City of Redmond
WASHINGTON

AM No. 11-222(C5)

MEMO TO: Members of the City Council

FROM: John Marchione, Mayor

DATE: November 15, 2011

SUBJECT: **BIENNIAL UPDATE OF THE FISCAL POLICIES**

I. RECOMMENDATION

Adopt the revised City of Redmond fiscal policies based on staff recommendations arising out of conversation with the City Council.

II. DESCRIPTION

Each biennial budget cycle starts with a review and refresh of the City's fiscal policies. In preparing recommendations for this review, staff reviewed the existing policy, as well as legislative and other changes that may affect those policies. The Public Administration and Finance Committee reviewed the policies and the staff recommendations at its meeting on September 26, 2011. The recommendations were further discussed with the full Council at their October 25, 2011, study session. The recommendations are included here for Council consideration of adoption.

The City's fiscal policies set the framework for several elements of its fiscal management practices. Most significantly, the policies are instrumental in the approach the city takes each year to creating, reviewing, and adopting its biennial budget. The policies build on the general guidance provided by state law and are also reviewed in the context of the best practices of the Government Finance Officers Association (GFOA).

The review of the city's fiscal policy in 2011 for the 2013-2014 budget process identified the following changes as recommended by staff (note – purely grammatical changes are not included in this review):

1. Page 2, item 2.g – As the city has already developed an equipment replace needs analysis, staff recommends changing the policy from developing the analysis to maintaining it.

2. Page 3, item 4.f - As the city has already developed a cost allocation plan, staff recommends changing the policy from developing the plan to maintaining it. Additionally staff recommends the policy call for a review of the plan as part of each budget cycle.

3. Page 4, item 5 (new item h) – A revision to state law allows the city to utilize Real Estate Excise Tax (REET) revenues for certain general operating maintenance; however, staff is recommending that the city retain its past practice, and as a matter of fiscal policy, restrict use of REET revenues to capital projects.

4. Page 5, item 6.c – Strike the words "by ordinance or resolution," as they seemed unnecessary.

5. Page 5, item 7.f – Staff is seeking to broaden the policy calling for the maintenance of good communications beyond just the rating agencies to the "investment community". This expansion would include potential for secondary market investors, investment publications, financial institutions, and others.

6. Page 7, item 8.d – Staff recommends the Council establish an Economic Contingency Reserve, as a standing reserve of 4% of revenues in addition to the Operating Reserve called for in 8. a. The City Council has included such a reserve in at least the past two biennial budgets as a "hedge" against underperforming revenues. The proposed change would have the effect of increasing the city's overall general operating reserves from 8.5% to 12.5%.

   Discussion at the Public Administration and Finance Committee included:

   a. The recent economy has demonstrated that revenues can sometimes be difficult to predict. That is especially true in a biennial budget.
   b. GFOA best practices recommend that governments "maintain an 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" (BEST PRACTICE - Appropriate Level of Unrestricted Fund Balance in the General Fund - 2002, revised 2009). (see attached)
   c. Discussions with bond rating agencies have revealed that they believe a stronger reserve policy would be advisable. While the city maintained its AAA credit rating in the most recent credit review, there was a significant amount of focus on the city's reserves.
   d. Neighboring jurisdictions – the Public Administration and Finance Committee requested that staff research the reserve policies and actual practices of neighboring jurisdictions to ascertain whether the city's practices are consistent. Attached are the results of such

review. It appears that Redmond's existing policy is a bit below neighboring jurisdictions. The proposed policy would continue to be at the low end of the local city jurisdictions.

e. As this reserve has been included in the current biennial budget the funding of the reserve already is in place.

7. Page 7, item 8. e – Staff recommends a requirement that, should a city reserve provided for in these polices be utilized, that a plan for replenishment be required.

8. Page 8, item 8. k – Staff recommends clarifying that the sick-leave payment is due for staff that qualify for retirement upon separation whether or not staff actually separate to retire. This matter has been a point of confusion with the city's auditors and we believe this will help clarify the existing city practice.

9. Page 8, item 9 – Staff recommends a clarification that proposed amendments (if any) will be considered biennially, as an investment policy already exists.

10. Page 9, item 10. a – Staff recommends the inclusion of Generally Accepted Accounting Principles (GAAP) as a basis for criteria regarding the creation of Special Revenue Funds. The GAAP for special revenue funds have narrowed significantly with GASB Statement 54 and this clarification is intended to highlight that change.

III. ATTACHMENTS

A. Comparative Reserve Policies

B. Best Practices: Appropriate Level of Unrestricted Fund Balance in the General Fund (2002 and 2009) (BUDGET and CAAFR)

C. Revised Fiscal Policies

Mike Bailey, Finance and Information Services Director — Date 11/4/11

Approved for Council Agenda J. Marchione
John Marchione, Mayor — Date 11/7/11

Comparative Reserve Policies

	Base	Economic	Other	**Actual** (year end 2010)
Renton	8%		4%	10%
Mercer Island	10%	$300,000		11.30%
Sammamish	10%	.375% of AV		above target
Kirkland [1]	5%	10%		below target
Bellevue [2]	15%			14%
Woodinville	30%	15%		80%
Redmond existing	8.50%			18.40%
Redmond proposed	8.50%	4%		18.40%

Notes:

1 Kirkland's 5% base reserve is on all general government operating funds
Kirkland's 10% economic stabilization reserve is on selected revenues
(e.g. sales and utility taxes)

2 Ending fund balance above reserve to be used as contingency as well.
Actual is estimate from their 2010 CAFR

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.

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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).