

CITY OF SALEM, MASSACHUSETTS

MANAGEMENT LETTER

JUNE 30, 2005



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To the Honorable Mayor
and Members of the City Council
City of Salem, Massachusetts

In planning and performing our audit of the basic financial statements of the City of Salem, Massachusetts, for the fiscal year ended June 30, 2005, we considered the City's internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the City's basic financial statements and not to provide assurance on internal control.

However, we became aware of several matters that are opportunities for strengthening internal controls and operating efficiency. The memorandum that accompanies this letter summarizes our comments and recommendations concerning those matters.

This letter does not affect our report dated October 6, 2005, on the basic financial statements of the City of Salem, Massachusetts.

The accompanying comments and recommendations are intended solely for the information and use of management of the City of Salem, Massachusetts, and are not intended to be and should not be used by anyone other than these specified parties.

We will review the status of these comments during our next engagement. We have already discussed these comments and recommendations with various City personnel, and we will be pleased to discuss them further at your convenience, to perform any additional studies of these matters, or to assist you in implementing the recommendations.

October 6, 2005

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Comments and Recommendations

Financial Condition

Comment

The City's financial condition has significantly deteriorated over the last several years. If this condition is not reversed the City's ability to provide essential core services will be adversely effected.

At June 30, 2005 the City only had \$335,000 in undesignated fund balance in the general fund. Over the past several years, the City has experienced a general fund budgetary loss of approximately \$1 million per year. These actual losses would have been greater if not for transfers in from other available sources such as special revenue fund accounts reserved for appropriation and the stabilization fund. During fiscal year 2006, approximately \$6 million in these, and other non-recurring revenue sources were used to balance the general fund operating budget. Based on the review of the FY2006 tax recapitulation report, the City's reserves and additional resources have been essentially depleted. Considering these facts and the taxing limitations of proposition 2 ½, the City has had and currently is left with a structural operating deficit going forward.

A structural deficit is when a fund's normal recurring revenues are not sufficient to cover the normal recurring expenditures. The use of reserves to balance a budget should be limited to funding capital expenditures, unexpected events such as a significant drop in revenue or an emergency expenditure of funds.

The demands to balance the FY2005 and FY2006 budgets have led to aggressive revenue projections which may be difficult to meet. Revenue shortfalls reduce fund balance and free cash which undermines the City's financial position.

During the same time period as the decline in the general fund, the health insurance internal service fund experienced a similar decline. At the end of FY2004 the fund deficit was (\$1.6 million) and increased to (\$3.0 million) at the end of FY2005. This deficit, for all essential purposes, is a hidden general fund deficit. A transfer of \$2.1 million from free cash was required to fund a portion of the deficit and the remaining (\$900,000) deficit must be funded starting in FY2007. It is anticipated that FY2006 will experience another deficit ranging from (\$1 - \$2 million).

The short-term effect of this problem is highlighted by the fact that insufficient cash flows have required the City to borrow in anticipation of tax revenues during fiscal year 2006 for the first time in several years.

We feel that the full impact of these financial issues could have a devastating effect on the City in FY2007 unless structural changes are made to increase revenues or decrease expenditures.

Recommendation

The City can address the current financial situation by (1) monitoring the fiscal year 2006 budgetary results on an ongoing basis and making adjustments, as necessary, to decrease expenditures if revenues fail to meet projections and to ensure that expenditures do not exceed appropriations except as allowed by law and as absolutely necessary, (2) by preparing future budgets using reasonable expenditure projections which can be funded by conservative, recurring revenue streams, (3) consider permanently reducing staffing levels and other discretionary expenditures, and (4) consider implementing a revenue enhancement program for either increased charges or new fees.

The negative impact of the health insurance internal service fund must be addressed and its structural deficit must be resolved.

Some of the areas that the City should look to increase budgetary revenues in the near-term would be in the

collection of outstanding receivables. Although the City has been actively pursuing the outstanding tax title properties, we noted several outstanding balances that, if acted upon and collected, could improve cash flows and help the City to meet or exceed revenue projections.

To help secure the City's financial future and prevent similar situations, the City can implement fund balance and reserve policies. A fiscal policy should include a plan to rebuild the City's stabilization fund and to rebuild and maintain the unreserved fund balance of the general fund. It should stipulate when reserves can be used, and a range of the minimum and the target level that fund balance will be maintained at. Moody's Investors Services recommends undesignated reserves of one to two months of operating expenses or between 5% and 10% of annual revenues. The City should also adopt policies related to cash balances to eliminate the future need to borrow for cash flow shortfalls.

Health Claims Internal Service Fund Deficit

Comment

As noted in the comment above, the health claims internal service fund has been experiencing significant declines in its fund balance for the past several years. At the end of FY2004 there was a cash deficit of (\$824,000) that should have been raised in FY2005 but was not. There was also a deficit created by what is known as the Incurred But Not Reported (IBNR) liability of (\$800,000). Since this deficit was not addressed, the total FY2004 deficit of (\$1.6 million) was carried over to FY2005. The cash deficit increased by (\$1.3 million) in FY2005 to a level of (\$2.1 million) and the IBNR deficit was (\$900,000).

Based on the legislation described below, the City was required to transfer \$2.1 million from the general fund to the health claims fund in order for the FY2006 tax rate to be set. The (\$900,000) IBNR deficit is now required to be funded and raised at a minimum of \$300,000 increments in FY2007, FY2008 and FY2009.

It is anticipated that a new cash deficit between \$1 and \$2 million will occur in FY2006, along with an increase in the IBNR deficit. Based on the current budget we would not expect the City to have positive free cash or any stabilization funds to draw on to fund this deficit. The City could well expect to raise from taxes at least \$2.0 million to fund this deficit in FY2007.

The cause of these deficits is the City not adjusting the employer and employee contributions to coincide with the ever rising health insurance costs. Again, this is a structural deficit that must be addressed.

The following recent legislation regarding health claims trust funds has added to the seriousness of the City's financial condition:

On August 3, 2005, Chapter 61 of the Acts of 2005 was approved relative to health claims trust funds. The main provisions of this act, which amends Section 3A of Chapter 32B of the General Laws, are as follows:

- An annual audit must be completed, which may be performed as part of the annual audit of the City.
- The basis of accounting must be the accrual basis in conformity with generally accepted accounting principles (GAAP).
- An estimate of the incurred but not reported liability (IBNR) must be included in the basic financial statements.

- The amount of any deficit, if not otherwise provided for, must be raised on the subsequent year's tax rate or provided for in the approved budget.
- For fiscal year 2005 only, a deficit caused by the IBNR can be amortized in equal installments in fiscal years 2007, 2008 and 2009.

Recommendation

The City and its insurance advisors must immediately review the coverage offered to its employees and retirees and determine if there are more cost effective alternatives. As part of this evaluation, the employee/employer contribution percentages should be reviewed and compared to other communities. Since this fund is legislatively required to be accounted for under the full accrual basis of accounting, similar to a business, the City should create a business model for this fund that consistently covers the cost of operations and creates a positive fund balance. A policy should be set that creates a minimum surplus to anticipate the normal fluctuations in a self-insured plan and to cover IBNR liabilities.

Budget Process

Comment

The City's practice for managing the general operating budget has been to budget less than the anticipated amounts required to operate the City and to adjust the budget once the fiscal year is underway as additional revenue sources (i.e. free cash) become available. This catch-up budgeting practice puts undue pressure on management to find additional revenue sources to fund known recurring line item appropriations.

An initial operating budget for the City should include realistic appropriations that can be funded by recurring revenues. Since any budget is a plan based on a set of assumptions that may not always match actual experiences during the fiscal year, the budget should be monitored for significant deviations from anticipated results and adjustments should be made so that the revised budget is consistent with revised expectations.

Recommendation

The City should establish an initial operating budget which encompasses all anticipated operating costs which can be funded with known recurring revenue sources. Adjustments should be made during the fiscal year only in response to unforeseen variances or events and not as a part of the normal operating procedures. Budgeting policies should be adopted that limit the use of non-recurring revenues to finance non-recurring expenditures and not to fund the general operating budget of the City.

Budgeting for Snow and Ice Removal

Comment

The City is allowed, under MGL, Chapter 44, Section 31D, to over-expend the budget for the removal of snow and ice, as long as the appropriation for each fiscal year is at least equal to the prior year's appropriation. Any deficits created from this are raised in the subsequent fiscal year. The City of Salem budgeted \$350,000 for snow and ice removal for fiscal year 2005 and incurred expenditures of \$1,181,208, leaving a deficit of \$831,208 to be raised on the fiscal year 2006 tax rate. The FY2006 budget for snow and ice was \$355,000 and a new line item of \$39,560 for a lease. Less than half way through the fiscal year, the budget was already overspent.

The policy of budgeting the minimum amount for snow and ice removal has become part of the ongoing structural deficit discussed earlier. The City has consistently postponed dealing with current budget problems, pushing them off until the next fiscal year. Although the practice of under-budgeting for snow and ice removal is legal, it does not demonstrate prudent budgeting practices.

Recommendation

The City should establish budget policies to incorporate realistic estimates for the removal of snow and ice in the initial City Budget. The amount budgeted does not have to be the worst case but could be the rolling average of the last three or five years of actual expenses.

The benefit would be to raise sufficient funds to cover the expected current expenditures and thus maintain fiscal stability from year-to-year.

Indirect Cost Allocation

Comment

The current methodology used to charge overhead costs and fringe benefits to enterprise funds are not adequately supported. The overhead and fringe costs used for allocations may not include the proper amounts. The charge is based on estimated expenses and a final analysis of the actual expenses for the year is not reconciled and adjusted.

The general fund provides services and pays for certain fringe benefits for its enterprise operations. It is sound business policy to complete a cost allocation plan to charge the enterprise funds for their share of these costs. If a properly approved and supported cost allocation plan is not used to calculate these charges, then the City is at risk that the general fund and enterprise funds are not being charged their fair share of expenses.

Recommendation

These shared costs should be apportioned by a systematic and rational allocation methodology that is documented in a cost allocation plan and approved each year.

The documentation in the plan should identify all fringe benefits and overhead departments that support each enterprise fund. The plan should document the direct and indirect charges used to calculate the allocable cost of the overhead department. The plan should document the appropriate base to allocate the specific cost. For example, the cost of processing payroll is allocated based on the percentage of the number of employees in a department to total City employees. The plan should identify costs that can use actual direct charges for specific expenses. This can be used for the employer share of health insurance where the specific premiums and employees can be determined. The plan should require a year-end reconciliation of the estimate budgeted allocation to the actual results of operations. A policy should be established to adjust for material variances.

The benefit of implementing these recommendations will be the assurance that the general and enterprise funds are not subsidizing each others operations and that the City has a documented sound policy that can be used to balance future budgets.

Allocation of Sewer Costs to the Water Fund

Comment

The City's water and sewer activities are maintained as individual enterprise funds, where the City charges rates to users to offset the cost of providing the corresponding services. The largest expense for each fund is the annual assessment from the Beverly-Salem Water District charged to the Water Enterprise Fund and the assessment from the South Essex Sewerage District (SESD) charged to the Sewer Enterprise Fund.

Prior to FY1997 the City charged 100% of the respective assessment to each fund and the separate water and sewer rates were calculated to cover the actual costs of operations. Beginning in FY1997 and continuing through FY2006, 11% of the SESD sewer charge was allocated to the Water Fund. Over this period of time \$6,375,990 of sewer assessments were charged to the Water Fund, an average of \$638,000 per year.

The SESD assessment is entirely related to sewer services. The City was unable to provide us with documentation to support this allocation of costs between funds.

The effect of this budgeting practice has overcharged water users and undercharged sewer users without apparent cause.

Recommendation

The City should document the rationale for charging sewer assessments to the water fund. If the charge is arbitrary, then it should be discontinued immediately. The City should evaluate the impact of past practices and determine if an adjustment is appropriate.

Revenue Enhancements

Comment

One of the possible solutions to the City's structural deficit is to increase revenues. Revenue enhancement can come in the form of increased collections of amounts already due, new fees, new grants and contributions, increased rates for fees and licenses, payment in lieu of tax agreements, internal control changes to current operations and other initiatives. We are not aware of a City policy that requires the periodic review of collection procedures, timing of requests for reimbursements, rate structure for fees, loss of potential revenues due to policy or controls, or new revenues.

We noted that the unpaid tax lien account at June 30, 2005 was \$1,735,000, of which only five taxpayers accounted for \$1,450,000 (84%). It should be noted that the original tax bill was only \$1,113,000 and the total was increased for interest and fees by \$622,000, or 66% of the original amount due. In some instances, the total due is more than twice the original amount. Dedicating additional resources to the collection process can produce immediate positive results.

We noted that the City has recently renovated its parking facilities. However, we are not aware if the City has implemented policies and procedures to recover these costs either through increased hourly rates, increased permit rates, hours of operations, automated collection procedures, or changes in internal controls. This significant revenue source potentially could generate additional revenues.

Many communities across the state have implemented trash fees to recover a portion or all of the costs associated this service. Again, the City may want to evaluate the feasibility of new fees.

Recommendation

Our recommendation for revenue enhancement is meant to suggest that the City may benefit through the evaluation of potential new or increased revenue sources and an expedited collection processes as a means for addressing the City's financial shortfalls. It is not intended to imply that the City must raise fees or create new fees.

Recording Revenue on the Budgetary Basis of Accounting

Comment

The Department of Revenue requires accounts receivable to be deferred at year end except for real and personal property taxes collected within 60 days of year-end and certain revenues specifically identified by them in a year-end closing memo. We noted several receivable balances that were not deferred on the City's general ledger at year end. For example, the state's Medicaid reimbursement estimate of approximately \$432,000 was recorded as revenue on the general ledger as an adjustment on June 30th. This practice results in an overstated budgetary fund balance and could lead to errors when free cash is certified.

Recommendation

The City should fully defer all receivables on the general ledger until the funds have been received.

Compensated Absences

Comment

The City maintains separate systems to monitor available sick and vacation balances for police, fire, school, and other city employees. The School Department utilizes a manual system to monitor these balances. None of these systems currently allow for an automated and perpetual balance of the City's liability for compensated absences at any point in time. The current process for determining the City's liability at year-end for financial reporting purposes is time consuming and inefficient. The systems do not provide the City with a tool for managing the accumulated liability, which at fiscal year-end, is estimated to be approximately \$7 million.

The City's payroll system has a function for tracking sick, vacation and compensatory time that is not utilized. The automation and centralization of this process would strengthen controls to ensure that compensated absences practices, within all departments, are in compliance with union contracts and it would provide management with a tool for monitoring and managing the City's growing liability in this area.

This growing liability is the result of contracts and policies which allow employees to carry-over unused sick, vacation and compensatory time and to be paid for that time upon the termination of their employment with the City. Allowing such liabilities to continue to accumulate puts the City at risk of having to pay on the liabilities at a time when available budgets have already been stretched, further impairing the City's financial condition.

Each year employees leave or retire and the accumulated liability must be paid out of current budgeted funds. In order to manage the budget, and eliminate another area that can add to the structural deficit, it would be useful if the finance director and department heads could access information on employees who are likely to retire based on years of service and age. With the associated accumulation of the liability the City could ensure that all departments include these added expenses within their budget projections.

Recommendation

There is increased accountability along with better management information and improved employee reporting if the City's liability for compensated absences is monitored through the payroll system. The City should consider using the payroll function to control this information.

We also recommend the City consider the existing policies related to the accumulation of compensated absences as a means of managing its future budgets and potential liabilities.

Require Employees to Take Vacations

Comment

City employees are not required to take an annual, uninterrupted, one-week or longer vacations. Requiring annual vacations is an important internal control function designed to help an employer to detect errors, inefficiencies, and irregularities; to provide management with a means of cross-training employees; and to help prevent employee burnout and the resulting inefficiencies. Additionally, it is important to require another person to perform the absent employee's duties while he or she is on vacation.

Recommendation

We recommend that the City consider implementing a policy requiring all employees to take an annual, uninterrupted vacation and that the policy be enforced.

Statement No. 45 of the Governmental Accounting Standards Board

Comment

In July of 2004, the Governmental Accounting Standards Board (the GASB) issued Statement No. 45 Accounting and Financial Reporting for Postemployment Benefits Other than Pensions. This Statement improves the relevance and usefulness of financial reporting by (a) requiring a systematic, accrual-basis measurement and recognition of other postemployment benefits (OPEB) cost over a period that approximates employees' years of service and (b) providing information about actuarial accrued liabilities associated with OPEB and whether and to what extent progress is being made in funding the plan.

For financial reporting purposes, an actuarial valuation is required at least biennially for OPEB plans with a total membership (including employees in active service, terminated employees who have accumulated benefits but are not yet receiving them, and retired employees and beneficiaries currently receiving benefits) of 200 or more, or at least triennially for plans with a total membership of fewer than 200. The projection of benefits should include all benefits covered by the current substantive plan (the plan as understood by the employer and plan members) at the time of each valuation and should take into consideration the pattern of sharing of benefit costs between the employer and plan members to that point, as well as certain legal or contractual caps on benefits to be provided. The parameters require that the selection of actuarial assumptions, including the healthcare cost trend rate for postemployment healthcare plans, be guided by applicable actuarial standards. Failure to obtain an actuarial valuation will result in a qualification to the independent auditors' opinion on the basic financial statements.

Net OPEB obligations, if any, including amounts associated with under or over contributions from governmental

funds, should be displayed as liabilities (or assets) in government-wide financial statements. Similarly, net OPEB obligations associated with proprietary or fiduciary funds from which contributions are made should be displayed as liabilities (or assets) in the financial statements of those funds.

An employer's net OPEB obligation is defined as the cumulative difference between annual OPEB cost and the employer's contributions to a plan, including the OPEB liability or asset at transition, if any. (Because retroactive application of the measurement requirements of this Statement is not required, for most employers the OPEB liability at the beginning of the transition year will be zero.) An employer with a net OPEB obligation is required to measure annual OPEB cost equal to (a) the annual required contribution (ARC), (b) one year's interest on the net OPEB obligation, and (c) an adjustment to the ARC to offset the effect of actuarial amortization of past under or over contributions.

This Statement generally provides for prospective implementation. This means that employers set the beginning net OPEB obligation at zero as of the beginning of the initial year. The City is required to implement this statement in fiscal 2008 although earlier implementation is encouraged.

Recommendation

We recommend that management take a proactive approach to the planning and implementation of GASB Statement No.45. The most important consideration in the planning process is obtaining an actuarial valuation.

Timeliness of CDBG Drawdowns

Comment

The City operates a Community Development Block Grant (CDBG) from the U.S Department of Housing and Urban Development (HUD). The City's policy is to request grant funding from HUD on a weekly basis sufficient to cover expenditures made from the grant for that same week. Due to a staffing shortage in the Planning Department, the City was unable to request funds from HUD in a timely manner at various times throughout the fiscal year. This resulted in the CDBG fund operating in a significant cash deficit, which was subsidized by the City's general fund operating cash. Therefore, the City's general operating fund has less cash available to meet ongoing needs and the City is earning less investment income to support the City's operating budget.

Recommendation

We recommend that the City's Planning Department take steps to ensure that CDBG funds are requested on a timely basis.

Fixed Asset Maintenance

Comment

The implementation of GASB #34 required the City to compile a historical cost inventory of all major capital assets. Since the initial compilation and analysis of the City's fixed asset listing, no formal policies and procedures have been established concerning the maintenance of the City's current database or to account for the acquisition and disposal of capital assets. In order to continue to meet the reporting requirements, the City will need to maintain a fixed asset sub-system to track all additions, disposals and depreciation of capital assets on an ongoing basis.

The City has elected to postpone the accumulation of its infrastructure assets as allowed by GASB #34. The City must record these assets for FY2006 to be in compliance with GAAP.

Recommendation

We recommend that the City implement policies and procedures to insure the proper accounting for capital assets and that the City maintain a fixed asset management sub-system to account for all capital assets and to ensure proper financial reporting.

City Council Meeting Minutes

Comment

The City was unable to produce approved, transcribed City Council meeting minutes for the period of July through December of 2004 and July through October of 2005. Upon request, we were provided with photocopies of notes from the time period specified. The Commonwealth of Massachusetts Public Records Law G.L.c.66 § 3-9, requires that a governmental body eventually put its minutes into a written form. Without establishing a strict policy regarding the timeliness of the preparation of "official" minutes, the Attorney General's Office has stated that a time frame of two to four weeks may be considered reasonable under most circumstances. City Council meeting minutes are important public documents that create a historical record of the events occurring at each meeting and the significant delay in preparing and approving these minutes increases the possibility that important details from any particular meeting could be lost or misinterpreted.

Recommendation

We recommend that the City implement procedures to ensure that City Council meeting minutes are transcribed and approved in a timely fashion.

Maintenance of Loan Balances on the General Ledger

Comment

The City has issued various economic development loans in conjunction with its Community Development Block Grant (CDBG). The loans are serviced by local banks and all records pertaining to loan activity are currently maintained in the Planning Department. The City maintains a balance for the principal portion of outstanding loans on the general ledger. However, the Finance Office is not provided with sufficient information to accurately account for new loans, uncollectible loans, and principal payments on current loans outstanding. As a result the City's outstanding loan balance was incorrectly stated at June 30, 2005.

Recommendation

We recommend that the City implement procedures to report all loan activity to the Finance Office to provide additional internal controls over the City's assets and to ensure accurate financial reporting. To achieve this, the principal payments on loans should be reported to the Finance Office independently when receipts are turned over to the City Treasurer, new loans issued and old loans considered uncollectible should be reported to the Finance Office as they occur, and the outstanding loan balance on the general ledger should be reconciled to the detailed information in the Planning Department on a monthly basis.

Reconciliation of Trust Fund Investments

Comment

The City's Board of Trust Fund Commissioners oversees a substantial portfolio of investments related to the City's trust funds. The City is periodically provided with a spreadsheet prepared by the Board's investment advisor that details the activity of the individual trusts that make up the investment pool and the City uses this spreadsheet to record the cumulative activity of the trusts to the general ledger. However, the City is not provided with an investment statement from the bank detailing the fair market value of the pool's individual investments to support the total amount of cash and investments reported on the spreadsheet. The reconciliation of the investment spreadsheet prepared by the advisor to the actual cash or investments supporting those balances is an important internal control over significant City assets. The lack of reconciliation procedures increases the possibility that errors or irregularities could occur.

Recommendation

We recommend that the Board of Trust Fund Commissioners complete a quarterly reconciliation of the amounts and activity reported on the investment advisor's spreadsheet to the investment statement received from the bank. This reconciliation should then be forwarded to the City's Finance Office and the activity should be reported on the City's general ledger and the balances should be reconciled to the supporting documentation.

School Lunch Deficit

Comment

The City's School Lunch Program was in deficit at June 30, 2005. This deficit is required to be funded through available funds or taxation in fiscal year 2006. School lunch deficits typically occur when the fees charged for the services provided are insufficient to cover the costs of operating the program.

Recommendation

In view of the City's current financial situation and the potential impact of future deficits in this fund, we believe that management could benefit by preparing a budget for the school lunch program and by comparing projected and actual results of operations throughout the year. This would allow management to better plan for potential shortfalls and to take action, as necessary, to reduce the future impact on the City's general fund. We further recommend that the budget be prepared with the input of the individuals who will be responsible for meeting budgetary goals. The cause of significant variations from the budget should be determined and documented to be used as a management tool so that corrective action can be taken if necessary in a timely fashion.

Personal Use of City Vehicles

Comment

The City does not report, as employee compensation, the value of the personal use of City owned vehicles for those employees that utilize a City vehicle to commute to and from work. Internal Revenue Service (IRS) regulations require that the value of noncash fringe benefits be reported as income to the recipient. Thus the commuting value of a vehicle owned or leased by a public entity usually represents taxable income to the employee.

Recommendation

We recommend that the City review the IRS guidelines relating to employees' personal use of City owned vehicles and establish policies and procedures to ensure compliance with all applicable laws and regulations.