



City of Shafter COUNCIL AGENDA REPORT

Meeting Date: May 12, 2020

FROM: Gabriel Gonzalez, City Manager
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SUBJECT: BUDGET AND FISCAL POLICIES

RECOMMENDATION

Conceptually approve the proposed *Budget and Fiscal Policies* in guiding preparation of the Preliminary Budget, with final adoption in June 2020 in conjunction with approval of the 2020-21 Budget.

DISCUSSION

Background

When clearly articulated (and followed), budget and fiscal policies provide an essential foundation for effective financial decision-making and in protecting the City's fiscal health, in both the short and long-term.

The City's fiscal health is a lot like personal health: it isn't what you live for; but it is hard to enjoy your life without it. Cities don't exist to be fiscally healthy: they exist to make communities better places to live, work and play. However, this requires the fiscal capacity to link community goals with the resources needed to achieve them. In short, fiscal health is not an end in itself; but it is an important part of the tool kit in achieving "ends."

And like personal health, fiscal health is rarely luck. The strength of the local economy is obviously an important fiscal health factor – just as genes are in personal health. However, regardless of the strength of its local economy, no city is immune from economic downturns or unexpected expenditure needs.

For this reason, clearly articulated policies are a city's "north star" in guiding the preparation and implementation of budgets and financial plans.

They help make tough decisions easier by stating an organization's values before they are placed under stress by adverse circumstances. The organization might still choose to do something different – effective policies are guides, not straightjackets – but they are a powerful starting point: but for "this," the organization should do what?

Formal statements key budget and fiscal policies provide the foundation for assuring long-term fiscal health by establishing a clear framework for effective and prudent financial decision-making.

Stated simply, articulating and then following prudent fiscal policies is the most effective and proven way for government agencies to ensure their long-term fiscal health.

Budget and Fiscal Policies

They are both preventative and curative: clearly articulated policies help prevent problems from arising in the good times; and help respond to bad times when they do occur. They also help provide continuity as elected officials and staff change. Lastly, budget and fiscal policies are most powerful when put in place before the need for them arrives.

In summary, adopting key fiscal policies is an essential factor for effective stewardship of the City's resources, both in the short and long-term.

Proposed Budget Policies

“One size does not fit all” in setting fiscal policies. Careful consideration needs to be given in developing policies that are appropriate given the unique circumstances of each city.

Based on “best practices” recommended by professional organizations like the Governments Finance Officers Association of the United States and Canada (GFOA) and the California Society of Municipal Finance Officers (CSMFO) as well as the major credit rating agencies, fiscal policy areas that the City will want to address are presented in the sidebar.

However, these can be developed over time when the new Administrative Services Director comes on board. Accordingly, for guidance in preparing the 2020-21 Budget, we recommend focusing on the following four policies as set forth in Attachment 1:

- Budget purpose and organization
- Revenue management
- Minimum fund balance and reserves
- Financial reporting and budget administration

Each of these will provide an important foundation and guidance for staff preparation of the Preliminary Budget for 2020-21 as well for the Council's review of it at the workshops and hearings that will follow its issuance by June 1, 2020.

Minimum Fund Balance and Reserves

While each of the attached policy areas speak for themselves, minimum fund balance is an especially important policy in determining the City's ability to respond to unexpected fiscal hardships such as local disasters, public health

Fiscal Policy “Best Practices”

“One size does not fit all” in setting fiscal policies. Careful consideration needs to be given in developing policies that are appropriate given the unique circumstances of each city. Fully addressing all of these areas is planned in the coming year.

- Budget purpose and organization (including a balanced budget policy and what this means)
- Revenue management
- User fee cost recovery: when should user fees fund services versus general purpose revenues?
- Minimum fund balance and reserves
- Financial reporting
- Budget administration
- Investments
- Appropriations limit
- Capital improvement plan (CIP) management
- Capital financing and debt management
- Purchasing
- Human resources management
- Productivity
- Contracting for services

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crises, downturns in the economy, external revenue hits (like State budget takeaways) and unforeseen operating or capital needs. Stated simply, it is the City's first line of defense in responding to adverse, unforeseen circumstances.

The City is fortunate to already have in place a comprehensive reserve policy, which was adopted by the Council in February 2017 (Resolution No. 2509). However, there are a few proposed clarifications that would be useful for 2020-21 and beyond in implementing this policy, most notably:

- **Purpose of reserves.** Reserves exist for a reason. The proposed policy sets forth those purposes in accordance with the risk assessment methodology developed by the GFOA.
- **Defining operating expenditures.** The current policy calls for a minimum assigned fund balance in the General Fund of 50% of operating expenditures; and minimum available working capital in the Water, Wastewater and Refuse enterprise funds of 25% of operating expenditures. However, it delegates determining operating expenditures to the Administrative Services Director. The proposed policy makes it clearer in defining how this basis should be determined: operating, debt service and revenue sharing pass-through expenditures, less any significant one-time operating costs.
- **Guidance on when it is appropriate to go below the minimum target.** The proposed policy clarifies the one-time circumstances where taking reserves below the target minimum balances would be appropriate.

These proposed changes to the current minimum fund balance/reserve policy are highlighted in the attached *Budget and Fiscal Policies*: additions are underlined, and deletions are ~~struck through~~.

Next Steps

If conceptually approved by the Council at this time, staff will use these policies as the foundation in guiding preparation of the 2020-21 Preliminary Budget. Final adoption of the policies will occur in June 2020 in conjunction with the Council's approval of the 2020-21 Budget. For future reference, the City's *Budget and Fiscal Policies* will be included the Budget document (as will any future additions or revisions).

In considering the proposed *Budget and Fiscal Policies*, it is important to note that while the City is currently in compliance with all of them, this may not always be the case in the future. Accordingly, it is important nonetheless to articulate the goal: clearly stating where the City wants to be (versus where it may at that time) will significantly enhance the City's ability to achieve it.

For this reason, each policy area is followed by a brief summary of "compliance status." If the City has not yet achieved the goal, a status summary on the City's progress in doing should be provided. In short, including the policies in the Budget document will keep the policies in front of the Council, community and organization; and help make the relationship between policy and actual transparent for these stakeholders.

FISCAL IMPACT

There are no direct fiscal impacts as a result of conceptually approving the proposed *Budget and Fiscal Policies*. However, this will provide an important policy framework and foundation for preparing the Budget.

ALTERNATIVES

1. Approve different budget and fiscal policies than those proposed.
2. Do not approve budget and fiscal policies in establishing a policy framework for financial management and decision-making.

ATTACHMENT

1. Proposed Budget and Fiscal Policies



BUDGET AND FISCAL POLICIES

BUDGET PURPOSE AND ORGANIZATION

A. **Balanced Budget.** The City will maintain a balanced budget. This means that:

1. Operating revenues must fully cover operating expenditures, including debt service and revenue sharing pass-throughs.
2. Ending fund balance/working capital must meet minimum policy levels or other target levels established by the Council for the fiscal year.

Under this policy, it is allowable for total expenditures to exceed revenues in a given year; however, in this situation, beginning fund balance should only be used to fund capital improvement plan projects or other “one-time,” non-recurring expenditures. (See *Minimum Fund Balance and Reserves* policy below for other circumstances when it would be appropriate to use beginning fund balance.)

B. **Budget Objectives.** Through its Budget, the City will link resources with goals and results by:

1. Identifying community needs for essential services.
2. Organizing the programs required to provide these essential services.
3. Describing programs and activities performed in delivering services.
4. Proposing objectives for improving the delivery of program services.
5. Identifying and appropriating the resources required to perform program activities and accomplish program objectives.

C. **Measurable Objectives.** The Budget will establish measurable program objectives and allow reasonable time to accomplish those objectives.

D. **Goal Status Reports.** The status of major program objectives will be formally reported to the Council on an ongoing, periodic basis.

E. **Mid-Year Budget Reviews.** The Council will formally review the City’s fiscal condition, and amend appropriations if necessary, six months after the beginning of each fiscal year.

Status: In Compliance. These practices are either in place or the Council has adopted a budget process and document for 2020-21 that meets these policy objectives. However, linking resources to outcomes and measuring performance will always be a work in progress, with ongoing improvements.

REVENUE MANAGEMENT

- A. Current Revenues for Current Uses; One-Time Revenues for One-Time Purposes.** The City will make all current expenditures with current revenues, avoiding procedures that balance current budgets by postponing needed expenditures, accruing future revenues or rolling over short-term debt. The City will avoid using one-time revenues to fund ongoing program costs.
- B. Revenue Distribution.** The Council recognizes that generally accepted accounting principles for state and local governments discourage the “earmarking” of General Fund revenues, and accordingly, the practice of designating General Fund revenues for specific programs should be minimized in the City's management of its fiscal affairs. In those cases where it does occur, the basis and methodology for earmarking should be clearly articulated in the City’s Budget and Fiscal Policies.

Status: In Compliance. These practices are either in place or the Council has adopted a budget process and document for 2020-21 that meets these policy objectives.

MINIMUM FUND BALANCE AND RESERVES

Section 1: Policy

- A. Policy Overview.** This policy accomplishes two main goals. First, it sets forth specific levels of minimum unassigned fund balance to be maintained for the City's General Fund and a minimum level of available working capital for the City's Water, Wastewater and Refuse enterprise funds. Secondly, this policy establishes a framework and process for the City to follow if these reserve levels falls below the established minimum.

This policy provides guidelines for fiscal sustainability through maintaining adequate operational liquidity and should be used in the preparation of the City's Annual Operating Budget, Capital Improvement Plan and general financial management of the City. It does recognize the need for exceptions in extraordinary conditions and unforeseeable events while maintaining a goal and path to regain fiscal sustainability when necessary.

This Policy should be submitted periodically for peer review, if available, to confirm compliance with best practices and industry standards, including those issued by the Governmental Finance Officers Association of the United States and Canada (GFOA) in setting reserve levels that adequately address risks such as:

1. Economic uncertainties, local disasters, public health crises and other financial hardships or downturns in the local or national economy.
2. Contingencies for unseen operating or capital needs.
3. Unfunded liabilities such as self-insurance, pensions and retiree health obligations.
4. Institutional changes, such as State budget takeaways and unfunded mandates.
5. Cash flow requirements.

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While an independent review does not serve as a substitute for adoption by the Council, it does demonstrate staff's due diligence in the preparation and updating of the policy.

- B. **Objectives.** The purpose of this policy is to assist the City in the pursuit of the following equally important objectives:
1. Maintain long-term fiscal sustainability of the General, Water, Wastewater and Refuse Funds.
 2. Meet the short-term liquidity needs of the General, Water, Wastewater and Refuse Funds.
 3. Cultivate a fiscally responsible internal control environment.
 4. Help achieve the highest possible credit ratings and lowest possible financing costs when borrowing funds.
- C. **Budget Integration and Financial Management.** The City's Annual Operating Budget and Capital Improvement Plan should be developed to comply and implement the various aspects of this policy. This includes but is not limited to both the budgeted use of excess unassigned fund balance or available working capital and the rebuilding of the same as needed to maintain compliance with the minimum reserve levels established herein. As a part of the budget process the City should conduct a sustainability analysis of the General Fund, which compares actual and budgeted recurring revenue sources with recurring expenditures. This tool can help identify a fiscal imbalance before it erodes the General Fund unassigned fund balance.
- Any areas of shortfall or otherwise non-compliance with the minimum reserve levels contained within this policy should be disclosed in the City's Annual Operating Budget document and Comprehensive Annual Financial Report, including a response from management on what actions are being taken to bring the City back into compliance with the policy.
- D. **Annual Policy Review.** Recognizing the liquidity needs of the City will change over time due to items such as the volatility of expenditures; exposure to significant one-time outlays; potential impact on the City's bond rating and cost of borrowed funds; other fiscal commitments and assignments; and the availability of other funds. Accordingly, this policy will be reviewed in conjunction with the City's budget process. Any changes to the policy shall be brought to the Council for consideration and approval.

Section 2: Minimum Balances

The following amounts are hereby established as the minimum unassigned fund balance for the City's General Fund and minimum available working capital for the City's major utility enterprise funds.

- A. **General Fund.** At the end of each fiscal year, the General Fund should have a minimum unassigned fund balance of at least 50% of the next fiscal year's budgeted General Fund annual operating expenditures ~~as calculated by the Administrative Services Director.~~ This is

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determined based on operating, debt service and revenue sharing pass-through expenditures, less any significant one-time operating costs. This represents 180 days of General Fund operating cash flow and is conservatively based on the risk assessment methodology for setting reserve levels developed by the GFOA.

- B. **Water, Wastewater and Refuse Funds.** The City operates three major utility enterprise funds: water, wastewater and refuse, which provide essential public services that are paid for by users of these services. Maintaining adequate liquidity in these funds is an essential factor in the City's ability to provide these services without interruption. Accordingly, at the end of each fiscal year the City should have a minimum available working capital balance (current assets less current liabilities, minus amounts designated for funding capital projects) in each of these enterprise funds at equal or more than 25% of ~~the next fiscal year's budgeted~~ operating expenditures for that fund ~~as calculated by the Administrative Services Director.~~ This is determined based on operating, debt service and revenue sharing pass-through expenditures, less any significant one-time operating costs.

This minimum available working capital balance should be factored into all future user rate studies used to establish utility user rates for these three funds.

- C. **Taking Reserves Below Minimum Policy Levels.** There are circumstances where intentionally taking reserves below the established policy levels would be appropriate in responding to the risks that reserves are intended to mitigate and are not considered a violation of this policy. These include one-time uses such as:

1. Making investments in human resources, technology, economic development, productivity improvements and other strategies that will reduce future costs or increase future revenue sources.
2. Reducing ongoing expenditures through the partial or full refinancing of liabilities
3. Closing short-term revenue/expenditure gaps.
4. Responding to unexpected expenditure requirements or revenue shortfalls.
5. Meeting one-time cash flow needs as well as normal cash flow needs during the year.
6. Where a forecast shows an ongoing structural gap, providing a strategic bridge to the future.

Any intentional use of reserves that reduces reserve levels below the minimum policy levels shall be specifically approved by the Council.

Section 3: Correcting Balances Below the Minimum Balance

Whenever the City's Funds with established minimum balances per this policy fall below these minimal levels, the City will strive to restore these balances to the minimum level within a three-year period. Some actions that may be considered to rectify this situation include the following:

Budget and Fiscal Policies

A. General Fund

1. Strategically reducing general fund operating budgets.
2. Updating and improving the City's economic development strategy.
3. Assessing workload and staffing levels to ensure appropriate staffing of General Fund operations, redeploy staffing if necessary.
4. Conduct a revenue study to update General Fund revenue sources that may have fallen behind.
5. Conduct an analysis of the General Fund cost allocation to plan to ensure other City funds are paying the appropriate fees for the General Fund services they receive.
6. Identify special revenues or other funds that can help support the General Fund.

B. Water, Wastewater and Refuse Funds

1. Strategically reduce operations budgets.
2. Initiate a user rate analysis and implement rate changes as needed.
3. Analyze existing debt and possible refinancing options to reduce existing debt service costs.
4. Defer non-essential capital improvement projects until adequate funding can be secured through rate increases, grants or debt issuance.

Section 4: Use of Balances Exceeding the Minimum Balance

At times, the City may find itself with unassigned General Fund balances and/or available working capital in the Water, Wastewater and Refuse funds that exceed the minimums established by this policy. This policy does not require or recommend that those additional reserve funds be spent down but it does establish the following guidelines regarding the potential use of those funds.

- A. Excess reserve funds are not to be used for new or existing recurring expenses except on a short-term basis.
- B. Investment of these funds on a longer-term basis, in compliance with the City's Investment Policy, should be considered to provide an ongoing source of recurring investment income for the City
- C. Assignment or use of these funds should be considered for early partial or full retirement of existing debt or other City liabilities.
- D. A review of the one-time capital improvements needed within the City should be considered to identify and prioritize potential capital projects. Once potential projects have been

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identified, assignment or use of these funds should be considered for these one-time capital improvement projects.

- E. New (as opposed to replacement) one-time capital improvement projects considered for funding should be consistent with the long-term planning of the Council and community led Shafter Visioning project.

Status: In Compliance. The unassigned General Fund balance was 54% of operating and revenue-sharing pass-through expenditures at June 30, 2019.

FINANCIAL REPORTING AND BUDGET ADMINISTRATION

A. **Annual Reporting.** The City will prepare annual financial statements as follows:

1. In accordance with Charter requirements, the City will contract for an annual audit by a qualified independent certified public accountant. The City will strive for an unqualified auditors' opinion.
2. The City will use generally accepted accounting principles in preparing its annual financial statements and will strive to meet the requirements of the GFOA's Award for Excellence in Financial Reporting program.
3. The City will issue audited financial statements within 180 days after year-end.

B. **Interim Reporting.** The City will prepare and issue timely interim reports on the City's fiscal status to the Council and staff. This includes on-line access to the City's financial management system; monthly reports to program managers; more formal quarterly reports to the Council and Department Heads; mid-year budget reviews; and interim annual reports.

C. **Budget Administration.** The Council may amend or supplement the budget at any time after its adoption by majority vote of the Council members. Council approval is required for all new appropriations from fund balance. The City Manager has the authority to make administrative adjustments to the budget as long as those changes will not have a significant policy impact nor affect budgeted year-end fund balances.

Status: In Compliance. These practices are in place.