DATE:	February 10, 2015
TO:	Town Council Town Manager Community Members Town Staff
FROM:	Gina Will, Finance Director
RE:	Fiscal Health Analysis via the Municipal Financial Health Diagnostic Tool

Michael Coleman, a financial consultant for the League of California Cities recently generated a 13-point report card that grades the financial health of California Cities. As a way to assess our financial health and as way to chart a course for taking control of our financial future, the Town of Paradise, completed the assessment tool. Below is a description of the diagnostic tool from the author, followed by a summary of our results. Attached are the worksheets that led to our final analysis.

California League of Cities Provides Municipal Financial Health Diagnostic Tool

BY MICHAEL COLEMAN

The Great Recession revealed fiscal distress that had not been readily apparent in many cities. In a few well-known cases, cities unable to meet all of their financial obligations entered into Chapter 9 bankruptcy. But most cities struggled financially. They pursued innovations, consolidations and reorganizations with new urgency, hoping to realize savings and avoid reducing services. Despite these efforts, most cities were forced to cut budgets. Some managed to garner sufficient voter support for tax increases.

A moderate economic recovery has followed the Great Recession, and local sales tax and property tax revenues — although lagging behind changes in the economy — are improving in most areas of the state. But while resources are no longer declining for a majority of California cities, neither are they back to the levels of 10 years ago. Moreover, cities' financial struggles were not simply the result of revenue impacts; expenses continue to escalate dramatically, especially in pensions, retiree health care and public works infrastructure.

Heeding the frightening tales of neighboring cities, local officials asked themselves, how are we doing? Are we ignoring something at our peril? How can we be more certain of our city's financial health? Existing methods of evaluating a city's fiscal health included diagnostic tools proffered by consultants, professional associations and academic texts as well as checklists routinely generated in some states. But, city officials wondered, would these have helped Vallejo or Stockton when those cities were en route to bankruptcy? If not, then what are the most relevant elements of such tools? Keeping in mind the unique aspects of California municipal finance and recent budgetary travails of California cities, what other questions and indices should be addressed to truly grasp a municipality's tendency toward fiscal insolvency now and in the near future?

The Municipal Financial Health Diagnostic Tool includes a 13-point report card that grades the near-term financial health of a city's General Fund and other operations. Each indicator receives either a green light (healthy), yellow light (caution) or red light (warning). Completing the tool helps a city identify areas of fiscal concern that should be addressed to avert fiscal crisis.

Staff has completed the California Municipal Financial Health Diagnostic, and it confirms the Town's current fiscal health. It reinforces the progress made as well as identifies areas of weakness that the Town must tackle. In simplest terms the Town is currently graded a C -. It can pay its bills in the short term, but must address longer term obligations and weaknesses to be truly "healthy". Following are areas where the Town is either doing well or has shown improvement:

- ✓ The General Fund is no longer subsidizing other funds
- ✓ The Town has few constraints on budgetary discretion
- ✓ The Town is not balancing the budget through borrowing
- ✓ The Town is not balancing the budget by deferring debt service payments
- ✓ The Town is not funding operating costs with non-recurring development revenues
- ✓ The Town provides timely and accurate financial reports

Following are areas that must improve for the Town's fiscal health to improve:

1. ***The Town has recurring general fund operating deficits.*** Even though the Town has a "balanced" budget where it is not spending more than it is taking in, it is not able to fund all of the expenditures necessary to operate a full service government. The Town has been cutting $400,000 - $450,000 of critical operating expenses out of each budget to balance. Measure "C" funds will help address this issue in the short term, ***but if these funds are not also invested for the long term the Town will be in the same position after six years***.

2. ***General fund reserves (unassigned reserves) are inadequate.*** Prior to 2012, the Town invested its reserve funds in the economic development of the Town by loaning funds to the Paradise Redevelopment Agency. Three prior loans had been paid in full and with appropriate interest of 5%. In 2012 however, the State abolished the redevelopment agency leaving three new loans to the general fund unpaid and with constraints limiting the amount that could be repaid on these loans. The Town has worked diligently with the State and now has these loans approved as enforceable obligations. These loans will eventually be repaid, but are a last priority and will be repaid slowly over time.

   To date all of the Town's general fund reserves are non-spendable because these loans and other receivables cannot be immediately converted to cash. The last couple years being conservative through budgeting and prudent through spending, the Town is approaching building a small unassigned reserve. Following are the reserves for the year ended June 30, 2014 and the estimated reserve for the year ending June 30, 2015:

Designated Reserves	June 30, 2014	June 30, 2015
Non-spendable (RDA loan)	$2,015,945	$2,006,863
Projected Measure "C" revenue		148,000
Unassigned (spendable) reserves	(81,449)	141,806
Total Reserve	$1,934,496	$2,296,669

3. ***Inadequate cash and short-term investments as a percentage of current liabilities.*** As indicated above, the Town is projected to have $141,806 in spendable reserves; however this is completely inadequate for a municipal budget. Our goal should be to bring the level of unassigned (spendable) reserves to approximately $1 Million. One way we will reach our goal is by investing our future RDA loan repayments to the unassigned (spendable) reserve category, thus building that fund over time and reducing our need to borrow money to pay our bills. Currently, the Town borrows cash during the first six months of the fiscal year to make timely vendor and employee payments. Building reserves and liquidity will save the Town roughly $30,000 a year in interest and loan underwriting costs. It will also provide the Town breathing room to sustain future inevitable economic downturns.

4. ***General fixed costs, salaries and benefits exceed 80% of net operating expenditures.*** Fixed costs like utilities, retiree health payments, contractual agreements, and lease purchase payments are those costs over which the government has little control in the short term. As the Town has already cut staffing to the bare minimum to maintain services, having fixed costs and salary costs exceed 80% of operating expenditures is an indication that there are inadequate revenues to fund services long term. It leaves insufficient room in the budget to fund equipment and maintenance

requirements. Our goal should be 80% or less, while our balance hovers around 90%. A healthy budget includes adequate discretionary funds to adequately function and also to weather financial crises. The cure to this dilemma is a more diversified revenue stream. Following is the formula used to measure this indicator. It assumes the inclusion of Measure “C” Funds.

5.

Fixed costs and labor costs as a percent of expenditures = $\dfrac{\text{Salaries + benefits + fixed costs}}{\text{Net operating expenditures}}$

2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
90.1%	90.6%	89.8%	90.5%	92.0%	92.0%

6. ***The general fund budget has been balanced repeatedly by deferring asset maintenance.*** Deferral of asset replacement and facility maintenance should only be a short term solution to budget shortfalls. The Town has deferred portions of these expenses for over five consecutive years. Again, this is an indication of an inadequate revenue stream for the level of service provided.

7. ***General fund pension liabilities or post-employment benefits have been repeatedly deferred.*** GASB 45, an accounting mandate established in 2010/11 requires all government agencies to measure and report the liabilities associated with post-employment benefits (OPEB). By tackling that obligation head-on, the Town has been able to reduce the unfunded liability by 70.2%. However, aside from one initial contribution, the Town has not been funding the Annual Required Contribution (ARC) related to this obligation. The Town has capped the premium costs associated with these benefits, but employees will continue to retire increasing the Town’s annual costs over time. The actuary report indicates that in addition to the actual premium costs paid directly by the Town, the Town should be contributing $150,000 to $200,000 toward these future premium payments building up a “bank” to fund these future obligations. It is critical for the Town to heed this advice and start setting aside funds now before the annual contribution becomes more than we can afford. **We cannot possibly keep up with this growing annual obligation without investing in this account. It is the strong recommendation of the Town Manager and Finance Director to fund this account as a priority. Even a small investment of $50,000/year for ten years will give us an account that will provide financial stability for the organization’s obligations relating to OPEB.** This bold action will not only get and keep us on a firm financial footing, but this “take the bull by the horns” approach to budget management shows strength in leadership and a direction that the community wants us to go.

With continued prudence and careful investment toward the Town’s future financial stability, many of these indicators can be improved. Measure “C” and the Town’s tough choices and cuts to date have improved many of these indicators already. With continued wise decisions and investment, the Town is expected to improve on its C – rating. It can likely move into the B’s with care, but will likely not be able to move into the A’s with its current revenue constraints.