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HIGHLIGHTS

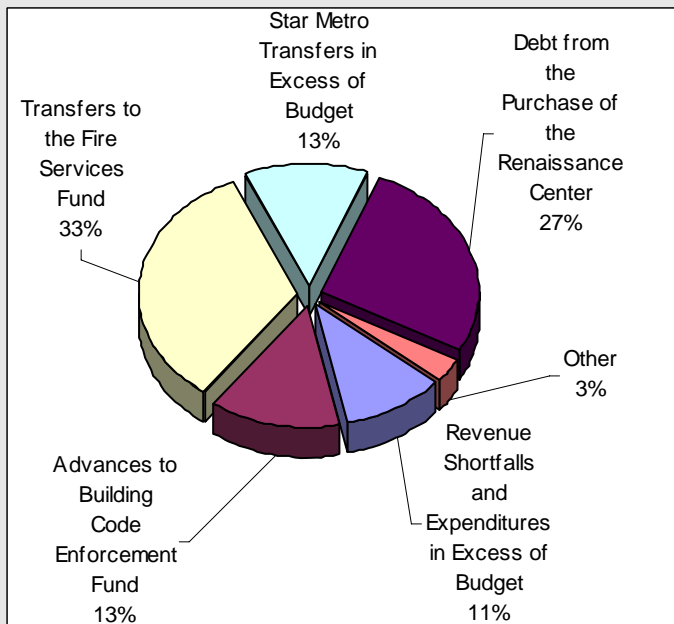
Highlights of City Auditor Report #1024, a report to the City Commission and City management

WHY THIS AUDIT WAS DONE

The purpose of this audit was to answer the following questions:

- What are the balances of the various components of the fund balance of the General Fund, which includes any applicable reserves?
- What activities/factors have impacted the decrease in the Deficiencies Fund over time?
- What are the best practices relating to fund balance and specifically reserves?
- Is the current status of the City's General Fund's fund balance and reserves in accordance with established policies and best practices? and
- How well does the City's policy relating to General Fund reserves and fund balance meet established best practices?

USES OF THE DEFICIENCIES FUND



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September 29, 2010

General Fund Reserves And Fund Balance

The Deficiencies Fund has decreased from \$26.8 million to \$5.3 million in the five years from FY 2004 to FY 2009.

WHAT WE FOUND

In our audit of the City's General Fund Reserves and fund balance we determined that

- The Deficiencies Fund has decreased significantly from \$26.8 million to \$5.3 million during the six year period (FY 2004 to FY 2009) we examined;
- The causes of the decrease included;
 - Transfers to the Fire Services Fund,
 - Accounting for the debt associated with the acquisition of the Renaissance Center,
 - Transfers to StarMetro,
 - Advances to the Building Code enforcement Fund, and
 - Revenue shortfalls and Expenditures in excess of budgeted amounts
- The City has incorporated many of the best practices related to fund balance and reserves put forth by the Government Finance Officers Association and bond rating agencies into its policies,
- The Governmental Accounting Standards Board has issued a new standard that will change how the City reports its General Fund reserves and fund balance.

WHAT WE RECOMMEND

We recommended that improvements be made to the reporting of the status and activities of the Deficiencies Fund. We also made recommendations relating to the replenishment of the Deficiencies Fund.

**Audit of the Fund Balance
of the General Fund**

AUDIT REPORT #1024

September 29, 2010



Copies of this audit report #1024 may be obtained from the City Auditor's web site (<http://talgov.com/auditing/index.cfm>), by telephone (850 / 891-8397), by FAX (850 / 891-0912), by mail or in person (City Auditor, 300 S. Adams Street, Mail Box A-22, Tallahassee, FL 32301-1731), or by e-mail (auditors@talgov.com).

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Sam M. McCall, Ph.D., CPA, CGFM, CIA, CGAP, City Auditor

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General Fund Reserves and Fund Balance



Sam M. McCall, Ph.D., CPA, CGFM, CIA, CGAP
City Auditor

Report #1024

September 29, 2010

Executive Summary

The General Fund of the City of Tallahassee is the predominant fund for recording and reporting the general government activities of the City. The City's administrative and management activities, the police department, cultural and recreation activities, and human services activities are examples of the operations of the City that are accounted for in the General Fund.

This audit examined the fund balance of the General Fund and its constituent parts, specifically the Deficiencies Fund. We identified several major factors that significantly decreased the balance in the Deficiencies Fund from \$26.8 million to \$5.3 million during the six-year period FY2004 through FY2009. We also looked into what best practices have been established for managing the fund balance and what funding level is recommended for the Deficiencies Fund. A third area we reviewed was the policy that governs the Deficiencies Fund. Finally, we reviewed a new standard that has been established by the Governmental Accounting Standards Board. The new standard, GASB 54 *Fund Balance Reporting and Governmental Fund Type Definitions*, addresses how the fund balance of the City's General Fund will be reported in the future and will be effective for the City's September 30, 2011 annual financial statements.

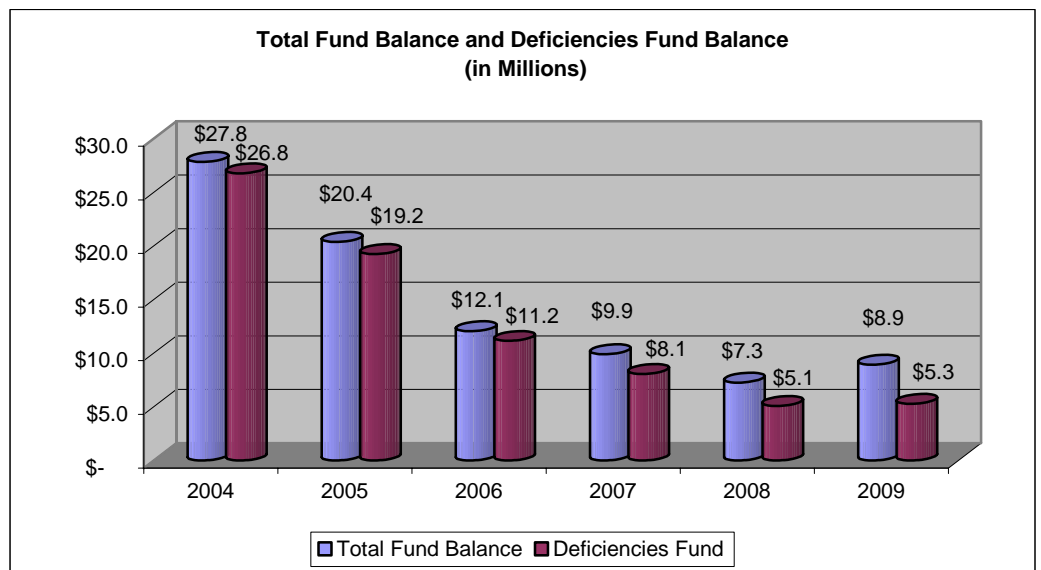
Financial Condition

Our examination of the fund balance of the General Fund showed that the fund balance is currently comprised of four basic elements; (1) encumbrances, (2) inventory, (3) advances to other funds, and (4) the Deficiencies Fund. Encumbrances represent commitments related to contracts not yet performed and orders not yet filled.

Inventory is the value of goods held for future use. Advances to Other Funds are the value of loans to other funds to make up for budgetary shortfalls in those other funds. The Deficiency Fund is the remaining portion of the fund balance and represents funds held for use in times of need.

A review of the total fund balance over the six-year period (2004-2009) shows a significant decrease in the total fund balance. This decrease was caused almost entirely by reductions to the Deficiencies Fund.

In 2004 the total fund balance was \$27.8 million of which \$26.8 million was in the Deficiencies Fund. At the end of fiscal year 2009 the total fund balance had fallen to \$8.9 million and only \$5.3 million was in the Deficiencies Fund. This is a \$21.5 million reduction in the Deficiencies Fund over the six-year period.



We identified several reasons for the decrease in the Deficiencies Fund. Those reasons include:

- Transfers to the Fire Services Fund (approximately \$7.1 million),

- The accounting treatment of the recording of debt from the acquisition of the Renaissance Center (approximately \$5.7 million),
- Transfers to Star Metro that exceeded the amount budgeted to be transferred (approximately \$2.8 million),
- Advances (loans) to the Building Code Enforcement Fund in fiscal years 2007, 2008, and 2009; this did not cause a decrease in the total fund balance of the General Fund, only a reclassification of monies from the Deficiencies Fund to Advances to Other Funds (approximately \$2.8 million), and
- Revenue shortfalls and expenditures in excess of budgeted amounts (approximately \$2.2 million).

In total these five items account for nearly all the reduction in the Deficiencies Fund shown in the City's financial statements.

Best Practices

We identified several best practices relating to the management of General Fund's fund balance and the Deficiencies Fund. Those best practices were put forth by the Government Finance Officers Association (GFOA) and the agencies that analyze the credit worthiness of the City and rate the risk to investors that loan money to the City.

The GFOA recommends that local governments maintain an unreserved fund balance or "rainy day fund" (the equivalent of the Deficiencies Fund for the City) of two months of operating revenues or expenditures. For the City, based on FY 2009 budgeted expenditures and transfers of \$132 million, the Deficiencies Fund should be maintained at approximately \$22 million. As previously noted, the balance was above that level in FY 2004 at \$26.8 million and as of the end of FY 2009 the balance was \$5.3 million.

The rating agencies (Fitch Inc. and Moody's Investor Services) recommend local governments have a written policy that outlines the requirement for a "rainy day fund" and that the policy stipulates when and how it can be used. Our review showed that the City has a policy (Commission Policy 224, Financing the Government) in place that addresses both fund balance and reserves, as recommended.

City Policy

We reviewed Commission Policy 224, Financing the Government, which is the City policy that governs the Deficiency Fund. The policy sets the level of the Deficiencies Fund to be at a maximum of two months operating expenditures, which is roughly in line with the recommendation by the GFOA. Based on our review of the policy we made three recommendations, which if implemented will strengthen the management of the Deficiencies Fund and increase the transparency of the uses of the Deficiencies Fund.

Those recommendations include: (1) defining or replacing the term "used sparingly" as it relates to drawing funds from the Deficiencies Fund, (2) requiring requests for approval for the use of funds from the Deficiencies Fund to specifically identify the request as a draw down of the Deficiencies Fund, and (3) the annual budgetary closeout process include a separate schedule that shows any change in the Deficiencies Fund and what occurred during the past year that caused the change.

Reporting Standard

In March of 2009, the Governmental Accounting Standards Board (GASB) issued a new standard that will change how the City reports its fund balance for governmental funds. That standard, GASB Statement No. 54 *Fund Balance Reporting and Governmental Fund Type Definitions*, (effective for periods beginning after June 15, 2010) will require the City to reclassify the current amounts reported

in the fund balance of the General Fund into at most five separate classifications. The determination on how the currently reported amount will be reclassified will be based on the level of restrictions placed on the City's ability to expend those funds. Those five classifications are:

- Non-spendable,
- Restricted fund balance,
- Committed fund balance,
- Assigned fund balance, and
- Unassigned fund balance.

As it relates to this audit, the new standard will have the effect of changing the Deficiencies Fund from being reported as unreserved designated. We recommend that the portion of the fund balance the City Commission intends to set aside for "rainy day" use be reported as committed fund balance.

After consulting with management it was clear that Accounting Services was already aware of this new standard and was making plans for its implementation when required.

Conclusion

As previously stated, the Deficiencies Fund has significantly decreased from where it was in 2004. While the fund has been used for its intended purpose, allowing the City to continue to provide necessary services, the City Commission recognized the need for the fund to return to a safe level and has directed management to deliberately replenish the fund over a five to seven year period.

We will conduct follow-up reports to address the City's progress toward building the Deficiencies Fund back up to the identified goal of \$23 million. We will conduct such follow-up work until the City Commission is satisfied that the target level for the Deficiency Fund has been reached.

We would like to acknowledge the full and complete cooperation and support of management and staff from the Department of Management and Administration, specifically the Office of Budget and Policy and Accounting Services.

Audit of the Fund Balance of the General Fund



Report #1024

September 29, 2010

Scope, Objectives & Methodology

The overall objective of this audit was to review the City's General Fund reserves and fund balance. That review consisted of answering the following questions:

- What are the balances of the various components of the fund balance of the General Fund, which includes any applicable reserves?
- What activities/factors have impacted the decrease in the Deficiencies Fund over time?
- What are the best practices relating to fund balance and specifically reserves?
- Is the current status of the City's General Fund's fund balance and reserves in accordance with established policies and best practices? and
- How well does the City's policy relating to General Fund reserves and fund balance meet established best practices, and are there improvements that can be made to enhance the management of the Deficiencies Fund and the transparency of the activities impacting the Deficiencies Fund?

Additionally, the audit reviewed Governmental Accounting Standards Board (GASB) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which changes how governments must report their fund balances, and how it will impact the City's reporting of the General Fund's fund balance and the Deficiencies Fund.

The scope of this audit was limited to the City's General Fund and the major activities that caused the changes in the fund balance. Our review included the years from FY 2004 to FY 2009.

To address the stated audit objectives we:

- Reviewed the City's comprehensive annual financial reports (CAFR) and annual budget documents for the years 2004 through 2009;
- Interviewed staff;
- Reviewed publications by GFOA and various bond rating agencies relating to best practices;
- Identified, reviewed, and analyzed applicable laws and City policies; and
- Obtained and reviewed the recent changes in the standards governing reporting of fund balance and reserves of the government.

This audit was conducted in accordance with the International Standards for the Professional Practice of Internal Auditing and Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Background

The General Fund of the City of Tallahassee is the predominant fund for recording and reporting the financial position of the City's general government and the results of its operations. Examples of City departments that are accounted for within the General Fund include: Tallahassee Police Department (TPD), Department of

Management and Administration (DMA), City Treasurer-Clerk, the City Attorney's Office, and Public Works.

The financial position and the results of operations of the City are reported annually in the Comprehensive Annual Financial Report (CAFR). The financial position of the City for governmental funds is reported in the Balance Sheet and the results of operations are reported in the Statement of Revenues, Expenditures and Changes in Fund Balance.

The balance sheet shows the assets, liabilities, and fund balance. The assets represent what the City owns and the liabilities represent what the City owes to others. The fund balance of the General Fund, which is the focus of this audit, represents the difference between assets and liabilities. The City's fund balance is broken down into four areas, encumbrances, inventory, advances to other funds, and the Deficiencies Fund. Each of those areas can be explained as:

- **Encumbrances:** Encumbrances represent commitments related to contracts not yet performed, and orders not yet filled.
- **Inventory:** Inventory represents an amount equal to the cost of the goods and materials that are held by departments for future use.
- **Advances to Other Funds:** Advances to other funds represents funds that have been loaned to other portions of City government. By reporting advances to another fund as a reserve of fund balance there is a presumption that the loans will be repaid to the General Fund at some future time.
- **Deficiencies Fund:** The Deficiencies Fund represents the remainder of all other fund balances held by the General

Fund. Often this is thought of as the “savings” or “rainy day” funds of the City’s General Fund that is set aside to sustain the government in times of need.

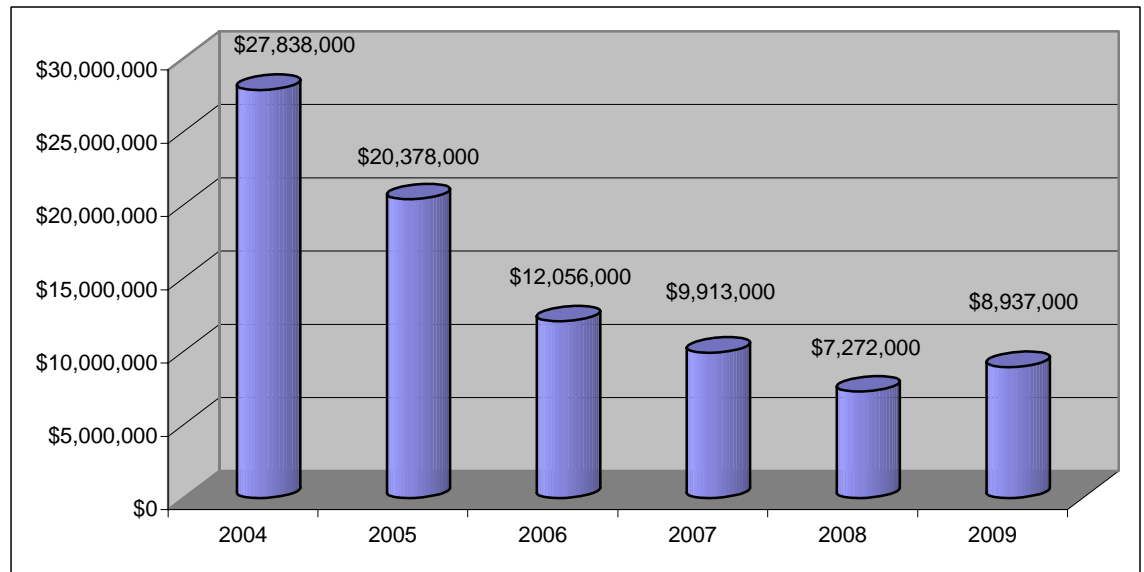
**Financial
Condition of the
General Fund**

The fund balance is one of the most important indicators of financial health for a government. In general, the total fund balance of the City’s General Fund has significantly decreased over the past several years. This decrease in the total fund balance is primarily attributable to a drawdown of the Deficiencies Fund.

Fund Balance

The history of the total amount in the General Fund’s fund balance shows a downward trend. For example, in 2004 the total fund balance of the City was \$27.8 million and by 2008 it had reached a low point of \$7.2 million. In 2009 however, the City Commission took actions to address and reverse this downward trend. Those actions resulted in increasing the total fund balance by \$1.7 million to a total of approximately \$8.9 million. Chart 1 below illustrates the downward trend and slight increase of the total fund balance of the General Fund by showing the total fund balance for each of the last six years.

**Chart 1
Fund Balance Trend**



Through discussions with management and reviews of financial information we identified several major factors that have led to this decrease in fund balance. The identified factors will be discussed in detail later in this report. However, generally the decrease has been caused by transfers from the General Fund to other funds, the accounting treatment of the debt associated with the acquisition of the Renaissance Center, loans to other funds, and a combination of revenue shortfalls and expenditures in excess of budget amounts.

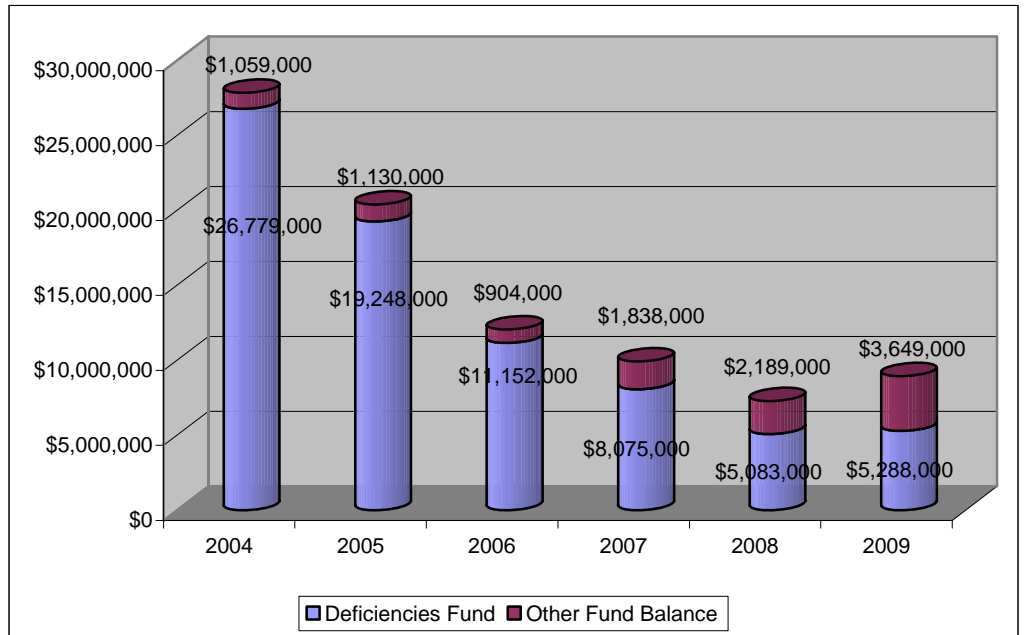
As noted in the background section total fund balance is made up of four elements. Table 1 shows the balances of those elements over the six years reviewed.

**Table 1
Detail of the Elements of Total Fund Balance**

	2004	2005	2006	2007	2008	2009
Encumbrances	\$ 885,000	\$ 663,000	\$ 566,000	\$ 685,000		\$ 483,000
Advances to Other Funds				\$ 802,000	\$ 1,889,000	\$ 2,882,000
Inventory	\$ 174,000	\$ 467,000	\$ 338,000	\$ 351,000	\$ 300,000	\$ 284,000
Deficiencies Fund	\$ 26,779,000	\$ 19,248,000	\$ 11,152,000	\$ 8,075,000	\$ 5,083,000	\$ 5,288,000
Total Fund Balance	\$ 27,838,000	\$ 20,378,000	\$ 12,056,000	\$ 9,913,000	\$ 7,272,000	\$ 8,937,000

From the fund balance detail shown in Table 1, we can see the Deficiencies Fund is the largest element of total fund balance. Chart 2 below is similar to Chart 1 above in that it shows the total fund balance of the General Fund for each of the past six years. However, Chart 2 illustrates the relative difference between the Deficiencies Fund and the other elements of the total fund balance.

Chart 2
Fund Balance - Deficiencies Fund Breakout

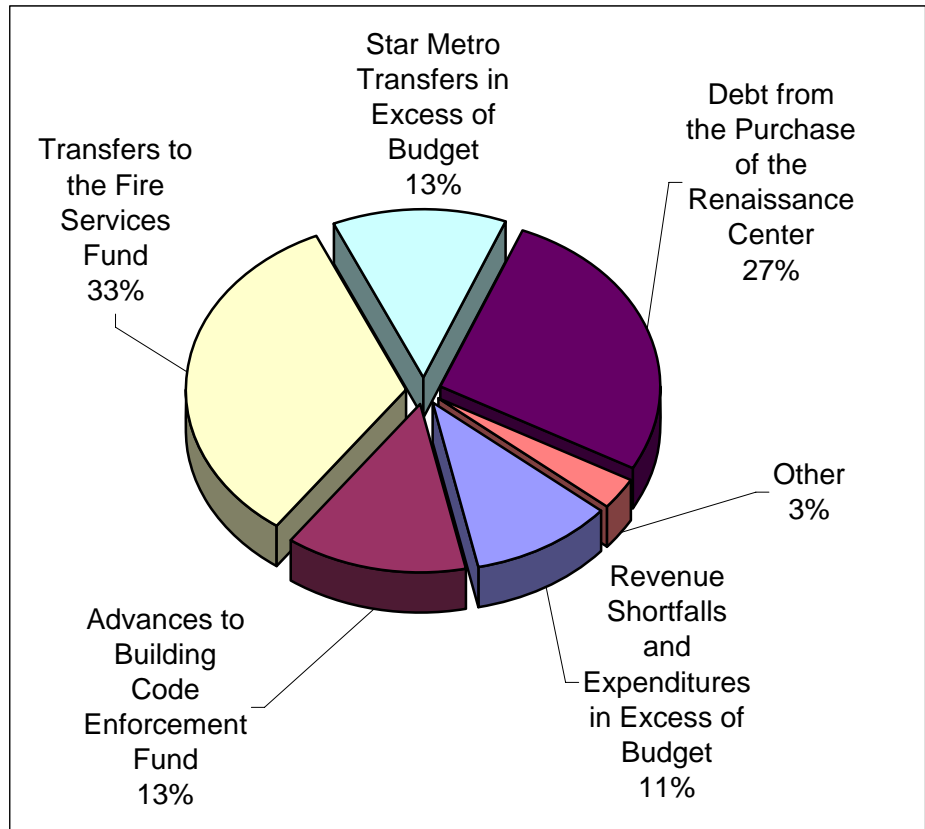


From this chart we can see two things: (1) the decrease in the total General Fund’s fund balance has been mirrored by a corresponding decrease in the Deficiencies Fund, and (2) the composition of the total fund balance has shifted from being primarily composed of the Deficiencies Fund in 2004 to a point where in 2009 the Deficiencies Fund only makes up about 60% of the total fund balance. Specifically, in 2004 the Deficiencies Fund was \$26.7 million (96% of total fund balance), all other components of the fund balance combined were slightly less than \$1.1 million (4% of total fund balance). In 2009, the Deficiencies Fund had decreased to approximately \$5.3 million (59% of the total) with the other portions of the fund balance equaling \$3.6 million (41% of the total). This shows the Deficiencies Fund has been relied upon to allow the City to sustain a desired level of services provided to its citizens. In total the balance of the Deficiencies Fund has been reduced by \$21.5 million over the six-year period reviewed.

The City's use of the Deficiencies Fund over the above period is consistent with the reason for having the fund – to have a surplus to draw from in times of need on downturns in the economy. It is intended to provide short-term relief and is not a long-term solution. Recognizing improvement in the current economy will take time, the City Commission has approved budget reductions in the government and has directed management to deliberately build back up the Deficiencies Fund over the next five to seven years.

With the downward trend in the total fund balance of the General Fund and specifically the Deficiencies Fund, it is important to identify and examine what caused the changes in the Deficiencies Fund. The main drivers of the change in the Deficiencies Fund has been (1) transfers to the Fire Services Fund, (2) the accounting treatment of the debt associated with the acquisition of the Renaissance Center, (3) transfers to Star Metro in excess of the amount budgeted, (4) advances, or loans to the Building Code Enforcement Fund, and (5) revenue shortfalls and expenditure overruns in the General Fund. Those five items account for over 97% of the change in the Deficiencies Fund. Chart 3 shows the breakdown of the causes for the reductions to the Deficiencies Fund.

Chart 3
Causes of the Decrease in the Deficiencies Fund



Transfers to the Fire Services Fund

The Tallahassee Fire Department is accounted for in the Fire Services Fund. The Fire Services Fund is accounted for as an enterprise fund. In general, enterprise funds are expected to be financially self sufficient in that costs are supported by collections of user fees. In the case of the Fire Services Fund the fees that support operations are collected as an addition to utility bills or property tax assessments of the citizens being protected by the Fire Department. By policy the Fire Services Fund is required to operate on a full cost recovery basis. We noted however that for five of the six years reviewed there was a transfer from the Deficiencies Fund to address shortfalls in the funding of operations. We also noted that for three of the six years the actual transfer exceeded the amount budgeted. In total, there was over \$7

million transferred from the Deficiencies Fund to the Fire Services Fund. The subsidy of the Fire Services Fund accounted for about 33% of the total reductions in the Deficiencies Fund.

Management has stated that the transfers to the Fire Services Fund were required because the fire services fees paid by Leon County were not sufficient to cover the costs of the services provided by the Fire Department in the unincorporated areas of the county and that the fees were part of a 20 year agreement with the County. The agreement was renegotiated with Leon County in 2008-2009 and should allow the Fire Services Fund to operate on a full recovery of cost basis in the future.

Debt from the acquisition of the Renaissance Center

The Renaissance Center was acquired with the use of long-term debt and as such would not normally have an impact on the fund balance of the General Fund. However, current treatment of the loan by accounting standards requires the debt be reflected in the General Fund as a liability (Advances from Other Funds) with a corresponding reduction in the Deficiencies Fund. As the liability is paid off over time the amounts will be shifted from a liability (Advances from Other Funds) to the Deficiencies Fund. As of September 30, 2009 this liability decreased the Deficiencies Fund by \$5.67 million or 27% of the reduction in the Deficiencies Fund.

Transfers to Star Metro

Like the Fire Services Fund, Star Metro is accounted for as an enterprise fund. However in the case of Star Metro there is no expectation that the user fees will fully cover the cost of operations. Annually, there is an anticipated and budgeted transfer from the General Fund to Star Metro. Over the six-year period there was approximately \$38.2 million budgeted to be transferred. The actual transfer from the General Fund was approximately \$41

million or \$2.8 million more than was anticipated in the budgetary process. These higher than planned transfers were funded through a corresponding \$2.8 million decrease in the Deficiencies Fund or 13% of the total \$21.5 million decrease.

Advances to the Building Code Enforcement Fund

The Building Code Enforcement Fund was established on October 1, 2006 as an enterprise fund to account for the portion of the Growth Management department that is responsible for enforcing the City building and sign codes. In general, enterprise funds are expected to be financially self sufficient in that costs are supported by collections of user fees. The Building Code Enforcement Fund however has not been able to operate on a self-sufficient basis since its inception. According to management, this has occurred because a downturn in the economy occurred at about the same time the fund was established and revenues for the fund have fallen short of expectations. In total, the General Fund has advanced (or loaned) the Building Code Enforcement Fund \$2.8 million in the three years that the fund has been in existence. This loan has had the effect of reclassifying funds from the Deficiencies Fund to Advances to Other Funds. The advance had no effect on the total fund balance of the General Fund. It is one of the main reasons for the change in the composition of the total fund balance from primarily being composed of the Deficiencies Fund (96%) to where the Deficiencies Fund is only about 60% of the total fund balance (as previously described). The advances of approximately \$2.8 million accounted for 13% of the reduction in the Deficiencies Fund.

Revenue Shortfalls and Expenditures in Excess of Budget

Variances between budgeted revenues and expenditures and actual revenues and expenditures have also been identified as one of the

major factors that contributed to the significant decrease in the Deficiencies Fund. This is particularly relevant for the 2007 and 2008 fiscal years. In each of those years there was a combined negative impact of slightly more than \$2 million per year. In total, for all six years, the shortfall in revenues and expenditures of the amounts budgeted caused a reduction in the Deficiencies Fund of approximately \$2.2 million or 11% of the total decrease in the Deficiencies Fund.

Replenishment of the Deficiencies Fund

A plan to restore the Deficiencies Fund to previous levels has been proposed by management and approved by the City Commission. The plan shows the Deficiencies Fund to be built back up to \$18.5 million by the end of FY 2014. Specific items that have been identified as sources of funds to be used in the replenishment of the Deficiencies Fund include; bond interest, year-end surpluses, repayment of the advances to the Building Code Enforcement Fund, budget transfers, interest earnings, and ad valorem taxes. We will monitor the replenishment and periodically report as part of our follow-up process.

Summary

In total the five areas identified account for \$20.8 million or 97% of the \$21.4 million change in the Deficiencies Fund that has occurred over the six-year period we reviewed.

Best Practices

There are many best practices relating to the fund balance and specifically the deficiencies fund of the City. Those best practices relate not only to how large or small the fund balance and reserves should be but also to the policies that govern the fund balance and reserves. As noted in the background section the Deficiencies Fund of the City could also be thought of as the unreserved fund balance or “rainy day fund” of the City. Many reviewers of the

financial condition of the City use the unrestricted fund balance as a key indicator as to the financial health of the City.

Government Finance Officers Association

The Government Finance Officers Association (GFOA) has published many reports, papers, and a specific best practice paper relating to fund balance and specifically unrestricted fund balance. Of specific applicability is a best practice paper titled “Appropriate Level of Unrestricted Fund Balance in the General Fund.” In that paper, the GFOA recommends that general-purpose governments (the City is a general purpose government) maintain, at a minimum, an unrestricted fund balance of no less than two months of operating revenues or operating expenditures (for the City because of the importance of transfers they should also be included in the calculation). This would equate to a minimum unreserved fund balance of approximately \$22 million for the year ended September 30, 2009 (based on FY 2009 budgeted revenues and net transfers of \$132 million). Chart 2 above shows that in 2004 the deficiencies fund was maintained at a level that was roughly inline with recommendations by the GFOA. Currently however, the deficiencies fund balance has a balance of approximately \$5 million and is about \$17 million lower than the recommended minimum (reasons and causes for the current status of the deficiencies fund were discussed above in the Financial Condition section of this report).

Rating Agencies

One of the key users of the City’s CAFR are the bond rating agencies. The bond rating agencies, such as Fitch Inc. (Fitch) and Moody’s Investors Services (Moody’s) review the City’s financial condition and rate the credit worthiness of the City. Those ratings have a direct impact on the cost of borrowing money by the City.

As such, the ratings are important and the City (as well as other local governments) strives to maintain a high rating.

To help local governments understand the factors that are considered when reviewing their financial condition, Fitch published “The 12 Habits of Highly Successful Finance Officers” that discuss the ratings process. The first areas identified by Fitch as being key to the rating process is fund balance reserve policy and working capital reserves. As this relates to the City, this refers to Commission Policy 224 Financing the Government (discussed in the next section of this report) and the Deficiencies Fund.

The recommendation of the rating agency is for local governments to maintain an operating reserve or “rainy day fund”. While a recommended size of a reserve is not directly stated, Fitch indicates that the appropriate size of the reserves should depend on the variability of the government’s revenues and expenditures.

Other recommendations or best practices noted by the rating agency (but not necessarily addressed in this report) and their importance to the ratings process are shown in table 3 below.

Table 3
Factors Considered by Bond Rating Agencies

Best practice	Importance
Fund Balance reserve policy/ working capital reserve	Very significant
Multiyear financial forecasting	Significant
Monthly or quarterly financial reporting	Significant
Contingency planning policies	Influential
Policies regarding nonrecurring revenues	Influential
Debt affordability reviews and policies	Very significant
Superior debt disclosure practices	Very significant
Pay as you go capital funding	Significant
Rapid debt retirement policies	Significant
Five year capital improvement plan integrating operating cost of new facilities	Influential
Financial reporting awards	Influential
Budgeting awards	Influential

In a publication by Moody's, "The Six Critical Components of Strong Municipal Management," fund balance policies and fund balance are again emphasized. In this case it is stated that; "Fund balance policies provide one of the best guarantees to bond holders that sufficient levels of fund balance will be maintained regardless of economic cycles, cash crunches or administrative turnover." As with the recommendations by Fitch, there is no required fund balance noted by Moody's. However, there is a recommendation that reserves should equal one to two months of operating expenditures or 5-10% of annual revenues. This recommendation roughly parallels the guidance provided by the GFOA.

A caveat included in all the best practices noted was that the recommended reserve balance should be adjusted from the noted levels based on the specific circumstances facing the government.

For example, if the government’s revenues fluctuate widely, are reliant on economic sensitive revenue streams (i.e., tourist taxes) or have the potential to be negatively impacted by natural disasters (i.e., hurricanes) a higher reserve than recommended may be justified. However if the circumstances are such that the revenues and expenditures of the government are fairly consistent and predictable, then maintaining a lower level of reserves could be reasonable.

Conclusion

The City has done a very good job establishing best practices as promulgated by the agencies that rate the credit worthiness of the City. Specifically, the City has a policy that addresses the need for adequate reserves or “rainy day funds”. The City has further shown its consideration of the best practices set forth by the GFOA and established limits for the deficiencies fund in its policies. The substance of the policy will be further discussed in the next section of this report.

City Policy

The City policy that governs fund balance and reserves is Commission Policy (CP) 224, Financing the Government. The policy is intended to establish standards for the planning, management, and financing of the general government and enterprise operations. The policy has specific provisions relating to; income and transfers between funds, how surpluses in the various funds of the government will be handled, general government revenue and fees, reserves, capital project construction funds, and operating budget work orders. For purposes of this audit we will focus on two areas, reserves, and income and transfers. Within the context of these two areas we address the question of how well the City’s policy meets the identified best practices relating to General Fund reserves and fund balance, and

what improvements can be made to the policy that will provide for greater controls and clarity of the policy.

Reserves

The section of the policy that relates to reserves specifically identifies the Deficiencies Fund as one of the City's reserves. It states that the Deficiencies Fund is established to provide for unforeseen expenditures and that it will be used sparingly and only with the permission (by appropriation) of the City Commission. The policy also states that the maximum level of the fund will be two months of regular general government operating expenditures. We noted there is a provision for the inclusion of transfers to the Star Metro fund, the Fire Services fund, and the golf course fund in this calculation. We also noted that there is a provision in the policy for any amounts accumulated in the Deficiencies Fund over the prescribed level will be made available to address any unfunded liabilities relating to other post employment benefits.

As previously described in the Best Practices section of this report we noted that both the GFOA and the bond ratings agencies recommend reserves of approximately 1-2 months of revenues or expenditures (to include transfers). Therefore, the limit on the size of the Deficiencies Fund of two months of expenditures, as set forth in the policy, is in line with the best practices as promoted by GFOA and the bond rating agencies.

In our review of policy we noted three areas where the policy could be strengthened. The first issue we noted is that the requirement for the Deficiencies Fund to be "used sparingly" and with the permission of the Commission. The term "used sparingly" is not specific as to the circumstances in which it would be appropriate to draw funds from the Deficiencies Fund. We recommend that the term "used sparingly" be replaced with a more

specific term or be defined, as that will reduce the ambiguity as to when the Deficiencies Fund can/should be drawn upon.

The second issue we noted was that there should be a more structured process for seeking approval of the City Commission when the Deficiencies Fund will be drawn upon. The current policy only requires the approval of the City Commission through the appropriation of funds to allow the use of funds from the Deficiencies Fund. We recommend that any requests for approval for the use of funds from the Deficiencies Fund be made in advance of the actual use of the funds and not as an “after the fact” appropriation of funds that have already been expended. We also recommend that specific reasons be identified as to why the initial appropriations were not adequate and the Deficiencies Fund must be drawn upon.

The third area where we noted that controls over the Deficiencies Fund could be made would be for a policy requirement that the annual budgetary close out Commission approval include a separate schedule that shows changes in the Deficiencies Fund, where funds were used during the previous year, and why the City’s General Fund reserves were drawn upon. This will allow for a clear understanding of the reasons for the use of funds from the Deficiencies Fund.

Income and Transfers

A second section of the policy that is relevant to the discussion of the City’s use and management of the Deficiencies Fund is the section of the policy titled Income and Transfers. The income and transfers section of the policy establishes a requirement that the utility funds (Electric, Gas, Sewer, Solid Waste, and Water) will transfer funds to the General Fund annually. The amounts of those annual transfers have been defined and limited in the policy as

either a percentage of sales (i.e., Electric, Water and Solid Waste Funds) or as a static amount (i.e., Gas Fund). This section also requires that the General Fund shall have expenditures balanced against revenues (to include transfers in from the utility funds) and recognizes that the Star Metro and Golf funds will be subsidized by the General Fund as necessary.

This section of the policy is important as it encourages fiscal responsibility by requiring the City's General Fund annual budget to be balanced annually. It also encourages fiscal responsibility because it places limits on the annual transfers from the utility funds that are used to help balance the General Fund's annual budget.

Another important part of this section of the policy is that it states that the Fire Services Fund shall operate on a full recovery of cost basis. However, in general this has not occurred in the six-year period we examined. As noted in our discussion of the financial condition of the City, the Fire Services Fund has consistently operated at a deficit with total transfers to the Fire Services Fund from the Deficiencies Fund totaling \$7.1 million for the six-year period reviewed.

Conclusion

The Commission policy established which governs the reserves and fund balance of the General Fund is adequate to properly manage the financial condition of the City. We also noted that the policy incorporates the best practices that have been established for the management of fund balance and reserves by the GFOA and the agencies that rate the City's bonds.

However, we did note areas where the policy could be improved and one instance of inconsistency within the policy. The areas where the policy could be improved included: (1) clarifying or

defining the term “used sparingly” as it relates to using the Deficiencies Fund, (2) increasing the transparency of the use of the Deficiencies Fund by requiring that actions which will impact the Deficiencies Fund specifically identify that the action will impact the Deficiencies Fund and to what extent the Fund will be impacted, and (3) we recommend that the annual budgetary closeout process specifically identify the changes in the Deficiencies Fund (i.e., include a separate schedule that reconciles the prior years ending deficiencies fund balance to the current years fund balance).

We noted one instance of inconsistency in policies. The policy for the Fire Services Fund states the fund shall operate on a full recovery of cost basis. However, for the six-year period we reviewed, the Fire Services Fund has received approximately \$7 million in transfers from the Deficiencies Fund to supplement operating shortfalls. A review of the Deficiencies Fund policy authorizes the transfer of funds to the Fire Services Fund to make up for shortfalls. The inconsistency between the policy that requires the Fire Services Fund to operate on a full recovery of cost basis and the policy that authorizes the Deficiencies Fund to support Fire Services operating shortfalls should be addressed and clarified.

According to management, the non-compliance with the full recovery of cost aspect of the policy has been caused by the fire services fees paid by Leon County pursuant to contract not being sufficient to fully cover the costs for the level of service provided by the Fire Department. In the past year a new agreement with Leon County relating to funding the Fire Services Fund has been reached. It is anticipated that the new agreement will allow the Fire Services Fund to operate in compliance with CP224.

Reporting Standard

The Government Accounting Standards Board (GASB) is responsible for setting the standards for governmental accounting and reporting. On March 11, 2009 GASB released a new standard, Statement No. 54 *Fund Balance Reporting and Governmental Fund Balance Type Definitions* (GASB 54), on how the fund balance of governmental funds will be reported and defined.

There are five types of governmental funds. Those funds include the: (1) General Fund, (2) Special Revenue Funds, (3) Capital Project Funds, (4) Debt Service Funds, and (5) Permanent Funds. As the scope of the audit is limited to the General Fund our review of the new standard will focus on its impact on the reporting of the City's General Fund.

The implementation of the new standard has not yet become mandatory for the City. Currently the City plans to implement the standard for the fiscal year ending September 30, 2011. Accounting Services is aware of this standard and has already made plans for its implementation when required.

Under the current standards governing fund balance reporting, the City reports its General Fund's fund balance as divided into two classifications, Reserved and Unreserved Designated. In FY2009 the fund balance portion of the General Fund balance sheet was shown as in Table 4.

Table 4
FY2009 General Fund, Fund Balance

Reserved for:	
Encumbrances	\$483,000
Advances to Other Funds	\$2,882,000
Inventory	\$284,000
Unreserved, designated for:	
General Fund - Deficiencies	\$5,288,000
Total Fund Balance	\$8,937,000

GASB has stated that the changes in reporting fund balance are due to a few key reasons, which include:

- Confusion among users of governmental financial statements as to the relationship and difference between reserved fund balance and restricted net assets,
- Inconsistency in interpretation and implementation of the current reporting standard, and
- Inability of financial statement users to readily interpret fund balance information.

GASB 54 requires fund balance for governmental funds to be divided into five classifications that divide the fund balance by the spending constraints placed on the various amounts in the fund balance. Those classifications are:

- Non-spendable fund balance – amounts that are not in spendable form (such as inventory) or can not be legally spent (such as an endowment);
- Restricted fund balance: - amounts that can only be spent for a specific purpose as designated by the provider of the funds (such as grant proceeds);

- Committed fund balance – amounts that can only be spent for a specific purpose as designated by the government itself at the highest level of that government;
- Assigned fund balance – amounts the government intends to use for a specific purpose; and
- Unassigned fund balance – amounts available for any purpose (only reported in the General Fund).

For the City's General Fund, GASB 54 will have an impact on how the items in the General Fund's fund balance are reported. For example, encumbrances will no longer be shown as a separate single item in the balance sheet. The concept of encumbering for future fiscal years will remain however they will not be reported as a separate line item in the fund balance section of the balance sheet. They will be reported as either committed or assigned depending on the level of restriction placed on those funds. For the City, encumbered funds will be reported as part of the assigned fund balance.

As stated earlier Accounting Services has plans for the implementation of GASB 54 but has not yet implemented the new standard. Until such time as Accounting Services completes the implementation of the standard (not required until the reporting for the FY 2011 period) a final determination has not yet been made as to how the various parts of the fund balance will be reported. Table 5 shows how the fund balance section of the General Fund's balance sheet *may* look under the GASB 54 standard, using the amounts from the 2009 CAFR.

**Table 5
Potential FY2009 General Fund, Fund Balance**

Non-spendable	\$3,166,000
Committed	\$5,288,000
Assigned	\$483,000

In this example the non-spendable classification would consist of advances to other funds and inventory, the committed classification would consist of the deficiencies fund, and the assigned classification would consist of encumbrances.

With the change in the reporting requirements established by GASB 54 an emphasis has been placed on how “rainy day” funds will be reported. The standard requires that funds set aside to be used as rainy day funds are reported as restricted or committed fund balance if they meet the requirements for those classifications. For the City, based on the restrictions already established for the Deficiencies Fund in CP 224, the committed designation should be used for the Deficiencies Fund. The standard also requires that information about the process through which constraints are imposed on amounts classified as committed be disclosed. Therefore, the footnotes to the City financial statements should show what restrictions are placed on the Deficiencies Fund and that those restrictions are imposed by CP 224.

However, in the event that management determines (and the external auditors concur) that the restrictions placed on the Deficiencies Fund by CP 224 do not rise to the level of requiring the Deficiencies Fund to be reported as committed fund balance, the Deficiencies Fund should be classified as assigned fund balance.

Based on the emphasis placed on the reporting of the Deficiencies Fund under GASB 54 and the definition of committed fund balance, we recommend that CP 224 be revised to specifically state that the committed portion of the General Fund's fund balance can only be reduced by specific action of the City Commission and that the approval should be on a case-by-case basis and at a higher level than the overall approval of the budget.

Designation and identification of a targeted amount to be in committed fund balance would not preclude the use of an assigned fund balance for specific purposes or an unassigned fund balance category for amounts available for any other purpose.

Conclusion

During this audit we examined the fund balance of the General Fund with an emphasis on the causes of the changes in the Deficiencies Fund. We looked at the best practices relating to managing the fund balance of the General Fund and at what level the Deficiencies Fund should be maintained. We also looked at CP 224, Financing of the Government. Finally, we reviewed GASB 54, which is a new accounting standard that governs the reporting of fund balance for governmental funds.

We found that the total fund balance of the General Fund experienced a significant downward trend for the past six years, and that decrease caused a major reduction in the Deficiencies Fund. The decrease in the Deficiencies Fund is mainly attributable to transfers to the Fire Services Fund and Star Metro, the accounting treatment of the acquisition of the Renaissance Center, advances to the Building Code Enforcement Fund, and revenue shortfalls accompanied by expenditures in excess of budgeted amounts.

We also found that many of the best practices put forth by the GFOA and the agencies that rate the City's bonds are incorporated

into the CP 224. Those best practices recommend that the City maintain reserves of two months operating expenditures (including budgeted transfers) and that the City have a policy in place to guide management. We noted that the current balance of the City Deficiencies Fund (General Fund reserves) is \$5.28 million, much lower than the recommended level of \$22 million. We also made recommendations for changes to CP 224 that would improve the management of the Deficiencies Fund. Those recommendations include: (1) clarifying when the Deficiencies Fund will be used by defining or replacing the term “used sparingly,” (2) require that requests for approval to use funds from the Deficiencies Fund specifically identify the request as a drawdown of the Deficiencies Fund and not as part of a larger appropriation of funds, and (3) the annual budgetary closeout process include a separate schedule that shows changes in the Deficiencies Fund and explains why the Deficiency Fund was used. Each of these recommendations will help increase the transparency of the use of the Deficiencies Fund, and improve the management of the Deficiencies Fund.

Finally, we reviewed a new accounting standard, GASB 54 *Fund Balance Reporting and Governmental Fund Type Definitions*, which will change how the fund balances of the governmental funds of the City are to be shown in the City’s financial statements. We also noted that Accounting Services was aware of this new standard and is in the process of developing a plan for its implementation when required, the fiscal year ending September 30, 2011. The main impacts to the reporting of the fund balance of the General Fund will be that encumbrances will no longer be specifically identified, and the Deficiencies Fund will no longer be considered unreserved designated fund balance. We recommend that the portion of the total General Fund fund balance the City

Commission intends to set aside for “rainy day” use be reported as committed fund balance.

We would like to acknowledge the full and complete cooperation and support of the Department of Management and Administration, specifically the Office of Budget and Policy and Accounting Services.

*Appointed Official's
Response*

City Manager:

We have reviewed the City Auditor’s report on the Audit of the Fund Balance of the General Fund and are pleased to see that the report reaffirms that the City has incorporated many of the best practices put forth by the Government Finance Officers Association (GFOA) as well as agencies that rate the City’s bonds as it relates to management of the general fund balance and the appropriate reserve balances for the Deficiencies Fund. Additionally we are pleased to see that the report reaffirms that there are no reasons, other than those already provided to the City Commission either through the budget process, budgetary closeout and or the CAFR, on why the reserve balance has decreased over the last few years. Staff will review the recommendations identified for improving the reporting of the status of the Deficiencies Fund balance and the replenishment process and will make changes as appropriate. We would like to thank the City Auditor’s staff for their time and effort on this audit.

<u>Appendix A – Proposed Action Plan</u>		
Action Steps	Responsible Employee	Target Date
A. Objective: <i>Improve the reporting of the status of the Deficiencies Fund</i>		
1. Discuss with the City Commission the term “used sparingly” as used in CP 224 to determine whether it continues to be adequate or whether the term should be replaced to convey a higher level of criteria and/or circumstances when it is appropriate to reduce the balance in the Deficiencies Fund.	Raoul Lavin	9/30/11
2. Each request of the City Commission for authorization to draw funds from the Deficiencies Fund will specifically identify that the request involves drawing down the Deficiencies Fund.	Becky Simpson	9/30/11
3. A separate schedule will be included in the City Commission agenda item for that annual budgetary closeout that reconciles the beginning and ending balance of the Deficiencies Fund and provides a detailed listing of the causes of the changes in the fund’s balance (increases or decreases).	Rick Feldman	9/30/11
B. Objective: <i>Replenish the Deficiencies Fund in accordance with the instructions provided by the City Commission</i>		
1. Periodically update the City Commission on the status of the replenishment of the Deficiencies Fund.	Becky Simpson	9/30/11
2. Notify the City Commission of changes to the “Future Funding Plan” when the sources of funds added or removed are significant to the plan to replenish the Deficiencies Fund.	Becky Simpson	9/30/11