Performance Audit
Review of the Submitted Budget
for Fiscal Year 2007

March 2006

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City Auditor's Office

City of Kansas City, Missouri

12-2006

March 1, 2006

Honorable Mayor and Members of the City Council:

This year's budget review focuses on financial pressures the city can expect to face in the medium term – the next 5 to 15 years. Looking at these medium-term financial issues helps put the current budget in context and provides decision-makers with advance notice of difficult issues city government will face.

Over the next 5-15 years, financial pressures the city expects to face include:

- **Adequately funding the city's four pension systems.** Since 2003, the city has funded less than the annual required contribution for the pension systems. The City Manager estimated that it would cost an additional $21 million a year to fully fund the city's pension systems. The reported liability related to the pension systems will increase once the city recognizes the costs of non-pension benefits, in particular health insurance, provided to retirees.

- **Making debt service payments.** At the end of 2005, projected principal and interest payments on outstanding tax-supported debt reached about $2.3 billion, up from about $1 billion the year before. Borrowing carries risk which can be mitigated by adopting recommended policies and benchmarking debt capacity. The city, however, has not adopted policies and no longer benchmarks debt capacity. Some of the debt is supported by the performance of economic development projects which carry uncertainty.

- **Addressing deferred capital maintenance.** The city continues to spend less on capital maintenance than needed. Under maintaining infrastructure tends to increase the future costs of repair.

- **Identifying revenue to meet unfunded commitments.** The City Manager identified about $126 million in commitments the city has made but has not funded. These include projects related to the American Royal, Music Hall, streets near the police academy, and Performing Arts Center.

- **Identifying revenue to meet future public safety needs.** Taxes used to fund public safety expire in about ten years. In the short term, the city needs to identify ways to fund staffing, operating, and maintaining the facilities. In the medium term, the city needs to address the expiration of the taxes.

- **Addressing low citizen satisfaction with many services.** Citizen surveys show low satisfaction with many services. While a "service deficit" does not show up in financial statements or budgets, addressing these issues is expected to pressure the budget in coming years.

The city's financial flexibility is limited, increasing the challenge of addressing these medium term issues. To put the city in a better position to take steps to address these, and other, financial concerns, we recommend the City Manager: propose a strategy for dealing with medium term financial obligations; provide the City Council with timely financial reports; and develop debt and other financial policies previously recommended by us.

We provided the City Manager and the Budget Officer a draft of this report on February 24, 2006, but did not ask for written responses. We would like to thank city staff for their cooperation. The audit team for this project was Sue Polys, Julia Talauliker, Vivien Zhi, Joan Pu, and Michael Eglinski.

Mark Funkhouser
City Auditor

Review of the Submitted Budget for Fiscal Year 2007

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List of Exhibits

Introduction

Objectives

This performance audit, a review of the City Manager's submitted budget, provides the City Council with information about the city's financial condition and the coming year's budget. A City Council resolution requires the City Auditor to review and comment on the City Manager's budget. We conducted this audit under the authority of Article II, Section 13 of the Charter of Kansas City, Missouri, which establishes the Office of the City Auditor and outlines the City Auditor's primary duties.

A performance audit systematically examines evidence to independently assess the performance and management of a program against objective criteria. Performance audits provide information to improve program operations and facilitate decision-making.[1]

We review the City Manager's budget each year. This is our 16th budget review.

This report is designed to identify and describe several financial issues the city will face in the next 5-15 years.

Scope and Methodology

Our review focuses on the City Manager's submitted budget for fiscal year 2007. Our methods included:

- Updating financial analyses from prior budget reviews.
- Reviewing prior audit work.
- Reviewing actuarial valuations and reviews of the city's pension systems.
- Reviewing the submitted budget and five-year financial forecast.

[1] Comptroller General of the United States, *Government Auditing Standards* (Washington, DC: U.S. Government Printing Office 2003), p. 21.

- Interviewing city staff.

- Reviewing responses from citizen surveys.

We conducted this audit in accordance with generally accepted government auditing standards. We omitted no information from this report because it was deemed privileged or confidential.

We discussed the report with the Budget Officer and City Manager and provided them with drafts of the report, but we did not ask them to write responses to the report and recommendations.

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Findings and Recommendations

Summary

Over the next 5-15 years, the city will face significant financial pressures. The city's four pension systems are underfunded. New accounting rules requiring the city to report non-pension benefits for retirees on its financial statements will further impact the city's budget. The city has doubled its debt, increasing annual debt payments. Funding for capital maintenance continues to decline pushing costs to the future. About $126 million in commitments made outside of the budget process could affect already budgeted capital projects. The city needs permanent revenue to fund fire operations after the fire sales tax expires and the city needs a plan to staff the city's new patrol station. In addition, addressing low citizen satisfaction with city services is likely to add pressure to the budget in coming years.

The city's financial indicators show additional challenges to addressing these medium term issues. The city's financial flexibility is limited by a high percentage of restricted operating revenues as well as growing fixed expenditures, like debt service. A fund balance below the city's policy of 8 percent could hamper the city's ability to handle unexpected expenses.

The five-year financial forecast shows improvement in the budget's structural balance with both current revenues equal to current expenditures and statistically insignificant deficits in the following four years.

In order to make informed decisions about the city's budget, the Council needs timely and adequate financial information. The Council continues to lack important monthly and annual financial information required by the city charter. The city also still lacks formal financial policies, which would promote stability and long-term thinking.

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City Faces Significant Medium Term Obligations

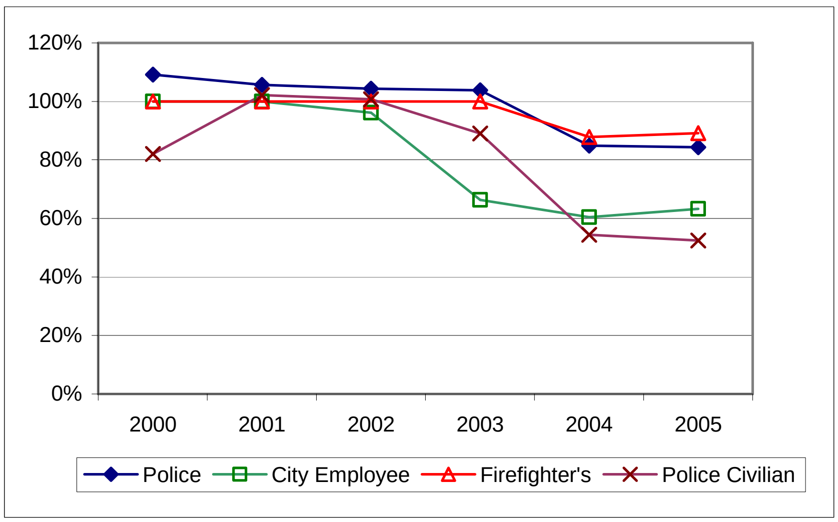
Over the next 5-15 years, the city will face some financial pressures including: adequately funding the city's four pension systems; making debt service payments; addressing deferred capital maintenance; identifying revenue to meet unfunded commitments; identifying revenue to meet future public safety needs; and addressing low citizen satisfaction with many services.

Underfunded Pension Plans Will Increase Pressure on City Budget

The city contributed less than the required amount to pension systems over the last couple of years, weakening the financial condition of the pension plans and setting the city up for a big payment to make up for the underfunding.

City's pension systems are not fully funded. The city has not contributed the required amount to the city employee system since 2002, to the Police civilian system since 2003, and the firefighters' and Police systems since 2004. (See Exhibit 1.) The funding gap, which is the difference between the required and the actual contributed amount was $13.6 million in fiscal year 2005 for all four plans. The Government Finance Officers Association (GFOA) recommends that required contributions be collected by the pension plan on a timely basis.

Exhibit 1. Pension Contribution as a Percentage of Required Amount



Sources: Actuarial Reports for Employees' Retirement System, Firefighters' Pension System, Police Retirement System and Civilian Employees' Retirement System.

The financial condition of the city's four pension systems has declined over the last several years. Benefits paid to current retirees are growing faster than the growth of the pension system assets. For example, the benefits paid to retirees from the city employees' system increased 88 percent from 2000 to 2005, while the pension plan assets only increased 8 percent in the same time period. (See Exhibit 2.)

Exhibit 2. Changes in Benefits Paid and Pension Plan Assets from 2000 to 2005

Pension System	Benefits Paid	Pension Plan Assets
City Employees	88%	8%
Firefighters	48%	7%
Police	30%	-5%
Police Civilian Employees	79%	13%

Sources: Actuarial Reports for Employees' Retirement System, Firefighters' Pension System, Police Retirement System and Civilian Employees' Retirement System.

The funded ratios for all four city pension systems show that they are underfunded by at least 15 percent, with the Police civilian system underfunded by 25 percent. (See Exhibit 3.) The pension fund liability ratio is used to determine the fiscal soundness of a pension system, which is the percentage of current pension liabilities covered by current assets. A pension system with a funded ratio of 100 percent or greater is considered fully-funded. The City Manager acknowledges that future investments need to be made or improvements in the value of the pension systems will need to occur in order to address the deficiency. The budget estimated that an additional $21 million per year would be needed to fully fund the city's pension systems.[2]

Exhibit 3. Current Funded Ratios for Pension Systems

Pension Systems	Funded Ratio
City Employee	82.6%
Firefighter	84.6%
Police Officer	81.6%
Police Civilian	74.5%

Source: Submitted Budget 2007.

New accounting rules will further impact the city's finances. The Governmental Accounting Standards Board (GASB) issued new rules on pension reporting in June 2004. This will increase the city's liability by requiring the city to recognize the costs of providing non-pension benefits, in particular health insurance, to retirees. The city is required to report this liability in financial reports starting with fiscal year 2008. It is important for the city to adequately address the issue because how the city funds the liabilities could affect bond ratings.

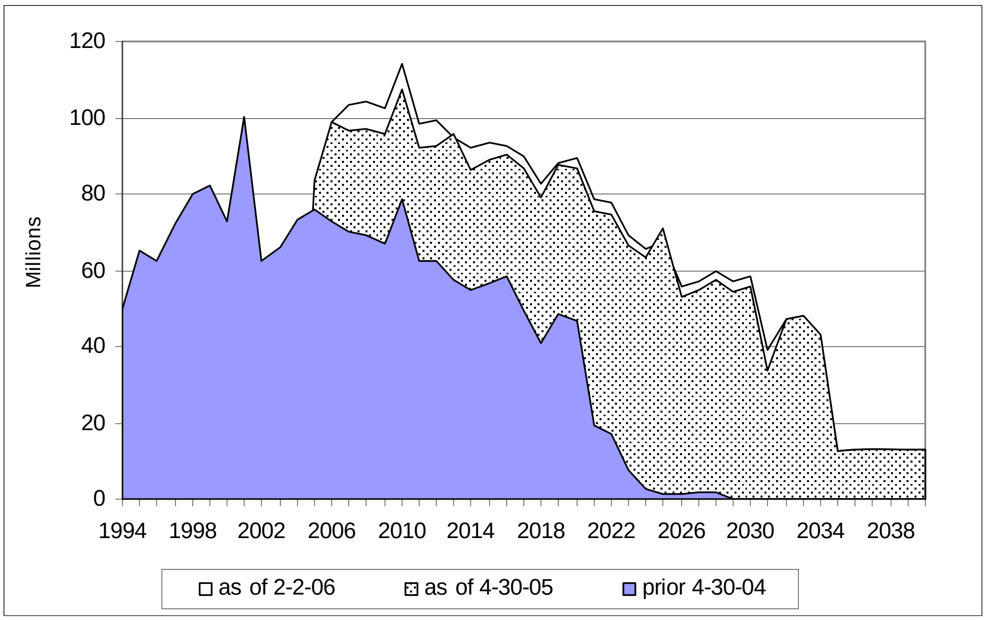
A working committee, including staff from Finance, Human Resources, and the Police Department, has prepared a Request for Proposal (RFP) to select a vendor for an actuarial study to determine the city's liability, including police liability.

[2] Submitted Budget 2007, City Manager's Transmittal Letter, p. 6.

Growing Tax-Supported Debt Obligates Future City Revenue

The city doubled its tax-supported debt in the last year. (See Exhibit 4.) The city issued debt to pay for the downtown entertainment district, the arena, several TIF projects, zoo expansion, the Liberty Memorial Museum, Bartle Hall expansion, and other capital improvement projects. Consequently, the city faces big annual payments for debt service. The city owed just over $1 billion in principal and interest on outstanding tax-supported debt at the end of fiscal year 2004. At the end of fiscal year 2005, projected principal and interest payments on outstanding tax-supported debt has doubled to about $2.3 billion.

Exhibit 4. Scheduled Debt Service Payments on Tax-Supported Debt



Source: Debt Manual payment schedules.

Borrowing can limit future flexibility. A government that relies too much on debt financing reduces its ability to pay for other priorities such as public safety or future street maintenance, as debt service obligations come due. Unanticipated changes in revenues or expenditures can also hurt a government's ability to repay debt. Debt service obligations could force a financially strapped government to cut services or raise taxes beyond a level acceptable to its residents. In rare cases, governments have defaulted on debts, greatly reducing their ability to provide public services.

The city does not have debt policies. Government borrowing obligates future revenue and, therefore, carries risk. Policies can reduce risks of government borrowing. The Government Finance Officers Association

(GFOA) and the National Advisory Council on State and Local Budgeting (NACSLB) recommend governments adopt debt capacity and debt management policies. The city has not enacted formal policies and no longer benchmarks debt capacity. The City Manager agreed to draft debt capacity and management policies for Council consideration in response to our recommendation in our August 2005 audit, *Managing the Risks of Increased Debt.*

KC Live!'s ability to cover its debt is uncertain. The city issued $180 million in economic development bonds in March 2005, to back KC Live! KC Live! is the seven block entertainment district under construction downtown. Management reports that up-to-date analysis of KC Live! debt coverage is not available because of unknown final project costs and an uncertain start of the revenue stream. Revenues do not start to flow until businesses are operating in the district. The Director of Finance told us that, in order to perform the analysis, management needs dates when businesses are projected to be in operation.

The KC Live! debt, like other economic development debt, wasn't subject to the same analysis as other types of debt before it was presented to the City Council. The city's process for issuing general obligation debt calls for the Office of Management and Budget (OMB) to analyze cost-benefit and cash flow before recommending a debt issuance to the City Council. However, OMB does not perform this analysis for debt related to economic development or other projects not initiated by city departments. The City Council relies on pro forma analysis from the developers when making decisions about these projects.[3] Although the city does not perform the analysis on this type of debt, the city is still responsible for paying the bill. As the City Manager states in the submitted budget, economic development projects that under-perform projections result in increased general fund support.[4]

Capital Maintenance Spending Down, Pushing Costs to The Future

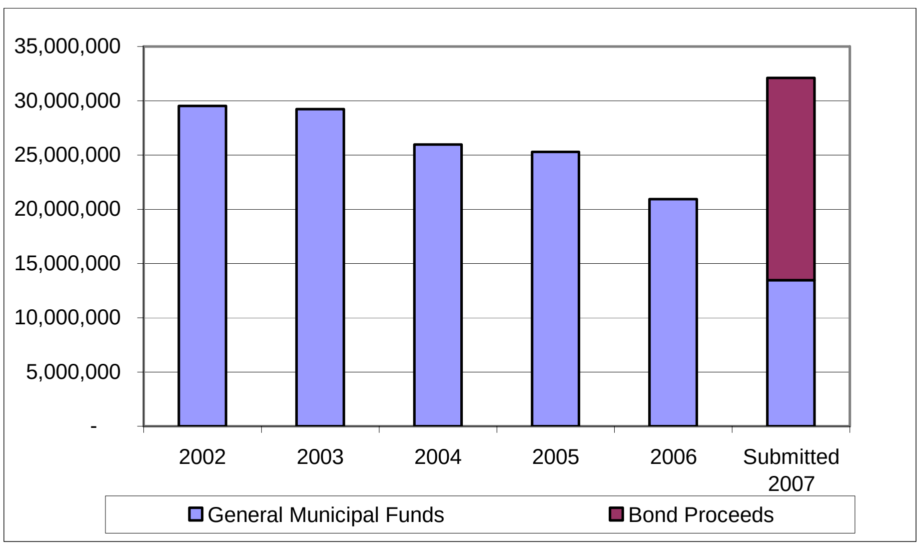
Funding for capital maintenance continues to decline. The budget decreases funding for capital maintenance by $7.6 million to support debt service obligation. Failing to maintain capital, such as roads and bridges, pushes costs to the future. If the city does not maintain capital regularly, the costs to eventually fix the capital assets generally are higher.

[3] In our 1998 audit of Tax Increment Financing, we concluded that developers' revenue projections systematically overstated revenue and that there was a clear tendency to overstate the projections. Projections are part of the proposals made by developers who have an interest in securing public incentives.
[4] Submitted Budget 2007, p. 36.

Capital maintenance spending continues to decline. Deferred maintenance funding is likely to continue to decline as capital maintenance tax revenue will be needed to cover debt from GO bonds. The Five-Year Forecast states that "deferred maintenance spending will be reduced in an equivalent amount to the increasing costs of annual support of debt service costs for the voter approved $300 million in general obligation bonds to be issued over the next five years."[5] In fiscal year 2007, capital maintenance funds are reduced by $7.6 million from the previous year to support the debt service obligation.[6]

The submitted budget has decreased the amount allocated for infrastructure maintenance activities – street preservation and marking; municipal building rehabilitation; bridge rehabilitation; traffic signal improvements; and boulevards, curbs, and sidewalks – from general municipal funds and added about $18 million from the GO bond proceeds. (See Exhibit 5.) The Five-Year Forecast considered using debt for capital improvements as a risk. "The issuance of debt for capital improvements consumes available resources currently dedicated for capital maintenance resulting in a further maintenance backlog."[7]

Exhibit 5. Infrastructure Maintenance Budget



Sources: Five-Year Capital Improvements Plan 2000-2005, and Submitted Budget 2007.

The citizen survey showed dissatisfaction with streets and rated the maintenance of streets, buildings and facilities as a high priority. The city needs to continue to improve capital maintenance. Crumbling

[5] Submitted Budget 2007, p. 36.
[6] Submitted Budget 2007, City Manager's transmittal letter, p. 18.
[7] Submitted Budget 2007, p. 36.

infrastructure increases the city's costs in the longer term and negatively affects people's perceptions about living and working in the city.

$126 Million in Unfunded Commitments Obligate Future Spending

The city has committed to about $126 million in capital projects that are not part of the adopted capital improvement plan. Finding resources to finance these projects puts pressure on the city's already tight budget. The Council will need to prioritize these projects against other planned capital projects. The Mayor recently combined the Finance Committee and the Budget and Audit Committee, which should improve Council oversight.

The city initiated unfunded capital projects outside of the adopted capital improvement plan. The Council directed the City Manager to develop financing for five capital projects totaling about $126 million. The Council adopted or passed four of the five projects between August and December of 2005; however, they did not undergo the same approval and budgeting process as other capital projects. (See Exhibit 6.) The city's Capital Improvement Program solicits input from city departments and the public about needed capital projects. The Public Improvement Advisory Committee (PIAC) narrows down capital requests. Project budgets and timelines are considered. PIAC recommends a five-year capital program to the City Manager, Mayor, and City Council. The City Manager makes adjustments and submits his final capital improvements recommendation as part of the submitted budget. The Council deliberates the capital budget as part of the overall budget process. The capital budget is finalized at the time the City Council adopts a budget for the new fiscal year.

Exhibit 6. Unfunded City Council Commitments

Project	Project Description	Ordinance/Resolution No. and Date Approved	Funding Amount
American Royal Improvements	The city will facilitate the needs of the American Royal Association to continue operating after the loss of a portion of the Liberty Street lot for redevelopment of the Mexican Customs Facility.	Ordinance No. 051401 Passed 12/15/2005	$8-10 million
Music Hall Improvements	The project improves the Music Hall's stage to facilitate larger touring productions of Broadway shows as well as improvements to backstage area and audience seating. The City expects the Theatre League to contribute $2.25 million.	Resolution No. 051010 Adopted 8/25/2005	$9 million

American Royal Master Plan	The Mayor and Council directed the City Manager to work with the American Royal Association to develop financing for their master development plan.	Resolution 051400 Adopted 11/17/2005	$35 million
Police Academy Road Improvements	The project would rebuild Shoal Creek Parkway, Pleasant Valley Road, and a portion of Searcy Creek Parkway to facilitate travel around the new Kansas City Police Academy and Shoal Creek Patrol Station as well as boost development in the area.	Resolution 050924 Adopted 8/4/2005	$10 million
Performing Arts Center	The city made a $62 million financial commitment to the new performing arts center. The city has already paid a total of $15 million toward the project commitment for the purchase of land and grading of 16th St. for the new Bartle Hall Ballroom.	Resolution No. 030372 Adopted 4/3/2003	$62 million
		Total commitments	$126 million

Unplanned spending puts pressure on budgeted capital projects. In December 2005, the City Manager asked the Mayor and Council, to provide him with guidance ranking the priorities of these unfunded capital initiatives, the mixture of private and public funding that should be used, whether any of the projects should supplant projects that are already budgeted, and whether any of the projects should be funded with other sources.[8]

The City Manager provided the Council funding options that included sale of city real estate, redirecting existing bridge rehabilitation funds, Capital Improvement Sales Tax money, tax increment financing revenue, public safety sales taxes, user fees, private contributions, and tax increases. In his memo, the City Manager said that without prioritization against all other city needs, reductions from the adopted Capital Improvement Plan and the current capital budget will be necessary. Management reports that there is no current plan in place to fund these projects.

In her response, the Mayor said the Council should not consider eliminating, but rather decide how to stage the completion of the projects.[9]

[8] Memorandum from City Manager Wayne Cauthen to the Mayor and City Council, December 2, 2005.
[9] Memorandum from Mayor Kay Barnes to the City Council, December 14, 2005.

Better council oversight will result from combining the Finance and Budget and Audit Committees. The Mayor combined the Finance Committee and the Budget and Audit Committee in January 2006.

In 2003, the Mayor divided the City Council's Finance and Audit Committee into those two committees. Prior to 2003, matters related to issuing debt went through the Finance and Audit Committee, which also dealt with the city budget. In our audit, *Managing the Risks of Increased Debt*,[10] we recommended combining the two committees. Combining the oversight of budget and finance should provide a broader context in which the Council makes financial decisions.

City Needs To Develop Plan for Funding Public Safety

Using the fire sales tax and the police, emergency medical response (EMR), emergency management sales tax, the city added firefighters, fire stations, and police facilities. Both of these taxes will expire. The city can only use the police tax for capital. The city needs a permanent revenue source to continue to finance the new firefighters hired by the tax and a plan to staff the newly built police station.

City used short-term revenue to hire fire fighters. The city used the fire sales tax to hire 135 new fire fighters, to buy new equipment, and to improve fire stations. Voters approved the fire sales tax, which became effective January 1, 2002. It imposed a ¼-cent sales tax for the purpose of Kansas City Fire Department operations. Before the tax expires in 2017, the city needs to renew the tax, find another source of income, or reduce fire spending.

The city cannot use police sales tax revenue to staff Shoal Creek. The city is using the tax to build the Shoal Creek patrol station and the new Police Training Academy. Voters approved the ¼-cent Police, EMR, Emergency Management tax, which became effective October 1, 2002. This tax is set to expire in July 2011, after 8 years and nine months. The tax pays for capital improvements, including capital improvements for police, emergency medical response, and emergency management to improve response to all hazards, including biological/chemical terrorism or events. It may also be used for the retirement of debt under previously authorized bonded debt.

City needs permanent revenue to pay for new fire fighters and a plan to staff Shoal Creek Patrol Station. Management reports that the city plans to submit a fire tax renewal to the voters in 2015 to continue to

[10] *Managing the Risks of Increased Debt*, Office of the City Auditor, Kansas City, Missouri, August 2005, p. 20.

fund the new fire fighter positions after the fire sales tax expires in 2017. The city does not have a plan in place for fully staffing the new Shoal Creek patrol station. The Police Department requested 100 new officers. The city's 2007 submitted budget does provide 20 officers for a partial year to staff the new patrol station. According to the City Manager's budget transmittal letter, the Police Department has agreed to find 17 civilian support positions necessary for Shoal Creek from its current staff. To fully fund 100 new officers would require $6 million annually in resources. The City Manager recommends that the city and Police Department address the need for additional officers over the next few years through consolidation, and redirecting that cost savings generated in both city and Police operations into additional officers.[11]

Survey Shows Citizens Not Satisfied With Services

Citizen satisfaction is an immediate and on-going issue that city leaders need to address consistently in their budget decisions. Citizen satisfaction has declined over the last few years according to the annual Citizen Satisfaction Survey. Citizens are dissatisfied with several basic city services. In comparisons with other large cities, Kansas City is less satisfied in four of five major services.

Kansas City residents are not satisfied with city services. In general, satisfaction with major city services declined over the last few years. Satisfaction is lowest with maintenance of city streets, buildings and facilities and highest with airport facilities, and police, fire and ambulance services. Respondents rated maintenance of city streets, buildings and facilities as the highest priority for emphasis in the next two years. (See Exhibit 7.)

[11] Submitted Budget 2007, City Manager's transmittal letter, p. 11.

Exhibit 7. Kansas City Survey Respondents' Satisfaction with Major City Services

Satisfied or very satisfied with major services categories the city provides	2000 – 2005
Quality of police, fire, and ambulance services	63%
Quality of city parks and recreation programs and facilities	47%
Maintenance of city streets, buildings and facilities	15%
Quality of city water utilities	53%
Enforcement of city codes and ordinances	28%
Customer service you receive from city employees	36%
Effectiveness of city communication with the public	29%
Quality of the city's stormwater runoff/management system	30%
Quality of local public health services	33%
Overall flow of traffic	33%
Quality of airport facilities	64%
Quality of city convention facilities	42%

Source: City Services Performance Report for Fiscal Year 2005.

Kansas City residents are less satisfied than residents in other major cities. In her budget transmittal letter, the Mayor stated that she would direct the City Auditor to compare our ratings with four cities of similar size: St. Louis, Dallas, Denver, and Minneapolis.[12] Kansas City survey respondent satisfaction is significantly lower in the areas of city streets, buildings, and facilities, and effectiveness of city communication with the public than those four cities. Kansas City and St. Louis are similar in their low satisfaction of enforcement of city codes and ordinances. Kansas City and Dallas are about equally satisfied with parks and recreation programs and facilities. Kansas City, Denver, and St. Louis all rate police, fire, and ambulance services at about the same level of satisfaction. (See Exhibit 8.)

[12] Submitted Budget 2007, Mayor's transmittal letter, p. 7.

Exhibit 8. Kansas City's Citizen Satisfaction Compared with Denver, Dallas, St. Louis, and Minneapolis[13]

	2002	2003	2004	2005
Overall quality of police, fire, and ambulance services				
Kansas City	**70**	**69**	**69**	**67**
Dallas	48	50	56	56
Denver	73	71	71	69
Minneapolis	78	79	79	77
St. Louis	70	69	68	66
Overall quality of city parks and recreation programs and facilities				
Kansas City	**53**	**55**	**51**	**51**
Dallas	38	36	52	52
Denver	76	71	71	68
Minneapolis	79	70	70	68
St. Louis	71	70	70	68
Overall maintenance of city streets, buildings, and facilities				
Kansas City	**24**	**21**	**14**	**15**
Dallas	37	31	41	41
Denver	37	44	44	45
Minneapolis	64	58	58	58
St. Louis	26	25	22	33
Overall enforcement of city codes and ordinances				
Kansas City	**45**	**48**	**30**	**32**
Dallas	39	41	43	43
Denver	51	48	48	49
Minneapolis	51	61	61	62
St. Louis	37	36	34	35
Overall effectiveness of city communication with the public				
Kansas City	**39**	**43**	**30**	**31**
Dallas	25	33	43	43
Denver	52	47	47	46
Minneapolis	52	58	58	57
St. Louis	43	43	40	42

Sources: City Services Performance Reports for Fiscal Years 2003-2006, and data from Citizen Satisfaction Surveys.

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[13] By percent of respondents who rated the item as “Satisfied” or “Very Satisfied,” excluding “don’t know”

Problems Remain With City's Financial Condition

The city's financial indicators show limited flexibility. A high percentage of operating revenues are restricted and fixed expenditures are growing. The fund balance remains below the city's policy of 8 percent, although the fund has been increasing over the last three years. The five-year financial forecast shows both current revenues equal to current expenditures and statistically insignificant deficits in the following four years. The Council continues to lack important monthly and annual financial information required by the city charter and necessary for making informed decisions. The city still lacks formal financial policies, which would promote stability and long-term thinking.

Financial Indicators Show Limited Flexibility

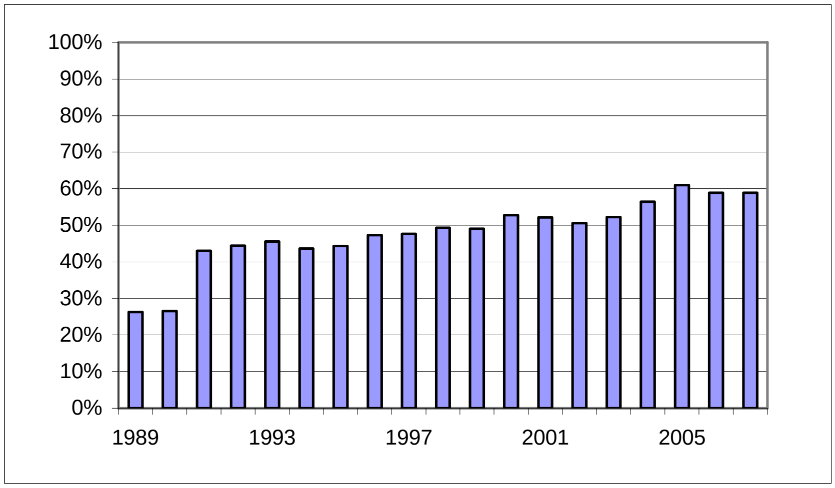
About 60 percent of the city's operating revenues are restricted. Fixed expenditures like debt service are growing. The city expects to issue even more debt in fiscal year 2007. As discussed in the previous section, the city needs to put more money in the city's pension plans to cover the actuarial required amount. The city will need to start showing Other Post Employment Benefits (OPEB) liability on financial statements.

The city's fund balance is projected to grow but it is still below 8 percent required by city policy.[14] Projected capital maintenance funding does not equal needed capital maintenance funding. However, the submitted budget projects for the first time in five years current revenues equal to current expenditures and the five-year forecast projects statistically insignificant deficits. Limited flexibility gives the City Council fewer options to respond to changing priorities or unforeseen conditions.

About 60 percent of the city's operating revenues are restricted. Restricted revenues are legally earmarked for a specific use by state law, bond covenants, city ordinances, or grant requirements. The higher the percentage of restricted revenues, the less flexibility the City Council has to respond to changing priorities and unforeseen conditions. The city's restricted revenues have been about 60 percent since 2005. (See Exhibit 9.)

[14] Resolution 980506.

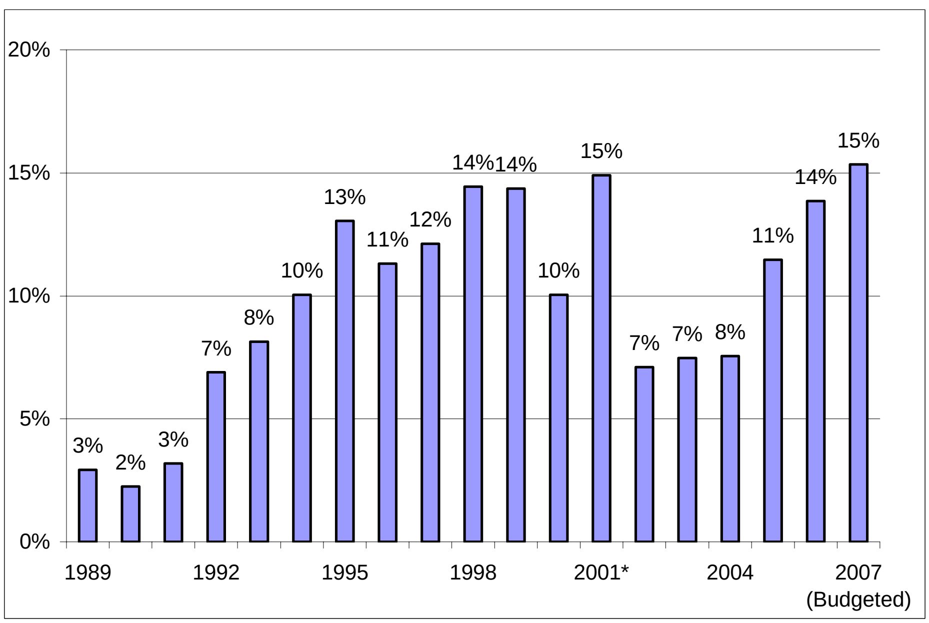
Exhibit 9. Restricted Revenues as Percentage of Operating Revenue



Sources: Adopted Budgets 1989 – 2006 and Submitted Budget 2007.

Fixed expenditures are growing. Fixed expenditures – such as debt service and pension benefits – are those over which officials have little short-run control. The higher the level of fixed expenditures, the fewer options the City Council has to adjust spending in response to economic changes. Debt service is budgeted at 15 percent ($94.9 million) of operating expenditures in fiscal year 2007, comparable to debt service levels in the mid-to-late 1990s.[15] (See Exhibit 10.)

Exhibit 10. Debt Service as Percentage of Operating Expenditures

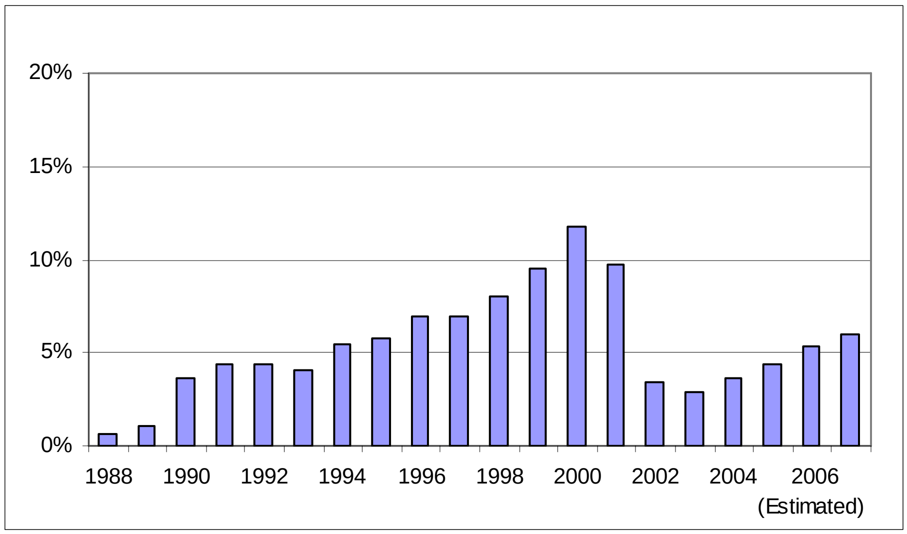


Sources: Adopted Budgets 1989 – 2006 and Submitted Budget 2007.

[15] The increase in debt service expenditures for 2001 is mostly due to refunding $29 million in Public Safety and Zoo.

The fund balance remains below the recommended level. The city's policy is to maintain a general fund balance of 8 percent of general fund expenditures. The unreserved general fund balance has been below 8 percent since 2002. The City Manager has steadily been rebuilding the fund balance. The submitted budget ends fiscal year 2007 with a general fund balance of about 6 percent of expenditures ($22 million). (See Exhibit 11.) A low fund balance diminishes the city's ability to respond to unanticipated emergencies such as natural disasters and uneven cash flow. Ideally, the city should restore the fund balance to the 8 percent level in the year after these reserves have been tapped and the balance goes below the recommended level.

Exhibit 11. General Fund Balance as Percentage of Expenditures



Sources: Adopted Budgets 1989 – 2006 and Submitted Budget 2007.

Budget projects current revenues equal to current expenditures. The proposed budget meets two of the requirements for a structurally balanced budget. For the first time in five years, the fiscal year 2007 forecast projects current revenues equal to current expenditures. The forecast assumes a revenue increase due to an improved local economy. The second requirement of a structurally balanced budget is projected revenues equal or exceed projected expenditures. (See Exhibit 12.) The city's five-year forecast projects statistically insignificant deficits.[16]

Financial decision-makers need to consider risks that could negatively affect the five-year forecast. The City Manager identified a number of risks in his five-year forecast. Unanticipated sharp price increases of basic commodities such as gasoline and construction materials could significantly affect city expenditures. Federal and state

[16] Submitted Budget 2007, City Manager's transmittal letter, p. 9.

funding reductions could occur, shifting the burden to city resources. Salary and benefit costs significantly above aggregate revenue growth would affect the budget forecast. Underperforming economic development projects would result in increased general fund support. Using one-time revenues for on-going expenditures would affect the five-year forecast. In addition, the issuance of debt for capital improvements that consumes available resources currently dedicated for capital maintenance could result in a further maintenance backlog.[17]

Exhibit 12. Projected Budgetary Imbalances

Fiscal Year	Imbalance
2007	$ -
2008	$ (2,500,000)
2009	$ 600,000
2010	$ (1,300,000)
2011	$ 800,000

Source: Submitted Budget 2007.

Council Lacks Financial Information

City staff is not providing the Council with timely financial information. The city has not released its Comprehensive Annual Financial Report (CAFR) in a timely manner in recent years. The city charter requires that the city's Finance Director have the annual financial report available for public examination no later than 90 days following the end of the fiscal year.[18] The city used to release the CAFR about 6 months after the end of the fiscal year, but the time it takes to complete it has been increasing. The CAFRs for fiscal years ending April 30, 2003, and April 30, 2004, were issued about 12 months after year-end. As of February 24, 2006, the city has not released the CAFR for fiscal year ending April 30, 2005.

City staff has not presented a monthly financial statement to the Council since December 2004, even though the city charter requires the Finance Director to submit the monthly financial statement to the City Manager and Council no later than 20 days after the close of each month.[19] These statements are prepared to keep City Council members informed of fund activity and status. The report contains the financial summaries of the revenue and expenditure activities of the city for each month.

Management needs good financial information to make recommendations to Council and the Council needs timely financial information in order to make informed decisions about the budget and to carry out their fiduciary responsibilities.

[17] Submitted Budget 2007, p. 36.
[18] City Charter, Article IV, Section 96.
[19] City Charter, Article IV, Section 96.

Adopting Financial Policies Makes Sense

GFOA strongly recommends that a government adopt and create formal financial policies in order to promote stability and continuity, standardize responses to situations, educate decision makers without background in government financial management, and promote long-term thinking. Bond rating agencies look favorably upon formal financial policies.

The city lacks most recommended financial policies. Although city staff has developed practices to address some of these issues, such informal policies have several shortcomings. Informal policies lack the explicit support of the governing body, tend to be applied inconsistently, and may not stand the test of time as usefulness diminishes with staff turnover.

We have previously recommended in budget reviews and audits that the city adopt formal financial policies. We again recommend that the City Manager direct staff to conduct policy research and submit draft financial policies for City Council consideration.

Recommendations

1. The City Manager should propose a strategy for dealing with medium-term financial obligations including:
   - Adequately funding the city's four pension systems.
   - Making debt service payments.
   - Addressing deferred capital maintenance.
   - Identifying revenue to meet unfunded commitments.
   - Identifying revenue to meet future public safety needs.
   - Addressing low citizen satisfaction.
2. The City Manager should ensure the Finance Director provides the City Council with timely financial reports.
3. The City Manager should develop debt and other financial policies we previously recommended.

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