SIGNIFICANT FINANCIAL AND BUDGETARY POLICIES

The basic policies related to the City's financial and budgetary procedures were formalized on November 10, 1987. These procedures were expanded in subsequent years with the adoption of the Integrated Budgeting and Planning Resolution (88-87), the Budget Calendar Ordinance, as amended (94-1211) in November 1994, as well as annual adopted budget ordinances.

Operating Policies

Revenues:

- Current revenues/resources will be sufficient to support current expenditures/expenses to present a balanced budget as defined.
- Each enterprise fund will maintain revenues to support the full (direct and indirect) cost of services provided.
- An annual review of all fees and charges will be conducted to determine the extent to which the full cost of services are being recovered by revenues.

Expenditure/Expense:

- The Mayor has the authority to transfer funds to and from the budget accounts within any department without limitation. In addition, the Mayor can authorize the transfer of funds from one department to another department within the same fund; however, such transfer cannot exceed 5% of the department's budget expenditure account group.
- All retirement and employee benefit systems will be financed in a manner to systematically fund liabilities. The City will assure that sufficient funds are provided to pay for current service plus interest on the unfunded liability plus authorization of the unfunded liability over a programmed period of time.
- City programs will be self-supporting unless City Council specifically determines that they are to be subsidized by general revenues.
- Recurring expenditures/expenses are to be funded with recurring revenue sources.
- The Beginning Fund Balance/Equity reflected in the Budget shall automatically be adjusted to the amount of the Ending Fund Balance/Equity as reported in the Comprehensive Annual Financial Report for the prior year. The revised Beginning Fund Balance/Equity shall thereafter be used to calculate the Ending Fund Balance/Equity. This policy applies to all funds for which an annual budget is adopted by the governing body.
- The Undesignated Fund Balance in the General Fund shall be maintained at a level sufficient to provide for temporary financing of unforeseen needs of an emergency nature and to permit the orderly adjustment to changes resulting from the termination or drop in a revenue sources(s). The level of the Undesignated Fund Balance in the General Fund will be a minimum of 5% of total expenditures less debt services, operating transfers and non-recurring costs.
- The City has created a Rainy Day Fund, which is a part of the General Fund balance. This fund is to be used only in case of an emergency.

Capital and Debt Management Policies

- Any capital project or equipment funded through the issuance of bonds will be financed for a period not to exceed the expected life of the project/equipment.
- Weighted average general obligation bond maturities will be kept at or below 12 years.
- Annual general obligation debt service (contribution) will not exceed 20% of the total General Fund revenue, excluding state and federal grants.
- To take advantage of the yield curve, up to 20%-30% of the outstanding general obligation debt may be maintained as variable rate debt.
- The attendant long-term debt and the maintenance and operating costs are an integral part of the five-year Capital Improvement Plan.
- The City will issue short-term securities for the purposes of providing 1) interim financing for long-term capital projects 2) financing of short-term assets at or near the useful life 3) interim cash-flow/working capital needs as they arise and 4) to reduce the overall interest cost of debt financings of the City.

Accounting, Auditing and Financial Planning Policies

- Financial statements are prepared in accordance with Generally Accepted Accounting Principles (GAAP).
- An annual audit is performed by an independent public accounting firm in accordance with Generally Accepted Auditing Standards. The auditor's opinion is to be included as part of the Comprehensive Annual Financial Report (CAFR).
- Full disclosure is provided in the CAFR as well as in any Official Statements as it relates to bond sales.

These policy statements are intended to serve as guidelines for financial practices and budgetary formulation and administration. Therefore, they have been applied in establishing specific assumptions and methods used in preparing the FY2007 Budget, as exhibited by the following methods.

Basis of Budgeting and Accounting

In general, the basis of budgeting and the basis of accounting used in the preparation of the City's annual financial report are the same for all governmental funds without exception. Revenues and expenditures are budgeted consistent with the City's financial statements, which are prepared in accordance with General Accepted Accounting Principles for all governmental funds.

Governmental funds are accounted for on a modified accrual basis, with revenues recorded when measurable and available and expenditures recorded when the services or goods are received and the liabilities are incurred with the exception of liabilities recorded in the General Long-Term Debt Account Group.

Significant receivables (revenues) and liabilities (expenditures) are recorded in the prior year's budget up to sixty days after fiscal year end if they represent earned income or expenditures as of June 30, the last day of the fiscal year. This includes the cost of employees' time as well as supplies, services, and equipment delivered by June 30.

- Significant governmental fund liabilities for salary and related accruals include the following:

  - Termination pay for accrued vacation and sick leave: Upon termination or retirement, employees are paid up to 90 days for unused vacation leave. If the employee is covered under the compensable sick leave plan, accrued unused sick leave time allowances exceeding 1,040 hours of employee's sick leave time balance are payable to the employee.

  - Workers Compensation claims: Full accrual of all incurred But Not Reported (BNR) claims in enterprise funds, until total fund expenditures equal the amount appropriated for all maintenance and operating expenditures.

  - Compensatory time payable under the Fair Labor Standards Act and local ordinance.

  - Full accrual of all accrued time, including that portion that may be used and not paid to the employee, until total fund expenditures equal the amount appropriated for all operating expenditures.

For enterprise funds, the budgeting and accounting basis are the same except for depreciation. Enterprise funds are accounted for on a full accrual basis. Revenues and expenses are recorded when they are earned/incurred. Enterprise funds focus on expenses related to maintenance and operations, equipment purchases and excludes depreciation and other allocations related to income determination. Revenues received and expenses paid for goods and services delivered by June 30 are credited or charged to the current fiscal year's budget.

Encumbrance accounting is used to reserve funds committed to vendors for supplies, services and equipment throughout the year in all funds. However, encumbrances for items not delivered by June 30 are canceled and re-established against the new fiscal year budget for all operating budgets. Encumbrances do not establish expenditures/expenses or liabilities. Appropriations and encumbrances for capital project funds are maintained in effect until they are liquidated.

Reserves

In every budget since FY1982, the City's fund balance level has been a critical component of the City's financial management program. Likewise, the General Debt Service fund balances have been budgeted to provide adequate reserves for debt service payments in the first seven months of the subsequent fiscal year. Pension fund contributions and employee health care costs have been funded with reserve components through the budget as well. These budgetary policies were recognized in the adoption by City Council of the financial policies previously mentioned.

Reserves exist in two forms:

- Those specifically created by ordinance, and

- Those maintained as unappropriated or undesignated ending fund balance.

Most of the City's budgetary reserves take the form of ending fund balance and are consequently the result of financial activity as presented in the City's financial statements.

General Fund Reserves

The following table shows the ending undesignated fund balance as well as the actual year end maintenance and operating costs (including transfers for debt service) for preceding fiscal years, the estimated year end costs for the current fiscal year and the proposed year end costs for the subsequent fiscal year.

Historical Data FY1995 – FY2007
General Fund Available Fund Balances
($ thousands)

Fiscal Year	Undesignated Ending Fund Balance	M&O Expenditures
FY1995	50,682	849,766
FY1996	69,579	864,668
FY1997	84,105	903,228
FY1998	106,856	956,893
FY1999	80,409	1,030,235
FY2000	66,590	1,064,160
FY2001	79,432	1,105,408
FY2002	80,335	1,206,160
FY2003	83,027	1,199,766
FY2004	88,659	1,235,994
FY2005 Estimate	100,836	1,301,976
FY2006 Budget	100,836	1,375,614
FY2007 Budget		

Debt Service Fund Reserves

The General Debt Service Fund reserves exist to ensure City bondholders that the City of Houston has set aside sufficient resources to meet debt service requirements.

A seven-month reserve is provided for fixed rate obligations. This reserve covers principal and interest amount payable in the first seven months of the following fiscal year for those issues which are funded from ad valorem taxes. This seven-month reserve policy has existed since FY1983 when the current fiscal year (July 1 to June 30) and the tax collection payment date (January 31) was established.

The City is required to maintain additional reserves due to changing interest rates on its variable rate debt (VRD). Reserves on VRDs are based on the difference between a maximum rate of fifteen percent (or the capped rate of the program) and the budgeted interest rate on outstanding variable rate debt during the fiscal year. The City also issues variable rate commercial paper notes. The calculation for reserves on commercial paper notes are based on the difference between a cap of ten percent and the budgeted interest rate on the amount projected to be outstanding during the fiscal year. The reserve requirement may not be necessary in the case that the reserves are covered under a credit agreement.

Enterprise Fund Reserves

The City also maintains enterprise fund reserves, which in most cases, include:

- One to two months' operating budget (8.33% per month of annual maintenance and operating expenses).
- Up to 5% of the value of each system's property, plant and equipment for purposes of renewing and replacing same.
- Amounts sufficient to pay the maximum annual debt service on outstanding bonds. As a result of refunding Combined Utility System bonds and certain bonds of the Airport System, the City has replaced a portion of the cash from the debt service reserve funds with surety bond insurance. The City continues to utilize surety bond policies for the enterprise fund reserves.

Other Fund Reserves

- Pension Funds – The City makes annual contributions to its three employee pension funds in accordance with state law or with "meet and confer" agreements with the trustees of a pension system as authorized by state law. The annual contributions to each plan are based on actuarial analyses, which are performed by independent actuarial firms selected by the respective pension fund board trustees. Actuarial analyses on each of the three systems must be performed at least once every three years.

  The actuarial assumptions and techniques used in the development of each actuarial valuation are discussed and approved by the respective board of trustees in an open meeting, and may also be reviewed by an actuarial firm chosen by the City administration. Details of these assumptions and techniques are summarized in each actuarial valuation, which becomes a public document once it is adopted by the board of trustees of a fund.

- Long-Term Disability

  The Long-Term Disability Plan is designed to provide City employees with an income protection plan in the event they become disabled. The Long-Term Disability Fund was established in FY1991 as an Internal Service Fund to budget and account for the revenues, expenses, and outstanding liabilities.

  Funds are provided to fully fund the outstanding and projected future liabilities from existing (and unreported) claims. These reserves will be adjusted annually based on an actuarial study of the funds.

Workers Compensation Administration

The potential for liability to City employees for injuries incurred while on the job is expanding as the definition of work-related injuries is expanded and more is learned about the hazards of chemicals and materials in the work environment. To handle this increasingly complex subject, the City has taken a proactive approach to its administration of the workers compensation program. Resources from accident prevention and loss control programs were consolidated to enhance the City's efficiency in handling these matters. Accident prevention works closely with loss control to develop programs to reduce the City's exposure in this area. The inclusion of this area in risk management as a revolving fund has allowed the City to focus attention on quantifying the City's liability on existing and unreported claims. Methods are continuously being developed to address the issue of funding this contingent liability.

The City has recently realized a decrease in the number of accidents and an increase in costs. It appears the driving forces behind the phenomenon are the expense of inventory claims and the increasing medical costs in Texas. The passage of time is expected to result in costs plateauing at reasonable levels. This along with the many efforts and initiatives of the Risk Management Division staff should stem the tide of rising medical costs, which will translate to a control of inventory payments.

Emphasis is placed on targeting coordinated accident prevention initiatives, team claims handling approach, enhanced coordination with customer departments, and early intervention to facilitate employees return to work. These efforts should result in decreased amounts paid by the City for workers compensation claims.

Through a needs assessment exercise, the Central Safety Office is committed to tailoring its activities to meet the needs of the customer departments. This is being accomplished by designing programs specific to the department activities and internal resources.

Property and Casualty

The potential liability resulting from injuries, property damage, and torts, which involve City employees, necessitates the property and casualty function. Property and liability insurance protects the City's financial and physical assets from acts of God and other causes or changes. Contributions to this fund are provided by the General Fund, Enterprise Funds, and proceeds from Claims and Judgment Bonds.

Interfund Transfers

Transfers between funds are an integral part of the budget. There are four types of transfers.

- Direct services provided by a department in one fund to a department in another fund, resulting in:
  - Expenditures in the provider fund for all costs incurred in rendering the service;
  - Revenues in interfund billing revenue account in the provider fund; and
  - Expenditures in a single expenditure account in the recipient fund.

  The cost billed includes a proportionate share of overhead costs, as well as all direct costs attributable to the service provided. Major services billed directly are as follows:

Service	**Provider**	**Recipient**
Airport fire suppression	Fire Department	Aviation Department
Airport police protection	Police Department	Aviation Department
Legal services	Legal Department	Various departments/funds
Land acquisition	Public Works & Engineering (PWE)/ Engineering Construction and Real Estate (ECRE) Legal Department	Capital improvement project funds
Design and engineering	PWE/ECRE Building Services Department (BSD)	Capital improvement project funds, grant and enterprise funds
Signal installation	PWE	Street and bridge bond funds
Building maintenance services	BSD	Various other departments (excluding Aviation Department)/ funds.

- Indirect costs are billed to the enterprise, special revenue, and grant funds of the City to recover each fund's proportionate share of the City's central administrative and support costs which are originally borne by the General Fund.

These costs are based on the annual cost allocation plan prepared by the Finance and Administration Department. The City's central service departments provide workload data used in the plan. Costs are taken from the City's audited financial statements. Each administrative and support department's full cost, including overhead (i.e. rent, computer support, fringe benefits, internal administrative costs), is calculated and allocated to all departments that receive the service(s). Certain line items in the enterprise and special revenue funds reflect the payment of these costs to the General Fund.

- Transfers of enterprise fund and operating reserves to sinking funds or reserves for renewal and replacement, maintenance and operations, and debt service are budgeted in the operating budget of each enterprise fund.

- Transfers from the General and Water and Sewer Funds to the General Debt Service Fund, are based upon each fund's allocation share of the annual debt service requirements.

  - The Water and Sewer Fund pays 100% of the debt service on previously issued public improvement bonds originally issued to construct sewer facilities before the former Wastewater Enterprise Fund was established and revenue bonds were utilized for this purpose.

  - The Water and Sewer Fund and General Fund each pay a portion of previously issued water district debt assumed by the City in annexations, based upon the proportionate amount of assets annexed that fall into three categories: water facilities and improvements, sewer facilities and improvements, and drainage or other general improvements. After each annexation, the City's auditors, accounting, financial management, and utility management staff assume the records and facilities of the annexed districts. The proportions used to allocate each district's outstanding debt are developed in proportion to the then-current value of the district's assets.

  - Previously, contract tax obligation payments were paid by the Water and Sewer Fund (Northwest Houston Water Supply Corporation obligations) because those obligations were incurred strictly to provide additional water and sewer system capacity. During FY1994 these obligations were refunded with general obligation refunding bonds. The Water and Sewer Fund continues to pay the refunding debt service related to these obligations.

  - Since 1986, the City has refunded some outstanding annexed water district bonds by issuing new general obligation refunding bonds. A proportionate share of the new debt service resulting from these sales are allocated to Water and Sewer Fund because the annexed water district assets are still held by those systems as a result of the original annexations. After this allocation is made, the Water and Sewer Fund realizes a proportionate share of the savings from the refunding.

  - The General Fund transfer to the General Debt Service Fund is calculated after all of the aforementioned allocations have been made. The transfers are set at a level to ensure that all existing and anticipated debt service obligations will be met and reserve requirements are satisfied.