

Monitoring Report:

2.4 Financial Planning/Budgeting

AAATA Board;

In accordance with Policies 4.2, 4.3, and 4.4; I present this monitoring report on **Executive Limitation Policy 2.4: Financial Planning/Budgeting**.

The evidence of compliance throughout this Monitoring Report comes from the process by which the annual budget was developed, and the resulting document – the recommended Fiscal Year (FY) 2019 Budget. Additional evidence comes from the Strategic Business Plan document, and previously published Auditor reports and Quarterly Financial Reports that are publicly available on TheRide’s website and have already been supplied to the Board. These documents are cited as evidence of compliance with sub-policies in this section.

In general, I believe that we are in compliance with this policy, with the possible exception of policy 2.4.5. Upon reflection, was difficult to interpret as it seems very broad and it is difficult to understand the Board’s intent. We would like to ask the Board to re-visit this policy or provide clarification.

I certify that the information is true and complete.

Matt Carpenter,
CEO
Ann Arbor Area Transportation Authority (TheRide)

Policy Being Monitored

2.4 FINANCIAL PLANNING/BUDGETING

Financial planning for any fiscal year or the remaining part of any fiscal year shall not deviate from Board's Ends priorities, risk fiscal jeopardy, or fail to be derived from a strategic multi-year plan. Further, without limiting the scope of the foregoing by this enumeration, the CEO shall not cause, allow or fail to address budgeting that:

- 2.4.1 Risks incurring those situations or conditions described as unacceptable in the Board policy "Financial Condition and Activities."
- 2.4.2 Fails to place business decisions in a comprehensive, strategic context that illustrates progress towards Ends and compliance with Executive Limitations.
- 2.4.3 Omits credible projection of revenues and expenses, separation of capital and operational items, cash flow, and disclosure of planning assumptions.
- 2.4.4 Is unclear about long-term funding needs and growth projections.
- 2.4.5 Allows inefficiencies due to over or under-funding.
- 2.4.6 Causes deficit spending.
- 2.4.7 Does not provide for adequate reserves.
- 2.4.8 Provides less for Board prerogatives during the year than is set forth in the Cost of Governance policy.

Executive Limitations Policy 2.4

Financial planning for any fiscal year or the remaining part of any fiscal year shall not deviate from Board's Ends priorities, risk fiscal jeopardy, or fail to be derived from a strategic multi-year plan.

Compliance: In Compliance.

Current Interpretation & Rationale

I interpret this policy to be listing parameters and expectations for the recommended annual budget and budgeting for the future. I submit that all necessary interpretations of this policy are provided in the interpretations of the sub-policies below.

Evidence

I believe that evidence submitted for the following sub-policies is sufficient to demonstrate compliance with the overarching policy of 2.4.

The evidence of compliance throughout this Monitoring Report comes from the process by which the annual budget was developed, and the resulting document – the recommended FY 2019 Budget. Additional evidence comes from the Strategic Business Plan document, and previously published Auditor reports and Quarterly Financial Reports that are publicly available on TheRide's website and have already been supplied to the Board. These documents are cited as evidence of compliance with sub-policies in this section.

Executive Limitations Policy 2.4.1

...the CEO shall not cause, allow or fail to address budgeting that...Risks incurring those situations or conditions described as unacceptable in the Board policy "Financial Condition and Activities."

Compliance: In Compliance.

Current Interpretation & Rationale

I interpret this policy to mean that I must take into account budgeting elements of 2.5 Financial Conditions that are not otherwise covered in policy 2.4. Additional requirements are:

- **Contracts in the budget** - I interpret this policy to mean that anticipated contracts greater than \$250,000 must be listed in the budget to be considered approved as part of the budget. Any contract not included in this list over \$250,000 will come to the board for approval.
- **Adjustment of fares or tax rate** - I interpret this policy to mean that staff may not change fares or tax rates without Board approval. Neither the CEO nor the Board has the power to change the tax rate (mill rate). The Board must approve any proposed change which is then voted on by residents.
- **Real estate** - I interpret this policy to mean that staff may not buy, sell, or borrow against real estate without Board approval.

Evidence

- **Contracts:** a list of all anticipated contracts and their dollar value is included on pages 37-38 of the recommended FY 2019 Budget.
- **Fares and Taxes:** as stated on pages 14, 26, and 28; the recommended FY 2019 Budget does not change fares. The Budget assumes a Board-approved 0.7 mill renewal as was approved by voters in August 2018.
- **Real Estate:** the FY2019 budget does not include buying, selling, or borrowing against real estate. As evidence, no real estate sale or acquisition is included in the capital budgets on pages 21, 22, and 26-38.

Executive Limitations Policy 2.4.2

...the CEO shall not cause, allow or fail to address budgeting that...fails to place business decisions in a comprehensive, strategic context that illustrates progress towards Ends and compliance with Executive Limitations.

Compliance: In Compliance.

Current Interpretation & Rationale

I interpret this policy to mean that the recommended annual budget should be accompanied by a multi-year corporate plan that illustrates how a single year fits into a longer-term approach to advancing the Board's policy goals, while also meeting expectations for risk management and prudent management of the agency's resources.

Together, the corporate plan and the budget must provide clear goals and priorities, illustrate how recommended efforts advance the policy goals of the Board, address all aspects of TheRide's business, and help the organization become more compliant with Board policies.

Evidence

Strategic Context: The Strategic Business Plan illustrates a strategic context for the annual budget by:

- Aligning priorities and resources towards the Board's written policy goals (pages 5, 8, 9-12),
- Providing clear goals (pages 8-12) which then guide the recommended annual budget (page 7),
- Establishing a situational awareness of the current status of the agency via a SWOT analysis (pages 7, 26-27), and
- Explicitly connect proposed initiatives with specific policy goals of the Board (page 18).

A key missing piece of strategic context is a clear long-term plan for transit services. The need for this is recognized in the Strategic Business Plan (pages 9, 15) and the recommended FY 2019 Budget (pages 18, 28).

Comprehensiveness: The recommended FY 2019 Budget encompasses all elements of TheRide's business. It combines the operating budget (pages 15-20, 26-27, 28-38) and capital budget (pages 21-23, 28-38) in one document. All existing services and infrastructure are funded and maintained (Budget page 14).

Risk is addressed in several parts of the recommended FY 2019 Budget, for example:

- Replenishment of the reserve (page 11),
- A focus on addressing deferred maintenance (page 13),
- Anticipating financial risks (page 19),
- Adjustments the various line times too numerous to list, and
- By placing the annual budget in the context of a new Strategic Business Plan that identifies Weaknesses and Threats (SWOT).

Both the CEO and CFO attest that, to the best of their knowledge, there are no elements missing from the budget. This confidence comes, in part, from a collaborative effort to develop the budget where staff, the public and Board members have been consulted repeatedly over a five-month period (Budget page 8).

Executive Limitations Policy 2.4.3

...the CEO shall not cause, allow or fail to address budgeting that... omits credible projection of revenues and expenses, separation of capital and operational items, cash flow, and disclosure of planning assumptions.

Compliance: In Compliance.

Current Interpretation & Rationale

I interpret this policy to mean that each recommended annual budget must include realistic estimates of future costs and revenues, sufficient to contextualize the annual budget and demonstrate longer-term financial implications.

In this context, a “credible projection” is an extrapolation of future costs and revenues based historic financial evidence, identified risks, and reasonable and realistic assumptions about future circumstances (i.e. inflation, ridership trends, anticipated economic changes, etc). In this context the forecasted cash flow is presented as annualized totals.

Furthermore, forecasts must clearly distinguish operating and capital expenses. The time horizon for operating forecasts will cover at least the next 5-year millage cycle, while capital costs are projected over a ten-year timeframe due to longer project-development and implementation cycles.

Evidence

- **Operations:** Six-year forecast of revenues, expenses and cash flow for operating costs are presented on page 20 of the FY 2019 Budget. We believe that these projections are realistic in light of historic trends as seen on page 17 and assumptions starting on page 18. In general, forecasted revenues and expenses are expected to increase about 2.5% each year (2019-2025) via inflation. Additional details about assumptions for the operating budget can be found in the appendix of the 2019 Budget, starting on page 26.
- **Capital:** The 10-year forecast of capital expenses and annual cash flow, as well as assumptions, are presented on pages 21-23 of the recommended FY 2019 Budget. Capital cost forecasts also include an inflationary factor (about 3%) and a staggered implementation of capital projects in particular years (as described in the Strategic Business Plan and appendix of the 2019 Budget).

Executive Limitations Policy 2.4.4

...the CEO shall not cause, allow or fail to address budgeting that... Is unclear about long-term funding needs and growth projections.

Compliance: In Compliance.

Current Interpretation & Rationale

I interpret this policy to mean that the recommended annual budget must anticipate and clearly account for the funding required in future years to 1) maintain existing services, 2) maintain assets as per policy 2.8: Asset Protection, 3) mitigate against foreseeable risks, and 4) implement plans for change adopted by the agency (e.g. expansion plans, new services, etc).

In this context I believe that "needs" will be clear when specific priority expenditures (e.g. projects, initiatives, line items, etc) are identified in annual budget, and when the scope and rationale for the expenditures is provided and is acceptable for the full Board. Clarity also requires:

- Realistic estimates of future costs,
- Adjustments for inflation and other reasonable assumptions about future economic conditions,
- Accounting for full-year costs of earlier partial-year initiatives, and
- Anticipation of operating costs that accompany new capital projects (e.g. staffing for a new building).

I interpret a "growth projection" to mean forecasts of changes in expenditures and revenues which are used to guide budget development.

I believe that "long-term" for budgeting purposes means that operational needs will be illustrated for at least a rolling five-year period, and capital for a rolling ten-year period. A longer-range forecast/plan can be adopted if helpful, for example based on a long-range service plan.

Evidence

- **Operating Needs:** The recommended 2019 Budget contains the expenditures necessary to maintain all existing services. As noted on pages 14, 15 and 19 all services are maintained at existing levels, except for an increase of frequency of service on Route 4 on Sundays. Forecasts of operational revenues and costs for 2019-2025 are provided on page 20 of the 2019 Budget. Recent historic trends are illustrated on page 17.
- **Capital Needs:** As illustrated on page 23 of the recommended 2019 Budget, ten years' worth of projected capital needs have been organized into four categories: State-of-Good-Repair, Value Added, Expansion, Research and Development. The first two categories are well populated with projects for maintaining and improving existing services and infrastructure. The "Expansion" category will be populated by projects derived from the Long-Term Service Planning effort called for in the budget and Strategic Business Plan.
- **Risk:** Risks and mitigations are discussed in the 2019 Budget on page 19. The Budget has a contingency of 2.8%, as well as a budgeted surplus (Reserve Retainage) of about \$93,000.

- **Strategic Business Plan:** The operational and capital projections in the 2019 Budget are further contextualized by the timeline of major initiatives provided in the Strategic Business Plan on page 14.

Executive Limitations Policy 2.4.5

...the CEO shall not cause, allow or fail to address budgeting that... Allows inefficiencies due to over or under-funding.

Compliance: TBD

Current Interpretation & Rationale

- TBD

Evidence

- TBD

[See first page for discussion of this section.]

Executive Limitations Policy 2.4.6

...the CEO shall not cause, allow or fail to address budgeting that... Causes deficit spending.

Compliance: In Compliance.

Current Interpretation & Rationale

I interpret this policy to mean that the TheRide should not risk financial jeopardy or services to existing passengers by budgeting or allowing overall spending to exceed revenue (i.e. deficit spending). For annual budgeting, this means that:

- Proposed expenses (operating and capital) in the recommended annual budget must be equal to or less than anticipated revenues,
- New expenses cannot create unfunded liabilities in future years.
- We cannot use reserves to pay for ongoing operating costs, and
- Should debt-financing be recommended as a part of an annual budget, the costs of financing a debt will be clearly articulated and will not cause operating deficits.

It is not acceptable to increase short-term spending by creating future financial burdens that are imprudent or excessively risky, or not clearly identified for the full Board. Specifically, ongoing operating costs cannot be funded by debt, drawing down the reserve (unrestricted net assets account), or under-funding capital or maintenance activities. While multi-year forecasts can show projected deficits as part of the financial planning exercise, the CEO will not recommend an annual budget for approval that includes deficits.

Furthermore, during a fiscal year should it become apparent that total annual expenses will actually exceed total revenue, the CEO is required to adjust spending or revenue to avoid deficit spending.

I further interpret this policy to mean there could be emergency situations in the future where short-term deficit spending is a prudent course of action (e.g. disaster recovery, etc). Such spending can be recommended by the CEO but would need to be approved by the Board.

Evidence

The FY 2019 Budget:

- Proposes total expenses (\$45,857,698) that are lower than total revenues (\$45,951,245), and a surplus (Reserve Retainage) of \$93,547 (p. 17).
- Creates no unfunded liabilities in FYs 2020-2025 (p. 20). There are no anticipated unfunded liabilities such as unfunded pensions or post-employment benefits in the FY2019 budget. The FY2017 fiscal year audit did identify an unfunded accrued liability for post-employment benefits other than pensions of \$1.3 million (see the FY2017 audit, pp. 22-23). In their presentation to the Board at the February 2018 Board Meeting, the auditing firm recommended that this liability be reported in the FY2018 financial statements. THERIDE will comply and the liability will be reflected in the year-end financials to be presented in November. The scheduling of this liability should not result in deficit spending for FY2018 as there is a projected operating surplus of \$1.4 million.

As illustrated on page 17, funding sources (i.e. revenue) do not include any contribution from the reserve account. The reserves (unrestricted net assets account) continues to grow, albeit slowly (p. 11), with a

budgeted \$93,547 contribution in FY 2019 (p. 17). However, the reserve will naturally fluctuate with cash flow through FY 2019, as discussed below.

The AAATA carries no debt. This is validated by the 2017 audit conducted by Plante Moran (Board Packet for February 2018) and demonstrated on the balance sheets of the Quarterly Financial Reports, and most recently the Third Quarter reports from August 2018. Both of these documents are available on TheRide's website.

Executive Limitations Policy 2.4.7

...the CEO shall not cause, allow or fail to address budgeting that... does not provide for adequate reserves...

Compliance: Not in compliance. Plan in place.

Current Interpretation & Rationale

I interpret this policy to mean that TheRide must have enough liquid financial resources readily available to prevent interruption to regular agency operations in the event of disruption to agency funding sources. For example, we need to have enough money to make payroll should funding from the State of Michigan or federal government be delayed (as has occurred in the past). Processing errors and federal government shutdowns have caused such delays in the past.

I define "adequate" to mean 2.5 months' worth of regular operating expenses (excluding one-time expenses). We will consider TheRide to have adequate reserves when we have a minimum of 2.5 months of operating expense in reserve for 12 consecutive months. A ratio is preferable to a fixed dollar amount as it will keep pace with budget changes. The specific threshold of 2.5 months is considered reasonable based on industry practice and agency history.

Evidence

According to the 2018 Third Quarter Financial Statements (August 2018), the reserve contained \$8.8 million, or 2.48 months of operating expense. As of September 2018, Year End projections for FY 2018 anticipate a surplus (Budget page 17) which will be directed to the reserve. The budget surplus in FY 2019 will also be directed to the reserve. As noted under policy 2.4.6 above, there are no plans to use the reserve to pay for any expenses. However, the recording of unfunded pension liability as recommended in the FY2017 audit, along with increasing annual operating expense for FY2019, will cause the reserve balance to drop in the first quarter of FY2019 to about \$7.4 million or 1.95 months. This will be a temporary setback on our progress on the reserve. Final compliance with this policy is still likely a few years away but progress is being made.

The Government Finance Officers Association (GFOA) best practice recommends, at a minimum, that governments maintain at least two months of regular operating expenditures in reserve. However several factors should be considered including the predictability of revenues, volatility of expenditures, and other considerations. (See <http://www.gfoa.org/fund-balance-guidelines-general-fund>). The CEO and CFO believe that 2.5 months should continue to be TheRide's objective based upon GFOA's recommendations and considering that state and federal grant funding can be unpredictable.

Executive Limitations Policy 2.4.8

...the CEO shall not cause, allow or fail to address budgeting that... Provides less for Board prerogatives during the year than is set forth in the Cost of Governance policy.

Compliance: In compliance.

Current Interpretation & Rationale

I interpret this policy to mean that the budget must include funds for Board to do its work and that the amount of funding be determined by the Governance Committee. This year the Governance Committee accepted a staff recommendation of a budget of \$50,000, the same as in FY 2018. Examples of past expenses in this area have included group and individual education and training, facilitators, and governance advisors.

Data and Metrics:

\$50,000 included in Budget, in "other expenses." While this line item is not called out specifically in the budget, the amount is included in Account 300,509,103 (Board Governance and Training).

(To be filled in based on Board action after submission)

Policy: 2.4 Financial Planning/Budgeting

Date Submitted: Sept 14, 2018

Date of Board Response: Sept 20, 2018

The Board has received and reviewed the CEO's Monitoring Report references above. Following the Board's review and discussion with the CEO, the Board makes the following conclusions:

Executive Limitations Report (select one)

The Board finds that the CEO:

- A. Is in compliance
- B. Is in compliance, except for item(s) noted.
- C. Is making reasonable progress toward compliance.
- D. Is **not** in compliance or is **not** making reasonable progress toward compliance
- E. Cannot be determined.

Board notes: