City of Annapolis
Financial Advisory Commission

Collaborative Stewardship: Guiding Principles and Metrics for City of Annapolis Financial Improvement
Adopted November 15, 2013

The inaugural Financial Advisory Commission was assembled in July, 2010. The Mayor, City Council, City Manager, and Director of the Finance Department welcomed the FAC as (1) a sounding board with respect to the immediate financial crisis and (2) a consultancy to recommend solutions for the profound structural[1] and operational deficiencies[2] that precipitated the crisis.

The FAC's deliberations and advisory opinions *vis a vis* the City's day to day operations are a matter of public record. Behind the scenes, the FAC concurrently engaged in substantive discussions with the Finance Director and members of the City Council's Finance Committee about the nuts and bolts of the collaborative stewardship envisioned in the FAC's charter: How can we safeguard proper financial controls with prudent policy and oversight to ensure the City's financial solvency and sustainability over the long-term? The blueprint below summarizes these consultative discussions for the public record.

It is the intent of the FAC that the guiding principles in this outline be accepted and adopted by the Mayor and City Council and that FAC members with relevant expertise and interest in specific topics will provide assistance and guidance, individually or in small work groups, to the Mayor, the City staff and the City Council to develop and implement the recommended models and metrics. In order to oversee implementation and compliance, the FAC should request, minimally annually, that the City Administration make a report to the Commission.

The Financial Advisory Commission recommends structural and operational remedies for the City's financial improvement. In order to implement these remedies, it is critical that the City take specific actions for each. The following is an outline of recommendations to achieve these goals.

<u>Structural Remedies</u>

I. Corporate governance

Introduction:

Corporate governance is the overall system by which the City is managed, directed, controlled and otherwise governed. An organization having a strong Corporate Governance model and corporate culture will make it more likely that goals will be realized. The components of corporate governance include state laws, City Code/Charter, policies and

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[1] Structural considerations include corporate governance, strategic planning models and developing a human capital model- the stock of competencies, and knowledge and personal attributes that are embodied by an organization.

[2] Operational considerations include financial reporting, budgeting, collective bargaining, risk management, and balance/non balance sheet oversight. Major categories being cash, fixed assets, debt, pension, Other Post Employment Benefits (OPEB) and fund balance/retained earnings.

procedures and stakeholder relationships. The responsibility, and therefore the advocacy, for corporate governance lie with the City Council, Mayor and Administration. Core components of corporate governance are strong financial oversight, including a Financial Oversight Board, the internal control environment, and established and documented policies.

Recommended Metrics:

- Establish and adopt a corporate governance model.
  Because corporate governance is driven downward, it is important that a resolution embracing corporate governance be adopted and that management be held accountable to implement and achieve stated goals. It is recommended that the City's measurement focus be by fiscal year and that, as part of the budget adoption process, performance measurements, goals and objectives are adopted annually and management report on each quarterly.

- Develop and maintain planning models.
  i. An annual Strategic Planning model identifying core functional service levels tied to annual performance budgets which are correlated to industry benchmarks.

  ii. An annual 5 year Capital Plan tied to the annual operating budget, identifying capital needs including the impact of operational expenditures, increases or decreases, debt service, the cost of deferring the project, inflationary costs and project present value calculations. If debt service will be used to finance a capital project, amortization schedules should be created for each such project and then summarized by fund. As part of the presentation, a tax rate and/or fee impact analysis should be included.

II. Human Capital

The backbone of any organization and, therefore, its ability to achieve and sustain high levels of success is the people the organization hires. In order to define the core competencies the City expects from its employees and then to perpetuate organizational culture, it is recommended that the City develop a comprehensive Human Capital Assessment and Accountability Framework. This step should begin immediately by developing an implementation plan with the City Manager and HR Director.

Operational Remedies

It is the intent of the City to achieve and then maintain a Triple A bond rating. In order to achieve this goal, the City needs to remedy the operational deficiencies noted above. In order to accomplish this goal, the City should implement the following steps.

The core financial functions of the City can be segregated into the following broad operational categories, financial reporting, budget implementation and oversight, balance and off-balance sheet management, risk management, employee and labor relations, and finally, economic strength. Each of these activities should be managed from a City-wide perspective. This approach can then be further driven down to each fund level, specifically general fund and by each enterprise fund. These categories are a reflection of key categories considered by rating agencies and also reflect operational functions.

I. Financial Reporting should include a policy requiring the frequency of financial reporting, such as; monthly, quarterly, and annually, the scope of the financial reports, and the completion date for each.

II. Budget implementation and oversight should include policy development that addresses each revenue and expenditure category. Revenue categories include taxes, local receipts, intergovernmental and state aid, and grants. Although grants are typically considered intergovernmental receipts, the City should adopt specific grant policies and procedures to preclude unintended and unforeseen future responsibilities. Expenditure categories should include salaries, benefits, operating, debt service and capital expenditures.

Specific Metrics and/or policies should include:

a. By revenue.
    i. Property tax should be based on constant yield / constant levy rather than the tax rate floating with the assessed values.
    ii. External revenue sources as a percentage of revenue, by category, ex., grants and by fund.
    iii. Fees should be correlated to the cost of service, including future capitalization costs.
b. A policy on one-time revenues. Ideally, one time revenues should only be used for one-time expenditures thereby correlating operating expenditures with operating revenues. However, for items such as "rainy day" transfers, there should be a threshold of non-recurring revenues as a percentage of total revenue used for recurring expenditures.
    i. A policy on subsidies from other funds as a percentage of revenue.
    ii. A policy that stipulates for what purpose reserves and retained earnings and/or fund balance can be appropriated.
c. A policy requiring that budget to actual performance be reported monthly and that variances exceeding 10% be documented.
d. A policy requiring a percentage of fund balance as a percentage of revenues.
e. A budget development policy.
    i. A policy requiring that budgets provide a three year history for trending purposes, and a five year forecast, including capital. The impact of capital improvements, including debt service and additional operating services should be noted. Debt service projections should include projections included in the 5 year capital plan.
    ii. A policy requiring that budgets provide key assumptions. Budgets should also provide stress test assumptions.
    iii. A policy requiring that supplemental budgets be adopted for budgets, by fund, not meeting projected revenues by quarterly thresholds or are over budget for expenditures by quarterly thresholds.
    iv. A policy requiring the impact of collective bargaining contracts to be footnoted as part of the budget.
    v. The budget should reflect a tax rate/fee impact analysis for each budget enhancement, including changes in debt service resulting from debt financing.
f. An expenditures policy.
    i. Fixed costs as a percentage of expenditures, by fund.

III. Management of the balance and off-balance sheet categories is essential to the success of the City. The primary categories include cash, investments, receivables, capital assets, accounts payable, debt, pension and OPEB liabilities, and fund balance/retained earnings.

Specific Metrics and/or policies should include:

a. Cash and investments is a measure of liquidity – short term liquidity needs.
    i. Cash as a percentage of expenditures.
b. Accounts Receivable is a measure of collections - should be no more then 2-3%.
c. Capital Assets - much of the oversight and management of capital assets is part of the Capital Plan.
d. Accounts Payable.
    i. Payables as a percentage of expenditures.
    ii. Payables as a percentage of cash.
e. Debt - a policy formalizing debt planning and debt policies incorporating debt burdens, operational debt service costs as a percent of total expenditures, and maximum debt levels. Consideration should be given to inside and outside debt as related to enterprise funds and self supporting debt. Additionally, the use of variable rate obligations and interest rate swaps should be addressed in relation to interest rate exposure and liquidity. The policy should require tying the amortization period to the useful life of the underlying asset and using level principal versus level payment amortization methods.
    i. Total debt outstanding, inside plus outside, as a percentage of full assessed value.
    ii. Inside debt, that inside the debt calculation, as a percentage of full assessed value.
    iii. Debt service as a percentage of the operating budget, in aggregate and by fund.
    iv. Full value per capita.
f. Pension and OPEB liabilities.
g. Fund Balance / Retained Earnings.
    i. Fund balance as a percentage of budgeted revenues, by fund.
    ii. Fund balance as a percentage of assets.
h. Off balance sheet items.
    i. Unsettled labor contracts.
    ii. Pending litigation.

IV. The City needs to adopt an organization risk management assessment which focuses not only on the city risks pools, such as the self insured health and general liability plans, but a risk analysis from a City-wide perspective.

V. The City needs to adopt human capital strategies that address pension and OPEB obligations, while also complementing the Human Capital Assessment and Accountability Framework.

VI. Rating agencies place the greatest weight on economic strength because it provides the source of leverage to support the tax base and drives other revenues including sales tax, utility fees and local receipts. Although the City may not be able to immediately influence this category, it is imperative that the policy makers of the City be familiar with the key attributes.

Specific Metrics and/or policies should include:

a. A policy requiring the development of key economic indicators and that they be reviewed as part the annual budget process and that financial policies be adjusted if necessary.
    i. Valuation and new growth trends, including comparing trends to other local municipalities and national trends.
        1. Occupancy rates.
        2. New building permits.
    ii. Percentage of commercial versus residential valuations - establish goals for diversifying the City's assessable tax base and implementing and providing for payment in lieu for exempt properties.
    iii. Zoning and development factors.
    iv. Type of economy, including:
        1. Diversity of the local economy - top ten tax payers as a percentage of valuation.
        2. Concentration of specific industries, especially vulnerable sectors within the economy - top ten tax payers by sector as a percentage of valuation.
    v. Socioeconomic and demographic profile:
        1. Population trends.
        2. Medium family income as a percentage of state income.
        3. Medium family income as a percentage of US income.
        4. Unemployment rates and trends.
        5. Foreclosure activity and trends.