CITY OF URBANA

Human Resources and Finance Department

400 S Vine St • Urbana IL 61801

MEMORANDUM

TO:	Mayor Diane Wolfe Marlin and City Council Members
FROM:	Elizabeth Hannan, Human Resources & Finance Director / CFO Alyana Robinson, Financial Analyst
DATE:	February 17, 2022
SUBJECT:	Proposed Changes to the Financial Policies

Introduction: The purpose of this memo is to discuss recommended revisions to the City's financial policies regarding the minimum fund balance requirement for the General Operating Fund and interfund transfers for the General Fund support of other activities.

Summary of Proposed Changes to the Financial Policies

<u>Changes Related to General Operating Fund:</u> Two specific changes in regards to the General Fund reserve, as shown on the attached strikeout version of the Policies. Changes include –

- The City will maintain reserves of at least 25% of recurring expenditures in the General Operating Fund.
- The reserve will be depleted below 20% only in the event of a catastrophic need.
- If the reserve dips below 25%, the Finance Director will recommend a strategy to replenish the reserve over a period of no more than three to five years.

<u>Changes Related to Interfund Transfers for General Fund Support of Other Activities:</u> A policy will be established in regards to the interfund transfers for General Fund support costs, changes include –

- Cost allocations for activities outside of the General Operating Fund will be charged to the activities described on the attached strikeout version of the Policies.
    - A step-down allocation method will be implemented.
- Other costs that can be directly allocated will be included in the transfer.
- A payment in lieu of taxes for the Parking Fund will be based on changes in tax rates and growth in the City's equalized assessed valuation (EAV).

Discussion:

<u>Minimum Fund Balance Requirement for the General Fund</u>

<u>Background:</u> Reserves are the cornerstone of financial flexibility. Reserves provide a government with options for responding to unexpected issues and a buffer against financial downturns, natural disasters, and other forms of risk. Managing reserves, however, can be a challenge.

Emergencies or unanticipated situations can happen at any time. A snowier than predicted winter can rapidly exhaust a city's snow removal budget. Economically sensitive revenues such as sales or income taxes may plunge far more than originally forecast as an economic downturn occurs.

The National Advisory Council on State and Local Budgeting (NACSLB) and the Government Finance Officers Association (GFOA) recommend that all governments develop a formal, written fund balance policy that is made publicly available.

<u>Current Practice:</u> The City's current practice has been to maintain a fund balance that is 25% of recurring expenditures. However, the policy has not been updated since 2020 and, in practice staff has been planning for a 25% fund balance.

The City's current policy regarding the fund balance of the General Operating Fund is as follows –

- The City will maintain reserves of at least 20% of recurring expenditures in the General Operating Fund. This is in addition to any reserve that is established for a specific purpose.
- The reserve will be depleted below 15% only in the event of a catastrophic need.
- If the reserve dips below 20%, the Finance Director will recommend a strategy to replenish the reserve over a period of no more than three to five years.

<u>Analysis:</u> In order to figure out the appropriate amount of reserve for the General Fund, staff followed the GFOA guidelines to analyze the risks that influence the level of reserves the City needs as a hedge against uncertainty and loss.

The following primary risks were identified: volatility of sales tax revenue, potential volatility of State-shared income tax revenue, the potential for infrastructure failures, and the dependency of other funds on the General Fund for support, particularly the Capital Improvement and Retained Risk Funds. Secondary risk factors were also examined, including cash flow and the potential for unexpected spikes in expenditures. In addition, a comparison of the reserves held by comparable cities provided context:

City	Population	FY21 General Fund Expenditures	Minimum Fund Balance
Rolling Meadows	24,200	$35.5M	30% of recurring expenditures
North Chicago	30,759	$23.6M	30-40% of recurring expenditures
Crystal Lake	40,269	$29.9M	50% of recurring expenditures
Quincy	39,463	$37.5M	10% of recurring expenditures
Urbana (proposed)	38,336	$37.8M	25% of recurring expenditures
DeKalb	40,290	$41.1M	25% of recurring expenditures
Wheaton	53,970	$44.3M	40% of recurring expenditures
Normal	52,736	$69.9M	15% of recurring expenditures

According to the risk analysis, the City has a moderate to high level of risk to manage through reserves. The recommended fund balance for cities with moderate risk is 17 -25% and the recommended fund balance cities with moderate to high risk is 26 – 35%. Staff believes that since we are at the very low end of the moderate to high category, 25% is adequate.

Staff recommends revising the financial policy to require a minimum fund balance in the General Fund of 25%, consistent with our current practice. This should be adequate for the foreseeable future, but will be reassessed periodically.

Interfund Transfers for General Fund Support of Other Activities

Background: The City provides support services for City activities through a variety of administrative support programs. As a result, some expenditures that benefit activities outside of the General Fund are not being directly allocated but are accounted for in administrative support programs in the General Operating Fund.

Current Practice: The General Operating Fund receives transfers from other funds each year as part of the budget process to reimburse for the costs incurred related to the services provided by the administrative support programs. The transfer amounts are increased each year in accordance with wage increases. The transfers have not been reconciled for a number of years, and the old methodology was unclear.

Analysis: The General Operating Fund is the primary source of City's basic services and there are many demands on the General Fund from programs citywide. In order to maintain current service levels, it is important to understand and develop a reimbursement method for costs incurred in the General Operating Fund related to the services that benefit other activities. Staff did an analysis to establish an appropriate methodology to identify the indirect or overhead costs and allocate them to benefiting activities in a logical manner.

Previous fiscal year's budgeted expenditures will be used to determine the amount to be budgeted for cost allocation with the exception of salary & benefits expenditures, which will be based on prior year's budget plus an increase to bring it to current. (This increase will vary annually.) It is intended that basing the allocation on prior year estimates is a conservative approach since prior year projections do not include any of the cost inflators of the current year. The basis for allocating costs would be calculated by various methods, such as budgeted expenses or number of full-time equivalent employees (FTEs), depending on the nature of the service. The allocation percentages will be reviewed annually for a material percentage increase or decrease.

A step-down allocation method will be implemented to ensure that costs incurred related to services that benefit between administrative support departments are recognized and fully allocated before final allocations to other activities are made.

To summarize:

a. First Step – Administrative support program budgeted expenditures are allocated to other administrative support programs, in which the amounts can be calculated by various allocation basis depending on the type of service.

b. Second Step – Allocate administrative support program budgeted expenditures plus the additional allocated costs calculated from the first step to the other activities outside the General Fund.

Other costs that can be directly allocated to a specific activity will also be included in the transfer. For example, General Operating Fund sewer maintenance activities will be fully allocated to the sanitary sewer and stormwater programs.

The Parking Fund has historically made a transfer for a payment in lieu of taxes to the General Operating Fund, for revenue generating properties that are tax exempt. This will be reassessed based on changes in tax rates and growth in EAV since it was last assessed. This is necessary because there is no current EAV attached to these properties.

Staff recommends adopting this methodology as a policy for interfund transfers for General Fund support of other activities. This will provide a clear and consistent method in allocating costs to other activities.

Fiscal Impact: This change has no direct impact on the current budget, since the General Fund fund balance already exceeds 25% of recurring expenditures. Governments that maintain adequate reserves are better positioned to deal with funding issues in bad times. Therefore, it is prudent for governments to use a portion of budget surpluses to help create, sustain, or increase the size of general fund reserves. Putting money into appropriate levels of reserves first is a more fiscally prudent action than spending surplus funds on new or expanded programs.

The proposed methodology for interfund transfers for General Fund Support costs will allow the General Operating Fund to recapture some costs of administrative support and offers the closest estimate of the services provided to other activities. Overall, this is likely to result in a slight decrease in support for the General Fund from other City funds, but that was anticipated and factored into the Financial Forecast.

Recommendation: Forward the revised Financial Policies for approval at the City Council meeting on February 28, 2022.

RESOLUTION NO. ________________

A RESOLUTION ADOPTING FINANCIAL POLICIES

(2022)

WHEREAS, Section 8-1-1 of the Illinois Municipal Code (65 ILCS 5/8-1-1) provides that the corporate authorities of each municipal corporation may control the finances of the corporation; and

WHEREAS, the City Council is the fiscal authority for the City of Urbana ("City") and is responsible for passing the annual budget ordinance and controlling the fiscal operations of the City; and

WHEREAS, the City Council is further responsible for ensuring that the City manages public funds appropriately; and

WHEREAS, on March 23, 2020, the City Council passed Resolution No. 2020-03-015R, adopting certain financial policies for the City to establish goals and targets for the City's financial operations, provide for a consistent approach to planning and budgeting, and support the City's long-term financial stability; and

WHEREAS, the City Council, after due consideration, finds that the adoption of revised financial policies as herein provided is in the best interests of the residents of the City and is desirable for the welfare of the City's government and affairs.

NOW, THEREFORE, BE IT RESOLVED by the City Council, of the City of Urbana, Illinois, as follows:

Section 1.

The financial policies attached hereto and hereby incorporated by reference, be and the same are hereby adopted.

Section 2.

Upon approval of this Resolution, the Finance Director shall administer these policies.

PASSED BY THE CITY COUNCIL this _____ day of _____________, __________.

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Phyllis D. Clark, City Clerk

APPROVED BY THE MAYOR this ___ day of ______________, ________.

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Diane Wolfe Marlin, Mayor

FINANCIAL POLICIES

I. **Purpose:** Financial policies establish goals and targets for the City's financial operations. Formal policies provide for a consistent approach to planning and budgeting, and support the City's long-term financial stability.

II. **Long-term Planning:** Each year the City's Finance Department will prepare a five-year financial forecast for the City's General Operating Fund to assess the City's future fiscal condition. The purpose of the forecast is to give context to decisions that will be made in the budget process.

III. **Balanced Budget:** The City considers the budget to be balanced if budgeted, recurring expenditures in the General Operating Fund do not exceed 98.5% of budgeted, recurring revenues. In other City funds, unless specific reserve targets have been established, expenditures will not exceed the total of budgeted revenues and unassigned fund balance at the beginning of the year.

IV. **Reserves:** The City will maintain adequate reserves to establish a cushion of available cash during economic downturns, finance cash flow needs, provide stable tax rates, and provide for unanticipated needs or unexpected opportunities.

A. **General Fund:** The City will maintain reserves of at least ~~20~~25% of recurring expenditures in the General Operating Fund. This is in addition to any reserve that is established for a specific purpose. The reserve will be depleted below ~~15~~20% only in the event of a catastrophic need. If the reserve dips below ~~20~~25%, the Finance Director will recommend a strategy to replenish the reserve over a period of no more than three to five years.

A reserve level of no less than ~~20~~25% is appropriate given-

- the City's reliance on cyclical revenue sources (e.g., sales tax)
- the reliance of other funds (e.g., Retained Risk and Capital Improvements) on the General Fund as a source of revenue
- the current backlog of unmet capital needs, which could result in an immediate demand for funds due to infrastructure failures
- the potential for unavoidable cost increases imposed by the State of Illinois
- concerns about the potential impact of the State's fiscal situation, including potential reductions in State-shared revenues

B. Vehicle & Equipment Replacement Fund (VERF): The City will maintain reserves of at least 10% of the total value of assets included in the VERF for planned replacement of capital equipment. Annual charges will be made to various operating budgets at 85% of projected replacement cost spread over the life of the asset accounted for in this fund. The replacement schedule will be updated at least biennially. A capital asset is defined as equipment with an initial purchase price of $5,000 or more and a useful life of 5 years or more.

Other funds, including the Landscape Recycling Center Fund and the Equipment Services Fund, may retain reserves for equipment replacement separate from the Vehicle and Equipment Replacement Fund. Adequate funds will be reserved in fund balance for planned equipment replacement.

C. Retained Risk: Retained Risk Fund reserves will be maintained to provide funding in the event of large workers compensation and liability claims. The reserve amount will be established based on a periodic actuarial review. Annual transfers will be made from operating budgets to support risk management activities such as insurance premiums and routine claims, as well as to replenish the reserve, when necessary. Reserves will be replenished over time to minimize impact on the operating budget.

V. Property Taxes: The City's goal is to maintain a property tax rate equal to that of the City of Champaign, and to work with overlapping taxing districts to create an overall tax rate equal to the City of Champaign.

A. Pension Funds: The City will levy property taxes to provide funding for a 20-year closed period amortization of 100% of unfunded liability, including a five-year transition to the higher funding level, beginning with the 2018 property tax levy. Contributions will be calculated using the entry age normal (level percent of pay) method. Asset smoothing will be used over a five-year period to reduce the effects of market volatility. An 8.12% share of the pension funding requirement will be allocated from personal property replacement tax, also consistent with State law.

Prior to levying taxes in 2028, staff will recommend to the City Council an appropriate strategy to minimize volatility as the funds move closer to the goal of being fully funded.

B. Library General Fund: The City levies property taxes for the Library to support operations, which are funded from the Library's General Fund. The

City Council approves the Library's budget, including estimated property tax revenues necessary to support the expenditure budget. When the City Council approves the property tax levy, it will include a levy sufficient to support the approved Library General Fund budget. (The City also allocates a portion of the Ameren franchise fee to the Library, based on the Library's proportionate benefit from free gas therms provided by Ameren prior to the franchise agreement approved in 2015. This allocation will continue in the same proportion.)

C. **Corporate Tax Levy:** Remaining funds that can be raised within the City's target tax rate will be allocated to the General Operating Fund to pay for public safety services.

VI. Capital Improvements: Capital improvements are defined as a project or activity costing more than $10,000 resulting in construction, renovation, or acquisition of land, infrastructure, or buildings, with an expected life of at least 10 years.

A. **Capital Improvement Fund:** The Capital Improvement Fund is used to pay for capital improvements that do not have another source of funding, or for which other sources are insufficient. The City's goal is to increase funding for capital improvements each fiscal year by at least the amount of increase in the construction cost index for the prior calendar year. This funding is to be used only for the purpose of funding capital improvements.

As the budget allows, the City will consider additional one-time transfers to provide additional funding for infrastructure maintenance and improvements; or increasing the base level of the recurring transfer to provide a stable, ongoing source of funding.

B. **Stormwater and Sewer Improvement Funds:** These enterprise funds are established to provide ongoing funding for maintenance and improvements to the City's stormwater and sanitary sewer systems. Fees will be established to provide funding consistent with long-term plans for operation and maintenance of these systems.

C. **State and Local Motor Fuel Tax Funds:** These funds are reserved for transportation improvements.

VII. Debt: The City may use long-term borrowing for capital projects that cannot be funded from current resources, when the improvements have a useful life of 25 years or more. Debt maturities will not exceed the useful life of the improvement. Combined debt service payments will not exceed 10% of recurring General Operating Fund revenues, regardless of the source of repayment. The City will generally use bank qualified bonds because of the lower cost of borrowing and reduced administrative burden.

VIII. Interfund Transfers for General Fund Support of Other Activities:

A. **Administrative Overhead:** The City provides support services for City activities through a variety of administrative support programs. As a result, some expenditures that benefit activities outside of the General Fund are not being directly allocated but are accounted for in administrative support programs in the General Operating Fund. Cost allocations for activities outside of the General Operating Fund will be charged to the following activities –

- Activities that are primarily supported by user fees (for example, sanitary and storm sewer maintenance).
- For internal services when less than 75% of support comes from the General Operating Fund (for example, the Equipment Services and Information Technology Funds would not be charged).
- Additionally, to maximize the use of grant funds available to the City, funds that receive most or all of their revenue from grants will not be charged.

A step-down allocation method will be implemented to ensure that costs incurred related to services between administrative support departments are fully allocated before final allocations to other activities are made.

B. **Direct Cost Allocations:** Other costs that can be directly allocated to a specific activity will also be included in the transfer (for example, General Operating Fund sewer maintenance activities will be fully allocated to the sanitary sewer and stormwater programs).

C. **Payment in Lieu of Taxes for Parking Fund:** The Parking Fund has historically made a transfer for a payment in lieu of taxes to the General Operating Fund, for revenue generating properties that are tax exempt. This will be reassessed based on changes in tax rates and growth in EAV since it was last assessed.