

**CITY COUNCIL AGENDA ITEM**  
CITY OF SHORELINE, WASHINGTON

<b>AGENDA TITLE:</b> Reserve Policies <b>DEPARTMENT:</b> Finance Department <b>PRESENTED BY:</b> Debbie Tarry, Finance Director
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**PROBLEM/ISSUE STATEMENT:**

The City's current adopted financial policies provide for maintaining an operating contingency reserve, unreserved operating fund balances, a budgeted operating contingency, and a budgeted insurance contingency. Staff has reviewed the current policies and is recommending that the City Council repeal the current policies and adopt new reserve policies that support the City's long-term fiscal stability goals and that would be more transparent and understandable to the public.

**BACKGROUND**

Adequate fund balance and reserve levels are a necessary component of the City's overall financial management strategy and a key factor in external agencies' measurement of the City's financial strength.

The City needs to maintain operating reserves for these primary purposes: a buffer for unexpected economic changes, to manage the City's cash flow needs, provide resources to pay for the City's insurance deductibles in the case of unexpected damage to the City's assets (buildings, equipment, infrastructure) and to provide flexibility for unexpected expenditures.

**Current Policies**

In 2000 the City adopted the following reserve policies:

**Contingency Reserve**

It is the City's policy to maintain a contingency reserve in accordance with RCW 35A.33.145. The reserve will be available for unforeseen urgent or emergency needs. The contingency reserve is intended to provide for unanticipated expenditures or revenue shortfalls of a non-recurring nature. The maximum allowable amount in the contingency reserve is 37.5 cents per thousand dollars of assessed valuation.

**Unreserved Fund Balance**

It is the City's policy to maintain a unreserved balance in each of the operating funds of the City (i.e., General, City Streets) at a level sufficient to provide for cash flow needs, a reasonable amount for emergent or unforeseen needs, and an orderly adjustment to adverse changes in revenues, including termination of revenue sources through actions of other governmental bodies. The Finance Director, in conjunction with the

departments and the City Manager, will analyze fund balance requirements and recommend formal fund balance policies for each of the principal City funds. Fund balance policies will be reviewed at least every three years to ensure all relevant factors are being considered. Until such time as a thorough analysis has been completed for each fund, the City's policy will be to provide a minimum fund balance (combination of Contingency Reserve and Unreserved Fund Balance) of at least 10% of budgeted operating revenues for the General Fund and a minimum unreserved fund balance of 5% of budgeted operating revenues for other City operating funds.

#### Budgeted Operating Contingency

In order to provide for unforeseen expenditures or new opportunities throughout the year, the General Fund budget will have an operating contingency of \$250,000 that will be used only with City Council approval. Savings within departmental budgets throughout the year will be the first source for funding unforeseen expenditures or providing for new opportunities before the Operating Contingency is accessed.

#### Budgeted Insurance Reserve

A separate insurance reserve account will be budgeted within the General Fund budget to be used for potential substantial events (street damage, inverse condemnation, etc.) and infrastructure repair not covered by insurance policies or other sources such as FEMA. The budgeted amount should approximate 2% of the City's assets (not including roads and surface water utilities).

#### Current Reserve Levels

As of January 1, 2007, the City had the following operating reserves:

General Fund Unreserved Fund Balance	\$ 8,482,000
General Reserve Fund	\$ 2,275,000
Total General Operating Reserves	<u>\$10,757,000</u>
City Street Fund	<u>\$ 947,000</u>

The required operating reserve levels per the City's adopted financial policies are:

General Fund Unreserved Fund Balance:	
Insurance Reserve	\$ 255,000
Budget Contingency	\$ 250,000
Fund Balance	\$ 2,862,270
General Reserve Fund	\$ 2,445,389
Total General Operating Reserves	<u>\$ 5,812,659</u>
City Street Fund	<u>\$ 121,104</u>

Comparing the actual General Operating Reserves as of January 1, 2007, and the reserve levels required, actual levels exceeded required levels by \$4,944,341. Even though this is the case, staff believes that the current policy does not provide adequate General Operating Reserves. The current policy does not provide a reserve level adequate to manage the City's operating cash flow needs or provide adequate reserve levels in the case of recessionary pressures.

## **ALTERNATIVES ANALYSIS**

### **General Reserve Fund**

Staff is recommending that Council eliminate the "General Reserve Fund", which has a legal cap on the amount of funds that can be accumulated. Instead, staff would recommend that Council establish a "Revenue Stabilization Fund". The purpose of the fund would be to set aside adequate reserves to cover revenue shortfalls over a recessionary period and basically serve as an "emergency savings account" for the City.

Cities have used a variety of formulas either tied to expenditure activity or revenue activity to establish such a reserve. Some formulas used by other cities include:

- A percentage of operating revenues or operating expenditures
- An amount equal to a certain number of months of expenditures such as the average of three months of general fund expenditures. (For Shoreline this would be approximately \$7.7 to \$7.9 million)
- A percentage of economically sensitive operating revenues for certain amount of time. The City of Des Moines uses such a formula which is defined as 10% of economically sensitive revenues to cover revenue shortfalls over a three year recessionary period. (For Shoreline this would be approximately \$6 million)

Staff would recommend that the City use a formula similar to that used by the City of Des Moines. The Revenue Stabilization Fund would accumulate an amount equal to 30% of annually budgeted economically sensitive revenues. Economically sensitive revenues include sales tax, gambling tax, utility tax, investment interest, state-shared revenues, permit fees, and recreation fees. Since historically recessions and their related recoveries have lasted two to three years, staff believes it is important to maintain a three year level of the recommended 10% of economically sensitive revenues, or 30% of the annually budgeted amount. For 2007 the amount required would be \$5,792,000.

Investment revenue from the investment of this reserve would go to the City's general fund to support operating services. This will be necessary to obtain the level of investment interest that is currently budgeted within the City's General Fund.

### **General Fund Operating Reserves**

In order to adequately manage the cash flows within the City's General Fund the City must maintain an operating reserve within the General Fund of \$3 million. This is primarily because the General Fund expenditures tend to occur on a relatively equal basis each month throughout the year, while many of the substantial revenue sources are received on a quarterly basis (i.e., gambling tax, utility taxes) or semi-annually (i.e., property tax). In reviewing the General Fund cash flow for 2005 and 2006 it appears that the largest negative cash flow balance during the year was \$2.5 million. Reserves allow the City to manage the cash flow adequately so that we do not have to borrow monies and pay interest during times of the year when there is a negative cash flow.

In addition to the need to manage cash flow, staff would recommend that the Council continue the policy of budgeting a budget contingency and insurance reserve. Staff would recommend that the budget contingency be \$550,000, approximately 2% of

budgeted operating revenues, and the insurance contingency of \$255,000. This would be a total of \$805,000 in reserve contingencies.

The total recommended General Fund Operating Reserve would be \$3,805,000 .

#### City Street Reserves

Staff recommends that the City Street reserves be set at 20% of operating revenues. The primary reason to establish reserves at this level is to provide adequate reserves to manage the cash flows of the fund. The operating revenues for the City Street fund are \$1,021,000 for 2007. A 20% reserve level is approximately \$200,000. The remaining revenues used to provide maintenance for City streets comes from the General Fund.

#### Total General Operating Reserves

If the Council agrees to revise the current operating reserve policy, as recommended by staff, the required 2007 operating reserves would be as follows:

General Fund Operating Reserve:	
Insurance Deductible Reserve	\$ 255,000
Budget Contingency	\$ 550,000
Cash Flow Reserve	\$ 3,000,000
Total General Fund Operating Reserve	<u>\$ 3,805,000</u>
Revenue Stabilization Fund	<u>\$ 6,000,000</u>

The combination of the General Fund Operating Reserve and the Revenue Stabilization Fund are \$9,805,000. This is approximately \$952,000 less than current general operating reserve levels of \$10.757 million. It should be noted that the \$952,000 includes the \$838,000 in one-time savings from 2006.

The City's financial policies state that resources (fund balance) greater than budget estimates in any fund shall be considered "one-time" resources and shall not be used to fund ongoing service delivery programs. If the Council chooses to modify the existing operating reserve policy and spend any reserves in excess of required levels then this needs to be done with the expectation that the funds are used for one-time purposes. To date the Council has discussed using approximately \$116,000 of the excess reserves for funding for the Senior Center and the YMCA.

At any time in the future if operating reserves drop below required levels the City will need to include in its annual budget funds to bring reserves to the required levels.

#### Other Reserves

In addition to the City's general operating reserves (General Fund, General Reserve and Street Fund) the City has fund balance in designated funds (those funds which have revenues that have been designated for a specific purpose such as code abatement, equipment replacement or drug seizure) and fund balance in funds that restricted for specific purposes (those funds in which there is a legal requirement that the resources must be spent for a specific purpose such as capital or surface water revenues).

Staff recommends that Council include in a modified reserve/fund balance policy the following:

- The City shall maintain reserves required by law, ordinance and/or bond covenants.
- The City shall maintain reserves in the Enterprise Funds as follows:
  - o Surface Water Utility Fund – 15% - 25% of total budgeted operating expenses plus any fund balance dedicated for future surface water capital improvements.
- Reserve balances of other funds shall be set through the budget process in an amount consistent with the purpose and nature of the fund.
- The City will maintain fully funded reserves for the replacement of City equipment, vehicles, personal computers, and computer network hardware. Contributions will be made through assessments to the using funds and maintained on a per asset basis. *This is the City's current practice.*

**FINANCIAL IMPACT:**

There is no financial impact to revising the City's reserve policies. The City currently has operating reserves within the City's General Fund in excess of the recommended policy revisions by approximately \$952,000. If the Council allocates any of the excess reserves for expenditures it should be for one-time items, as per the City's financial policies. To date the Council has discussed using \$116,000 of these monies for one-time funding for the Senior Center and the YMCA.

**RECOMMENDATION**

Staff recommends that the Council adopt by motion revised reserve policies as is provided in Attachment A to this staff report.

Approved By:      City Manager  City Attorney \_\_\_\_

## ATTACHMENT A

### RESERVE AND FUND BALANCE POLICIES

Adequate fund balance and reserve levels are a necessary component of the City's overall financial management strategy and a key factor in external agencies' measurement of the City's financial strength.

Maintenance of fund balance for each accounting fund assures adequate resources for cash flow and to mitigate short-term effects of revenue shortages. Reserve funds are necessary to enable the City to deal with unforeseen emergencies or changes in condition.

A. General Policy

The City shall maintain reserves required by law, ordinance and/or bond covenants.

All expenditures drawn from reserve accounts shall require prior Council approval unless previously authorized by the City Council for expenditure within the City's annual budget.

If reserves and/or fund balances fall below required levels as set by this policy, the City shall include within its annual budget a plan to restore reserves and/or fund balance to the required levels.

All reserves will be presented in the City's annual budget.

B. Revenue Stabilization Fund

The City will establish a Revenue Stabilization Fund and shall accumulate a reserve equal to thirty percent (30%) of annual economically sensitive revenues within the City's operating budget to cover revenue shortfalls resulting from unexpected economic changes or recessionary periods.

C. General Fund Operating Reserves

The City shall maintain a General Fund Operating Reserve to provide for adequate cash flow, budget contingencies, and insurance reserves. The General Fund Operating Reserves will be determined as follows:

1. **Cash Flow Reserve:** The City shall maintain a cash flow reserve within the General Fund in an amount equal to \$3,000,000. This is approximately equal to 1.5 months of operating expenditures. The City will review annually the required cash flow reserve level that is necessary to meet the City's cash flow needs. If it is determined that \$3,000,000 is not adequate, the Finance Director shall propose an amendment to these policies.
2. **Budget Contingency:** The City shall maintain a budget contingency reserve within the General Fund equal to 2% of budgeted operating revenues.

3. Insurance Deductible Reserve: The City shall maintain a an insurance reserve within the General Fund to be used for potential substantial events that cause damage to the City's fixed assets and/or infrastructure.

D. Equipment and Vehicle Replacement Reserves

The City will maintain fully funded reserves for the replacement of vehicles, computer equipment, and equipment identified on the City's fixed asset listing. Contributions will be made through assessments to the using funds and maintained on a per asset basis.

E. City Street Fund Reserve

The City shall maintain an operating reserve within the City's Street Fund an amount equal to 20% of annually budgeted operating revenues.

F. Surface Water Utility Fund Reserve

The City shall maintain an operating reserve within the Surface Water Utility Fund an amount equal to no less than 20% of budgeted operating revenues.

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