COUNTY OF ERIE

DAVID J. SHENK
COMPTROLLER

July 12, 2012

Honorable Members
Erie County Legislature
92 Franklin Street, 4th Floor
Buffalo, NY 14222

Re: Budget Modernization Act of 2012 – Proposed Amendment to Local Law No. 3-2006 (the Erie County Charter) to Amend Article 25, Section 2605 regarding Fund Balance

Dear Honorable Members:

My office and I have completed our review of the proposed Budget Modernization Act of 2012, Section 3, entitled "Amendment to the Erie County Charter" ("BMA"). In many respects the BMA updates and enhances Erie County ("County") Local Law No. 3-2006 also known as the Erie County Charter Article 25, section 2605 ("Charter") and brings the Charter's fund balance language into compliance with Governmental Accounting Standards Board Statement No. 54 ("GASB #54"), *Fund Balance Reporting and Governmental Fund Type Definitions*. However, the BMA does not create a comprehensive fund balance policy as recommended by the Government Finance Officers Association ("GFOA"), the main professional resource for government finance best practices. Furthermore, approval of this measure will allow the County to reduce the County's required unassigned fund balance to an unsatisfactory level with respect to credit rating agencies' considerations and the County's long term financial health.

Note that the Comptroller's Office's recommended policy for managing fund balance components ("COMM. 9E-33 (2012)"), which was approved by the Legislature on May 24, 2012, focuses on fund balance components other than unassigned fund balance, which is the BMA's salient topic.

ERIE COUNTY OFFICE BUILDING • 95 FRANKLIN STREET • ROOM 1100 • BUFFALO, NEW YORK • 14202-3972
TELEPHONE: (716) 858-8400 • FAX: (716) 858-6195 • INTERNET: www.erie.gov

Background

From 2000 to 2004, the total fund balance in the General Fund decreased substantially by approximately $197.1 million, representing a 98% decrease. During this period, the County's independent auditors presented management letters commenting that within the County there were differing interpretations of the County Charter regarding the use of fund balance, and there was confusion about identifying fund balance utilized to balance certain annual budgets.

Overall, the significant decrease in fund balance during the five year period was partially due to the lack of controls and policies governing fund balance. As a result, the independent auditors recommended the County establish a formal policy governing the maintenance of fund balance and further noted that as the County began to rebuild its fiscal strength and stability, a fund balance policy would become critical to the County.

Note that credit rating agencies carefully monitor levels of fund balance to evaluate a municipal government's continued creditworthiness. A well developed and transparent strategy to replenish fund balance is also important and may well reduce the costs of borrowing. A formal replenishment strategy will demonstrate to the public, rating agencies, and investors that the County is committed to restoring used fund balance if it is reduced below the desirable level.

Current "Policy" – Erie County Charter Section 2605. Fund Balance

Currently the Charter does not constitute a comprehensive fund balance policy. Rather, the main elements of the Charter establishes 5% as the desirable level of unreserved/undesignated fund balance to maintain in all funds (based on the following year's budget), and the required number of votes at the two particular times (i.e., at the time of approval of the annual budget and the time following approval of the annual budget) where spending may be authorized to reduce fund balance below that level.

Recommended Components of a Comprehensive Fund Balance Policy

GFOA recommends that municipal governments, in their comprehensive fund balance policy:

- Define the appropriate level of fund balance
- Specify the various intended portions of fund balances (Note that components other than unassigned fund balance are addressed in COMM. 9E-33 (2012)
- Determine how and what resources will be directed to replenish fund balance

- Include a statement that establishes the broad strategic intent of replenishing fund balance once economic conditions allow
- Minimize the use of fund balance except in specific circumstances
- Contain additional provisions that are particular to the municipality's unique circumstances

Source: GFOA's Best Practice report titled **Replenishing Fund Balance in the General Fund (2011)**

GFOA's Best Practice report focuses on the general fund. In particular, if fund balance falls below a government's policy level, then it is imperative to establish a solid plan to replenish fund balance to the adopted levels. Rating agencies also focus on the general fund and consider the government's fund balance policy, history of use of fund balance, and policy and practice of replenishment of fund balance when assigning ratings. Therefore, a well-developed and transparent strategy to replenish fund balance may reduce the costs of borrowing. However, it might be challenging to rebuild fund balances to the recommended levels because of other financial needs and various political considerations.

Review of the BMA

The BMA appropriately translates the fund balance definitions to be consistent with the provisions of GASB #54.

The proposed revision removes all references to funds other than the general fund. The intent of this change appears reasonable since any shortfalls in non-general funds are usually covered by subsidies from the general fund. The rating agencies, the GFOA and the County's previous independent auditors differentiate non-general funds from the general fund, and recognize the need for flexibility in policies related to non-general funds. A provision regarding the fund balances of non-general funds should be incorporated into a comprehensive fund balance policy.

Considering the 2012 Adopted Budget, if the proposed amendment is enacted, then the unassigned fund balance requirement would decrease from $76.2 million to $52.8 million which is a reduction of approximately $23.4 million, or nearly 31%. This reduction would be viewed negatively by the rating agencies, and in the future could limit the County's financial flexibility. Also, lowering the County's fund balance requirement is contrary to GFOA's current recommendations.

Over the past several years, all three rating agencies have recognized the County's improved financial position as it worked to restore structurally balanced budgets and improve its fund balance and liquidity positions. The County's positive operating results have led to multiple notch rating upgrades, and the County now enjoys "A" level ratings from each agency.

In Moody's most recent credit report on the County dated September 16, 2011, the agency stated that while the County had improved its fund balance position over the last few years, the County's "...narrow reserves provide little cushion to economically sensitive revenues." Concern about the County's reliance on volatile sales tax revenues was echoed by Fitch Ratings earlier this year in its credit update report in late February 2012.

The proposed amendment to Section 2605 of the Erie County Charter will further heighten rating agencies' concern over the County's reliance on economically sensitive revenues, and adoption of the amendment will weaken the County's financial flexibility going forward. While adoption may not lead to an immediate downgrade by the agencies, it could result in a negative rating action if the County's economy weakens.

Any positive strides that the County has made, leading to it prudently issuing its own debt, could be undermined by reducing its fund balance requirement.

Recommendations

The County Executive, County Legislature and the County Comptroller should, at minimum, consider the updated GFOA recommendations and collaborate to craft a well-developed and transparent comprehensive fund balance policy that (1) governs the use of the County's fund balances, (2) contains specific plans for increasing or decreasing the level of unassigned fund balance if fund balance should fall below or be too far above the 5% established level, and (3) includes a more flexible provision for non-general funds.

It is in the best interest of our community to establish a replenishment plan that emphasizes three standards: clarity, honesty and strategy.

- Clarity regarding the specific circumstances under which the County will be able to tap into unassigned fund balance below the 5% threshold.

- Honesty with the citizens and taxpayers about the conditions that have led the County to utilize unassigned fund balance in this manner, and what steps the County plans to take in order to square its spending or otherwise deal with this new reality.

- Strategy regarding the replenishment of the funds – a clear plan that defines the method and length of time it will take to restore unassigned fund balance to the required level.

If you have any questions or concerns regarding this correspondence, please contact me at 858-8404.

Sincerely,

David J. Shenk

David J. Shenk
Erie County Comptroller

DJS/nr
Enclosure

Cc: Mark C. Poloncarz, Esq., Erie County Executive
Robert W. Keating, Director, Budget and Management
Erie County Fiscal Stability Authority