DEKALB COUNTY, ILLINOIS

AGREED-UPON PROCEDURES REPORT

APRIL 30, 2012

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INDEPENDENT ACCOUNTANT'S REPORT
ON APPLYING AGREED-UPON PROCEDURES

The Honorable Chairman
Members of the County Board
C/O Mr. Gary Hanson
Deputy County Administrator
DeKalb County
250 North Main Street
Sycamore, Illinois 60178

Ladies and Gentlemen:

We have performed certain agreed-upon procedures enumerated in the accompanying prescribed report, which were agreed to by DeKalb County, Illinois (the County), relating to an analysis of the targeted and minimum fund balance for the County's general fund. The County's management is responsible for the County's accounting records and related policies such as fund balance policies. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in the report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures we performed are specified in the attached report.

We were not engaged to, and did not, conduct an audit, the objective of which would be the expression of an opinion, on the accounting records. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the Chairman, members of the County Board and management of DeKalb County, Illinois and is not intended to be and should not be used by anyone other than those specified parties.

Sikich LLP

Naperville, Illinois
April 30, 2012

DEKALB COUNTY GOVERNMENT

FUND BALANCE ANALYSIS

I. Introduction

Fund balances and targeted fund balances are the cornerstone of financial flexibility and short-term and long-term financial planning. Adequate fund balances provide the County with options to respond to many issues and afford a buffer against shocks and other forms of financial risk. A fund balance financial policy helps the organization answer these fundamental questions.

The general fund's target fund balance is typically the most important one a government maintains. The report is focused primarily on the general fund; however, we considered other funds specified by the County as part of the analysis.

II. Major Reasons for Adopting a Targeted Fund Balance Policy

The primary reason for a target fund balance policy is to plan for contingencies (e.g., future emergencies). Other reasons exist for keeping a policy, though. Five major purposes for a target fund balance policy are cited below.

A. Plan for Contingencies

No guarantees exist that governments will always be able to match planned revenues with actual expenditures for any given fiscal year. Reliance on elastic revenue sources - such as sales and income taxes - results in a volatile revenue structure. Local events, such as the closure of a major employer, can also negatively affect revenues. Finally, extreme events (major winter storms or floods, for example) can increase operating costs (e.g., public works crews for snow removal) or capital costs (e.g., new infrastructure needed due to storm damage).

B. Maintain Good Standing with Rating Agencies

Bond rating agencies (such as Standard and Poor's, Moody's, and Fitch Ratings) evaluate several financial indicators to assess a government's fiscal health and the overall economic health of the community at large. An adequate level of fund balance is considered a sign of creditworthiness because it enhances a government's ability to repay debt on time and in full. Fund balances should be maintained at an appropriate level considering the locality's own unique characteristics. Rating agencies generally view sudden, unplanned drops in fund balances unfavorably.

II. <u>Major Reasons for Adopting a Targeted Fund Balance Policy</u> (Continued)

C. Avoid Interest Expenses

There are two main methods for avoiding interest expense through the use of fund balance reserves: 1) fund capital projects using reserves rather than debt and 2) cover expenditures when revenue is unavailable using fund balance reserves instead of debt. Capital projects that are funded using current resources are typically referred to as pay-as-you-go projects. Using pay-as-you-go financing allows a government more spending flexibility as less revenue is used to meet future debt service obligations. Historically the County has funded most capital needs for equipment, rolling stock and building improvements from existing resources, accessing the debt market only for very large projects (e.g., Nursing Home and Courthouse).

D. Generate Investment Income

Fund balance reserves can be a source for investment yield, thereby diversifying the government's revenue streams and decreasing reliance on taxes. A well-planned investment program that considers diversity, yield, and maturities can generate additional revenue to supplement the annual recurring revenue streams.

E. Ensure Cash Availability When Revenue is Unavailable

Implementation of a fund balance reserve policy allows governments to have funds available during periods of the year when revenue inflows are slow. A common example is property tax revenues that are received primarily at two points during the year, which must then last through the interim. Maintaining adequate reserves can balance intra-period differences in revenue availability and revenue streams.

III. <u>General Fund Target Fund Balance Reserve Policy</u>

The general fund's fund balance reserve is often the most important reserve for a local government because the general fund accounts for most general government services, including critical services like public safety.

A. Fund Balance Reserve Level Targets

A policy must set a target level of fund balance reserves to maintain. The target is typically defined in terms of unrestricted fund balance as a percentage of either regular operating revenues or regular operating expenditures (as such, general fund reserve policies are often also called "fund balance policies"). A common alternative target is to measure reserves as a certain number of month's worth of revenues or expenditures.

With the basis of the target defined, the next step is to select a reserve level target number. The Government Finance Officers Association (GFOA) recommends, at a minimum, that general-purpose governments, regardless of size, maintain unrestricted fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures.[i]

III. <u>General Fund Target Fund Balance Reserve Policy</u> (Continued)

A. *Fund Balance Reserve Level Targets* (Continued)

However, the GFOA recommendation is only a baseline, so needs to be adjusted according to local conditions and risks. To make the adjustment, finance staff should conduct an analysis of the risks and drivers that influence the need for maintaining reserves as a hedge against uncertainty and loss. A "risk" is defined as the probability and magnitude of a loss, disaster, or other undesirable event.[ii] A fund balance reserve is one tool that governments can use to mitigate risk. A "driver" is some other factor that doesn't necessarily entail a potential loss, but still influences the desired fund balance reserve target. In many cases, a driver will not have a direct impact on the desired fund balance target level, but will have an influence on how the risk factors are considered thereby impacting the target level.

B. Types of Risks

1. **Vulnerability to extreme events and public safety concerns.** This factor concerns the extreme events (e.g., natural disasters) a community is vulnerable to, the public safety programs that must be funded during the occurrence of an extreme event, and the federal or state programs that would help and how long it would take to get assistance. Reimbursement from the Federal Emergency Management Agency may not occur right away, so it is important that the County maintain reserves to absorb the cost in the meantime.

   For the County analysis, specific extreme event risks considered were extreme losses from a workers' compensation loss, general liability loss, and natural disasters as the county is self insured for these risks.

2. **Revenue source stability.** Volatile revenue sources call for higher level of fund balance reserves in order to avoid the need for sudden cutbacks in services. Some revenues are inherently volatile. For example, sales taxes (about 21% of total general fund revenues) are very sensitive to swings in the economy. Concentration of the tax base in a particular industry or entity is also an important consideration.

   For the County analysis, we assessed all of the County's major revenue streams in the general fund and assessed the potential negative variation from the average as well as the probability of negative variation in the next three years.

3. **Expenditure volatility.** This risk factor refers to potential spikes in expenditure, usually arising from a special, non-recurring circumstance.

   For the County analysis, we assessed significant expenditure sources identified by the County and assessed the potential magnitude of costs associated with each source. Sources assessed include personnel costs (health insurance, pension, union costs) and costs associated with the housing of prisoners.

III. General Fund Target Fund Balance Reserve Policy (Continued)

B. Types of Risks (Continued)

4. **Leverage.** A highly leveraged organization has less flexibility. Examples of leverage include unfunded asset maintenance or replacement needs, long-term debt, and pension obligations. Reserves are a critical source of financial flexibility, so high leverage may call for higher reserves.

   The County examined unfunded pension liabilities, OPEB liabilities and liabilities for compensated absences and found that all of these potential liabilities were adequately funded, so leverage did not significantly impact the County reserve amounts. DeKalb County also carries a relatively low level of debt for a government of its size.

   For the County analysis, we also considered that the County had balances in other funds that were specified as part of our analysis. $2,400,000 of these fund balances were deemed available for the General Fund and were utilized to reduce the targeted and minimum fund balance amount based on input from the County. The balances in these funds at December 31, 2011 were as follows:

Source	Balance – December 31, 2011
Retirement Fund	$1,259,705
Medical Insurance Fund	1,045,897
Tort & Liability Fund	4,627,342
Renewal & Replacement Funds	2,867,464
Asset Replacement Fund	3,076,285
Special Projects Fund	887,645
Total	**$13,764,338**

5. **Budget practices.** The County does not have significant contingencies built into its budget. As the budget is lean, the general fund and other specified funds fund balance reserves are looked to as the source of contingency, then the general fund reserve must to be of sufficient size to fill this role.

   For the County analysis, the County concluded that based on current fund balance levels that a contingency of approximately 2.5% of 2012 budgeted expenditures was appropriate.

6. **Liquidity.** A larger amount of unrestricted fund balance may be needed to avoid cash flow problems if the average maturity of receivables significantly exceeds the average maturity of payables. A common example of this can be found in governments that are heavily reliant on property taxes. The bulk of taxes may only be received at one or two points during the year, requiring reserves to bridge the months with lower receipts.

   For the County analysis, we included the General Fund as well as other funds provided by the County that rely on the General Fund to bridge the timing gap between receipts.

III. General Fund Target Fund Balance Reserve Policy (Continued)

7. Borrowing

The County received a bond rating from S&P in 2010 of Aa1.

For the County analysis, we calculated the following ratios:

Debt Measure	Your Value	S&P Range Risk
Overall Net Debt per Capita	$ 213.11	Low
Overall Net Debt as a % of Equalized Assessed Value	**0.34%**	**Low**
Debt Service as a % of Expenditures	**2.59%**	**Low**

Based on the above ratios and recent bond rating as well as the consideration of other funds that have sizable reserves compared to the risks they are retaining, the County could potentially justify reduced general fund fund balance reserve targets.

While the County can not issue general obligation bonds without voter approval, it can access the general obligation alternative revenue source bond market. However, internal borrowing should not be considered an alternative without a strong internal borrowing policy in place.

IV. Summary Reserve Analysis

See Appendix A for calculations.

V. Conclusion

Based on the factors and assumptions discussed above, the calculated overall fund balance target is $8,065,000 (35% of 2011 general fund expenditures). If balances are not available from the "leverage" category, the target unassigned fund balance would be increased to $10,465,000 (45% of 2011 general fund expenditures). Appendix A provides additional information on the calculations that were performed to determine the overall target and minimum recommended targets. It is imperative to note that these targets are based on the information and assumptions provided to us by the County. These targets should be re-evaluated and refined annually or more frequently if needed to address changes in the operating or financing environments of the County.

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[i] GFOA Best Practice. "Appropriate Level of Unrestricted Fund Balance in the General Fund." Government Finance Officers Association. 2009.

[ii] Definition of risk taken from: Douglas W. Hubbard. *The Failure of Risk Management: Why It's Broken and How to Fix It.* John Wiley and Sons, Inc. Hoboken, New Jersey. 2009.

APPENDIX A - FUND BALANCE TARGET

		Amount
A	**CURRENT STATUS - AUDITED**	
(1)	County General Fund Revenues for Fiscal Year 2011	24,980,840
(2)	County General Fund Expenses for Fiscal Year 2011	23,232,116
(3)	*Unassigned Fund Balance as of 12-31-2011*	11,351,661
(4)	Unassigned Fund Balance as Percent of Expenditures	49%
B	**IDEAL UNRESERVED FUND BALANCE TARGET**	
(1)	Vulnerability to Extreme Events	65,000
(2)	Revenue Source Stability	1,500,000
(3)	Expenditure Volatility	250,000
(4)	Leverage	(2,400,000)
(5)	Budget Practices	650,000
(6)	Liquidity	8,000,000
(7)	Borrowing	0
(8)	Total Target Unassigned Fund Balance 12-31-2011	8,065,000
C	Target Unassigned Fund Balance as % of Expenditures	35%

D Note: If balances are not available from the "Leverage" category then the "Target Unassigned Fund Balance" amount would be increased to $10,465,000 or 45% of Expenditures.

APPENDIX B

Fund Balance Terminology

In governmental funds, "reserves" typically comprise a portion of total fund balance. Fund balance reporting standards play a large part in defining how much of fund balance might be available for a "reserve" and how much is for other purposes. GASB Statement No. 54, "Fund Balance Reporting and Governmental Fund Type Definitions" fundamentally altered how fund balance has traditionally been reported. In the past, reporting of fund balance focused on whether resources were available for appropriation (i.e., budgeting) and distinguished between "unreserved fund balance (i.e., available for appropriation) and reserved fund balance (i.e., not available for appropriation). GASB 54 changed the focus to the "extent to which the government is bound to honor constraints on the specific purposes for which amounts in the fund can be spent."[i] GASB 54, which was implemented by the County for the fiscal year ended December 31, 2011, establishes five different components of fund balance:

- **Non-spendable fund balance.** Fund balance in this category is inherently non-spendable, such as the long-term portion of loans receivable, the principle of an endowment, and inventories.
- **Restricted fund balance.** This category has externally enforceable limitations on the use of fund balance, imposed by parties such as creditors, grantors, or laws or regulations of other governments.
- **Committed fund balance.** This encompasses limitations imposed by the government on itself at its highest level of decision-making (e.g., governing board). For example, the governing board might like to commit a portion of fund balance to a "stabilization fund" to provide a cushion against unknown economic shocks and revenue declines.
- **Assigned fund balance.** This category is for the portion of fund balance that is for an intended use. The intent is established at either the highest level of decision-making or by a body or an official designated for that purpose. For example a portion of fund balance might be assigned to the purpose offsetting a gap in the budget stemming from a decline in revenues or a portion could be assigned to pay for an upcoming special project.
- **Unassigned fund balance.** This encompasses all fund balances that are left after considering the other four categories. This is the category of fund balance where use is least constrained.

The last three components together comprise "unrestricted fund balance." Unrestricted fund balance is typically going to be the subject of a fund balance reserve policy. This is because unrestricted fund balances are either unconstrained or the constraints are self-imposed so could be lifted in order to free up fund balances for other purposes. Conversely, restricted fund balances or non-spendable fund balances are not very fungible, so are ill suited too many of the purposes a reserve policy typically is intended to fulfill (e.g., buffer against shocks, provide working capital).

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[i] GASB Statement No. 54, paragraph 5.