To: Cape Elizabeth Town Council

From: Michael K. McGovern

Re: Surplus Policy

Date: June 1, 2011

With the implementation of GASB 54 accounting rules and with recent discussions regarding surplus policy, it is timely to have a discussion regarding surplus policies.

The current surplus policy was prepared 8 years ago at a time when we had never met the surplus target. After a banner year in FY 2010, we met the surplus target for the first time.

The current policy in the opinion of management has three significant structural problems.

First, if we have a banner year such as we had in FY 2010, the amount of surplus generated would cause a yo-yo effect in tax rates if the entire amount over the target was immediately applied to lowering the tax rate. This is not in keeping with long term financial planning for the municipal government nor for citizens planning their tax payments and escrow payments to their mortgage companies. It is better advised to moderate radical adjustments in the tax rate.

Second, the current policy does not differentiate the undesignated school surplus from the balance of the surplus. As the School Board and not the Town Council controls the use of the school surplus, it should not be used in the calculation. Under GASB 54, the school surplus would not be "unassigned" so it is not available as part of the calculation.

Third, the current policy does allow for some use of the surplus for budget and capital needs when the target is not met, but has no flexibility in times when the target is met.

For example, helping with the school boiler and the school funding shortfalls technically should not have occurred under the current policy. Nor could any funds have been provided for the Future Open Space Committee or for the Fort Williams Park master plan as was done this past year. If we had a disaster or a need for severance expenses such as we had when consolidating dispatching, the current policy provides for flexibility only when the target is not met.

The draft policy below seeks to address these concerns.

To facilitate understanding of the effect of the policy:

In FY 2010, we ended the year with the surplus at 139% of target with a gain for the year of $1,217,933. Of this amount, $923,460 was above the target. Of the $923,460, $223,412 was school surplus and $700,048 was the municipal portion above the target. Total revenues were $28,349,337. A strict reading of the current policy would have required $923,460 to be applied to tax reduction. The adopted budget provided 50% of the $700,048 to tax reduction or $350,000.

The draft policy would have applied $354,225 to tax reduction. (15% of the $2,361,500 target) .

Town of Cape Elizabeth Fund Balance Policy

The Town of Cape Elizabeth shall comply with GASB 54 standards for reporting fund balances.

The fund balance shall be reported in five categories:

- Non-spendable- Funds that cannot be spent because they are either illiquid or legally or contractually required to be maintained intact.
- Restricted- Funds that are constrained with either externally imposed constraints or mandated to be reserved by law.
- Committed- Funds that can only be used for certain purposes per a formal action of the Town Council
- Assigned- Funds that are constrained by the Town Council's intent of use for a certain purpose, but are neither restricted nor committed.
- Unassigned- The residual classification for the general fund.

The general fund shall seek to have an ~~undesignated~~ unassigned municipal (excluding schools) fund balance of 8.33% of annual general fund operating revenues. This is equivalent to revenues anticipated in an average one month period

If the ~~targeted undesignated~~ unassigned municipal (excluding schools) fund balance target is exceeded, 100% of any excess funds between 100% and 115% of the target shall be used to reduce the tax commitment in the next budget to be considered by the Town Council. Any amount over 115% of the target may be committed or assigned for any capital need or unanticipated expenditure or may be placed in an assigned fund for future property tax relief.

~~Until~~ If the ~~undesignated~~ unassigned fund balance ~~reaches~~ falls below its target level, an interim objective is to increase as a percentage of operating revenues the ~~undesignated~~ unassigned fund balance every year. The balance shall not be used to support the annual budget or ~~other~~ for capital needs to a degree that the ~~undesignated~~ unassigned fund balance will be a lower percentage of operating revenues than in the previous year.

Museum at Portland Head Light Fund

The Museum at Portland Head Light Fund is an independent 501C entity under the control of a board of directors consisting of the members of the Cape Elizabeth Town Council.

The Museum at Portland Head Light Fund shall have an ~~undesignated~~ unassigned fund balance of not more than 100% of its annual projected income nor less than 25% of its annual projected income. Any excess greater than the ~~undesignated~~ unassigned fund balance target shall be used for improvements to the property and for operating expenses as provided in the by-laws of the Museum at Portland Head Light.

Surplus Analysis

Year	Town Undesignated	Tax Commitment	10% of Commitment	Surplus as % of Target	Variance
1997	$ 1,190,485	$ 11,260,124	$ 1,126,012	106%	64,473
1998	$ 954,468	$ 12,869,344	$ 1,286,934	74%	(332,466)
1999	$ 1,071,101	$ 13,413,688	$ 1,341,369	80%	(270,268)
2000	$ 1,320,702	$ 13,823,932	$ 1,382,393	96%	(61,691)
2001	$ 1,296,501	$ 14,474,517	$ 1,447,452	90%	(150,951)
2002	$ 1,402,565	$ 15,646,228	$ 1,564,623	90%	(162,058)
2003	$ 1,140,263	$ 16,937,695	$ 1,693,770	67%	(553,507)
2004	$ 1,338,439	$ 17,981,535	$ 1,798,154	74%	(459,715)
2005	$ 1,844,653	$ 19,574,389	$ 1,957,439	94%	(112,786)
2006	$ 2,060,845	$ 20,324,369	$ 2,032,437	101%	28,408
2007	$ 2,093,201	$ 20,948,952	$ 2,094,895	100%	(1,694)
2008	$ 2,151,825	$ 21,590,312	$ 2,159,031	100%	(7,206)
2009	$ 2,164,739	$ 23,076,498	$ 2,307,650	94%	(142,911)
2010	$ 3,061,548	$ 23,412,310	$ 2,341,231	131%	720,317

The Information Below Relates to the Adopted Policy. The Information Above is Informational

Year	Total Undesignated	Total Revenues	% of Surplus to Revs. Target is 8.33%	Surplus as % of Target	Target	Variance	Town Portion Undesignated	School Portion Undesignated	Town Portion Balance above Target
1997	$ 1,330,260	$ 18,012,421	7.4%	89%	$1,500,435	$(170,175)	$ 1,190,485	$ 139,775	$ (309,950)
1998	$ 1,308,616	$ 18,265,039	7.2%	86%	$1,521,478	$(212,862)	$ 954,468	$ 354,148	$ (567,010)
1999	$ 1,850,385	$ 19,949,354	9.3%	111%	$1,661,781	$ 188,604	$ 1,071,101	$ 779,284	$ (590,680)
2000	$ 1,546,458	$ 21,571,165	7.2%	86%	$1,796,878	$(250,420)	$ 1,320,702	$ 225,756	$ (476,176)
2001	$ 1,581,134	$ 20,720,716	7.6%	92%	$1,726,036	$(144,902)	$ 1,296,501	$ 284,633	$ (429,535)
2002	$ 1,824,215	$ 23,265,925	7.8%	94%	$1,938,052	$(113,837)	$ 1,402,565	$ 421,650	$ (535,487)
2003	$ 1,412,508	$ 22,299,113	6.3%	76%	$1,857,516	$(445,008)	$ 1,140,263	$ 272,245	$ (717,253)
2004	$ 1,562,508	$ 23,501,607	6.6%	80%	$1,957,684	$(395,176)	$ 1,338,439	$ 264,292	$ (659,468)
2005	$ 2,282,702	$ 25,658,201	8.9%	107%	$2,137,328	$ 145,374	$ 1,844,653	$ 438,049	$ (292,675)
2006	$ 2,451,478	$ 26,659,302	9.2%	110%	$2,220,720	$ 230,758	$ 2,060,845	$ 390,633	$ (159,875)
2007	$ 2,453,685	$ 28,260,787	8.7%	104%	$2,354,124	$ 99,561	$ 2,093,201	$ 360,484	$ (260,923)
2008	$ 2,400,771	$ 28,794,231	8.3%	100%	$2,398,559	$ 2,212	$ 2,151,825	$ 248,946	$ (246,734)
2009	$ 2,906,678	$ 29,522,354	9.8%	118%	$2,459,212	$ 447,466	$ 2,164,739	$ 741,939	$ (294,473)
2010	$ 3,284,960	$ 28,349,337	11.6%	139%	$2,361,500	$ 923,460	$ 3,061,548	$ 223,412	$ 700,048

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Credit FAQ:

GASB 54: How Will It Change Fund Balance Reporting?

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Credit FAQ:

GASB 54: How Will It Change Fund Balance Reporting?

Governmental Accounting Standards Board (GASB) Statement No. 54 (GASB 54) is a new rule intended to make fund accounting in general, and fund balance reporting in specific, more consistent and transparent by assigning strict rules for the classification of governmental fund balances based on "specific purposes for which amounts in those funds can be spent." The new classifications, in order of most to least restrictive, are:

- Non-spendable--balances that cannot be spent because they are either illiquid or legally or contractually required to be maintained intact;
- Restricted--constraints placed on these resources that were either externally imposed or mandated by law;
- Committed--funds that can only be used for certain purposes as per a formal action by that government's highest level of decision-making authority;
- Assigned--funds that are constrained by the government's intent of use for a certain purpose, but are neither restricted nor committed; and
- Unassigned--the residual classification for the general fund.

Standard & Poor's Ratings Services supports efforts to improve transparency and disclosure. We note, however, that the financial condition of a rated issuer has always been, and remains, one of the key factors in our rating analysis regardless of the type of financial reporting.

Frequently Asked Questions

How will this new rule affect Standard & Poor's view of the creditworthiness of rated U.S. public finance issuers?

We will soon be updating the language in our credit analyses, and our opinion of the relative strengths of the respective issuer's reserve levels, to incorporate these new classifications. Over time, we will have sufficient data to also update various statistical summary credit comments to include GASB 54. However, at this time, we do not believe the recharacterization of fund balance labels will, by themselves, materially affect credit. There still remain some parts of the country that do not even use GASB-format financial statement reporting, such as those who use cash-based accounting.

What is the effective date for GASB 54?

Aside from those issuers choosing to implement GASB 54 early, most issuers will begin compliance starting with their fiscal 2011 financial reporting. Besides the early implementers, issuers may also choose to retroactively update the unaudited statistical section of their comprehensive audited financial report simply for illustrative purposes, but that is purely at their discretion.

How will GASB 54 affect financial reporting for issuers that Standard & Poor's rates?

In general, GASB has represented that Statement 54 is intended to provide a better picture of how liquid and available the reporting entity's reserves are. Some reserves may simply reflect a non-liquid asset like materials and supplies; a large receivable (such as property taxes) that is not currently available; or a fiduciary responsibility that the reporting government provides, in which case the reserves are never available. Not every one of the five labels may always be applicable or used in a given financial report for a given reporting period.

What can be learned from the three categories that represent some kind of spending constraint on that fund balance?

Among restricted, committed, and assigned fund balance, the "assigned" category is most likely to be correlated with liquid reserves that may be lawfully available for any purpose and might be included in what we would calculate as available fund balance. This is because the governing body viewed the reserves as assigned because it has some intended use for those reserves; however, the intent can be changed or withdrawn either by the governing body or even by its lawful delegates, such as top administrative officials. Restricted fund balance is restricted because some kind of externally, legally enforceable claim on the reporting entity's assets is present, such as from a creditor or regulator. Committed fund balance has constraints that the reporting entity has itself placed on its reserves, but only the governing body can remove. We would incorporate into our analysis whether the governing body could legally or even politically choose to remove such constraints before determining whether or not such funds are also included as available. GASB, however, has indicated a true rainy day fund might be classified as any of these, or even as unassigned, depending on the level of oversight and approval of use required by the governing body. GASB expects issuers to display further disclosure on rainy day funds in the notes to the financial statements.

What is the unassigned fund balance?

The unassigned fund balance is simply a calculation: as the excess of total fund balance less the other four categories. It will be a positive balance in the general fund, but could be negative in any other governmental fund. We continue to consider in our analysis whether revenues and reserves in other funds are material to the credit rating. For example, sometimes revenues in other funds may support general governmental operations or even debt service, and reserves in those funds may be available for emergencies or contingencies or even for future general appropriations.

Doesn't GASB 54 therefore imply that having larger percentages or amounts of unrestricted cash or highly liquid cash equivalents with no identifiable constraints, and the reserves clearly available for any lawful purpose, would be a credit strength?

We recognize that any audited financial statements represent a snapshot in time. Key revenue streams for a particular issuer can vary from state to state, by governmental entity or issuer type, and even by time of year. For this reason, our analysis typically includes an evaluation of cash flows and requirements, to determine if there are particular periods of stress, and if so, to what degree (if any) we believe they are a credit concern. Most issuers have significant working capital requirements throughout their fiscal year, while some do not. Some may experience little or no distress during times of peak liquidity needs, while for others the distress may be significant. Additionally, we do not require that a rated issuer attain certain financial or other metrics simply to attain a particular rating level.

Related Criteria And Research

- USPF Criteria: GO Debt, Oct. 12, 2006
- USPF Criteria: Investment Guidelines, June 25, 2007
- USPF Criteria: Key General Obligation Ratio Credit Ranges – Analysis Vs. Reality, April 2, 2008

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PUBLIC FINANCE

Public Finance Criteria: Key General Obligation Ratio Credit Ranges – Analysis Vs. Reality

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Municipal governments maintained strong ratios in key general obligation (GO) performance measures through 2007, despite continued concern about current economic conditions and the impact on governments. The representative ranges of ratios for GO debt issuers in table 1 provide an indication, through the use of descriptors, of what constitutes a high to low ratio from an analytical credit perspective. The selected ratios represent key factors Standard & Poor's Ratings Services uses in the credit rating process and an indication of their weighting.

These key ratios complement Standard & Poor's annual release of historical median ratios for local governments (see "U.S. GO Rating Distributions And Summary Ratios: Year-End 2007," published Jan. 2, 2008). Our annually calculated medians are broken out by types of government, rating categories, and population. The medians represent recent measures of economic, financial, and debt characteristics for rated credits. These statistics will drift up and down during the economic cycle, as Standard & Poor's analysis is forward looking. In recent years, the medians have outperformed analytic guidelines.

Reading Behind The Numbers

Medians, particularly for lesser-weighted ratios, may give a false impression in certain cases that Standard & Poor's is concerned by deviations from the medians, when in fact there may be analytical comfort in a broad band of numbers for a particular ratio.

Examples of this phenomenon are evident when comparing key ratio ranges (see table 1) to the 2007 medians for similar ratios (see table 2). While the median GO credit had a household effective buying income (EBI) equal to 99% of the U.S. level, the key ratio ranges show that a credit with household EBI equal to 91% of the U.S. level would still be considered as having good income levels for supporting the typical tax burden associated with government services. While a credit with a general fund balance less than 21% of expenditures would be technically below the median, we would nevertheless view it as having a very strong balance.

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Similarly, a credit with per capita net debt in excess of $2,000 would be above the average, but Standard & Poor's would generally view levels as high as $5,000 per capita to be moderate.

Key Rating Factors

The relative weight of individual criteria elements is discussed in detail in Standard & Poor's Public Finance Criteria published on RatingsDirect. When evaluating GO credits, Standard & Poor's examines four main factors in the following order:

- Economic factors;
- Administrative factors;
- Financial factors; and
- Debt factors.

Variation in any of these factors can influence a bond rating. The description of key ratio ranges below will help clarify the significance of variations among ratios. They will also serve as a stable guide to what is considered high or low regardless of the economic cycle.

A note of caution

Ratios do not tell the whole story — they are only a portion of what Standard & Poor's uses in its analysis. Economic, administrative, structural, and other qualitative factors may outweigh any of these ratios when a rating is assigned. Numbers alone can not determine an entity's willingness to meet its financial obligations, nor can they reveal a history of late budgets or the operating restraints presented by the state/local framework.

The key ratios below do not represent a complete set of the ratios Standard & Poor's uses in its analysis. We also incorporate information from many internal and external databases. Depending on various credit conditions, certain ratios can take on more significance than others. In addition, a municipal entity's trends in any of these ratios may be more important than the historical ratios. A rating, after all, is prospective in nature.

Table 1

Analytical Characterization Of Ratios

Household/Per Capita Effective Buying Income As % Of U.S. Level	
Low	Below 65%
Adequate	65%-90%
Good	90%-110%
Strong	110%-130%
Very strong	Above 130%
Market Value Per Capita	
Low	Below $35,000
Adequate	$35,000-$55,000
Strong	$55,000-$80,000
Very strong	$80,000-$100,000
Extremely strong	Above $100,000
Top 10 Taxpayers	

Table 1

Analytical Characterization Of Ratios (cont.'d)	
Very diverse	Below 15%
Diverse	15% - 25%
Moderately concentrated	25% - 40%
Concentrated	Above 40%
Available Fund Balance	
Low	Below 0%
Adequate	1%-4%
Good	4%-8%
Strong	8%-15%
Very strong	Above 15%
Debt Service As % Of Expenditures	
Low	Below 8%
Moderate	8%-15%
Elevated	15%-20%
High	Above 25%
Overall Net Debt Per Capita	
Very low	Below $1,000
Low	$1,000-$2,000
Moderate	$2,000-$5,000
High	Above $5,000
Overall Net Debt As % Of Market Value	
Low	Below 3%
Moderate	3%-6%
Moderately high	6%-10%
High	Above 10%

Table 2

Selected 2007 Medians For All Standard & Poor's Local Government GO Ratings	
Per capita EBI as % of U.S. level	95%
Household EBI as % of U.S. level	99%
Market value per capita	$73,960
Top 10 taxpayers as % of assessed valuation	8.10%
Total general fund balance as % of expenditures	21%
Debt service as % of expenditures	7%
Overall net debt per capita	$1,999
Overall net debt as % of market value	2.62%

GO Ratio Definitions

Table 3

GO Ratio Definitions	
Household/per capita effective buying income (EBI) % of U.S. level	Effective buying income measures income after taxes. Household EBI measures income on a household basis, regardless of the number of family members and compares it on a ratio basis to the national average. Per Capita EBI measures the same on a per person basis. Source: Claritas Inc.
Market value per capita	Total market value of all taxable property within the jurisdiction divided by population.
Top 10 taxpayers	This measures total assessed valuation of the 10 largest taxpayers as a percentage of the total taxable assessed valuation of the jurisdiction.
Available fund balance	The annual dollar amount of available reserves a municipality has in its operating and reserve funds at fiscal year-end.
Debt service as a percentage of expenditures	The portion of operating expenditures consumed by debt service costs.
Overall net debt per capita	This ratio measures net debt to population.
Overall net debt as a percentage of market value	A ratio of net debt to the taxable market value of the tax base.