CITY OF STANWOOD
CITY COUNCIL
AGENDA STAFF REPORT

SUBJECT: Proposed Financial and Investment Policies – Part B	**FOR AGENDA OF: April 25, 2013 – Finance Committee** **DEPARTMENT OF ORIGIN: Finance**
ATTACHMENT(S): **None**	**DATE SUBMITTED: April 11, 2013** **CLEARANCES: (check box)** ☐ **City Attorney** ____________ ☐**City Clerk/HR** ____________ ☐**Community Development** ____________ ☐**Fire** ____________ ☐**Finance** ____________ ☐**Police** ___________ ☐ **Public Works** ____________ **APPROVED FOR SUBMITTAL BY THE CITY ADMINISTRATOR:____________**
COST OF PROPOSAL: N/A	**AMOUNT BUDGETED: N/A**

SUMMARY STATEMENT

At the January 31, 2013 council workshop, council and staff discussed current, adopted city financial policies, and the opportunity to expand them into a more comprehensive set of policies that will foster good financial decisions and improve the city's fiscal stability in the short and long term.

As a result of that discussion, council directed the finance committee to discuss and recommend specific financial goals and policies, which would then be presented to the council for consideration and adoption.

DISCUSSION

There are many components to a comprehensive set of financial policies. Listed below are some of the broad goals and topics that the committee may wish to address:

1. General Financial Goals
2. Operating Budget Policies
3. Revenue Policies

4. Expenditure Policies
5. Capital Investment Budget Policies
6. Short-Term Debt Policies
7. Long-Term Debt Policies
8. Reserve Fund Policies
9. Investment Policies
10. Special Revenue Policies
11. Accounting, Auditing, and Financial Reporting Policies
12. Budget Calendar
13. Others (this list is not all-inclusive; finance committee may wish to add or subtract from this list as it sees fit)

It has been said that "the best way to eat an elephant is one bite at a time." This concept applies to comprehensive financial policies as well. So as to not overwhelm the committee and council with all of the components at once, the categories have been broken up into smaller parts to be considered and discussed by the Finance Committee as follows:

Covered to date:

1. General Financial Goals
2. Operating Budget Policies
3. Revenue Policies

To be covered at the April 25, 2013 Finance Committee meeting:

4. Expenditure Policies
5. Capital Investment Budget Policies
6. Short –Term Debt Policies
7. Long-Term Debt Policies
8. Reserve Fund Policies

To be covered at future Finance Committee meetings:

9. Investment Policies
10. Special Revenue Policies
11. Accounting, Auditing, and Financial Reporting Policies
12. Budget Calendar
13. Others

The finance committee would make a recommendation to council for consideration and adoption before moving down the list. The ultimate goal of the finance committee over the next few months would be to consider all the topics above, adding or subtracting from the list as necessary, and to make recommendations to council for adoption in about four or five "bites."

FINANCIAL IMPACT

A comprehensive set of financial policies will foster good financial decisions, improve financial operations (i.e. the “bottom line”), and as a result, enhance the city’s fiscal stability in the short and long term.

DISCUSSION

A municipal budget is comprised of a set of underlying assumptions about community goals and priorities, and the resources needed to achieve those goals.

It typically takes three to five years to implement a work plan to achieve a specific desired outcome such as building new roads, improving maintenance, and meeting customer service expectations.

Financial policies are the framework which supports moving the community in a particular direction. Key components include:

- Clear direction on council priorities
- Stable revenues
- Staffing levels to implement priority programs
- Adequate facilities and equipment
- Sufficient reserves to take advantage of opportunities and address emergencies
- Careful use of financial leveraging (debt to revenue ratios) to meet long-range priorities

Recommendation:

The finance subcommittee should carefully consider the proposed financial policies to ensure they provide the right framework to achieve the city council’s and the community’s long-range goals.

The city has limited financial resources. Dividing up the funding among facility maintenance, equipment replacement, staffing, and capital improvements is one of the council’s primary functions. The financial policies will guide, or constrain, future council actions and the community toward a particular outcome.

This is the context to share your thoughts on where the city is now, where you want it to be in the future, and the financial policies we need to make the future you want a reality for Stanwood.

CURRENT FINANCIAL GOALS FOR CONSIDERATION

1. General Financial Goals

a. To provide a financial base sufficient to sustain municipal services, the social well being of city residents and businesses, and the physical infrastructure of the city.

b. To be able to withstand local and regional economic cycles, to adjust to changes in the service requirements, and to respond to other changes as they affect the community.

c. To maintain an excellent credit rating in the financial community and assure taxpayers that Stanwood city government is maintained in sound fiscal condition.

Policy Question:

1. ***Are there other general financial goals important to the council?***

2. Operating Budget Policies

a. The base operating budget is the city's comprehensive annual financial plan which provides for the desired level of city services as defined by the city's priorities. A budget will be developed every year based on council priorities.

Policy Questions:

1. ***Does the council want to consider changing from an annual to a biennial (i.e. every two years) budget process?***

2. ***What are the advantages and disadvantages of a biennial budget?***

b. The goals of the budgeting by priorities process are:

- Align the budget with long-range goals and objectives
- Measure progress towards priorities
- Get the best value for each tax dollar
- Foster continuous learning in the city
- Build regional cooperation

c. “One-time” expenses require specific authority to be carried forward into subsequent budgets.

d. Revenues and expenditures for the general fund and all operating funds shall be projected for the ensuing year.

e. Annual operating budgets should provide for design, construction, maintenance and replacement of the city’s capital, plant, and equipment consistent with the capital facilities plan including the related cost for operating such new facilities.

f. The city will maintain all its assets at a level such that it protects the city's capital investment and minimizes future maintenance and replacement costs.

Policy Questions:

1. ***Where does maintenance fall in council priority?***

2. ***In government, maintenance is oftentimes deferred until failure. How should this be addressed?***

g. The city will develop a six-year projection of equipment replacement and maintenance needs, and will update this projection every budget cycle consistent with budget development.

Policy Question:

1. ***Should the city adopt a “pay-as-you-go” policy to replace equipment as needed, or long-range planning with scheduled replacement?***

h. All general government current operating expenditures will be paid from current revenues and cash carried over from the prior biennium.

Reports on revenues and expenditures will be prepared monthly and reviewed quarterly by the city council during the year.

The city will avoid budgetary and accounting procedures which balance the current budget at the expense of future budgets.

Policy Questions:

1. ***Would the policy still allow balancing the street fund budget with REET funds, as has been done in recent years, or a similar “short-term fix”.***

2. ***If so, for how long?***

3. ***What would be the procedure for weaning the city off a “short-term fix”?***

The City of Stanwood defines a balanced budget as current fund revenues (including beginning net cash and investments) are equal to or greater than current budgeted expenditures (including ending net cash and investments).

Policy Question:

1. ***Under what circumstances is it acceptable to build up a fund's cash reserves?***

2. ***Under what circumstances is it acceptable to draw down a fund's cash reserves?***

3. ***This will be discussed in more detail when we address cash reserve policy, but it affects the city's definition of "balanced budget".***

The city will attempt to utilize beginning balances and other one-time revenues only for onetime/non-recurring expenditures.

i. All supplemental appropriations for programs (appropriations requested after the original budget is adopted) will be considered as a result of <u>the availability of new revenues</u> (such as unanticipated grants).

Policy Questions:

1. ***Does the council want to limit consideration of new programs to new revenues?***

2. ***Are there other, new priorities, such as economic development or equipment replacement the council would consider funding by changing priorities or untapped reserves in the middle of a budget cycle?***

j. Use project/task revenues to support related expenditures (e.g. park and building permit fees).

All supplemental appropriations will conform to the "budgeting by council priorities" process.

3. Revenue Policies

a. The city will strive to maintain as diversified and stable a revenue system as permitted by state law to shelter it from short-run fluctuations in any one revenue source. The revenue mix should combine stable revenue sources and volatile revenue sources to minimize the effect of an economic downturn. In the general fund, examples of stable revenue sources include property taxes (in normal economic times), and utility taxes, while examples of volatile revenue sources include sales taxes and building/permit fees.

b. Because revenues, especially those of the general fund, are sensitive to both local and regional economic activities, revenue estimates provided to the city council shall be conservative.

c. The city will estimate its annual revenues by an objective, analytical process using best practices as defined by the Government Finance Officers Association.

BEST PRACTICE

Financial Forecasting in the Budget Preparation Process (1999)

Background. The National Advisory Council on State and Local Budgeting (NACSLB) has endorsed the forecasting of revenues and the forecasting of expenditures in their Recommended Budget Practices. The Government Finance Officers Association (GFOA) recognizes the importance of combining the forecasting of revenues and the forecasting of expenditures into a single financial forecast. A government should have a financial planning process that assesses long-term financial implications of current and proposed policies, programs, and assumptions that develop appropriate strategies to achieve its goals. A key component in determining future options, potential problems, and opportunities is the forecast of revenues and expenditures.
Revenue and expenditure forecasting does the following:

- Provides an understanding of available funding;
- Evaluates financial risk;
- Assesses the likelihood that services can be sustained;
- Assesses the level at which capital investment can be made;
- Identifies future commitments and resource demands; and
- Identifies the key variables that cause change in the level of revenue.

Recommendation. The GFOA recommends that governments at all levels forecast major revenues and expenditures. The forecast should extend at least three to five years beyond the budget period and should be regularly monitored and periodically updated. The forecast, along with its underlying assumptions and methodology, should be clearly stated and made available to participants in the budget process. It also should be referenced in the final budget document. To improve future forecasting, the variances between previous forecast and actual amounts should be analyzed. The variance analysis should identify the factors that influence revenue collections, expenditure levels, and forecast assumptions.

d. The city will project revenues for the next six years and will update this projection annually. The finance department will annually review and make available to the finance committee an analysis of each potential major revenue source before going to the full council for review.

Policy Question:

1. ***Forecasts are generally less accurate as the forecast horizon extends beyond two years. However, there is a benefit to understanding long-range trends. Is six years a reasonable projection period for city revenues?***

e. The city will establish all user charges at a level related to the cost of providing the service and within policy parameters established by the city council.

Policy Questions:
In government, fees rarely cover the total cost of service for general fund expenses. Most cities use property taxes and utility taxes to supplement fees.

1. ***What about park fees? They are not related to the cost of providing service.***

2. ***What about development fees?***

3. ***Fees are often set based on public/political input. Should this be recognized and addressed in policy?***

f. In each odd numbered year, the city will review user fees to adjust for the effects of inflation and other factors as appropriate. The city will set fees for user activities, such as recreational services, <u>at a level to support the direct and indirect costs</u> of the activity in accordance with cost recovery policies adopted by council.

Policy Questions:

1. ***How often should fees be reviewed and updated? Annual? Biennial?***

2. ***Full cost recovery or partial?***

3. ***Fixed or variable costs?***

g. The city will set fees and user charges for each enterprise fund, such as water, sanitary sewer and storm drainage, at a level that fully supports the total direct and indirect cost of the activity including the cost of annual depreciation of capital assets. Additionally, for analysis and rate modeling purposes, the proposed rates shall also take into account debt service coverage commitments made by the city of 1.25 times annual debt service.

Policy Questions:

1. ***When a municipality issues revenue bonds (and other types of debt instruments), it agrees to certain terms and conditions related to repayment of those bonds. One of those terms is referred to as bond coverage. Simply put, the agency agrees to collect enough in annual system revenues to meet all operating expenses and not only pay debt service, but actually collect an additional multiple of that debt service. Bond coverage ratios typically range from 1.10 to 1.50, meaning that the agency would collect expenses plus 1.10 to 1.50 times revenue bond service as a minimum legal level of revenues. The stated coverage is a minimum requirement – meaning anything less than this***

level would be a technical default of the bond covenant. The annual debt service factor used by FCS in their most recent rate study was 1.25. Does the city want to consider another factor?

4. Expenditure Policies

a. The city budget will provide for a sustainable level of service as defined in the context of the budget process.

b. The city's operating budget will not use one-time revenues to support ongoing expenditures. An example would be to hire full-time staff in response to a surge in sales tax or building/permit fees. Eventually such revenues will fall back to normal levels, while the city maintains a higher staff level that is no longer funded.

c. The city will maintain expenditure categories according to state statute and administrative regulation. Capitalization standards shall be in accordance with GFOA best practices, a policy for "small and attractive" assets (i.e. assets below the capitalization threshold that must be inventoried and tracked due to their susceptibility to theft or conversion to personal use) as required by the State Auditor.

Policy Questions:

1. ***Is the current capitalization threshold (i.e. the amount above which a purchase is considered a capital expense) of $500 too low? GFOA recommends $5,000 (see below).***

2. ***Update procedures for taking annual, physical inventory count?***

3. ***Is our current definition of a "small and attractive" assets still appropriate? Current policy defines as "equipment that is determined to be at-risk and valued below the capital asset threshold of $500. Attractive assets may include such items as: electronic devices, including cellular phones, computers, computer peripherals, like PDA's. Attractive assets are not to include items that are equipment for the purpose of accomplishing tasks that are small in nature or minimal monetary value, such as shovels, wrenches, staplers and the like."***

4. ***Is our current threshold for small and attractive assets (items less than $500 – no minimum) still appropriate?***

5. ***If the city increased the capitalization threshold, would it then be appropriate to establish a minimum threshold for small and attractive of $750 or $1,000? How does the city weigh the risk of asset loss vs. the cost of maintaining a large inventory list?***

BEST PRACTICE

Establishing Appropriate Capitalization Thresholds for Capital Assets (1997, 2001, and 2006) (CAAFR)

Background. The term *capital assets* is used to describe assets that are used in operations and that have initial lives extending beyond a single reporting period. Capital assets may be either intangible (e.g., easements, water (rights) or tangible (e.g., land, buildings, building improvements, vehicles, machinery, equipment and infrastructure). It is incumbent upon public-sector managers to maintain adequate control over all of a government's resources, including capital assets, to minimize the risk of loss or misuse.

As a practical application of the materiality principle, not all tangible capital-type items with useful lives extending beyond a single reporting period are required to be reported in a government's statement of position. Items with extremely short useful lives (e.g., less than 2 years) or of small monetary value are properly reported as an "expense" or "expenditure" in the period in which they are acquired.

When outlays for capital-type items are, in fact, reported on the statement of position, they are said to be *capitalized*. The monetary criterion used to determine whether a given capital asset should be reported on the balance sheet is known as the *capitalization threshold*. A government may establish a single capitalization threshold for all of its capital assets, or it may establish different capitalization thresholds for different classes of capital assets.

Capitalization is, of its nature, primarily a financial reporting issue. That is, a government's principal concern in establishing specific capitalization thresholds ought to be the anticipated information needs of the users of the government's external financial reports. While it is essential to maintain control over all potentially capitalizable items, there exist much more efficient means than capitalization for accomplishing this objective in the case of a government's smaller tangible capital-type items.[1] Furthermore, practice has demonstrated that capital asset management systems that attempt to incorporate data on numerous smaller items are often costly and difficult to maintain and operate.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments consider the following guidelines in establishing capitalization thresholds:

- Potentially capitalizable items should only be capitalized only if they have an estimated useful life of at least two years following the date of acquisition;
- Capitalization thresholds are best applied to individual items rather than to groups of similar items (e.g., desks and tables), unless the effect of doing so would be to eliminate a significant portion of total capital assets (e.g., books of a library district);
- In no case should a government establish a capitalization threshold of less than $5,000 for any individual item;
- In establishing capitalization thresholds, governments that are recipients of federal awards should be aware of federal requirements that prevent the use of capitalization thresholds in excess of certain specified maximum amounts (i.e., currently $5,000) for purposes of federal reimbursement; and
- Governments should exercise control over potentially capitalizable items that fall under the operative capitalization threshold.[

d. The City will structure service levels in the context of financial sustainability.

e. The city will forecast its general fund expenditures annually for the next six years. The drivers and assumptions used in the forecast will be described.

f. The city's cost allocation plan will be updated annually. The cost allocation plan will be the basis for distribution of general government costs to other funds or capital projects (also known as indirect costs).

5. Capital Investment Budget Policies

a. The city will make capital improvements in accordance with an adopted capital improvement program.

b. The Capital Improvement Program and the base operating budget will be reviewed at the same time to ensure that the city's capital and operating needs are balanced with each other and that the Capital Improvement Program is aligned with the city's other long-range plans.

b. The city will develop and update the six-year plan for capital improvements including operations and maintenance costs and update it every year. Capital expenditures will be forecasted taking into account changes in population, changes in real estate development, or changes in relevant economic condition of the city and the region.

Policy Questions:

1. ***As a part of the biennial budget process, should the City analyze and report on its program to maintain existing capital assets to ensure that they are kept in good condition and repair?***

2. ***If, during lean times, the City is practicing "deferred maintenance", should this be disclosed as a part of the budget report?***

3. ***Should the City provide a "plain language report" on a 3-year cycle that is reported to the Council and provided to the public that describes:***

a. Condition ratings jurisdiction-wide compared to established policy standards
b. Condition ratings by geographical area, asset class, and other relevant factors
c. Indirect condition data (e.g., water main breaks, sewer back-up complaints)
d. Replacement life cycle(s) by infrastructure type
e. Funding sources for assets, including any restrictions that might be imposed on use and/or disposal
f. Year-to-year changes in net value of assets
g. Actual expenditures and performance data on capital maintenance compared to budgeted expenditures performance data (e.g., budgeted street miles, reconstructed compared to actual)

d. The city will identify the estimated costs and potential funding sources for each capital project proposal before it is submitted to council for approval. The city will use intergovernmental assistance and other outside resources whenever possible.

d. The city will balance financing methods for capital projects with the desire to meet construction deadlines.

GFOA BEST PRACTICE

Capital Asset Assessment, Maintenance and Replacement Policy (2007 and 2010)(CEDCP)

Background. Capital assets include major government facilities, infrastructure, equipment and networks that enable the delivery of public sector services. The performance and continued use of these capital assets is essential to the health, safety, economic development and quality of life of those receiving services.

Budgetary pressures often impede capital program expenditures or investments for maintenance and replacement, making it increasingly difficult to sustain the asset in a condition necessary to provide expected service levels. Ultimately, deferring essential maintenance or asset replacement could reduce the organization's ability to provide services and could threaten public health, safety and overall quality of life. In addition, as the physical condition of the asset declines, deferring maintenance and/or replacement could increase long-term costs and liabilities. Government entities should therefore establish capital planning, budgeting and reporting practices to encourage adequate capital spending levels. A government's financial and capital improvement plans should address the continuing investment necessary to properly maintain its capital assets. Such practices should include proactive steps to promote adequate investment in capital maintenance and replacement and necessary levels.

Recommendation. The Government Finance Officers Association (GFOA) recommends that local, state and provincial governments establish a system for assessing their assets and then appropriately plan and budget for any capital maintenance and replacement needs. This includes:

1. Developing a policy to require a complete inventory and periodic measurement of the physical condition of all existing capital assets. The assessment should document the established methods of condition assessment, including any that are used to evaluate below-ground infrastructure. This physical condition inventory and measures used should be kept current, with facility condition ratings updated every one to three years.[1]

This inventory should contain essential information, including:

a. Engineering description
b. Location
c. Physical dimensions and condition
d. "As-built" documents
e. Warranties
f. Maintenance history
g. Replacement costs
h. Operating cost information
i. Usage statistics
j. Book value
k. Original Useful Life
l. Remaining Useful Life

2. Establishing condition/functional performance standards to be maintained for each type of capital assets. The condition measures and related standards should be understandable and reliable. Such standards may be dictated by mandated safety requirements, federal, state, or provincial funding requirements, or applicable engineering and other professional standards,[2] including available software models. Use these standards and a current condition assessment as a basis for multi-year capital planning and annual budget funding allocations for capital asset maintenance and replacement. Assets near high risk areas such as hospitals may require a higher standard of performance and require a higher frequency of condition assessment.

3. Evaluating existing assets to determine if they still provide the most appropriate method to deliver services. Maintenance and replacement plans for assets should then be prioritized in accordance with overall goals and objectives to maintain expected service levels. Consider developing financial policies that identify and dedicate fees or other revenue sources to help achieve this goal. Also consider a procedure of performing a condition assessment prior to replacing a major asset or acquiring a new asset.

4. Allocating sufficient funds in the multi-year capital plan and annual operations budget for condition assessment, preventative maintenance, repair and replacement of capital assets in order to continue the provision of services that contribute to public health, safety, and quality of life of the public.

Each government should establish an on-going source of funds in both the capital plan and budget for the repair and renewal needs of its assets consistent with this best practice. The Capital Improvement Program (CIP) should also include projections based on the remaining useful life and replacement costs over the next three to ten years regarding the government's intended future investment in these facilities and the estimated impact of these investments toward achieving the minimum or adequate-performance rating for each asset type or class. If the assets are part of the function of an enterprise fund, the rates, fees and charges may need to be adjusted to meet the funding requirements.

5. Monitoring and communicating progress toward stated goals and the overall condition of its capital assets with appropriate controls to ensure the validity and accuracy of the information. This process should describe how actual facility condition and

performance compares to the targeted standard for each asset type. Governments should also review and report the operating impacts related to capital investments during project implementation and for a specified time period following project implementation. Governments should likewise monitor and report on the delivery of capital projects by establishing standards for planning, designing and constructing capital projects.[3]

6. At least every one to three years, providing a “plain language” Report on Capital Facilities to elected officials and made available to the general public that describes:

a. Condition ratings jurisdiction-wide compared to established policy standards
b. Condition ratings by geographical area, asset class, and other relevant factors
c. Indirect condition data (e.g., water main breaks, sewer back-up complaints)
d. Replacement life cycle(s) by infrastructure type
e. Funding sources for assets, including any restrictions that might be imposed on use and/or disposal
f. Year-to-year changes in net value of assets
g. Actual expenditures and performance data on capital maintenance compared to budgeted expenditures performance data (e.g., budgeted street miles, reconstructed compared to actual)

h. Long-term trends extending over the prior four to six or more years. Year-to-year expenditure figures are less valuable due to general inflation rates and the changing supply and cost of construction contractors and contract bids over time.

Other more “global” measures such as replacement cycle,[4] year-to-year comparisons of work completed (e.g., miles of sewers, water mains, street lights, etc., repaired/replaced), book value, etc., may also be used.[5]

References.

- GFOA Best Practice, Considerations on the Use of the (GASB 34 Reporting Model) Modified Approach to Account for Infrastructure Assets, 2002.
- John Vogt, *Capital Budgeting and Finance: A Guide for Local Governments*, ICMA, 2004.
- Nicole Westerman, "Managing the Capital Planning Cycle: Best Practice Examples of Capital Program Management", *Government Finance Review*, 2004.
- GFOA Best Practice, Capital Project Budget, 2006.
- GFOA Best Practice, Establishing the Estimated Useful Lives of Capital Assets, 2007.
- GFOA Best Practice, Capital Project Monitoring and Reporting, 2007.
- GFOA & National Advisory Council on State and Local Budgeting Best Practices in Public Budgeting (Practice #s 2.2, 5.2, 6.2, 11.5)
- EPA, *The Clean Water and Drinking Water Gap Analysis*, 2002.
- AWWA, *Dawn of the Replacement Era: Reinvesting in Drinking Water Infrastructure*, 2001.

Approved by the GFOA’s Executive Board, March 5, 2010.

1 The frequency of physical condition rating and asset inventory updates may vary depending on several factors, including the asset age and type, likelihood of degradation, and ease at which assessments can be conducted.

2 These measures include state government-established standards, bridge sufficiency ratings, Pavement Quality Index (PQI) or Pavement Condition Index (PCI), Facility Condition Index (FCI), etc. Indirect measures such a water main breaks, sewage overflows, etc., are also available for certain asset types.
3 Measures to assess the delivery of capital projects may include budget soft versus hard costs, schedule and budget variations, change orders, quality of construction, and architectural/engineering estimates versus actual delivery.
4 “Replacement cycle” means the number of years to replace/reconstruct an entire infrastructure network assuming an average annual level of replacement. Example: 500 miles of concrete surface streets in network/ 10 miles average annual miles of streets replaced equals a 50-year replacement cycle. This can be compared to the engineering estimate of the useful life of the average concrete surfaced street.
5 Other useful measures of level of effort or condition can be found in internal government database, including department annual reports, fixed asset account records, GIS systems, etc.

6. Short-Term Debt Policies

a. Short-term debt is defined as a period of three years or less.

b. The City may use short-term debt to cover temporary cash flow shortages, which may be caused by a delay in receipting tax revenues or issuing long-term debt. The City will not use short-term debt for current operations.

c. The City may issue interfund loans rather than outside debt instruments to meet short-term cash flow needs. Interfund loans will be permitted only if an analysis of the affected fund indicates excess funds are available and the use of these funds will not impact the fund's current operations. All interfund short-term borrowing will be subject to Council approval by ordinance or resolution and will bear interest based upon prevailing rates.

7. Long-Term Debt Policies

a. Long Term debt is that debt which exceeds three years.

b. The City will utilize long-term borrowing for capital improvements that cannot reasonably be financed on a pay-as-you-go basis from anticipated cash flows.

c. Acceptable uses of bond proceeds are items which can be considered capital assets. Refunding bond issues designed to restructure currently outstanding debt is also an acceptable use of bond proceeds provided that the net present value (NPV) of savings is at least four percent (4%).

Policy Questions:

1. ***GFOA Best Practice recommends that refunding bond issues should not be done unless a net present value of 3% to 5% can be achieved. Should the City adopt a NPV minimum standard of 4%?***

d. The City will determine whether self supporting bonds (such as special assessment improvement district bonds) are in the City's best interest when planning to incur debt to finance capital improvements.

a. The City will not use long-term debt for current operations.

b. The City will maintain good communications with bond rating agencies about its financial condition. The City will follow a policy of full disclosure on every financial report and bond prospectus including proactive compliance with disclosure to the secondary market.

c. General Obligation Bond Policy

1. Every project proposed for financing through general obligation debt shall be accompanied by a full analysis of the future operating and maintenance costs associated with the project.

2. Bonds cannot be issued for a longer maturity schedule than a conservative estimate of the useful life of the asset to be financed.

d. Limited Tax General Obligation Bond Policies

1. As a precondition to the issuance of limited tax general obligation bonds, alternative methods of financing should also be examined.

2. Before general obligation bond propositions are placed before the voters, the capital project under consideration should have been included in the Capital Improvement Program. The source of funds should describe the intended use of bond financing.

3. Limited tax general obligation bonds should only be issued under certain conditions:

   - A project requires monies not available from alternative sources;

   - Matching fund monies are available which may be lost if not applied for in a timely manner; or

   - Catastrophic conditions.

e. Financing of Lease Purchases

1. Under Washington State law, the public may vote to approve bond issues for general government purposes in an amount not to exceed 2.5% of assessed valuation. Within the 2.5% limit, the Stanwood City Council may approve bond issues and/or lease purchases up to 1.5% of the City's total assessed value. In addition, state law provides for an additional 2.5% of assessed valuation for parks and open space purposes with a vote of the public.

2. Lease purchase financing may be used when the cost of borrowing or other factors make it in the City's best interest.

GFOA BEST PRACTICE
Debt Management Policy (1995, 2003, and 2012) (DEBT)
Background. Debt management policies are written guidelines, allowances, and restrictions that guide the debt issuance practices of state or local governments, including the issuance process, management of a debt portfolio, and adherence to various laws and regulations. A debt management policy should improve the quality of decisions, articulate policy goals, provide guidelines for the structure of debt issuance, and demonstrate a commitment to long-term capital and financial planning. Adherence to a debt management policy signals to rating agencies and the capital markets that a government is well managed and therefore is likely to meet its debt obligations in a timely manner. Debt management policies should be written with attention to the issuer's specific needs and available financing options and are typically implemented through more specific operating procedures. Finally, debt management policies should be approved by the issuer's governing body to provide credibility, transparency and to ensure that there is a common understanding among elected officials and staff regarding the issuer's approach to debt financing.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments adopt comprehensive written debt management policies. These policies should reflect local, state, and federal laws and regulations. To assist with the development of these policies the GFOA recommends that a government's Debt Management Policy (Policy) should be reviewed periodically (and updated if necessary) and should address at least the following:

1. ***Debt Limits.*** The Policy should consider setting specific limits or acceptable ranges for each type of debt. Limits generally are set for legal, public policy, and financial reasons.

a. *Legal restrictions* may be determined by:

- State constitution or law,
- Local charter, by-laws, resolution or ordinance, or covenant, and
- Bond referenda approved by voters.

b. *Public Policies will address the internal standards and considerations within a government and* can include:

- Purposes for which debt proceeds may be used or prohibited,
- Types of debt that may be issued or prohibited,
- Relationship to and integration with the Capital Improvement Program, and
- Policy goals related to economic development, including use of tax increment financing and public-private partnerships.

c. *Financial restrictions or planning considerations* generally reflect public policy or other financial resources constraints, such as reduced use of a particular type of debt due to changing financial conditions. Appropriate debt limits can have a positive impact on bond ratings, particularly if the government demonstrates adherence to such policies over time. Financial limits often are expressed as ratios customarily used by credit analysts. Different financial limits are used for different types of debt. Examples include:

- *Direct Debt, including general obligation bonds,* are subject to legal requirements and may be able to be measured or limited by the following ratios:

o Debt per capita,
o Debt to personal income,
o Debt to taxable property value, and
o Debt service payments as a percentage of general fund revenues or expenditures.

- *Revenue Debt* levels often are limited by debt service coverage ratios (e.g., annual net pledged revenues to annual debt service), additional bond provisions contained in bond covenants, and potential credit rating impacts.

- *Conduit Debt* limitations may reflect the right of the issuing government to approve the borrower's creditworthiness, including a minimum credit rating, and the purpose of the borrowing issue. Such limitations reflect sound public policy, particularly if there is a contingent impact on the general revenues of the government or marketability of the government's own direct debt.

- *Short-Term Debt Issuance* should describe the specific purposes and circumstances under which it can be used, as well as limitations in term or size of borrowing.

- *Variable Rate Debt* should include information about when using non-fixed rate debt is acceptable to the entity either due to the term of the project, market conditions, or debt portfolio structuring purposes.

2. ***Debt Structuring Practices.*** The Policy should include specific guidelines regarding the debt structuring practices for each type of bond, including:

- Maximum term (often stated in absolute terms or based on the useful life of the asset(s)),
- Average maturity,
- Debt service pattern such as equal payments or equal principal amortization,
- Use of optional redemption features that reflect market conditions and/or needs of the government,
- Use of variable or fixed-rate debt, credit enhancements, derivatives, short-term debt, and limitations as to when, and to what extent, each can be used, and
- Other structuring practices should be considered, such as capitalizing interest during the construction of the project and deferral of principal, and/or other internal credit support, including general obligation pledges.

3. ***Debt Issuance Practices***. The Policy should provide guidance regarding the issuance process, which may differ for each type of debt. These practices include:

- Selection and use of professional service providers, including an independent financial advisor, to assist with determining the method of sale and the selection of other financing team members,
- Criteria for determining the sale method (competitive, negotiated, private placement) and investment of proceeds,
- Use of comparative bond pricing services or market indices as a benchmark in negotiated transactions, as well as to evaluate final bond pricing results,
- Criteria for issuance of advance refunding and current refunding bonds, and
- Use of credit ratings, minimum bond ratings, determination of the number of ratings, and selection of rating services.

5. ***Debt Management Practices.*** The Policy should provide guidance for ongoing administrative activities including:
- Investment of bond proceeds,
- Primary and secondary market disclosure practices, including annual certifications as required,

- Arbitrage rebate monitoring and filing,
- Federal and state law compliance practices, and
- Ongoing market and investor relations efforts.

6. ***Use of Derivatives.*** The Debt Management Policy should clearly state whether or not the entity can or should use derivatives. If the policy allows for the use of derivatives, a separate and comprehensive derivatives policy should be developed (see GFOA's Advisory, Developing a Derivatives Policy and Derivatives Checklist).

References.

- GFOA Advisory, Using Variable Rate Debt Instruments, 2010.
- GFOA Advisory, Use of Debt-Related Derivatives Products and the Development of a Derivatives policy, 2010.
- GFOA Derivatives Checklist, 2010.
- GFOA Best Practice, Selecting Bond Counsel, 2008.
- GFOA Best Practice, Selecting Financial Advisors, 2008.
- GFOA Best Practice, Selecting Underwriters for a Negotiated Bond Sale, 2008.
- GFOA/NABL Post Issuance Compliance Checklist, 2003.
- *Benchmarking and Measuring Debt Capacity*, Rowan Miranda and Ron Picur, GFOA, 2000.
- *A Guide for Preparing a Debt Polic*y, Patricia Tigue, GFOA, 1998.

Approved by the GFOA's Executive Board, October, 2012.

8. Reserve Fund Policies

a. The City will maintain General Operating Reserves at a level equal to at least two (2) months (16.67%) of the total General Fund budgeted revenue, excluding the beginning fund balance, development review revenue, and any significant one-time revenue. A separate reserve shall be established for development review services. These reserves shall be created and maintained to:

   1. Provide sufficient cash flow to meet daily financial needs.

   2. Sustain City services in the event of a catastrophic event such as a natural/manmade disaster (e.g. earthquake, windstorm, flood, terrorist attack) or a major downturn in the economy.

   In general, the City shall endeavor to support ongoing operations with ongoing revenues and maintain General Operating Reserves of at least 16.67% of the total General Fund budgeted revenue, as set forth in section 8a above. The City may allow reserves to fall below this minimum on a one-time basis to support City operations. If this occurs, the City will begin to replenish these reserves within two years of a withdrawal.

b. Annual surpluses in the General Fund will be used to fund one-time operations and capital expenditures, dedicated to the Capital Improvement Program or placed in an economic contingency account if:

   1. There are surplus balances remaining after all current expenditure obligations and reserve requirements are met.

   2. The City has made a determination that revenues for the ensuing year are sufficient to support budgeted General Fund operations.

c. A surplus is defined as the difference between the actual beginning fund balance and the budgeted beginning fund balance. It consists of under-expenditures and excess revenues over and above the amounts included in the following annual budget.

d. The City may also maintain, at its discretion, an Economic Contingency to serve as a hedge against economic fluctuations, fund future one-time operational and capital needs or support City services on a one-time basis pending the development of a longer term financial solution. The source of funding for this reserve is the biennium surplus as outlined in sections 8b and 8c above. Restoration of this reserve is at the City's discretion.

e. The City will maintain a building permit reserve in the Operating Reserves Fund to provide for completion of building permit responsibilities in the event of a decline in development activity. This reserve will be equal to 25% of the annual building inspection and review costs.

f. The City will maintain operating reserves in the following funds:

   1. Water – Twenty-five percent (25%) of Water Fund budgeted operating expenditures.

Policy Questions:

1. ***FCS Water / Sewer Rates and charges Study (Dec 2010) recommends a water operating reserve of 60 to 90 days of annual operating and maintenance expenses (O&M) for the water utility, which translates to 16.67% to 25%.***

   - ***Based on 2013 budgeted O&M expenditures of $850,557, the recommended reserve would be $141,760 at 60 days, and $212,639 at 90 days.***

   - ***Based on annual operating revenues of about $1.4 million long term rates (over 10 years) would need to be about 0.005% (one half of one percent) higher than otherwise to maintain the higher 90 day reserve level ($70,879 difference / $1,400,000 annual revenues / 10 years).***

2. ***Should the City adopt the more conservative 25% (90 days), or another figure?***)

   2. Sanitary Sewer – Sixteen and two-thirds percent (16 2/3%) of Sanitary Sewer budgeted operating expenditures.

Policy Questions:

1. ***FCS Water / Sewer Rates and charges Study (Dec 2010) recommends a sewer operating reserve of 45 to 60 days annual O&M expenditures for the sewer utility, which translates to 12.5% to 16.67%. Should the City adopt the more conservative 16.67% (60 days), or another figure?***)

    - ***Based on 2013 budgeted O&M expenditures of $893,534, the recommended reserve would be $111,692 at 45 days, and $148,922 at 60 days.***

    - ***Based on annual operating revenues of about $1.6 million long term rates (over 10 years) would need to be about 0.002% (two-tenths of one percent) higher than otherwise to maintain the higher 60 day reserve level ($37,230 difference / $1,600,000 annual revenues / 10 years).***

2. ***Should the City adopt the more conservative 16.67% (60 days), or another figure?***)

3. Storm Drainage – Sixteen and two-thirds percent (16 2/3%) of Storm Drainage budgeted operating expenditures.

Policy Questions:

1. ***The City has not conducted a Storm Drainage rate study. Should the City adopt a reserve policy of 16.67% of annual O&M expenditures (60 days), or another figure?***

These operating reserves shall be created and maintained to provide sufficient cash flow to meet daily financial needs and will be based upon total operating expenditures. For budgeting purposes, operating expenditures will be calculated upon the funds' total expenditure budgets excluding ending fund balances, capital purchases, and the current year's portion of principal paid on outstanding debt.

g. The City will establish a capital contingency reserve for the Water, Sanitary Sewer, and Storm Drainage Utilities in the amount of 2% of system fixed assets, which is set aside in case of an emergency. Additionally, the reserve could be used for other unanticipated capital needs or capital cost overruns.

Policy Questions:

1. ***FCS Water / Sewer Rates and charges Study (Dec 2010) recommends 1% to 2% be set aside as a contingency reserve for each utility. Should the City use the more conservative 2%, or some other figure?***

    - ***Based on FCS estimates, adjusted for inflation, water utility assets are valued at about $32.5 million. This means that the contingency reserve for the water utility would be $325,000 (at 1%) and $650,000 (at 2%).***

    - ***Based on FCS estimates, adjusted for inflation, sewer utility assets are valued at about $27.5 million. This means that the contingency reserve for the sewer utility would be $275,000 (at 1%) and $550,000 (at 2%).***

h. In order to maintain the significant investments in utility capital assets there shall be regular, annual transfers from the utility operations funds to the utility capital project or reserve funds to be expended on future utility capital projects

i. The City will establish a revenue stabilization reserve for the Water, Sanitary Sewer, and Storm Drainage utilities. The required fund balance shall be set at 25% of the total of water and wastewater revenues collected through monthly rates. Moneys may be withdrawn from the revenue stabilization reserves to supplement operating revenues in years of revenue shortfalls caused by reduced sales due to weather or restrictions on water use. The revenue stabilization reserves will be replenished within four years of a withdrawal.

Policy Questions:

1. ***FCS Water / Sewer Rates and charges Study (Dec 2010) recommends a rate stabilization reserve for all utilities of 10% to 25% of annual rate revenues. Should the City adopt the more conservative 25% or another figure?***

    - ***Based on 2013 budgeted water service charges of about $1.4 million, the rate stabilization reserve for the water utility would be $140,000 (at 10%) and $350,000 (at 25%).***

    - ***Based on 2013 budgeted sewer service charges of about $1.6 million, the rate stabilization reserve for the sewer utility would be $160,000 (at 10%) and $400,000 (at 25%).***

- ***Based on 2013 budgeted storm drainage service charges of $425,000, the rate stabilization reserve for the storm drainage utility would be $42,500 (at 10%) and $106,250 (at 25%).***

j. Bond reserves shall be created and maintained by the Water/Wastewater and Stormwater Utilities in accordance with the provisions set forth in the bond covenants. These shall be in addition to the reserves described above.

Policy Questions:

1. ***Typically, revenue bonds require a minimum reserve of one year's debt service, while Public Works Trust Fund loans require no reserves. Should the City adopt a policy of setting bond reserves at the level of that required by bond covenants or other legal requirements, or at higher, more conservative amount?***

k. The City shall additionally maintain the following Equipment Replacement Reserve Funds:

    1. Equipment Reserve Fund;

    2. Fire Impact Fees Fund; and

    3. Utility Equipment Reserve.

    The Equipment Reserve Funds will be maintained at a level sufficient to meet scheduled equipment replacement so as to sustain an acceptable level of municipal services and prevent a physical deterioration of City assets.

BEST PRACTICE

Appropriate Level of Unrestricted Fund Balance in the General Fund (2002 and 2009) (BUDGET and CAAFR)

Background. Accountants employ the term *fund balance* to describe the net assets of governmental funds calculated in accordance with generally accepted accounting principles (GAAP). Budget professionals commonly use this same term to describe the net assets of governmental funds calculated on a government's budgetary basis.[1] In both cases, fund balance is intended to serve as a measure of the financial resources available in a governmental fund.

Accountants distinguish up to five separate categories of fund balance, based on the extent to which the government is bound to honor constraints on the specific purposes for which amounts can be spent: *nonspendable fund balance, restricted fund balance, committed fund balance, assigned fund balance, and unassigned fund balance.*[2] The total of the last three categories, which include only resources without a constraint on spending or for which the constraint on spending is imposed by the government itself, is termed *unrestricted fund balance*.

It is essential that governments maintain adequate levels of fund balance to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stable tax rates. Fund balance levels are a crucial consideration, too, in long-term financial planning.

In most cases, discussions of fund balance will properly focus on a government's general fund. Nonetheless, financial resources available in other funds should also be considered in assessing the adequacy of unrestricted fund balance (i.e., the total of the amounts reported as committed, assigned, and unassigned fund balance) in the general fund.

Credit rating agencies monitor levels of fund balance and unrestricted fund balance in a government's general fund to evaluate a government's continued creditworthiness. Likewise, laws and regulations often govern appropriate levels of fund balance and unrestricted fund balance for state and local governments.

Those interested primarily in a government's creditworthiness or economic condition (e.g., rating agencies) are likely to favor increased levels of fund balance. Opposing pressures often come from unions, taxpayers and citizens' groups, which may view high levels of fund balance as "excessive."

Recommendation. The Government Finance Officers Association (GFOA) recommends that governments establish a formal policy on the level of unrestricted fund balance that should be maintained in the general fund.[3] Such a guideline should be set by the appropriate policy body and should provide both a temporal framework and specific plans for increasing or decreasing the level of unrestricted fund balance, if it is inconsistent with that policy.[4]

The adequacy of unrestricted fund balance in the general fund should be assessed based upon a government's own specific circumstances. Nevertheless, GFOA recommends, at a minimum, that general-purpose governments, regardless of size, maintain unrestricted fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures.[5] The choice of revenues or expenditures as a basis of comparison may be dictated by what is more predictable in a government's particular circumstances.[6] Furthermore, a government's particular situation often may require a level of unrestricted fund balance in the general fund significantly in excess of this recommended minimum level. In any case, such measures should be applied within the context of long-term forecasting, thereby avoiding the risk of placing too much emphasis upon the level of unrestricted fund balance in the general fund at any one time.

In establishing a policy governing the level of unrestricted fund balance in the general fund, a government should consider a variety of factors, including:

- The predictability of its revenues and the volatility of its expenditures (i.e., higher levels of unrestricted fund balance may be needed if significant revenue sources are subject to unpredictable fluctuations or if operating expenditures are highly volatile);
- Its perceived exposure to significant one-time outlays (e.g., disasters, immediate capital needs, state budget cuts);
- The potential drain upon general fund resources from other funds as well as the availability of resources in other funds (i.e., deficits in other funds may require that a higher level of unrestricted fund balance be maintained in the general fund, just as, the availability of resources in other funds may reduce the amount of unrestricted fund balance needed in the general fund);[7]
- Liquidity (i.e., a disparity between when financial resources actually become available to make payments and the average maturity of related liabilities may require that a higher level of resources be maintained); and
- Commitments and assignments (i.e., governments may wish to maintain higher levels of unrestricted fund balance to compensate for any portion of unrestricted fund balance already committed or assigned by the government for a specific purpose).

Furthermore, governments may deem it appropriate to exclude from consideration resources that have been committed or assigned to some other purpose and focus on unassigned fund balance rather than on unrestricted fund balance.

Naturally, any policy addressing desirable levels of unrestricted fund balance in the general fund should be in conformity with all applicable legal and regulatory constraints. In this case in particular, it is essential that differences between GAAP fund balance and budgetary fund balance be fully appreciated by all interested parties.

Approved by the GFOA's Executive Board, October, 2009.

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[1]For the sake of clarity, this recommended practice uses the terms GAAP fund balance and budgetary fund balance to distinguish these two different uses of the same term.

[2]These categories are set forth in Governmental Accounting Standards Board (GASB) Statement No. 54, Fund Balance Reporting and Governmental Fund Type Definitions, which must be implemented for financial statements for periods ended June 30, 2011 and later.

[3]Sometimes restricted fund balance includes resources available to finance items that typically would require the use of unrestricted fund balance (e.g., a contingency reserve). In that case, such amounts should be included as part of unrestricted fund balance for purposes of analysis.

[4]See Recommended Practice 4.1 of the National Advisory Council on State and Local Budgeting governments on the need to "maintain a prudent level of financial resources to protect against reducing service levels or raising taxes and fees because of temporary revenue shortfalls or unpredicted one-time expenditures" (Recommended Practice 4.1).

[5]In practice, a level of unrestricted fund balance significantly lower than the recommended minimum may be appropriate for states and America's largest governments (e.g., cities, counties, and school districts) because they often are in a better position to predict contingencies (for the same reason that an insurance company can more readily predict the number of accidents for a pool of 500,000 drivers than for a pool of fifty), and because their revenues and expenditures often are more diversified and thus potentially less subject to volatility.

[6]In either case, unusual items that would distort trends (e.g., one-time revenues and expenditures) should be excluded, whereas recurring transfers should be included. Once the decision has been made to compare unrestricted fund balance to either revenues or expenditures, that decision should be followed consistently from period to period.

[7]However, except as discussed in footnote 4, not to a level below the recommended minimum.

BEST PRACTICE

Appropriate Levels of Working Capital in Enterprise Funds (BUDGET & CAAFR) (2011) (new)

Background. Enterprise funds distinguish between current and non-current assets and liabilities. It is possible to take advantage of this distinction to calculate working capital (i.e., current assets less current liabilities). The measure of working capital indicates the relatively liquid portion of total enterprise fund capital, which constitutes a margin or buffer for meeting obligations.

It is essential that a government maintain adequate levels of working capital in its enterprise funds to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenses) and to ensure stable services and fees.

Working capital is a crucial consideration, too, in long-term financial planning. Credit rating agencies consider the availability of working capital in their evaluations of continued creditworthiness. Likewise, laws and regulations may speak to appropriate levels of working capital for some enterprise funds.

Recommendation. The Government Finance Officers Association (GFOA) recommends that local governments adopt a target amount of working capital to maintain in each of their enterprise funds. Ideally, targets would be formally described in a financial policy and/or financial plan.

GFOA recommends that governments use working capital as the measure of available margin or buffer in enterprise funds. Although as previously stated, working capital is defined as current assets minus current liabilities, government finance officers should be aware of certain characteristics of working capital that affect its use as a measure. Specifically, the "current assets" portion of working capital includes assets or resources that are reasonably expected to be realized in cash (e.g., accounts receivable) or consumed (e.g., inventories and prepaids) within a year, which leads to two considerations for an accurate calculation of working capital:

- **Strength of collection practices**. An appropriate allowance for uncollectibles should be established and the amount of the receivable that is expected to be collected in cash within one year should be determined in a manner that is consistent with the collection practices of the government. If the accounts receivable collection practices of the enterprise fund are inconsistent or weak, then less of the accounts receivable amount should be reported as current assets.
- **Historical consumption of inventories and prepaids**. The amount of inventories and prepaids included in current assets should be a realistic estimate of the amount that will be consumed in one year based on a historical usage pattern

and current operating levels (inventories) or based on the time periods to which the items relate (prepaids).

Because the purposes, customers, and other characteristics of enterprise funds can vary widely, GFOA recommends that governments develop a target amount of working capital that best fits local conditions for each fund. However, GFOA recommends that under no circumstances should the target for working capital be less than forty-five (45) days worth of annual operating expenses[1] and other working capital needs of the enterprise fund.* A target of 45-days would only be appropriate for those enterprise funds with the least amount of need for cushion or buffer.

In order to arrive at a customized target amount of working capital, governments should start with a baseline of ninety (90) days worth of working capital and then adjust the target based on the particular characteristics of the enterprise fund in question (using 45 days as the minimum acceptable level). The primary characteristics to think about when customizing a working capital target are presented below. The appendix to this Best Practices provides more detailed considerations for these characteristics as they pertain to common types of government enterprise funds.

- **Support from general government**. Some enterprise funds may be supported by general taxes or transfers from a general government. These enterprise funds may require lower levels of working capital if they are supported by these contributors. For a heavily subsidized enterprise fund the 45-day minimum working capital recommendation contained in this Best Practice might be met through support from the general government, if a financial buffer or cushion for the enterprise fund is to be provided by the general government (or other outside contributor).
- **Transfers out**. If the enterprise fund is expected to make a transfer to the general government or to some other fund, then this sort of claim on the enterprise fund's assets may call for higher levels of working capital to maintain flexibility. Transfers could include an enterprise fund's contributions to overhead/support functions, subsidies granted to other operations, or any other transfer of resources. Regardless of the rationale of the transfer, governments should take into account the claim on working capital when setting a target amount.
- **Cash cycles**. Does the enterprise fund experience large peaks and valleys in its cash position during the year? For example, a water enterprise fund may experience significantly higher levels of cash on hand during the summer months compared to the winter. Volatile cash cycles call for higher levels of working capital. Another consideration is the length of the billing cycle. A longer billing cycle would call for higher levels of working capital because the enterprise fund will have longer durations between major infusions of cash.
- **Customer concentration**. Is the enterprise fund dependent on a few customers for a large portion of its revenues or is the customer base diversified? For example, a port enterprise fund may be dependent on a few major shippers or commerce in a niche product. Lower customer concentration may mean that the enterprise fund can safely operate with lower levels of working capital.
- **Demand for services**. Does the enterprise fund face a steady demand for service or is demand potentially volatile, thereby leading to volatility in of income? For example, the demand for utility services is steady compared to demand for air travel. Also consider the impact of competitive position on demand. Direct competitors or the availability of reasonable substitutes could lead to greater volatility in demand for the enterprise fund's services. More volatility implies greater need for working capital margins.
- **Control over rates and revenues**. Does the enterprise fund have the ability to change rates, implement new charges, or otherwise raise revenues from its customers in a simple fashion? For example, transit enterprise funds are often constrained from raising rates by political pressure. Other enterprise funds may be subject to a rate control board. Those that face competitors in their market may have less effective control over their rates and revenues. More revenue constrained enterprise funds may need higher levels of working capital.
- **Asset age and condition**. What is the age and condition of the enterprise fund's infrastructure? Older infrastructure has greater exposure to extraordinary repair needs. Enterprise funds with newer and/or well maintained capital assets may be able to operate with less working capital than other enterprise funds.
- **Volatility of expenses**. Are the expenses of the enterprise fund volatile or does the enterprise fund have a high degree of control over its expenses? For example, the expenses of a solid waste enterprise fund tend to be fairly stable throughout the year. In another example, water or sewer enterprise funds may be more vulnerable to large expense spikes from extreme weather. Enterprise funds with more stable expenses can safely operate with less working capital than other enterprise funds.
- **Control over expenses**. Consider the enterprise fund's level of fixed and variable costs and the ability to reduce variable costs in response to lower revenues. For instance, if a convention center does not book an event, it does not need to hire temporary help and incur other expenditures in support of the event. An enterprise fund with a high percentage of operational costs which vary depending upon revenues or operating levels may operate with lower levels of working capital.
- **Management plans for working capital**. Working capital includes assets, which can include both truly unrestricted resources and resources that have internal limitations placed upon them (e.g., board-designated) and/or that may be committed for future capital spending. These amounts may appear as unrestricted on the balance sheet but, in actuality, may be unavailable in the future to serve as a buffer or tool to help manage financial risk. If these types of limitations exist, the working capital target should be adjusted to arrive at an amount that represents a true amount available as a tool to manage financial risk.
- **Separate targets for operating and capital needs**. Depending on the nature of the enterprise fund, governments might also consider designating separate targets for operating and capital needs, especially when the enterprise fund is very capital intensive. For example, there might be a separate amount identified for equipment replacement or debt service. In such a case, targets should be separately evaluated based on the particular features of the isolated amounts.
- **Debt position**. Enterprise funds often carry significant amounts of debt, which is used to acquire capital assets. The amount and type of debt an enterprise fund carries can have important ramifications for working capital targets. For

example, an enterprise fund with a large amount of variable rate debt may need additional buffer to manage the risk associated with interest rate volatility. In addition, uneven and increasing or lump-sum debt principal payments to be made in future years may raise the amount of working capital that the enterprise fund should maintain. Viewing the amount of working capital in this broader context will help ensure that resources are available to make debt payments as they come due.

Approved by the GFOA's Executive Board, February, 2011.

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[1]The recommendation is to use annual operating expenses which include depreciation expense. If, however, annual depreciation expense is significantly more or less than the anticipated capital outlays of the next period to be paid from working capital consideration should be given to adjusting the benchmark. An appropriate adjusted benchmark may be annual operating expenses – annual depreciation expense + capital outlays of the next period to be paid from working capital.
* Subject to the exception for heavily subsidized enterprises, described later in this Best Practice.

9. Investment Policies (to be continued at the May 2013 Finance Committee Mtg)

City of Stanwood Investment Policy

1.0 Policy:

It is the policy of the City of Stanwood to invest public funds in a manner which will provide the maximum security of the principle while meeting the daily cash flow demands of the city and highest investment return while conforming to all Washington statutes governing the investment of public funds, in this specific order.

2.0 Scope:

This investment policy applies to all financial assets of the City of Stanwood other than any Fiduciary funds which include, but are not limited to; The Municipal Employees Benefit Trust and Deferred Compensation Plan funds managed externally; Contractors Deposit funds; and such funds excluded by law or bond covenant.

The applicable funds are accounted for in the City's Annual Financial Report and include:

2.1 Funds:

- 2.1.1 General Fund
- 2.1.2 Special Revenue Funds
- 2.1.3 Capital Project Funds
- 2.1.4 Enterprise Funds
- 2.1.5 Debt Service Funds (unless prohibited by bond covenant)
- 2.1.6 Internal Service Funds
- 2.1.7 Any new fund created by Council, unless specifically exempted by Council

3.0 Prudence:

Investments shall be made with judgment and care - under circumstances then prevailing - which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.

3.1 The standard of prudence to be used by investment officials shall be the "prudent person" standard and shall be applied in the context of managing an overall portfolio. Investment officers acting in accordance with written procedures and exercising due diligence shall be relieved of personal responsibility for an individual security's credit risk or market price changes, provided deviations from expectations are reported in a timely fashion and appropriate action is taken to control adverse developments.

4.0 Objective:

The primary objectives, in priority order, of the City's investment activities shall be:

4.1 Safety: Safety of principal is the foremost objective of the City of Stanwood. Investments of the City shall be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolio. To attain this objective, diversification is required in order that potential losses on individual securities do not exceed the income generated from the remainder of the portfolio.

4.2 Liquidity: The City's investment portfolio will remain sufficiently liquid to enable the City to meet all operating requirements which might be reasonably anticipated.

4.3 Return on investment: The City's investment portfolio shall be designed with the objective of attaining a market rate of return given the City's risk constraints and cash flow requirements.

5.0 Delegation of Authority:

Management responsibility for the investment program is hereby delegated to the Investment Committee, who shall establish and monitor written procedures for the operation of the investment program, consistent with this investment policy. Such procedures shall include explicit delegation of authority to persons responsible for investment transactions. No person may engage in an investment transaction except as provided under the terms of this policy and the procedures established by the Finance Director. The Finance Director shall be responsible for all transactions undertaken and shall establish a system of controls to regulate the activities of subordinate officials.

5.1 Investment Committee: The investment committee shall be made up of the Mayor, the chair of the Finance Committee and the Finance Director. The committee shall meet quarterly and provide overall guidance with regard to investment transactions. The committee will review and authorize financial dealers and institutions as provided for in Section 7.

6.0 Ethics and Conflicts of Interest:

Officers and employees involved in the investment process shall refrain from personal business activity that could conflict with proper execution of the investment program, or which could impair their ability to make impartial investment decisions. Employees and investment officials shall disclose to the Mayor any material financial interests in financial institutions that conduct business within this jurisdiction, and they shall further disclose any large personal financial/investment positions that could be related to the performance of the City's portfolio. Employees and officers shall subordinate their personal investment transactions to those of the City of Stanwood, particularly with regard to the time of purchases and sales.

7.0 Authorized Financial Dealers and Institutions:

The Finance Director will maintain a list of broker/dealers and financial institutions authorized to provide investment services to the city. Authorized broker/dealers and financial institutions will be limited to those that are approved by the Investment Committee and meet one or more of the following:

- Financial institutions approved by the Washington Public Deposit Protection Commission (RCW 39.58); or,
- Primary dealers recognized by the Federal Reserve Bank; or,
- Non-primary dealers qualified under the U.S. Securities and Exchange Commission Rule 15C3-1, the Uniform Net Capital Rule, and a certified member of the National Association of Securities Dealers.

Each authorized broker/dealer or financial institution will be selected by creditworthiness, required to maintain an office in the State of Washington, and required to regularly submit annual reports, including audited financial statements. Additionally, broker/dealers are required to complete a broker/dealer questionnaire or any other information that may be required by the

City to assess the qualifications of the firm. An annual financial statement is required to be on file for each financial institution and broker/dealer with which the City invests.

8.0 Authorized Investments:

Authorized investments are securities and investments authorized by state statute as defined in RCW's 39.58 and 39.59. Authorized investments include:

8.1 Investment deposits, including certificates of deposit, with qualified public depositories as defined in RCW 39.58.

8.2 Certificates, notes, or bonds of the United States, or other obligations of the United States or its agencies, or of any corporation wholly owned by the government of the United States (such as the Government National Mortgage Association).

8.3 Obligations of government-sponsored corporations which are eligible as collateral for advances to member banks as determined by the Board of Governors of the Federal Reserve System. (These include but are not limited to Federal Home Loan Bank notes and bonds, Federal Farm Credit Bank consolidated notes and bonds, and Federal National Mortgage Association notes, bonds and guaranteed certificates of participation.)

8.4 Bankers' acceptances purchased on the secondary market.

8.5 Bonds of the State of Washington and any local government in the State of Washington which have, at the time of investment, one of the three highest credit ratings of a nationally recognized rating agency.

8.6 Repurchase agreements for securities listed in 2, 3, and 4 above, provided that the transaction is structured so that the City of Stanwood obtains control over the underlying securities and a Master Repurchase Agreement has been signed with the bank or dealer.

8.7 State Investment Pool.

8.8 Commercial Paper purchased in the secondary market and having received the highest rating by at least two (2) Nationally Recognized Statistical Rating Organizations (NRSROs) at the time of purchase and adhering to the investment policies and procedures adopted by the State Investment Board.

8.9 Mutual funds used specifically for debt issues related to arbitrage.

9.0 Safekeeping and Custody:

All security transactions, including collateral for repurchase agreements, entered into by the City of Stanwood shall be conducted on a delivery-versus-payment (DVP) basis. Securities will be held by a third party custodian designated by the Finance Director.

Certificates of Deposit in the City's name, or confirmations of them, will be delivered to and held in the Finance Department.

10.0 Diversification:

The City will diversify its investments by security type and institution. The following schedule provides the maximum holdings in any one type of investment or with any one issuer.

Type of Security	Maximum Holdings
Certificates of Deposit	50% of Portfolio 10% per Issuer 20% of Issuer's Net Worth
U.S. Treasury Notes, Bonds or Certificates	100% of Portfolio
U.S. Government Sponsored Corporations	100% of Portfolio
Bankers Acceptances	25% of Portfolio 10% per Issuer
State of Washington or Local Government Bonds	25% of Portfolio 10% per Issuer
Repurchase Agreements	25% of Portfolio 25% per Dealer
State Investment Pool	100% of Portfolio
Commercial Paper	10% of Portfolio 10 % per Issuer
Mutual Funds	Arbitrage related only
Other Authorized Investments	10% of Portfolio

Separate guidelines containing additional or more restrictive limitations for certain investment instruments are contained in the investment procedures document.

11.0 Maturities:

To the extent possible, the City will attempt to match its investments with anticipated cash flow requirements. Unless matched to a specific cash flow or restricted by state guidelines, the City will not directly invest in securities maturing more than five years from the date of purchase. However, the City may collateralize its repurchase agreements using longer-dated investments.

Separate guidelines containing additional or more restrictive limitations for certain investment instruments are contained in the investment procedures document.

12.0 Internal Control:

The Finance Director shall establish a process of independent review by an external auditor. This review will provide internal control by assuring that policies and procedures are being complied with. Such review may also result in recommendations to change operating procedures to improve internal control.

13.0 Performance Standards:

The City of Stanwood's investment portfolio will be designed with the objective of attaining a rate of return commensurate with the City's investment risk constraints and the cash flow characteristics of the portfolio.

13.1 Average Rate of Return: The basis used by the Finance Director to determine whether an average rate of return is being achieved shall be the 2 year average of the 2-Year Treasury Note.

14.0 Reporting:

The Finance Director is charged with the responsibility of including a report on investment activity and returns in the City's Quarterly Financial Report.

15.0 Investment Policy Adoption:

The City of Stanwood's investment policy shall be adopted by resolution of the City Council. The policy shall be reviewed on a biennial basis by the Finance Committee and any modifications made thereto must be approved by the City Council.

GLOSSARY OF TERMS

AGENCIES: Federal agency securities.

ANNUAL FINANCIAL REPORT: The official annual report for the City of Stanwood. It is based on a December 31st fiscal year end and is submitted to the State Auditor no later than May 31st of the following year. The State Auditor reviews and issues opinions on the City's annual financial reports on a biennial basis.

ASKED: The price at which securities are offered.

BANKERS' ACCEPTANCE (BA): A draft or bill or exchange accepted by a bank or trust company. The accepting institution guarantees payment of the bill, as well as the issuer.

BID: The price offered for securities.

BROKER: A broker brings buyers and sellers together for a commission paid by the initiator of the transaction or by both sides; he does not position. In the money market, brokers are active in markets in which banks buy and sell money and in interdealer markets.

CERTIFICATE OF DEPOSIT (CD): A time deposit with a specific maturity evidenced by a certificate. Large-denomination CD's are typically negotiable.

COLLATERAL: Securities, evidence of deposit or other property which a borrower pledges to secure repayment of a loan. Also refers to securities pledged by a bank to secure deposits of public monies.

COUPON: (a) The annual rate of interest that a bond's issuer promises to pay the bondholder on the bond's face value. (b) A certificate attached to a bond evidencing interest due on a payment date.

DEALER: A dealer, as opposed to a broker, acts as a principal in all transactions, buying and selling for his own account.

DEBENTURE: A bond secured only by the general credit of the issuer.

DELIVERY VERSUS PAYMENT: There are two methods of delivery of securities: delivery versus payment and delivery versus receipt (also called free). Delivery versus payment is delivery of securities with an exchange of money for the securities. Delivery versus receipt is delivery of securities with an exchange of a signed receipt for the securities.

DISCOUNT: The difference between the cost price of a security and its value at maturity when quoted at lower than face value. A security selling below original offering price shortly after sale also is considered to be at a discount.

DISCOUNT SECURITIES: Non-interest bearing money market instruments that are issued at a discount and redeemed at maturity for full face value, e.g., U. S. Treasury bills.

GLOSSARY OF TERMS (Continued)

DIVERSIFICATION: Dividing investment funds among a variety of securities offering independent returns.

FEDERAL CREDIT AGENCIES: Agencies of the Federal government set up to supply credit to various classes of institutions and individuals, e.g., S&L's, small business firms, students, farmers, farm cooperatives, and exporters.

FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC) An independent federal agency that insures deposits in member banks, currently up to $100,000 per deposit.

FEDERAL FUNDS RATE: The rate of interest at which Fed funds are traded. This rate is currently pegged by the Federal Reserve through open-market operations.

FEDERAL HOME LOAN BANKS (FHLB): The institutions that regulate and lend to savings and loan associations.

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA): FNMA, like GNMA was chartered under the Federal National Mortgage Association Act in 1938. FNMA is a federal corporation working under the auspices of the Department of Housing & Urban Development, H.U.D. It is the largest single provider of residential mortgage funds in the United States. Fannie Mae, as the corporation is called, is a private stockholder-owned corporation. The corporation's purchases include a variety of adjustable mortgages and second loans in addition to fixed-rate mortgages. FNMA's securities are also highly liquid and are widely accepted. FNMA assumes and guarantees that all security holders will receive timely payment of principal and interest.

FEDERAL OPEN MARKET COMMITTEE (FOMC): Consists of seven members of the Federal Reserve Board and five of the twelve Federal Reserve Bank Presidents. The President of the New York Federal Reserve Bank is a permanent member while the other Presidents serve on a rotating basis. The Committee periodically meets to set Federal Reserve guidelines regarding purchases and sales of Government Securities in the open market as a means of influencing the volume of bank credit and money.

FEDERAL RESERVE SYSTEM: An independent agency of the U.S. government that plays a central role in monetary policy, domestic payment systems, and the regulations of financial institutions.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA or Ginnie Mae): Securities guaranteed by GNMA and issued by mortgage bankers, commercial banks, savings and loan associations and other institutions. Security holder is protected by full faith and credit of the U. S. Government. Ginnie Mae securities are backed by FHA, VA or FMHM mortgages. The term pass-throughs is often used to describe Ginnie Maes.

LIQUIDITY: A liquid asset is one that can be converted easily and rapidly into cash without a substantial loss of value. In the money market, a security is said to be liquid if the spread between bid and asked prices is narrow and reasonable size can be done at those quotes.

GLOSSARY OF TERMS (Continued)

LOCAL GOVERNMENT INVESTMENT POOL (LGIP): The aggregate of all funds from political subdivisions that are placed in the custody of the State Treasurer for investment and reinvestment.

MARKET VALUE: The price at which a security is trading and could presumably be purchased or sold.

MASTER REPURCHASE AGREEMENT: A written agreement covering all future transactions between the investor and dealer or financial institution. The agreement defines the nature of the transactions, identifies the relationship between the parties, establishes normal practices regarding ownership and custody of the collateral securities during the term of the investment, provides for remedies in the event of a default by either party, and otherwise clarifies issues of ownership.

MATURITY: The date upon which the principal or stated value of an investment becomes due and payable.

MONEY MARKET: The market in which short-term debt instruments (bills, commercial paper, bankers' acceptances, etc.) are issued and traded.

OPEN MARKET OPERATIONS: Purchases and sales of government and certain other securities in the open market by the New York Federal Reserve Bank as directed by the FOMC in order to influence the volume of money and credit in the economy. Purchases inject reserves into the bank system and stimulate growth of money and credit; sales have the opposite effect. Open market operations are the Federal Reserve's most important and most flexible monetary policy tool.

PORTFOLIO: Collection of securities held by an investor.

PUBLIC DEPOSIT PROTECTION COMMISSION: The Public Deposit Protection Commission provides security for public treasurers in Washington State by protecting public deposits which exceed the amount insured by the FDIC. It also minimizes participating depositaries' liability for defaulting institutions

PRIMARY DEALER: A group of government securities dealers that submit daily reports of market activity and positions and monthly financial statements to the Federal Reserve Bank of New York and are subject to its informal oversight. Primary dealers include Securities and Exchange commission (SEC) registered securities broker-dealers, banks, and a few unregulated firms.

PRUDENT PERSON RULE: An investment standard. In some states the law requires that a fiduciary, such as a trustee, may invest money only in a list of securities selected by the state--the so-called legal list. In other states the trustee may invest in a security if it is one which would be bought by a prudent person of discretion and intelligence who is seeking a reasonable income and preservation of capital.

GLOSSARY OF TERMS (Continued)

QUALIFIED PUBLIC DEPOSITORIES: A financial institution which does not claim exemption from the payment of any sales or compensating use or ad valorem taxes under the laws of this state, which has segregated for the benefit of the commission eligible collateral having a value of not less than its maximum liability and which has been approved by the Public Deposit Protection Commission to hold public deposits.

RATE OF RETURN: The yield obtainable on a security based on its purchase price or its current market price. This may be the amortized yield to maturity on a bond or the current income return.

REPURCHASE AGREEMENT (RP OR REPO): A transaction between a securities dealer and an investor in which the dealer sells the security to the investor with an agreement to buy the security back at a specific time and price that will result in a predetermined yield for the investor.

SAFEKEEPING: A service provided/contracted with a financial institution for the settling and holding of securities on behalf of the customer. In the case of book entry securities; holding of securities in the customer's name.

SECONDARY MARKET: A market made for the purchase and sale of outstanding issues following the initial distribution.

SEC RULE 15C3-1: See uniform net capital rule.

SECURITIES & EXCHANGE COMMISSION: Agency created by Congress to protect investors in securities transactions by administering securities legislation.

TREASURY BILLS: A non-interest bearing discount security issued by the U. S. Treasury to finance the national debt. Most bills are issued to mature in three months, six months, or one year.

TREASURY BOND: Long-term U. S. Treasury securities having initial maturities of more than ten years.

TREASURY NOTES: Intermediate term coupon bearing U. S. Treasury securities having initial maturities of from one to ten years.

YIELD: The rate of annual income return on an investment, expressed as a percentage. (a) INCOME YIELD is obtained by dividing the current dollar income by the current market price for the security. (b) NET YIELD or YIELD TO MATURITY is the current income yield minus any premium above par or plus any discount from par in purchase price, with the adjustment spread over the period from the date of purchase to the date of maturity of the bond.

GLOSSARY OF TERMS (Continued)

UNIFORM NET CAPITAL RULE: Securities and Exchange Commission requirement that member firms as well as nonmember broker-dealers in securities maintain a maximum ratio of indebtedness to liquid capital of 15 to 1; also called *net capital rule* and *net capital ratio*. Indebtedness covers all money owed to a firm, including margin loans and commitments to purchase securities, one reason new public issues are spread among members of underwriting syndicates. Liquid capital includes cash and assets easily converted into cash.

10. Special Revenue Policies

a. The City will establish and maintain Special Revenue Funds which will be used to account for the proceeds of specific revenue sources to finance specified activities which are required by statute, ordinance, resolution, or executive order.

b. Special Revenue Funds will be reviewed by the City during the budget process.

11. Accounting, Auditing, and Financial Reporting Policies

a. The City will establish and maintain a high standard of internal controls and accounting practices. The City accounts for revenues and expenditures on a cash basis.

b. The accounting system will maintain records on a basis consistent with accepted standards for local government accounting and the State of Washington Budgeting, Accounting, and Reporting Systems (BARS).

c. Regular monthly and annual financial reports will present a summary of financial activity by major types of funds. Such reports will be available via the City's website (www.ci.stanwood.wa.us).

d. The annual financial report shall conform to Washington State statutes and the State of Washington Budgeting, Accounting and Reporting Systems (BARS) manual prescribed by the State Auditor, which is a comprehensive basis of accounting other than generally accepted accounting principles.

e. A fixed asset system will be maintained to identify all City assets, their location, and their condition.

f. The City will ensure that City records are audited biennially and which will result in the issuance of a financial opinion. The results of such audit are to be available to the public via the City’s website.

12. Budget Calendar

a. In order to facilitate and implement the budget process, the Mayor will propose an annual budget calendar sometime in the first quarter of every year.

b. The calendar will be comprehensive in nature and generally provide for a process that resembles the Best Practices as published by the Government Finance Officers Association.