Forecasting is not just for weather – Budgets too!

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Forecasting and Long-Term Financial Planning

Benefits of forecasting our financial data and utilizing a long-term financial approach are clear:

- Achieve Goals
  - Improve credit rating and financial position
  - Provide residents with new/improved resources and programs
  - Implement tools to increase organizational efficiency
- Problem Solving and Avoidance
  - See problems coming before they are imminent
  - Financial flexibility to handle the unknown
- Efficient Planning
  - More focused budget workshops and meetings
  - Data and support readily available for discussion

Forecasting and Long-Term Financial Planning

Forecasting ⇄ Long-Term Planning & Policy

- Financial forecasting is the process of projecting revenues and expenditures over a long-term period, using assumptions about economic conditions, future spending scenarios, and other variables.
- Long-term financial planning combines financial forecasting with strategizing. It is a highly collaborative process that considers future scenarios and helps governments navigate challenges where we can align our long-term objectives with our financial capacity.

Success in these areas requires collaboration at all levels of the organization:

  - Assumptions required
  - Defined policies required to guide Governing Body and decision makers

Adopting Financial Policies

Financial policies are central to a strategic, long-term approach to financial management. Some of the most powerful arguments in favor of adopting formal, written financial policies include their ability to help governments:

1. Institutionalize good financial management practices. Formal policies usually outlive their creators, and, thus, promote stability and continuity. They also prevent the need to re-invent responses to recurring issues.
   - Roadmap for Governing Body and decision makers
   - Restriction to outside pressures

2. Define boundaries. Financial policies define limits on the actions staff may take. The policy framework provides the boundaries within which staff can innovate in order to realize the organization's strategic intent.
   - Promotes safeguards and controls
   - Segregation of duties

Adopting Financial Policies

3. Support good bond ratings and thereby reduce the cost of borrowing
    - Bond ratings are a tangible metric of financial position

4. Promote long-term and strategic thinking. The strategic intent articulated by many financial policies necessarily demands a long-term perspective from the organization.
    - A strong financial position is cultivated slowly year by year

5. Manage risks to financial condition. A key component of governance accountability is not to incur excessive risk in the pursuit of public goals. Financial policies identify important risks to financial condition.

6. Clarify and crystallize strategic intent for financial management. Financial policies define a shared understanding of how the organization will develop its financial practices and manage its resources to provide the best value to the community.

Adopting Financial Policies

Steps to consider when making effective financial policies include

1. Scope – Financial categories to consider for a formal policy
2. Development - Create, Review, Adopt, and Implement
3. Design – Form and availability
4. Presentation and review – Organized, reviewed, and updated as needed in a systematic fashion

Financial Policies - Scope

Fund Balance

- A formal policy on the “Appropriate” level of unrestricted fund balance that should be maintained
- “Appropriate” level is unique to each entity. Factors to consider:
  - Capital and operational needs
  - Revenue volatility
  - Exposure to one-time outlays (Disasters, State Aid cuts, etc)
- Use and Replenishment
  - The fund balance policy should define conditions warranting its use, and if a fund balance falls below the government’s policy level, a solid plan to replenish it.
  - Generally, governments should seek to replenish their fund balances within one to three years of use.

Financial Policies - Scope

Fund Balance (Continued)

GUIDELINE 1: Surplus included as revenue in any annual budget should not exceed the amount of surplus generated in the prior calendar year. *Surplus included as revenue is essentially a contingency reserve or cushion within the budget, intended to protect the Borough against revenue shortfalls and to provide funds should additional spending be needed for operations. The intent of this guideline is to smooth or stabilize the amount of surplus used in the annual budget while allowing modest increases over time. The prior year constraint helps prevent surplus from falling below desired levels. The use of such a constraint is a practice rating agencies prefer to see*

GUIDELINE 2: Surplus at the end of any calendar year should be 20-25% of total appropriations for the coming year. *The guideline range (a) provides a prudent amount of "surplus as revenue" for inclusion in the annual budget while (b) maintaining an ample balance sheet reserve for emergency situations; unique, one-time developments; and contingent liabilities. The range is also consistent with best municipal practices, third-party analyses and rating agency criteria for the most highly rated municipalities.*

GUIDELINE 3: Surplus in excess of the upper end of Guideline 1B range (i.e., >25%) may only be used for the Capital Improvement Fund (CIF) or to pay down debt (including prefunding of obligations). *The intent is for "excess surplus" to be used for improving the long-term financial condition of the Borough, not for near term or operating appropriations.*

Financial Policies - Scope

<u>Debt Management</u>

- Debt management policies are written guidelines, allowances, and restrictions that guide the debt issuance process
- Adherence to a debt management policy signals to rating agencies and the capital markets that a government is well managed
- Examples:

1. <u>**Debt Limits**</u>

- Setting specific limits or acceptable ranges for each type of debt. Limits generally are set for legal, public policy, and financial reasons.
- Measurement ratios: Debt per capita, Debt to personal income, Debt to taxable property value, and Debt service payments as a percentage of general fund revenues or expenditures

GUIDELINE 1: Debt service (interest and principal) within the municipal budget should not exceed 10% of total appropriations.

GUIDELINE 2: No bond ordinance shall be finally adopted if it appears from the supplemental debt statement required by this chapter that the percentage of net debt as stated therein pursuant to 40A:2-42 exceeds 3 ½%

Financial Policies - Scope

Debt Management (Continued)

2. **Debt Structure**

- Maximum term (often stated in absolute terms or based on the useful life of the asset(s)
- Average maturity
- Debt service pattern such as equal payments or equal principal amortization

GUIDELINE: New borrowing should generally be limited to capital assets having a useful life of at least 15 years. Exceptions can be made for a capital asset that generates revenue and produces a reasonably attractive return on the investment required for the asset.

3. **Debt Issuance**

- Selection and use of professional service providers
- Criteria for issuance of advance refunding and current refunding bonds
- Criteria for determining the sale method

3. **Debt Management**

- Investment of Bond Proceeds
- Market disclosures, annual certification, and federal/state compliances
- Arbitrage monitoring and filing

Financial Policies - Scope

Capital Projects and Planning

- Effective policies help a government to assure the sustainability of its infrastructure by establishing a process for addressing maintenance, replacement, and proper fixed asset accounting over the full life of capital assets
- A sustainable capital plan must consider all capital needs as a whole, assess fiscal capacity, plan for debt issuance, and understand impact on reserves and operating budgets, all within a given planning timeframe.
- **Examples:**

1. A clear definition of what constitutes a capital improvement project
2. A description of the role of the public and other external stakeholders in the process
3. A requirement that the planning process includes an assessment of the government' fiscal capacity so that the final capital plan is based on what can realistically be funded by the government rather than being simply a wish list of unfunded needs.
4. A procedure for accumulating necessary capital reserves for both new and replacement purchases

GUIDELINE: The Capital Improvement Fund (CIF) line item in each municipal budget should be at minimum 2% of total budgeted appropriations

Financial Policies - Scope

Other Policy Categories

- Investments
- Financial Reporting
- Risk Management and Internal Controls
- Annual Budget Process
- Economic Development
- Revenue and Expenses

Forecasting in the Budget Process

- Integral to the budget process
- The purpose of the financial forecast is to evaluate current and future fiscal conditions to guide policy and programmatic decisions
- Help identify future revenue and expenditure trends that may have an immediate or long-term influence on government policies, strategic goals, or community services.
- Best Practices:
  - GFOA recommends that governments at all levels forecast major revenues and expenditures
  - The forecast, along with its underlying assumptions and methodology, should be clearly stated and made available to stakeholders in the budget process
  - The forecast should be regularly monitored and periodically updated.

Forecasting in the Budget Process

- Six Step Process
    1. Define Assumptions
    2. Gather Information
    3. Exploratory Analysis
    4. Select Methods
    5. Implement Methods
    6. Utilize Forecasts

Forecasting – Define Assumptions

- What is the time horizon?
  - Usually looking 5-10 years out
  - Forecast becomes more generic as years are extended
- What is the objective of the forecast?
  - Conservative Approach – Underestimate revenues and build in contingencys for expenditures. Might make it harder to balance the budget, but will reduce long term risk.
  - Objective Approach – Estimate revenue and expenses as accurately as possible. Easier to balance the budget, greater risk in shortfall.
- What are the political/legal issues related to the forecast?
- What are the major revenue and expenditure categories?

Forecasting – Gather Information

- Engage resources to obtain information on future performance and impactful events:
  - Department Heads
  - Governing Body
  - Outside professionals (auditors, advisors, legal team)

- Examine historical data
  - Past budgets
  - Financial results

- Communication is essential!
  - Contracts, capital plans, financial agreements, redevelopment, etc

Forecasting – Analysis

- Engage resources to obtain information on future performance and impactful events:
  - Department Heads
  - Governing Body
  - Outside professionals (auditors, advisors, legal team)

- Examine historical data
  - Past budgets
  - Financial results

Forecasting – Analyze, Implement, and Present

- Presentation of a Financial Forecast
  - Build the message around a baseline set up assumptions that represent a reasonable level on consistency
  - Any assumptions that stray from the norm should be clearly stated
  - Avoid overpromising and communicate the future conditions are subject to change
  - Describe forces that may cause actual results to stray from the forecast and briefly discuss how these forces would affect the predicted analysis

Examples in Municipal Budgets:

- Salary and Wages
- Other Operating Expenses
- Revenues
- Fund Balance
- Debt Service
- Capital Purchases Plans
- Cash Flow

Sources:

- Governmental Finance Officers of America – Best Practices https://www.gfoa.org/best-practices
- Township of Verona – Policy and Procedure Manual
- Borough of Madison – 2014 Strategic Plan Initiative