benefit liability substantially while also establishing a method to fund its promise to pay for the health care of its retired employees.

The city took two significant steps to address this liability. First, beginning in 2015, the city successfully negotiated with its retirees to shift many of them to lower-cost health care plans, offering an incentive of \$5,000 to change plans. Primarily because of this effort, the city had reduced its net OPEB liability to \$50 million as of June 2021. Second, in 2016 the city made an initial contribution of \$750,000 to a trust to offset the costs of its OPEB obligations. As of June 2021, the balance of the city's OPEB trust was \$2.2 million. As we previously discuss, Hemet's city council passed a resolution in February 2022 directing staff to establish a second trust for pension and OPEB stabilization and establish guidelines for funding that trust using excess revenues. We consider the city's progress in reducing its liability as evidence that the city is taking appropriate steps to address this risk area.

HIGH-RISK AREA #5—Underfunded Fire Department

Status: We conclude that the city has partially addressed this issue by increasing its firefighter staffing and purchasing new vehicles; however, its firefighter staffing levels remain low.

Hemet has obtained substantial additional funding for its fire department. In November 2016, its voters approved a 1 percent sales tax increase. Although the city can use the proceeds of the tax for any lawful purpose, the city council adopted a resolution to dedicate these proceeds to enhancing public safety services. As a result, the city's budget for its fire department increased from \$11.8 million in fiscal year 2015–16 to \$13.3 million in fiscal year 2020–21. For fiscal year 2021–22, Hemet budgeted \$4.9 million of the sales tax increase for its fire department, roughly a quarter of the fire department's total funding. Using this additional funding, the city had increased firefighter staffing by three positions as of fiscal year 2020–21. It stated that it has also used the funding to purchase new vehicles and to pay for firefighter positions that it previously funded with other general fund revenue.

Nonetheless, Hemet's fire department's staffing levels remain low. In our 2016 audit, we cited a 2015 review that determined that the city had 0.55 firefighters per 1,000 residents while the regional median at that time was 0.92 per 1,000 residents. Hemet's fiscal year 2021–22 budget includes 49 firefighters, a ratio of 0.58 firefighters per 1,000 residents. Hemet would need to add about 29 more firefighters to reach a ratio of 0.92 firefighters per 1,000 residents. However, the city's improved financial condition will likely allow it to pursue additional steps to reduce that risk further in the future.

HIGH-RISK AREA #6—Lack of Coordinated Approach to Promote Community Engagement

Status: We conclude that Hemet has addressed this risk area by making an effort to engage with the community through multiple venues.

Hemet has sufficiently addressed this risk area by taking steps to improve community engagement. The most recent city manager has implemented several methods of communication, including publishing a community newsletter and using social media channels. In September 2020, the city launched an online tool that allows residents to request services and report issues for the city to address, such as graffiti and potholes. In addition, in May 2021, the city established a position for a public information social media officer within the police department to prepare and disseminate information to the community about the police department and other city departments.

HIGH-RISK AREA #7—Inefficient Structure of City Government

Status: We conclude that Hemet has addressed this risk area primarily by reducing the number of individuals reporting directly to the city manager.

Hemet has made changes to the reporting relationships of certain city personnel to increase efficiency. According to a major consulting firm, a position with characteristics similar to those of the city manager should typically have six or seven positions that directly report to it. Our 2016 audit recommended that the city reduce the number of individuals reporting to the city manager to facilitate more effective oversight. Since that time, Hemet has reduced the number of individuals reporting to the city manager. First, the city consolidated its engineering and public works departments, eliminating a director-level position. Second, the city has not funded its economic development director position in any budget since fiscal year 2016–17. As a result, the number of individuals reporting directly to the city manager decreased from nine to seven, allowing the city manager to provide more effective oversight and focus on citywide issues.

HIGH-RISK AREA #8—Turnover of Key Positions and Lack of Consistent Leadership

Status: We conclude that Hemet has partially addressed this risk area: although turnover in key positions has declined, the city manager recently resigned and thus the city council will need to take action to ensure consistency in the city's strategic direction.

After experiencing an extended period of frequent turnover in key positions, Hemet maintained consistent leadership in the city manager position from April 2019 through June 2022. In our 2016 audit, we noted that Hemet had eight different city managers over a nine-year period. Since 2016 it has had three city managers with average tenures of two years. Following our audit, the city council replaced the city manager in 2017 with an external candidate. In 2019 it replaced that city manager with an individual who had served as the deputy city manager. According to the city, this most recent city manager resigned in June 2022.

The tenure of the most recent city manager allowed the city to develop and begin implementing a strategic plan to guide its future. Hemet's city council and city manager began the process of identifying the city's priorities in January 2021, and the city council adopted a strategic plan in June 2021. Hemet also developed a dashboard on its website to track its progress in implementing certain aspects of its strategic plan. For example, the dashboard shows that the city has met seven of its goals for increasing public safety visibility and response and has partially met five. Despite the recent resignation of the city manager, the city continues to use both of these tools. Further, Hemet improved its communication efforts with its residents as we describe previously.

Because of the resignation of its most recent city manager, Hemet once again risks a change in strategic direction. To address this risk, the city council will need to find methods of ensuring that the city continues to consistently implement the strategic plan and does not change its focus. However, the strategic planning and enhanced communication that the most recent city manager implemented provides a starting point for future city management.

HIGH-RISK AREA #9—Inconsistencies in Outsourcing Maintenance Activities

Status: We conclude that this risk area has been resolved because the city no longer has an urgent need to reduce costs.

Although Hemet has not outsourced all of the maintenance activities for its parks, its improved financial condition reduces the need for such action. Our 2016 audit noted that the city had outsourced some of its landscape maintenance work but had not done so for other areas, including its parks. We determined that the city could achieve savings by fully outsourcing its groundskeeping. However, given Hemet's substantially improved financial condition, we now consider this issue resolved.

Local High-Risk Dashboard

Hemet has also shown sustained improvement on our local high-risk dashboard, as Table 2 shows. Hemet's overall risk ranking improved from 39th highest risk among all cities in the State in fiscal year 2016–17 to 189th in fiscal year 2020–21. Additionally, financial data from Hemet's fiscal year 2020–21 annual comprehensive financial report shows that its general fund reserve ratio and revenue trends improved when compared to the amounts it reported in fiscal year 2019–20. Hemet's pension cost indicators did not change significantly, although the city took action to address its net pension liability in fiscal year 2021–22 by creating a trust to offset these liabilities, as we previously discuss. Moreover, Hemet improved its OPEB cost indicators.

Table 2
Hemet Has Shown Sustained Improvement in Many Local High-Risk Dashboard Indicators

CATEGORY (MAXIMUM POSSIBLE POINTS)	2016-17	2017-18	2018-19	2019-20	2020-21	IMPROVEMENT (FISCAL YEARS 2016-17 TO 2020-21)
General Fund Reserves (30)	7.90	6.00	6.60	19.74	29.21	21.31*
Debt Burden (15)	15.00	15.00	15.00	15.00	15.00	0.00
Liquidity (10)	10.00	10.00	10.00	10.00	10.00	0.00
Revenue Trends (5)	3.25	4.63	4.88	3.00	3.63	0.38†
Pension Obligations (10)	1.20	1.92	2.80	3.36	2.80	1.60
Pension Funding (5)	3.35	3.40	3.40	3.35	3.95	0.60
Pension Costs (5)	1.67	1.94	1.67	1.94	1.67	0.00
Future Pension Costs (5)	0.00	0.00	0.00	0.56	0.00	0.00
OPEB Obligations (10)	5.36	7.12	7.28	7.92	7.76	2.40
OPEB Funding (5)	0.05	0.10	0.15	0.15	0.20	0.15
Total Score	47.78	50.11	51.78	65.02	74.22	26.44

Note: The highlighting above matches the dashboard’s methodology for high risk (red), moderate risk (yellow), and low risk (green) for each category. For further information on the methodology used for this year’s calculation, see our website at https://auditor.ca.gov/local_high_risk/process_methodology.

Explanations for significant variances:

* Hemet has significantly increased its general fund reserves by managing its spending and conservatively estimating its revenue. In recent years, its revenue has exceeded estimates, resulting in a substantial fund balance.

† The revenue trends indicator is based on average annual change in general fund revenue over three years. Fiscal year 2017-18 was the first full year during which Hemet received revenue through a new sales tax measure, which is why the city scored well in fiscal years 2017-18 and 2018-19.

This assessment was conducted in accordance with California Code of Regulations, title 2, section 61140. In compliance with that section, we have informed the Joint Legislative Audit Committee and the city of Hemet of our conclusion that we no longer consider Hemet to be high risk.

Respectfully submitted,



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Acting California State Auditor

For questions regarding the contents of this report, please contact our Public Affairs Office at 916.445.0255.