City of Alexandria, Virginia

MEMORANDUM

DATE: MARCH 31, 2009

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: JAMES K. HARTMANN, CITY MANAGER

SUBJECT: BUDGET MEMO # 65 : REVIEW OF FUND BALANCE POLICIES

This memorandum is in response to the following question asked by Councilman Krupicka: "Can staff/BFAAC review our fund balance policies to see if additional actions should be put in place to turn these into a more formal "rainy day" fund."

It is possible to develop more formal guidance for the possible use of fund balances for "unexpected financial problems or emergencies." These policies, if adopted, would extend beyond the simple minimum and desired ratios described in the existing debt-related financial policies adopted by City Council and the procedural requirement that any appropriations from the undesignated fund balance beyond that proposed in the City Manager's proposed budget requires the affirmative vote of five members of the City Council[1]. Staff suggests that such a review be conducted during the summer and early fall and subsequently be brought back to City Council.

Background:

The City's fund balance policies and practices are an important component of its ability to maintain its triple A bond ratings. City Council's debt related financial policies, (originally adopted in June 1987, and subsequently reaffirmed and updated on December 9, 1997, and amended on October 26, 1999 and June 24, 2008) established a lower limit of 4 percent and a target of 5.5 percent for undesignated General Fund balance as a percentage of General Fund revenue, and established a lower limit of 10 percent for unreserved General Fund balance as a percentage of General Fund revenue.[2]

[1] As provided for in a resolution initially adopted by City Council in 1997, and readopted by every Council since then.
[2] The specific targets and limits for fund balance ratios were adopted initially in 1997 and have remained unchanged since then.

Based on projected revenues and expenditures and designations in fiscal year 2009, the undesignated General Fund balance at June 30, 2009 is currently estimated to be $26.8 million or 5.0 percent of projected FY 2009 General Fund revenues; and the unreserved General Fund balance is estimated to be $45.4 million or 8.5 percent of projected General Fund revenues. The undesignated General Fund balance ratio is in accord with the minimum limits established by the debt policy guidelines. The unreserved General Fund balance is below the 10% minimum established by the City's debt policy guidelines. This is caused in large part by the spend-down of $7.4 million in prior year surpluses for one-time expenditures such as cash capital contributions, and a $4.2 million initial down payment to the new post-retirement benefits trust fund (OPEB). The FY 2009 budget will also draw on $4.6 million in prior year surpluses, but this will be followed (based on the FY 2010 proposed budget which is subject to change) only by a $1.3 million draw on fund balance in FY 2010. Staff believes that going below this ratio, while of long-term concern, is an appropriate financial management response to the current recession caused revenue shortfall, and will not put the City's triple A bond ratings at risk given the City's overall financial health, the strength of our undesignated fund balance ratio, and overall economic conditions. However, the unreserved fund balance needs to be increased above the 10% minimum.

The Fund Balance section of the FY 2010 Proposed Operating Budget (pp. 9-1 to 9-14) contains information on the General Fund Balances as of the end of FY 2008 and the estimated fund balances as of the end of FY 2009 as well as information on the fund balances in the Special Revenue Fund, the Capital Projects Fund, the Sanitary Sewer Fund and the Internal Services (Equipment Replacement) Fund. This section also contains the "Layperson's Guide to Fund Balance", a document based on BFAAC report issued December 9, 1997. Excerpts from that "Guide" are found in an attachment to this budget memorandum.

<u>Analysis:</u>

As noted in the debt policy guidelines reprinted on pages 23-29 to 23-31 of the FY 2010 Proposed Operating Budget:

> These ratios [as shown above] indicate the ability of the City to cope with unexpected financial problems or emergencies. The Unreserved General Fund Balance represents the funds legally available to the City. It is desirable that the City maintain Unreserved Fund Balance that is comparable to the ratio maintained by other double triple A rated jurisdictions, but not to fall below the limit of 10 percent. The Undesignated General Fund Balance corresponds to the checkbook balance of the City. Both balances are important to consider. The unreserved balance includes designations that the City Council has made but presumably could change.

The extreme financial stress created by the current national, regional and local economic conditions raises an issue of when and how the City should rely on any of its fund balances to help meet pressing operating and capital needs.

It should be noted that City Council's Resolution 2303, adopted on November 27, 2008 and which guided preparation of the FY 2010 budget said in Section 8:

> **Credit Rating:** The City Manager's proposed budget shall not make any material changes that may threaten the City's AAA/aaa bond rating.

Section 9(a) of that Resolution said:

> **Use of Unreserved, Undesignated Fund Balance**: Aside from the use of prior-year surpluses, City Council requests that the City Manager's proposed budget not include the use of unreserved, undesignated fund balance.

Given existing Council policies and specific Council guidance for FY 2010, a more formal "policy" would describe in advance the circumstances in which the drawdown of fund balances should be authorized.

The use of fund balances to meet <u>recurring</u> operating budget needs is generally frowned upon by financial experts and bond rating agencies because it leads to unsustainable levels of spending in the future as the expenses recur but the fund balances are depleted. There are several situations in which the use of fund balances may be appropriate:

1. Generally the use of fund balances for non-recurring expenses, such as capital projects, or planned transitions to other funding sources (such as the City's current plans to fund Other Post Employment Benefits (OPEB)) can be viewed as prudent.
2. The use of small surpluses from the immediate past fiscal year – particularly if a much larger part of the surplus is designated as a reserve for possible one-time expenses or added to the unreserved or undesignated fund balance – is an acceptable practice, especially if the size of such budgeted use of surpluses for recurring operating expenses is held steady or is declining from the previous year.
3. The use of significant fund balances to meet recurring operating expenses should be confined to an unplanned emergency situation – such as a sudden and precipitous and unbudgeted decline in revenue for which no reasonable expenditure reductions or tax rate increases can be planned and implemented in a timely fashion. The City's undesignated/unreserved fund balance is meant for <u>catastrophic</u> events, and not general downturns where there are expenditure reduction or tax increase options. In effect, the City's undesignated fund balance would be used to respond to "hurricanes" and not "rainy days".

4. The use of these fund balances should be a temporary measure and efforts should be made to restore the fund balance ratios to the levels called for in the City's financial policies through future budget surpluses.

Finally, the undesignated/unreserved fund balance also serves as cash flow margin for those months where the City's cumulative fiscal year revenue income for the fiscal year is less than its cumulative fiscal year expenditures. This cash flow issue caused by peaks and valleys of the City's heavy reliance on real estate tax revenues (56% of the General Fund revenues) which are paid twice yearly in November and June. The months prior to November and June (especially June) are very low cash flow balance months in which the cash on hand is lower than the undesignated/reserved targets. This means that if the City did not maintain its reserves, the City would not have sufficient cash to meet its payroll and to pay its bills (absent a cash flow revenue anticipation rate borrowing that would put the AAA/Aaa bond ratings at risk). It is also for this reason that using the undesignated/unreserved fund balance to close a budget gap would not be recommended by staff.

These best practices, or similar statements, could be included in a future revision of the City's financial policies to be studied by City staff and BFAAC over the summer and early fall. A docket item could be scheduled for Council consideration in the late fall.

Excerpts taken from the "Layperson's Guide to Fund Balance" in the FY 2010 Proposed Operating Budget, pp. 9-9 to 9-13

As the Government Financial Officers Association (GFOA) has said in its Elected Official's Guide to Fund Balance:

> In our system of government, crucial decisions involving the lives of citizens are placed in the hands of elected officials. Many of these decisions involve the allocation of scarce financial resources. Arguments for and against proposed allocations of financial resources often focus on "fund balance." Unfortunately, published discussions of fund balance, as a rule, are directed toward the professional accountant rather than toward the elected official or others who may not have background or experience in governmental accounting and financial reporting. Accordingly, elected officials often find themselves in the difficult position of having to weigh arguments involving fund balance with only a vague, or even erroneous understanding of its true nature and significance.

Use and Protection of the Fund Balance Under the City's Fiscal and Debt Related Financial Policies

The fiscal policies of the City of Alexandria and mandatory accounting rules have established a wise and prudent set of checks and balances to help ensure the City's fiscal stability. Neither the City's total fund balance, its unreserved General Fund balance, [n]or its designated fund balance, should be referred to as a "rainy day fund" or seen as a "savings" easily available for meeting emergency needs. As will be explained below, reservations of some portion of the General Fund balance are required by accounting rules that cannot be ignored. Designations of some of the unreserved balances represent decisions of the City Council and Manager that financial resources need to be set aside now to meet future needs. Only the remaining undesignated fund balance is available for meeting other unknown future financial needs. And this undesignated fund balance is not available for expenditure as would be recurring revenues. The City Council has imposed on itself a rule that it cannot appropriate undesignated fund balances beyond that proposed in the City Manager's budget except by an affirmative vote by at least five members of the Council. This appropriately balances the need to make such monies available if truly necessary in the judgment of the elected City leaders, and the need to protect against the temptation to use this balance to meet recurring operating needs when recurring operating revenues are not sufficient.

Indeed, the City Council has stated its policy to "not establish a trend of using General Fund equity to finance current operations." Specifically, its debt related financial policies declare "the City will not finance operations from the General Fund equity balance for periods longer than two years."

It is prudent to maintain some sort of balance. A portion of the balance is required to provide the City with adequate cash flow. For example, the real estate tax, which is the City's largest single revenue source, is collected in November and June, but payroll expenditures occur every two weeks. The City has adopted a debt related financial policy that it will not issue tax or revenue anticipation notes to fund governmental operations, so it must manage its cash flow in a way that provides funds to meet all working capital needs at all times. The balance also helps to protect against unanticipated expenditures or lower than expected revenues.

Reserved General Fund Balance

Sometimes the checkbook balance of the City is limited by commonly used accounting restrictions or other legal restrictions that make certain funds unavailable for future spending by the City. Under current Generally Accepted Accounting Principles (GAAP) for the fund financial statements, the City must reserve funds to equal its inventory of supplies and its encumbrances. The inventory of supplies includes supplies that are to be used within the year. Encumbrances include undelivered orders (contracts under which goods or services have been ordered but not yet delivered and paid for). The accounting rationale for these reserves is that the inventory of supplies, notes receivable and encumbrances are not financial resources available for future spending by the City.

Designated Fund Balance

Current accounting rules for municipal governments also recognize what are termed "designations" of fund balances. Sometimes governments wish to specifically segregate or "earmark" financial resources for specified purposes. Such "earmarking" is reflected in financial statements by means of "designations." For example, a government may wish to "designate" resources to help meet obligations expected to arise in connection with claims and judgments.

Only the chief executive officer or the legislative body of a government may create a designation. Also from GFOA:

It is very important to distinguish between "reserves" (i.e., "reserved fund balance") and "designations." The former are an indication that financial resources are not available for appropriation, whereas the latter only indicate that management would <u>prefer</u> to use available financial resources for a specified purpose. Accordingly, although earmarked, designations remain an integral part of a government's spendable or appropriable resources (i.e., "unreserved fund balance").

The Power to Designate and the Effects of a Designation

Although the City Manager proposes the amounts to be designated for several items as noted above, only the City Council has the power to approve designations of fund balances. Only the City Council can make appropriations from the unreserved fund balance for expenditure. As provided for in a resolution initially adopted by City Council in 1997, and readopted by every Council since then, any appropriations from the undesignated fund balance beyond that proposed in the City Manager's proposed budget requires the affirmative vote of five members of the City Council.

The effect of a designation, therefore, is to remove certain funds from availability for future appropriation outside the purpose of the designation. Council can, by simple majority, approve the City Manager's estimate of a reduction in a designation.

From the fund accounting perspective described above, this undesignated General Fund balance is the equivalent of the checkbook balance of the City of Alexandria. The required reservations and designations made as policy choices by the City Council and generally recommended by the City Manager are analogous in the checkbook example to checks written and presented for payment but not yet cleared through the bank. It is entirely reasonable for the City Council and the City Manager to debate how much should be set aside in designations as described above. These decisions are the equivalent of making real spending decisions in the annual budget, even if cash is not immediately exchanged for goods or services.