

CITY OF ANNAPOLIS FINANCIAL ADVISORY COMMISSION
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BY E-MAIL AND HAND DELIVERY

Mayor and City Council of the City of Annapolis
160 Duke of Gloucester Street
Annapolis, Maryland 21401

Re: Improvement to City's Budget Process

Dear Mayor Pantelides and Members of the City Council:

I am writing to you on behalf of the City of Annapolis Financial Advisory Commission ("Commission" or "FAC").

In November, 2013, after four years observing the processes employed by the City to manage City finances, the Financial Advisory Commission (FAC) presented a report to the Mayor and City Council titled, "Collaborative Stewardship: Guiding Principles and Metrics for City of Annapolis Financial Improvement." A copy of that report accompanies this letter. As the City's FY 2016 budget process is about to begin, this is an appropriate time for the FAC to reiterate some of the recommendations from the Collaborative Stewardship report and focus the attention of the policy-makers on the need for reform in the budget process that has been used in the past and to offer the assistance of the FAC to help move budget reforms forward. As discussed below, the FAC strongly recommends that the City promptly begin to transition to a programmatic budget format that includes a strong component of performance measures, referred to in the remainder of this letter as a programmatic and performance based budget process.

The incremental appropriations approach to budget preparation traditionally used by the City is not based on, nor coordinated with, explicitly stated goals or performance measures. This approach reconciles the prior year's approved line item budget with actual year-to-date expenditures to establish a baseline, and then line items in the proposed budget are marginally increased or decreased relative to this baseline. This process is related to the concept of what is referred to as zero-based budgeting. Expenditures are predominantly related to what was spent before and not to any measures of worthiness or to collective agreement on what is best for the City. In this manner, services and programs become entrenched for another year without any significant cost-benefit analysis, and little sunlight is shone on why and how taxpayer money is spent. The City needs to move away from line item incremental budgeting now.

The FAC's Collaborative Stewardship report recommended that the Mayor and City Council formally embrace the corporate governance approach presented by former City Manager Mike Mallinoff and current Finance Director Bruce Miller. A corporate governance model should supplant the traditional incremental appropriations model with a programmatic and performance based budgeting approach.

The corporate governance approach to budgeting begins with defining the City's core services, setting goals within each service delivery area, establishing the unit costs to perform those services at the level set by the goals, and then allocating available resources. This programmatic and performance based budget process links strategic planning, performance measurement and budgeting activities. Once core services are defined, planning activities examine the processes by which both core services and discretionary services are delivered. Performance measurement quantifies the cost per unit of each deliverable service and program output. These metrics then can be scrutinized to assess process performance and identify efficiencies and inefficiencies in service delivery.

This type of budgeting facilitates a transparent negotiation within and among the City Council, the administration, program managers, and citizens to match services outcomes to resource availability on the basis of the unit costs associated with established program goals and priorities that are comparable across programs.

The City's "2014 Organizational Dashboard and Annual Report" showcases a corporate governance "best practices" approach to city management that has been validated by independent research, and should be a useful basis for the City to get started on moving to a programmatic and performance-based budget approach. This Organizational Dashboard may be accessed at <http://www.annapolis.gov/docs/default-source/mayor's-office/2014-organizational-scorecard-draft-final.pdf?sfvrsn=4>.

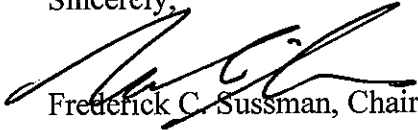
While there are a number of other financial issues to be considered as a result of the FY 2015 budget experience, the FAC believes that it is urgent that the City focus on taking the necessary steps to transition to a programmatic and performance based budget process as the highest priority to be addressed before actual FY 2016 budgeting begins. The first steps toward implementing a programmatic and performance based budgeting approach are:

1. The Administration and the City Council, beginning with the Finance Committee, defines each program that they want to fund and the outcome goals that are expected from each program to be funded.
2. Finance Department staff then establishes City-wide parameters for measuring the unit costs of programs so that costs of service delivery can be measured across multiple departments and programs. Department managers then apply the unit costs of service delivery performance outcomes for each of the pre-established program outcome goals.
3. The Administration presents a budget that shows how the pre-established program goals and service delivery outcomes are directly related to the proposed

expenditure of projected revenue resources for the next fiscal year. The City Council and the public then have a basis for debating and seeking consensus on how the City's resources are allocated towards meeting the agreed-upon needs of the citizenry that is transparent and based on current needs and expectations.

The FAC is available and welcomes the opportunity to meet with the Mayor and the City Council to help facilitate the City's transition to a programmatic and performance based budget model. If there are any specific aspects of the programmatic and performance based budget approach that the Mayor and City Council would like the FAC to consider in more detail, the FAC stands ready to support the City in improving the City's fiscal processes.

Sincerely,



Frederick C. Sussman, Chair

cc: Commission Members (By e-mail)
Bruce Miller, Finance Director (By e-mail)
Hilary Raftovich, Boards and Commissions Coordinator (By e-Mail)
Jessica Cowles, Legislative and Policy Analyst (By e-mail)

**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 structural¹ and operational deficiencies² 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.

Structural Remedies

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

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 than 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.