

## **CHAPTER THREE**

### **Financial Administration**

#### **Introduction**

Financial administration, in its simplest definition, is matching dollars with needs and then telling the story.

Financial administration is the small town mayor who notices that the City Hall has a leaky roof and makes a mental note to have it patched and then replaced when the money is available. Financial administration is a million-dollar capital improvements program, a bond election preceded by a barrage of information disseminated through the news media and a bond sale. Financial administration is a report to the taxpayers through a magazine supplement of Sunday's newspaper. Financial administration is a system of tracking a water bill payment from receipt to the deposit in the bank—all of this is part of financial administration.

Financial administration involves an understanding of the extent and the limits of the economic resources of the community and the methods of tapping them to meet citizens' demands for municipal services. It begins with a thorough knowledge of revenue sources and ends with a proper accounting of all of the funds expended by the city. Much lies in between; it is all financial administration.

#### **Revenue Sources**

City revenues come from many sources, including utility systems, property taxes, sales taxes, user fees, fines and forfeitures, federal grants, and street rentals. The first three sources listed contribute about 85 percent of the total revenues of the average city. But even as municipal revenues and expenditures have grown phenomenally, both have generally fallen behind the inflation rate; thus, city administrators are being required to manage their programs and budgets more effectively.

#### ***Utility Sources***

While comparatively few Texas cities operate electric or gas systems, most own water and wastewater systems. Among those which own water or wastewater systems, the revenue produced by utility billings generally accounts for more than a third of all money taken in at City Hall. This percentage is considerably higher among cities which own electric or gas systems.

In order to maximize the revenue potential of each utility system, customer rates should be reviewed periodically in the light of these questions: (1) What does it cost, in terms of units of service rendered, to operate the system? (2) Who uses the service? Is one class of users being favored by the rate schedule at the expense of another?

The answer to the first question can be ascertained by simply dividing the utility's total annual operating costs by the number of units of service rendered. (For example, a city which sold one billion gallons of water during a given year, and spent \$900,000 to operate the system, had a production cost of 90 cents per 1,000 gallons.) In determining production costs, care must be taken to include the expense producing the water,

distributing the water to customers, accounting for the funds, and costs of debt service (payments of principal and interest) paid during the year on bonds issued to finance any improvements to the system. Another area that needs to be included is any administrative overhead as well as reasonable transfers to the city's general funds to cover the utility system's fair share of the administration of the city government.

The answer to the second question --Who uses the service?-- will require preparation of a consumer analysis or rate study. This is a relatively simple undertaking, though it can be burdensome if the city's consumer billings are not handled by data processing equipment. The analysis should include a list of all consumer billings for a representative period of a year or two and the preparation of a summary in which there is reflected, for each consumption bracket or rate block: (1) the number of consumers; (2) total consumption; and (3) total dollar billings. When this has been completed, it is a simple matter to project the result of any combination of adjustments in the rate schedule, both on total revenues and with respect to customers in any given consumption bracket.

With respect to both water and sewer systems, an analysis of the current rate schedule should begin with a look at the rates charged for higher volumes. In many cases, in years past, it was found that many larger consumers were paying rates below the actual cost of producing the water or disposing of the sewage. There is now much more emphasis on basing rates on actual costs of service, and in some areas, in efforts to encourage conservation, higher rates are actually being charged to the larger users.

### **Property Taxes**

Property taxes are a principal revenue source of Texas cities. The overall amount of municipal property tax collections continues to grow each year, both in total dollars and on a per-capita basis; however, the total size of city budgets has increased at a much greater rate than property tax levies. While some cities in metropolitan areas have seen property values rise at phenomenal rates, in most small cities and particularly those in more rural areas, the purchasing value of the dollars raised from taxes has lagged far behind the rate of inflation.

#### ***Maximum Tax Rates***

The Texas Constitution and statutes established the maximum permissible property tax rate for cities at the following levels: (1) for Type B general-law municipalities--25 cents per \$100 assessed valuation; (2) for other cities of less than 5,000 population--\$1.50 per \$100 assessed valuation; and (3) for cities with 5,000 or greater population--\$2.50 per \$100 assessed valuation. A number of home-rule cities of over 5,000 population are limited to tax rates below \$2.50, but this results from self-imposed restrictions incorporated into their charters.

#### ***Administrative Procedures***

Texas' system of property tax administration has undergone several significant changes over time. Prior to 1980, the appraisal of property for tax purposes was fragmented among more than 3,000 cities and other local jurisdictions, and there were no statewide standards governing the administration of local taxes. In 1979, however, the Texas Legislature

radically changed this situation by enacting a new State Property Tax Code which established uniform appraisal policies and procedures.

Under the Code, countywide appraisal districts are now responsible for preparing a unitary tax roll which encompasses all property within the county. Although cities and other jurisdictions retain the authority to set their tax rates and collect their own taxes, they must use the tax roll prepared by the central appraisal district for all tax-related purposes. The basic procedures for administering property taxes include the following:

1. *Appraisal:* The taxable value of all property in the county is determined by the central appraisal district of that county.
2. *Equalization:* Any property owner dissatisfied by the value fixed by the central appraisal district can appeal to the appraisal review board. Upon presentation of a convincing demonstration that the appraisal district's determination was erroneous, the review board has authority to reduce the taxable value of the appellant's property.
3. *Assessment of taxes:* The tax roll prepared by the central appraisal district is furnished to cities and other taxing entities within the county, which use it as the basis for levying taxes for the coming fiscal year. If most cities or other entities plan to increase their tax levy by more than 3 percent during the next fiscal year, the governing body must publish notice of its intention and then hold a public hearing on the proposed increase. This public hearing is separate from the mandatory public hearing on the proposed city budget. If the property tax increase is 8% or more, the entity becomes subject to a tax rollback election at which local voters may reduce the tax levy increase to no more than 7.99 percent. If the taxing unit owns, operates, or controls an Internet Web site, the unit shall post notice of the public hearing on the Web site continuously for seven days.
4. *Simplified tax rate notice for taxing units with low tax levies.* Taxing units for which the total tax rate proposed for the current tax year is less than 50 cents or which impose taxes of \$500,000 or less are exempt from the more burdensome notice and publication requirements. However, any such unit may provide public notice of the proposed tax rate by mailing a notice to each owner of taxable property or by publishing a notice of the proposed tax rate in the legal section of a newspaper having general circulation in the taxing unit.
5. *Vote to set the tax rate.* The meeting to vote on a tax increase must not be earlier than the third day nor later than the 14<sup>th</sup> day after the date of any tax rate public hearing, and must generally take place by September 29th.
4. *Collection:* After the council has set the property tax rate for the coming fiscal year, the tax assessor-collector mails tax notices to all property owners in the city and initiates the collection of taxes. Most cities now join with other taxing jurisdictions to send out joint tax bills.

Most of the procedures for assessing and collecting property taxes are prescribed by the Property Tax Code. Complete copies of the Code are available from the Property Tax Division of the Office of the Comptroller of Public Accounts, P.O. Box 13528, Austin, Texas 78711-3528.

### ***Delinquent Taxes***

For obvious reasons, it is to the city's advantage to collect as much as possible of the amount of property taxes due and payable to the city. First, financial analysts are inclined to criticize any municipal tax collection agency which fails to consistently collect at least 95 percent of the taxes levied. Second, for any taxes that are not collected, someone else must pay higher taxes to make up the difference in order to provide the level of funding necessary for the city's programs. In many Texas cities, a 99 percent collection rate is the norm.

The more successful city tax offices are assisted by an attorney who is skilled in collecting delinquent taxes, and it is strongly recommended that any tax offices for that matter be assisted by a qualified attorney. In some cases, this may be the city attorney, but the more common practice is for the city to hire a lawyer who specializes in the delinquent tax field. Contracting with an outside lawyer, most of whom charge fees on the basis of a percentage of the delinquent taxes they collect, can be money that is well spent, but the city needs to be careful to ensure that the contract requires that the lawyer diligently attack the hard to collect taxes rather than just skimming the easy collections and going back home.

### **City Sales Taxes**

The City Sales Tax first became available to Texas cities on January 1, 1968, and by 1998 has become almost universal, with 1,094 cities, which is more than 92 percent of all cities representing over 99 percent of the city population in the state, having adopted the basic one cent tax. Further, now with the various options, including the one half cent tax to reduce the property tax and the various economic development opportunities, many cities are now levying sales taxes of up to two cents. By 1998, there were 353 cities that adopted the one-half cent sales tax for economic development and 282 that have adopted the one-half cent for property tax relief. There are 138 cities that have adopted both the economic development and the property tax relief sales tax. During 1997, this tax generated approximately \$143 per capita in cities where it was collected. This is up from approximately \$65 per capital in 1982.

In addition to the general sales and use taxes, the economic development sales tax, and the property tax relief sales taxes, eight cities have adopted sales taxes to support transit programs. There have been 118 counties that have adopted a county sales tax, and the sales and use taxes are collected for 34 special purpose districts around the state. Where the counties, special purpose districts, or transit authorities, etc., have adopted the sales tax, cities may be blocked from adopting the additional taxes because of the state cap on the amount of sales taxes that may be collected from the citizens. New in 2001 is a one-fourth or one-eighth cent sales tax for street maintenance.

A major concern of local governments is the efforts of some businesses to block the collection of sales taxes on sales made over the Internet. In 1998, the federal government adopted a 3-year moratorium on taxes on Internet sales, which has since been extended.. Making this permanent will cost the State of Texas and Texas local governments millions of revenues.

### **User Fees (Other than Utility Charges)**

Charges for use of city services are an increasingly popular method of generating revenues. In addition to charging for solid waste collection, water, and wastewater services, cities impose charges for the use of a variety of facilities, including swimming pools, golf courses, airports, buildings, etc.

In the average city, all of these revenue sources account for 10 to 15 percent of the total revenues. Income derived from charges of collecting and disposing of solid waste accounts for about 10 percent of the average city's total revenues. Even then, however, there often is no net gain from refuse services, since many cities charge less than the actual cost of the service and subsidize the solid waste service out of the general funds. As the Environmental Protection Agency has issued more and more restrictions on the disposal of solid wastes, the cost has grown in geometric portions, and two-thirds of the cities have had to close their landfills. Solid waste has been a prime target for privatization of services as private companies with their larger trucks, transfer stations, and large landfill operations are taking over more and more of the solid waste operations from cities.

### **Federal Grants**

It is always interesting to watch the pendulum swings in various areas. Following the heyday of the grantsmanship of the 1960's and 1970's, the federal grants are becoming less and less as the programs and funding sources are drying up, or are being changed over to loan programs. Still, federal financial aid is an important part of the municipal revenue picture. Statewide, an average of 10 percent of all municipal revenues is derived from federal grants. For individual cities, federal aid as a proportion of all revenues fluctuates from less than one percent to more than 30 percent, with "distressed" cities receiving the larger amounts of federal money, and the better-off cities receiving comparatively little.

- The *Catalog of Federal Domestic Assistance*, published each year by the U.S. Office of Management and Budget, lists all of the different types of federal grants available to cities and is an indispensable resource for city officials seeking federal funds.
- The Office of the Comptroller of Public Accounts keeps current a computerized listing of federal funds that are available, and this is available on the Comptroller's Web site at [www.window.state.tx.us](http://www.window.state.tx.us), or you can call 1-800-531-5441, ext. 3-4911.
- The Texas Rural Development Council (TRDC) has prepared a special guide of resources available for rural communities, and the guide is available through TRDC's Web page at <http://www.trdc.org>.
- The Local Government Services Section of the Texas Department of Housing and Community Affairs publishes a *Resource Guide for Local Governments* which is a compilation of State and Federal programs of interest to local governments, and another publication entitled *How to Successfully Compete for Grant Dollars*.
- State Grants Team, Office of Budget and Planning, Office of the Governor of Texas provides technical assistance and training for local governments seeking grants information. For additional information, go to the following Web site <http://www.governor.state.tx.us/stategrants/index.htm>, and click on the State Grants Team link, or contact personnel at 512/463-1778

## **Street Rentals**

Approximately four percent of the average city's revenue is produced by street rental charges collected from private firms—such as taxicab and cable TV companies and gas, electric, and telephone utilities—in return for allowing them to use streets and other public right-of-ways. Cities need to be really on their toes relating to the franchise or street rental fees, for the utility companies are making massive efforts at the federal and state levels to limit or to block altogether the assessing of these fees. A common practice of the utility companies is to show these as separate charges on the individual bills submitted to the consumers. Cellular, digital, or other wireless phones are quickly complicating the street rental agreements.

## **Miscellaneous Revenues**

Miscellaneous income is derived from many different sources, such as rental charges for the use of the city's property; the sale of water or other utility services to other jurisdictions; and interest income from idle city funds. Other sources of miscellaneous revenues include municipal court fines; permit fees, such as those imposed in conjunction with building inspections and other regulatory activities; license fees; such as those paid by electricians and plumbers to cover the cost of qualifying these service personnel who do business within the city. There are a myriad of other sources of revenue such as hotel-motel taxes, taxes on alcohol and other such items in which the city may charge one-half of the state tax levy, occupation taxes, special assessments for street improvements, downtown improvements, etc. As with all sources of revenue, these must be handled equitably and fairly to assure that all pay their fair share.

## **Budgeting**

The budget is a financial plan and policy statement which expresses, in dollars-and-cents terms, the scope, type, and cost of city services that will be provided during a particular fiscal year. The budget also shows the total amount of revenue that will be collected and spent on behalf of city services and projects during the fiscal year.

### ***The Budget Officer***

The *Texas Local Government Code* requires that the mayor shall be the budget officer; however, if the city has the city manager form of government, the city manager shall be the budget officer. While the responsibility is assigned by the statute, city managers as well as mayors often will delegate lead responsibility to other offices of the city. In smaller cities, operating under the mayor-council form of government, this duty is often performed by the city clerk/secretary, the city treasurer, or chief financial officer. Some mayors will appoint a committee of council members, and there have been cities that bring in individuals from the private sector such as bankers, accountants, or contractors to assist in the preparation of the budget. In cities which operate under the council-manager form of government, the city manager, even though designated by law as budget officer, often will delegate the task to the finance director or to another subordinate.

Regardless of the person designated to serve as budget officer, a clearly understood framework, such as an administrative plan, should be established to ensure that the city council and all department heads know who is responsible for each function of the budget process. Additionally, the city council should adopt a written policy which clearly

delineates the budget officer's duties and powers, as well as the limitations on those powers.

Although practices vary from one city to another, the budget officer usually is responsible for conducting the budget planning process, preparing budget forms, making revenue forecasts, and collecting all of the many other types of financial information needed to compile the budget. The extent to which the budget officer actually drafts the proposed budget varies. In some cities, the budget officer submits budget requests of the various departments directly to the mayor or city manager, who may make desired adjustments or may pass the requests along, substantially unchanged, to the city council for its action. In yet other cities, the budget officer assembles the budget requests and compiles them into the form of a preliminary budget for submission to the mayor or city manager, who then puts the document into a recommended form and transmits it to the city council.

### ***Budget Preparation<sup>1</sup>***

Budget preparation should be approached in a systematic manner in order to ensure that all of the necessary steps are followed and deadlines are met. The following checklist may be helpful in this regard:

- The city council, either at a retreat or some other workshop setting, adopts its goals for the next fiscal year and highlights special projects to be addressed, as well as limitations that are desired.
- The budget officer initiates the actual budgeting process by preparing and distributing a budget information packet and budget forms to each department head.
- The budget officer compiles revenue figures—including actual revenues for the prior fiscal year, projected revenues for the current fiscal year, and initial estimates of revenues for the next fiscal year.
- Departments put together their requirements for the next year and submit their budget request forms to the budget officer; the budget officer reviews these requests and compiles them into a preliminary budget.
- The budget officer transmits the preliminary budget to the chief executive officer, whether the mayor or the city manager. The chief executive officer reviews the preliminary budget, makes modifications, and then submits it to the city council. Copies of the proposed budget are distributed to the local news media and filed with the city secretary, who makes it available for public inspection.
- The city council conducts a tentative review of the proposed budget, makes such modifications as deemed desirable, and calls a public hearing on the budget proposals to offer local citizens an opportunity to express their views.
- After the public hearing, the council considers citizens' comments, amends the budget as appropriate, and then adopts the final budget as amended by approving an ordinance.
- The city council passes an ordinance setting the tax rate for the next fiscal year. This action must be taken no sooner than 30 days after the chief executive officer files the proposed budget with the city secretary. The legislature has added a new limitation on the adoption of the tax rate that provides that a meeting to vote on a *tax increase* may

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<sup>1</sup> For a comprehensive discussion of the budget preparation process, see *Budget Manual for Texas Cities*, published by the Texas Municipal League in 1983 and revised in 1989, and with a third revision by the Texas Department of Housing and Community Affairs and the Office of the Comptroller in 2001.

not be earlier than the third day nor later than the fourteenth day after the date of a public hearing to consider a possible tax increase of more than three percent. If necessary, the city council also must approve ordinances changing the rates of service fees and charges for the next fiscal year to generate the revenues necessary to fund the adopted budget.

- The chief executive officer initiates the administrative actions necessary to place the budget into effect.

The length of time required to complete each step of the budget process will depend upon several factors, such as time consumed by staff in budget preparation, the length of time the city council spends in reviewing and adopting it, etc. In most smaller cities three months will be sufficient to complete the budget cycle; a medium sized city probably will need four months or more. *The Budget Manual for Texas Cities*, published jointly by the Texas Municipal League, the Comptroller's Office, and The Department of Housing and Community Affairs, contains a more detailed Administrative Plan outlining who does what and the sequence of the budgeting process. In addition, budget and tax deadlines are posted each year on TML's Web site: [www.tml.org](http://www.tml.org), under the *Legal Information Index*.

### **Municipal Borrowing**

It is a rare case when a city is able to carry out a capital improvements program of any consequence without using its credit. More often, the city borrows money and, in doing so, offers future tax collections or utility revenues as security for the loan.

Loans fall into two categories: short-term and long-term—or stated differently, loans to be repaid within the current fiscal year versus those to be repaid in future years. This section briefly reviews the two types of loans.

#### ***Short-Term Borrowing***

Most short-term loans are made with local banks. Ordinarily, their purpose is to provide funds of a temporary nature, and they usually are made with the expectation of repayment within the current fiscal year. A bank loan made in August to avoid an overdraft in the General Fund pending receipt of tax collections in October is a good example of a short-term loan. Another example is a loan to cover the cost of unexpected repairs to a major item of equipment such as a dozer, fire apparatus, or motor grader.

A short-term loan differs from a long-term loan in two respects: (1) it will mature within the current fiscal year; and (2) it can be approved by the city council, without approval at a referendum election.

Short-term loans should be used sparingly. An excessive amount of short-term debt can adversely affect the city's bond rating and impair its ability to accomplish long-term borrowing for major capital improvement programs. Frequent use of short-term borrowing reflects deficiencies in the quality of the city's management of its financial resources.

#### ***Long-Term Borrowing***

Unlike short-term loans, which can be repaid with General Fund or utility dollars derived from various revenue sources, long-term loans require that the specific source of revenue that will be used to repay the debt be identified and pledged. Of the many different sources

of city revenue, only property taxes and utility revenues can be legally pledged to secure the payment of long-term loans.

Long-term loans secured by a pledge of property taxes are called “general obligations,” and include ad valorem tax bonds, time warrants, and certificates of obligation. There are a number of other types of instruments that are now in use; however, the three identified above are the most commonly used. Any city that is interested in any long-term financing mechanisms should consult with a qualified financial advisor. Long-term loans secured by a pledge of revenue from an income producing facility are called “revenue bonds.”

### ***General Obligations***

General obligations are secured by a pledge of future property tax collections. Under standards promulgated by the Attorney General of Texas, a city with a maximum permissible tax of \$1.50 per \$100 assessed valuation may not incur general obligation debt which will require, for the payment of maturing principal and interest (debt service), the levy of a tax at a rate higher than \$1.00 after allowing 10 percent for delinquencies in collection. For a city with an authorized tax rate of \$2.50, the permissible rate for debt service is limited to \$1.50. These limitations include all types of general obligations secured by a pledge of future property tax collections.

General obligation debt is commonly expressed as a percentage of the city’s total assessed valuation. For example, a city which has a tax roll of \$10 million, and outstanding general obligation debt in the principal amount of \$500,000, is said to have a debt ratio of 5 percent.

As a general rule of thumb, each 10 cents of available tax rate can service one percent of general obligation debt. With this formula as a criterion, the average city in Texas, other than Type B general-law municipalities, will be able to use about 50 cents of its available tax rate to pay the annual principal and interest owing on its general obligation debt.

### ***Ad Valorem Tax Bonds***

Ad valorem tax bonds are commonly referred to as general obligation, or G.O. bonds. They are issued pursuant to an ordinance adopted by the city council following their approval at a referendum election. They are examined as to legality by the Attorney General of Texas, and delivered to the successful bidder for payment in cash. This cash is then used by the city to pay for libraries, police buildings, street improvements, city halls, and other facilities with a long useful life.

G.O. bonds usually are issued in \$5,000 denominations, and the bond issue always provides serial maturities, with a certain amount of principal maturing each year over a period not to exceed 40 years. At no time should the life of a bond issue be longer than the life of the equipment or improvements financed by the bonds.

General Obligation bonds have a higher degree of investor acceptance than any other type of municipal indebtedness, and they command the lowest interest rates. Therefore, unless exceptional circumstances dictate otherwise, G.O. bonds are the preferred means of borrowing against a pledge of tax revenues.

### ***Time Warrants***

Time warrants are another form of general obligation. Unlike G.O. bonds, which are sold for cash, time warrants are issued directly to vendors to pay for goods and services. Also unlike G.O. bonds, time warrants do not require voter approval, although the law does require that the city council publish notice of its intent to issue them and that the council must call a referendum election upon presentation of a petition signed by ten percent of the qualified voters.

The procedures for issuing time warrants are cumbersome and expensive, and will result in the city paying a higher rate of interest than if the borrowing were accomplished with bonds. Nevertheless, time warrants can occasionally be advantageous; for example, to complete the construction of a public works project where there has been a cost overrun and bond funds have been exhausted.

Where time warrants are issued, in appreciable amounts, it may be to the city's advantage to exchange the warrants for general obligation refunding bonds. The expense of refunding usually can be recouped many times over through savings resulting from lower interest rates on the refunding bonds as compared to interest rates for warrants.

### ***Certificates of Obligation***

The third common form of general obligation borrowing is certificates of obligation (COs). Like time warrants, COs can be issued without voter approval—except that upon notice of the city's intent to issue certificates, five percent of the qualified voters can force an election on the issue by submission of a petition. Certificates can be issued directly to vendors to pay for construction work, equipment, machinery, materials, supplies, land, or professional services furnished to the city. Also, under certain circumstances, COs can be sold, like bonds, for cash, in which case, they must be approved by the Attorney General in the same manner as bonds.

### ***Anticipation Notes***

Certain cities may have authority to borrow against anticipated revenue (typically federal grant money) by issuing anticipation notes. Anticipation notes may be appropriate for borrowing relatively small amounts of money when the issuance of bonds would be cost prohibitive. State agencies may be authorized to purchase anticipation notes from cities, thus speeding the grant process to fund city projects. The law relating to anticipation notes may be found in Chapter 1431 of the *Texas Government Code*.

### ***Revenue Bonds***

Although there are three principal types of general obligations that are secured by the pledge of property taxes, there is only one type of bond secured by a pledge of revenues of an income-producing facility such as a utility system. These obligations are revenue bonds, usually designated with the name of the system whose revenues are pledged (Waterworks & Sewer System Revenue Bonds, etc.). Under state law, revenue bonds do not require approval at a referendum election, but still many city councils ask for voter approval prior to issuing even revenue bonds.

When utility revenues are pledged to support revenue bonds, the pledge is made of the system's *net* revenues—that is, gross revenues less the cost of operation and maintenance.

Such bonds are payable solely from these revenues and are required to contain a statement on their face that the holder shall never be entitled to demand payments from property taxes.

In determining whether the amount of pledged revenues is sufficient to repay the outstanding revenue bonds of a utility system, analysts will look at the ratio between the system's net earnings and the requirements of principal and interest maturities over a period of years. As a rule, net revenues should be at least one-and-one-half times larger than the debt service requirements of the system. This ratio is called "coverage," and revenue bonds are said to have 1.50X coverage, or 2.23X coverage, and so on. The higher the coverage, the better the security for the bonds; and all other things being equal, the lower the rate of interest at which the bonds can be issued.

In pledging the revenues of a utility system, it is common to make a "cross pledge", that is, to pledge the revenues of one system to repay bonds issued for improvements to a different system. An example of this would be pledging the net revenues of the water system to the payment of bonds issued to improve the sewer system. Conversely, the revenues of a utility system may not be cross-pledged to the payment of bonds issued on behalf of a non-revenue-producing facility. For instance, water system revenues cannot be pledged to the payment of bonds issued to build a city hall.

More detailed information about procedures for issuing bonds can be obtained from the Municipal Advisory Council of Texas, P.O. Box 2177, Austin, Texas 78768-2177.

### ***Other Types of Indebtedness***

There are other types of indebtedness that may be incurred by cities to finance municipal operations and capital improvements, such as Certificates of Participation, private loans, etc., but the types described above are the most common.

### **Debt Management**

The amount of outstanding municipal debt has greatly increased in recent years. Indications are that the volume of local indebtedness will continue to increase in the future, as cities issue more and more bonds to finance the construction of streets, parks, utilities, and other capital improvements needed to keep pace with population growth and business expansion. Another feature in the accelerated growth of debt is the need to keep pace with the standards that are demanded by the public. The quality of streets that was acceptable 20 years ago is not acceptable to the public today, as the public demands better quality and higher standards.

In the face of this ever-increasing volume of debt, the cost of borrowed money has become a growing proportion of the budgets of most cities. This fact has generated additional emphasis on effective debt management practices as a method for minimizing borrowing costs.

Every city should establish orderly procedures for planning, marketing, and administering all of its debts. Many useful suggestions in this regard are contained in *Debt Management*

*Handbook for Small Cities and Other Governmental Units*, which is published by the Municipal Finance Officers Association, 180 North Michigan Avenue, Chicago, Illinois 60601.

### **Bond Ratings**

As the annual volume of long-term debt incurred by state and local governments has grown over the years, competition between cities and other borrowers for the investor's dollar has increased correspondingly. Municipal bond ratings are one of the methods used to help alleviate the problems arising from this competitive situation.

A bond rating gives a quick indication of the quality of a new issue being offered, so that prospective bidders may know if they want to develop a bid. But a bond rating has greater value than a mere screening device; it also influences the rate of interest payable on bonds. Therefore, it is desirable that the city maintain a good rating for its bonds, because it can mean the difference between a good bid and a poor one, and a difference in interest charges running into many tens of thousands of dollars.

Most Texas cities have more than one bond rating. Each bond issue is rated separately, based on the source of revenue that has been pledged to secure payment. General obligation bonds are, therefore, rated separately from water or sewer revenue bonds. Assuming that there is still another class of revenue bonds, such as electric system revenue bonds, these would also require a separate rating. A city with bonds outstanding similar to this illustration would have three bond ratings.

In determining the rating of a bond issue, analysts focus on the nature of the particular security. In the case of general obligation bonds, prime importance is attached to relationships between the city's debt, wealth, population, and tax collection experience. The economic base of the community, its stage of development, its sociological character, and the quality of its government also are leading factors. And last, analysts examine the exact nature and strength of the legal obligation that the bonds represent.

The bond ratings of two particular firms are universally accepted in investor circles. These are Moody's Investors Service and Standard & Poor's Corporation, both of which are based in New York City. The five highest ratings granted by these services are listed as follows:

#### **Moody's Investors Service**

- Aaa: Best quality, carrying the smallest degree of investment risk.
- Aa: High quality (together with Aaa, comprise "high-grade bonds").
- Higher medium grade: many favorable investment attributes.
- Baa: Lower medium grade, neither high-quality nor high-risk.
- Ba: Have speculative elements.

#### **Moody's Investors Service may be contacted at:**

[www.metlife.com/Applications/Corporate/WPS/CDA/PageGenerator/0,1674,P268,00.html](http://www.metlife.com/Applications/Corporate/WPS/CDA/PageGenerator/0,1674,P268,00.html)

#### **Standard & Poor's Corporation**

- AAA: Highest rating, with extremely strong capacity to repay loan.
- AA: Only a small degree below AAA in the capacity to repay the loan.

- A: A strong capacity to repay loan, although more susceptible to adverse effects in economic conditions.
- BBB: Adequate capacity to repay loan.
- BB: Predominately speculative.

**Standard and Poor's may be contacted at:** [www.ratings.standardpoor.com](http://www.ratings.standardpoor.com)

In offering a new bond issue for bids, the city should apply to one or both of the rating agencies to obtain a rating on the issue being offered. The nominal cost of obtaining a rating can be recovered many times over by minimizing interest costs on the basis of a favorable bond rating, as opposed to the sale of non-rated bonds.

### ***Bond Elections***

If it has been determined by the city council that a bond election is required, the first step, and the key step in a successful campaign, is citizen participation. The tried-and-true elements of a successful bond election include the following:

- Let private citizen volunteers, rather than the city council, conduct the campaign to persuade voters to vote for the bonds, however, city funds generally may not be spent to influence an election.
- Enlist the support of community and civic organizations.
- Before the campaign gets underway, conduct a public opinion survey to measure the degree of support for the bonds that already exists in the community. This information will provide guidance as to the type of campaign techniques needed and the kinds of information the voters will need to make their decision.
- Adopt a catchy slogan or theme that is easily remembered.
- Emphasize, in clear terms, the advantages that will be derived from projects that would be constructed with the bond funds. Stress how the improvements will impact the individual citizen.
- Begin the campaign with a big kickoff about six to eight weeks before the voting day, and work toward a crescendo of activity in the last two weeks, with the climax occurring in the last few days preceding the vote.
- During the final week before election day, concentrate on radio and television spot announcements, panel discussions, testimonials, and door-to-door pamphlet distributions. Telephone campaigns are also very helpful.

Useful bond campaign reference materials include the *Anatomy of a Bond Campaign* (Investment Bankers Association of America, 425 13<sup>th</sup> Street, Washington, D.C. 20004).

### **Capital Improvements Programming**

It is a financial fact of life in every city that the demand for new and better streets, waterlines, parks, fire stations, and other capital improvements will always exceed the supply of current funds. Capital improvements programming is the primary method used by most cities to cope with the perpetual imbalance between capital demands and limited financial resources.

A capital improvements program (CIP) is a long-term plan, usually spanning five to six years, for financing major cost items which have a long useful life such as buildings, land, streets, utility lines, and expensive equipment (fire trucks, etc.). The CIP documents list all

of the capital items scheduled for construction or acquisition during the next five to six years, the time when construction or acquisition is to occur, the amount expected to be spent during each year of the CIP, and the source of funding for each expenditure. The planning and zoning commission is usually responsible for the preparation and maintenance of the CIP, however the final responsibility for the plan rests with the city council. Often a city council will name a capital improvements committee to assist the planning and zoning commission with the development and prioritizing of the CIP.

Regardless of the specific body involved, preparation of a CIP requires five major steps. First, a list of proposed capital improvements is prepared on the basis of recommendations from the city council, planning and zoning commission, city staff, and citizen groups. The city's comprehensive plan will be the source of many CIP items; but whatever the source, each item included in the list should be supportive of the community's goals as expressed in the plan. It is most important to ensure that all of the community's needs are included in the list of proposed projects.

Next, cost estimates are developed for all proposed CIP items. In addition to stating the up-front cost of each item, these calculations usually include a description of savings or additional costs that will result from its acquisition or construction, as well as the impact the item would have on future revenues or operating costs.

Third, a determination is made of the city's ability to pay for the items included in the draft CIP, together with a description of the method by which each will be financed. Ability-to-pay will be determined by a financial analysis of past, current, and future revenue, expenditure, and debt patterns. Options for financing particular items include special assessments, state or federal grants, additional fees or taxes, current revenues (pay-as-you-go), reserve or surplus funds, general obligation or revenue bonds, or certificates of obligation. The objective of this step is to determine, for each year, the minimum costs the city must take care of before any new capital expenditures can be financed.

Next, all proposed CIP items are organized by the staff for orderly presentation to the city council or CIP committee. Each is ranked in suggested priority order. Items which overlap or duplicate previously approved projects, or which are inconsistent with the city's comprehensive plan, are identified and perhaps downgraded. And last, the tentative CIP is discussed at public hearings, thoroughly reviewed by both the CIP committee and the city council, and finally approved by formal council action.

Based on information contained in the CIP, a capital budget is prepared to show all capital expenditures in priority order, together with summaries of the financial activities planned for each year—including the amounts of bonds to be issued, amounts of operating funds required, and so forth.

The capital budgeting process normally takes place on a cyclical basis. Under a 6-year CIP, Year 1 is the current capital budget, which is adopted by the city council at the same time it approves the operating budget. Many times, the capital budget is included as a component of the operating budget. Years 2 through 6, having been approved by the council when it adopted the CIP, remain in the record as expressing the council's intent to carry forward with the balance of the CIP.

At the conclusion of Year 1, the council reviews and approves another one-year capital budget and extends the CIP, with revisions, for another year. Thus, Year 2 of the previous CIP becomes Year 1 of the new 6-year program, and the cycle begins anew.

Many of our smaller cities do not have the staff nor financing options to maintain an annual CIP as described above. Should this be the case in your city, please keep in mind that the process is still the same. The planning and zoning commission should keep the comprehensive plan current; including a listing of needed improvements with priorities. Rather than annual CIP budgeting, the city may look at the capital improvements needs on a four- or five-year basis, or the city may keep a listing of priorities until it becomes necessary to address a specific need, and then appoint a capital improvements committee to study that need as well as all other needs and plan a course of action to secure financing for those top priorities that can be afforded with the financing available at that particular time. The city should follow the same five-step process; prepare a listing of the needs, develop cost estimates, do a financial analysis to determine the ability to pay through the various funding options, establish a ranking of the needs by priority, then call a bond election or seek other sources to fund those top ranked priorities.

Capital programming and budgeting offers several advantages. By scheduling ample time for construction or acquisitions, costly mistakes can be avoided, as is the case when streets have to be dug up repeatedly because they have not been planned in relation to underground utilities or other facilities. Also, by working with a list of planned projects, sites can often be purchased at less cost than on a crash basis. And by spacing out projects over several years, the city's tax and debt load can be stabilized and balance maintained between debt services and current expenditures.

### **Accounting and Financial Reporting**

The disposition of the city's funds must be controlled and reported in a systematic manner. This is accomplished by means of accounting, reporting, and auditing procedures, which conform to accepted principles and standards.

#### **Accounting**

Municipal accounting is based on a system known as fund accounting. A "fund" is simply an accounting device that is used to subdivide activities for financial management purposes. All of the city's financial activities are classified in relation to different funds, the number of which varies according to the complexity of the city's operations. If, for example, the city operates an electric or gas company, separate funds would be set up for each. Funds commonly utilized in municipal accounting systems include:

1. *Enterprise Funds* are used to account for utility system revenues and expenditures. Depending on the number and types of city-owned utilities, the accounting system could include a Water Fund, Sewer Fund, Electric Fund, Gas Fund, Airport Fund, etc.
2. *Capital Projects Funds* are used to account for revenues (most of which are probably derived from bond proceeds or state or federal grants) and expenditures relative to the acquisition or construction of major capital facilities.
3. *Special Revenue Funds* are used to account for revenues that are earmarked for specific purposes, for example, hotel-motel tax receipts that have been promised to the chamber of commerce or to the arts council. (Keep in mind that the city may not give public

funds to private organizations, but a city may contract with a private organization to perform public services for the public).

4. *Debt Service Funds* are used to account for funds set aside to pay the principal and interest on tax or revenue bonds, certificates of obligation, and other long-term debts.
5. *Special Assessment Funds* are used to account for revenues and expenditures relative to street improvements and other projects financed by means of special assessments against properties that will benefit from the improvements. (We understand that the experts in the field are now including these funds under the Special Revenue Funds.)
6. *Trust and Agency Funds* are used to account for collections and disbursements earmarked for employee pensions and other restricted purposes.
7. *The General Fund* is used to account for all financial resources not covered under another fund, such as those for general city administration, police, fire, street maintenance, libraries, etc., that are ordinarily funded from tax revenues.
8. *Internal Service Fund* is used to account for the financing of goods or services provided by one department or agency to other departments or agencies of the city on a cost reimbursement basis.

The city's accounting system should be maintained in a manner which permits the preparation of a report for each fund and a consolidated statement encompassing all funds. The accounting system should be designed to permit easy comparison to the budget.

Revenues and expenditures should be categorized to a chart of accounts, which allows revenues and expenditures to be systematically entered into ledgers and journals and ultimately, into balance sheets and other financial reporting devices. *Governmental Accounting, Auditing and Financial Reporting*, published by the Municipal Finance Officers Association, contains a good sample chart of accounts that can be easily modified for local use. The *Budget Manual for Texas Cities*, published by the Texas Department of Housing and Community Affairs, the Comptroller's Office, and the Texas Municipal League, contains a very simplified chart of accounts and explanations of the various line items.

The accounting system should classify revenues by fund and source. Expenditures can be classified as follows:

1. Fund
2. Function (or program)
3. Activity (subdivisions of functions)
4. Organizational units (departments)
5. Object of expenditure (type of goods or services)

Duplication of work and accounting inconsistencies can be reduced by assigning the responsibility for maintaining the city's accounting system to one person or department. The system must also contain internal controls designed to deter the misappropriation of funds. Examples of internal controls include:

- Pre-numbering and accounting for each form used to record accounting transactions.
- Avoiding procedures which allow one employee to exercise complete responsibility over transactions from beginning to end. This may be impossible for very small cities;

thus, it is imperative that procedures are followed closely to reduce the opportunity or even the temptation for misappropriation of funds.

- Inventorying, numbering, and controlling moveable fixed assets.

### **Financial Reporting**

Financial reports prepared periodically throughout the fiscal year are an essential part of the control system necessary to permit the city council and administrator to determine whether funds are being expended in accordance with the budget and identify discrepancies between anticipated and actual revenues. Financial reports fall into three categories—internal budgeting reports, financial reports, and audits, each of which is briefly discussed below.

#### ***Internal Budgetary Reports***

Internal budgetary reports showing both revenues and expenditures are prepared monthly and are distributed to the city council, the city administrator, and the department heads. They illustrate the financial condition of the city as it unfolds from month to month and answer such questions as: Are city services being provided as planned? Are expenditures according to budgeted levels? Is cash inflow at the expected level? By determining the answers to these questions on a regular basis, the officials who oversee the city's finances can identify problem areas and initiate corrective actions accordingly.

#### ***Financial Report***

The financial report is compiled at the conclusion of the fiscal year and shows, item by item, budgeted versus actual revenues and expenditures, together with other information which describes the city's year-end financial condition. The financial report should be prepared by an independent certified accountant appointed by the city council and made available to the city council, department heads, the news media, and other interested parties.

#### ***Annual Audit***

Under state law, every city is required to have an annual audit of its financial records and accounts. The audit may be performed by either a certified public accountant or a qualified city employee, and it must be made available for public inspection no later than 120 days after the close of the city's fiscal year.

The audit involves examination of three aspects of the city's financial operations: (1) internal controls; (2) statements, records, and accounting transactions; and (3) compliance with statutory and budgetary requirements. These matters are fully explained in *Standards for the Audit of Governmental Operations, Programs, Activities, and Functions*, published by the U.S. General Accounting Office, Washington, D.C.

### **Cash Management**

Cash management involves the administration of funds needed to pay the city's current bills and idle funds that are available for deposits and investments. The goals of good cash management are to: (1) have cash available to meet expenses as they arise; and (2) earn the highest possible yield on all investments.

The Municipal Finance Officers Association recommends the following procedures be adopted as part of the city's ongoing cash management program:<sup>2</sup>

1. Billing Procedures

- Mail bills for taxes, utilities, and other services promptly.
- Provide penalties for late payments and/or discounts for early payment of taxes and service charges.
- Aggressively pursue the collection of delinquent accounts.
- If utilities and other services are billed semi-monthly, or quarterly, change to monthly billings.

2. Collection Procedures

- Facilitate the payment of taxes, utility charges, and other items by providing convenient payment locations and providing preaddressed return envelopes.
- Investigate the possibility of using banks or other facilities as collection agents for the city.

3. Deposit Procedures

- Deposit all receipts on the same day the money is received, or if that is not possible, as quickly as possible. Very large cities may deposit several times during the day.
- Maintain as few bank accounts as possible in order to make it easier to identify idle cash for investment.
- If feasible, use a lock-box account to speed deposits, especially of utility receipts.

4. Disbursements

- Bills should be paid biweekly or on some other regularly scheduled basis. Bills should be paid as late as possible (and without creating delinquency problems), but timely enough to gain the benefit of any discount offered.
- Checks should be released after the city's bank has closed for the day; if a payment can be delayed until Friday, an additional two days of float will be gained.
- Goods and services should be paid for only after they have been received by the city.
- If payroll checks are issued weekly, the city's cash flow could be improved by extending the payroll period to two weeks or monthly, if the change would not result in undue disruptions. Some entities have found that going to two-week pay periods rather than twice a month have enabled the entity to better organize the finance office. Payroll activities take place on the same day of the week each pay period. The downside is that employees must watch their monthly payments more closely.

Efforts should be made to maintain good working relationships with local banks, which can benefit the city in terms of servicing accounts, providing technical advice on cash management and investments, and bidding on short-term investments.

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<sup>2</sup> Municipal Finance Officers Association. *Implementing Effective Cash Management in Local Government: A Practical Guide* (Chicago, Illinois, 1980)

The city probably will find it advantageous to designate a depository bank to handle its demand deposits and day-to-day transactions. State law requires that the relationships between the city and its depository bank be clearly expressed in the form of a contract that is let by competitive bid. State law also requires that depository balances in excess of FDIC insurance limits be collateralized by securities pledged by the depository bank.

If the city is fortunate enough to have several banks submit depository bids, award of the contract will have to be made on the basis of the best combination of benefits offered, such as the provision of free checking services or pickup and delivery services, whether interest will be paid on demand deposit balances, and any number of other possible services. Forms for inviting depository bids and for designating a depository bank are available from the Texas Municipal League.

### **Investment of Idle Funds**

Any effective cash management program will include procedures under which interest is earned on idle funds that are not needed for current operations. The Public Funds Investment Act of 1995 (Codified as Chapter 2256 of the *Texas Government Code*), as amended, provides the directions for investments including designation and training for an “Investment Officer,” development of an “investment strategy statement,” and the Act actually prescribes the types of authorized investments. The Texas Municipal League provides annual training sessions for investment officers and the investment policies.

Additional information relating to investment procedures is described in *A Treasury Management Handbook for Small Cities and Other Governmental Units*, published by the Municipal Finance Officers Association.

### **Financial Warning Signals**

In the early 1980’s, a lot of attention was given to monitoring the financial health of cities; however, as the nation’s economy has improved, there has not been much said in recent years, as most cities have also experienced healthy times. Cities really need to watch for warning signals, even though their economy seems to be getting along quite well. Although most of the chronic financial problems of cities tend to slowly snowball over an extended period of time, they usually result from a standard set of problems, including:

- (1) decline in revenues or tax base;
- (2) an eroding capital plant;
- (3) a faltering local or regional economy;
- (4) growing debt burden;
- (5) accumulation of unfunded pension liabilities;
- (6) a sudden loss of substantial federal funds;
- (7) an increase in spending pressures;
- (8) failure to address operating requirements of tax as well as revenue supported facilities and ignoring the need to provide additional revenues as needed; and
- (9) ineffective financial management practices.

A publication by the Municipal Finance Officers Association, *Is Your City Headed for Financial Difficulty?* (published about 1980), provided a system of “financial warning signals” that can be utilized by city officials to evaluate their city’s financial condition and

if necessary, take corrective actions to control or alleviate points that are causing stress. Two similar publications, *Evaluating Financial Condition: An Overview* and *Financial Trend Monitoring System: A Technique for monitoring Changes in the Financial Condition of a General Purpose Local Government*, by the International City Management Association (1120 G Street, N.W., Washington, D.C. 20005), also should be reviewed by local officials concerned about the future financial health of their city.

*Municipal Finance Criteria*, published annually by Standard and Poor's, highlights the key general areas of municipal rating analysis and this might be helpful for those who want to dig deeper into financial and credit analysis of local governments.

In 1993, the United States General Accounting Office published a report based on a GAO study of the financial condition of state and local governments. The report, *State and Local Finances, Some Jurisdictions Confronted by Short- and Long-Term Problems*, was to identify-at state, city and county levels-short-term financial conditions, longer-term fiscal capacities, and actions taken by state and local officials in response to their short- and long-term problems.

#### *Sources of Information for Municipal Finance*

- Attorney General, State of Texas, P.O. Box 12548, Capital Station, Austin, Texas 78711.
- State Comptroller of Public Accounts, State of Texas, LBJ State Office Building, 11 East 17<sup>th</sup> Street, Austin, Texas 78711.
- Government Finance Officers Association, 180 North Michigan Ave, Suite 800, Chicago, Illinois 60601. Web site is [www.gfoa.org](http://www.gfoa.org).
- Municipal Advisory Council of Texas, P.O. Box 2177, Austin, Texas 78768-2177.
- The Texas Municipal League, 1821 Rutherford Lane, Suite 400, Austin, Texas 78754-5128.
- Municipal Finance Offices Association, 1313 East 60<sup>th</sup> Street, Chicago, Illinois 60637.
- International City Management Association, 1120 G. Street, N.W., Washington, D.C. 20005.
- Standard and Poor's may be contacted at: [www.ratings.standardpoor.com](http://www.ratings.standardpoor.com).
- Moody's Investors Service.
- The Texas Department of Housing and Community Affairs, P.O. Box 13941, Austin, Texas 78711-3941, phone 512-475-3844 or 800 544-2042.