CITY OF STANWOOD
CITY COUNCIL
AGENDA STAFF REPORT

SUBJECT: Proposed Financial and Investment Policies – Continuation of February 28, 2013 Committee Discussion	**FOR AGENDA OF: March 28, 2013 – Finance Committee** **DEPARTMENT OF ORIGIN: Finance** **DATE SUBMITTED: March 20, 2013** **CLEARANCES: (check box)** ☐ **City Attorney ____________** ☐**City Clerk/HR ____________** ☐**Community Development ____________** ☐**Fire ____________** ☐**Finance ____________** ☐**Police ___________** ☐ **Public Works ____________** **APPROVED FOR SUBMITTAL BY THE CITY ADMINISTRATOR:____________**
ATTACHMENT(S): **None**	
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, presented below for consideration and discussion are just the first five categories:

1. General Financial Goals
2. Operating Budget Policies
3. Revenue Policies
4. Expenditure Policies
5. Capital Investment Budget Policies

Attachment A (current financial goals) outlines a set of proposed policies.

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 the availability of new revenues (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.

c. 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.

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.

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