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CITY OF DURHAM | NORTH CAROLINA

Date: **October 7, 2011**

To: Thomas J. Bonfield, City Manager
Through: Wanda Page, Deputy City Manager
From: David Boyd, Finance Director
Subject: Fund Balance Policy for General Fund and Operating Reserve Requirement for Water and Sewer Fund

Executive Summary
Due to changes in accounting rules, an update of the existing fund balance policy is proposed to be adopted by the City Council. The new policy will address changes in how fund balance is categorized and will maintain the requirement that General Fund reserve levels do not drop below 12% of adjusted spending. The new policy will also create a requirement that operating reserve levels in the Water and Sewer Fund do not drop below 50% of annual operating expenses. This is an addition to the existing policy that is consistent with the City's current financial planning practices within that utility.

Recommendation
To adopt a Resolution Superseding Resolution #8571, adopting a Policy Specifying the Level of Fund Balance in the General Fund and the Level of Operating Reserves in the Water and Sewer Fund.

Background
The Government Finance Officers Association (GFOA), the Local Government Commission (LGC) and all three bond rating agencies strongly recommend that local governments adopt a fund balance policy. City Council previously adopted resolution #8571 on June 21, 1999 dictating a fund balance policy for the General Fund.

The GFOA's current guidance suggests that local governments assess the adequacy of their fund balance levels "…based upon a government's own specific circumstances." Previous ratings reviews by Moody's, Standard & Poor's and Fitch have all deemed the minimum fund balance levels prescribed by the City's current fund balance policy as adequate. However, recent changes in accounting rules have resulted in the need to update the policy.

The City has adopted, as required, GASB Statement 54 effective with the fiscal year ending June 30, 2011. Among other things, this statement changed how fund balance is classified. Fund balance previously referred to as "undesignated" is now referred to as "unassigned". While there are minor differences between how each are calculated, they are essentially the same. The goal of the new policy is to ensure that the policy is in alignment with the financial statements but not increase or decrease the amount of fund balance that the City is required to maintain in order to be in compliance with the policy. Moreover, it was desirous that the new policy provide the ability for City Council, in certain extreme instances, to intentionally

drop below the target level without violating the policy. Both of these goals have been met in the new policy.

Issues and Analysis
The policy sets the required unassigned fund balance at 12% of Adjusted Budgeted Expenditures (same as previous required level of undesignated fund balance) and contains a provision that City Council may direct actions that would result in an amount below 12% as long as the next budget contains a plan to restore the fund balance to the minimum level in a reasonable amount of time. At the end of fiscal year 2011, the unassigned fund balance of the General Fund was equal to $21,879,765.00 or 13.5% of Adjusted Budgeted Expenditures - $2,463,729.00 higher than the 12% minimum level.

The policy also includes an Operating Reserve requirement for the Water and Sewer Fund of 50% of annual Operating and Maintenance Expenses. The City does not currently have a policy addressing reserve levels in this fund. To have a reserve policy is consistent with best practices and is something that rating agencies look for when evaluating the financial condition of utility funds. This policy has been an internal financial planning practice within the existing rate model and adding this to the policy would formalize this practice. At the end of fiscal year 2011operating reserve levels were at $108,901,773.00, well above the required level of $25,730,610.00. These funds have been accumulated over time and are anticipated to be spent down closer to required levels over the next several years as the extensive capital plan of the utility is funded.

Alternatives
The City Council could choose to not adopt the resolution, however the current policy is out of date and not consistent with current accounting practices and could be viewed negatively by rating agencies, the LGC and external auditors.

A more conservative policy could be adopted (higher fund balance / operating reserve levels). While this would be viewed favorably by rating agencies, the LGC and other credit granting agencies, it would have future budgetary impacts as more dollars would need to be directed to fund balance as opposed to be available for spending.

A less restrictive policy could be adopted (lower fund balance / operating reserve levels), however rating agencies, the LGC and other credit granting entities would not view these lower reserve levels favorably which could result in higher borrowing costs or limit the City's access to the credit markets.

Financial Impact
This adoption of this resolution will have no incremental financial impact as the policy is consistent with current practices in this area.

SDBE Summary
Not applicable to this item

Attachments
Resolution (1 page)
Finance Policy FP 112.01 (2 pages)