CITY OF FORT LAUDERDALE

OFFICE OF THE CITY AUDITOR

Review of Proposed Budget for FY 2011/2012

Report #10/11-03

September 16, 2011

CITY OF
FORT LAUDERDALE

City Auditor's Office

Memorandum

Memorandum No: 10/11-07

Date: September 16, 2011

To: Honorable Mayor and Commissioners

From: John Herbst, CPA, CGFO
City Auditor

Re: Review of the Proposed Budget for Fiscal Year 2011/2012

Executive Summary

The City Auditor's Office has performed a limited review of the FY 2011/2012 Proposed Budget. All information included in this budget is compiled by the City Manager of the City of Fort Lauderdale pursuant to section 4.09 of the City Charter. Our analysis consisted of staff inquiries, analytical procedures, review of documentation provided by management, and limited testing of the evidence provided to substantiate staff's assertions.

The hiring of the new City Manager significantly impacted our task this year. As a consequence of coming on board near the date at which the first draft of the proposed budget must be presented to the Commission, there was little opportunity for him to provide input, guidance and direction in its formulation. This resulted in a second draft, with significant revisions, coming to the Commission in late August. In addition, further adjustments produced a third version for the public hearings in September.

Based on the shifting landscape, we made the decision to limit our review to revenue items only.

Conclusion

Our initial conclusion was that the budget as originally presented had several significant errors and aggressive assumptions. We have since resolved our differences with management on those items. In some cases we raised our estimate to theirs, in others they lowered their estimate to ours. After accounting for those changes, the use of additional reserves will be needed. After the adjustments are incorporated, we believe that we have a budget that is balanced, revenue and expenditure estimates are reasonable and materially correct, and that the proposed millage is in compliance with Florida Statutes.

Objectives

The primary focus of our review was to ensure that the budget is balanced, revenue estimates are reasonable and materially correct, and that the proposed millage is in compliance with Florida Statutes. We did not attempt to identify operational areas where additional cost savings might be achieved.

Scope

We analyzed the City Manager's Proposed Budget for FY2011/2012 as presented to the City Commission. The material reviewed included the Budget Message, Executive Summary including supporting tables and schedules as well as revenue and expenditure detail reports from the City's budget preparation system (BPREP).

Methodology

We performed various analytical procedures, reviewed budget support worksheets and made inquires of the OMB, the Finance Department, and individual department budget coordinators. Additionally, we compared the line item revenue detail from the Proposed Budget to the June estimate of actual expenditures through 9/30/11. Furthermore, we analyzed the variances of the three prior fiscal years budget vs. actual to gain an historical perspective and identify opportunities to improve the accuracy of revenue and expenditure estimates.

Fund Balance

The extensive use of fund balance without changes to the level of staffing or services has again resulted in a budget that is not structurally balanced. It violates City budget policies that state:

General Guidelines

- Current, recurring revenues should equal current, on-going expenses.
- One-time revenues can be used to build up the undesignated fund balance or be used for truly one-time expenses without impacting service levels.
- Internal service funds are used by the City to provide services within the City organization. Charges to City departments should be set to cover all costs.

Fund Balance Levels

- Non-recurring revenues should not be used to balance the annual budget for recurring expenses.

While use of reserves to balance the annual budget is a violation of established policy, the City's present fund balance level exceeds the targets established by the Commission and therefore may be reduced without threatening our fiscal strength or bond rating at this time.

Fleet Internal Replacement Charges

For the second year, management is proposing to recapture $4M from the accumulated reserves in the Fleet Replacement Fund. We are not convinced that the fund can continue to sustain additional depletion without incurring much higher charges in future years.

Five-Year Financial Forecast

Management has presented the five-year financial forecast in accordance with the new ordinance. This forward-looking document demonstrates the need for the City to make structural changes in the coming years to ensure that we remain stable and solvent. The overall economic outlook remains very weak and the potential for another recession is increasing. The type of services delivered, how they are delivered, and the level of taxes required to pay for them, are all items that will need to be evaluated if we are to remain fiscally strong.

Pension Obligation Bond (POB)

We are generally supportive of the POB concept, however it is not without risk. The conceptis that by borrowing at roughly 5.7% and investing at 8% (percentages used for illustrative purposes only), an arbitrage spread can be earned that will reduce our overall cost of financing our pension obligation.

The risks here are primarily threefold:

1. That the stock market will underperform in the short-term, losing value on our increased contribution.

   This risk can be mitigated by splitting the POB into two or three tranches, to be invested over a multiyear period. The interest rate market is likely to remain stable for the foreseeable future, as the Federal Reserve has indicated no intention of increasing rates in order to support the fragile economy.

2. The moral hazard that will be experienced when political pressure is applied to enhance benefits or add COLAs.

   This risk can be mitigated by requiring that all benefit enhancements require a unanimous vote of the City Commission. While this won't eliminate pressure to increase benefits, it makes its passage far less likely. I would strongly urge this be incorporated into any POB funding mechanism.

3. That the City will lose control over the funds once they are turned over to the pension trustees.

   The choice of City appointees to the pension boards will become more critical. They must be chosen based on having significant experience in complex financial markets/transactions. In addition, the City should consider obtaining on a voluntary basis, two more seats on the Police & Fire Pension Board as a condition for advance funding of such a significant portion of the outstanding liability.

One final consideration is that the Government Accounting Standards Board (GASB) has developed a new accounting pronouncement that will, among other things, force two substantive changes to the way in which we currently value and account for the unfunded liability. First, the liability will move from a footnote disclosure to a balance sheet liability. Second, the discount rate used for the portion of the liability that is not covered by assets will be reduced from the actuarially assumed rate of return of 7.75% to a tax-exempt muni bond rate, effectively increasing the present value of our unfunded liability significantly.

cc: Lee R. Feldman, City Manager
Harry Stewart, City Attorney
Jonda Joseph, City Clerk
Stanley Hawthorne, Assistant City Manager
Susanne Torriente, Assistant City Manager

PENSION OBLIGATION BONDS – WHEN DO THEY MAKE SENSE?

Pension Obligation bonds (POBs) are a controversial tool for dealing with pension funding shortfalls. The overall experience of almost every government that has issued them has been negative. That being said, further analysis into why those experiences have been negative is warranted. In most cases, the governments that issued those bonds were very shaky to begin with. They issued the bonds because they did not the resources to make their current annual required contribution. The POB served as a type of short-term funding holiday. Additionally, most were issued well into a bull-market cycle, making the likelihood of achieving positive long-term arbitrage slim.

Issuing a POB allows a financially strong government to gamble on the spread between interest rate costs and asset returns to avoid raising taxes during a recession.

- POBs issued during dramatic stock market downturns have produced positive returns
- POBs issued when rates are particularly low have performed well
- POBs should not be used to finance the current year obligation
- Borrowers should not be in a fundamentally weak position or structurally unbalanced
- Borrowers should have a reasonable capacity to bear increased financial risk
- The size of the borrowing should not constrain additional borrowing capacity
- The size of any single borrowing should not exceed 20% of the pension funds assets to reduce the impact of poor market timing when committing the borrowed funds
- The issue should be callable
- A full experience study should be conducted to validate the actuarial assumptions
- The POB's performance must be stress tested under different return scenarios
- To avoid the moral hazard that may result from the pressure to enhance benefits when the pensions appear to be fully funded, any new benefits should require unanimous/supermajority approval