Agenda Item: 3.1

ISSUE BRIEF:
Monitoring Report for Policy 2.4 Financial Planning/Budgeting

Finance Committee Review Date: September 15, 2020

Board Meeting Review Date: September 24, 2020

INFORMATION TYPE:

Decision

RECOMMENDED ACTION(S):

That the Board consider accepting this monitoring report as either level:
- A – In Compliance, OR
- B – In compliance, except for item(s) noted.

ISSUE SUMMARY:

TheRide's Board of Directors establish policies that define what methods are unacceptable to use to achieve expected results, called Executive Limitations. This monitoring report provides the CEO's interpretations of those policies, evidence of achievement, and an assertion on compliance with the Board's written goals. As with other monitoring reports, the Board decides whether the interpretations are reasonable, and the evidence is convincing.

BACKGROUND:

Monitoring Reports are a key Policy Governance tool to assess organizational/CEO performance in achieving Ends (1.0) within Executive Limitations (2.0). A Policy-Governance-consistent Monitoring Process is:

1. CEO sends Monitoring Report to all board members

2. At Board meeting, board accepts Monitoring Report through majority vote (or if not acceptable, determines next steps)

IMPACTS OF RECOMMENDED ACTION(S):

- Governance: Perform key Policy Governance process

ATTACHMENTS:

1. Monitoring report for Policy 2.4 Financial Planning/Budgeting

TheRide
Ann Arbor Area Transportation Authority

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Compliant   Partially Compliant   Non-Compliant

Preliminary CEO Interpretations and Evidence

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. Further, without limiting the scope of the foregoing by this enumeration, the CEO shall not cause, allow or fail to address budgeting that:

Degree of Compliance: In Compliance

EXECUTIVE LIMITATIONS POLICY 2.4: Interpretation

I interpret this policy to be listing parameters and expectations for the recommended annual budget and budgeting for the future. Compliance with this overall policy will be demonstrated by compliance with the following sub-policies. Throughout this monitoring report, references are made to the published budget document available on the web site Budget Page.

EXECUTIVE LIMITATIONS POLICY 2.4: Evidence

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 2021 Budget. Additional evidence comes from corporate strategy documents 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.

- See monitoring reports for sub-policies.

EXECUTIVE LIMITATIONS POLICY 2.4.1:

Risks incurring those situations or conditions described as unacceptable in the Board policy "Financial Condition and Activities."

Degree of Compliance: In Compliance

EXECUTIVE LIMITATIONS POLICY 2.4.1: Interpretation

I interpret this policy to mean that I must take into account budgeting elements of Policy 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.

EXECUTIVE LIMITATIONS POLICY 2.4.1: Evidence

- **Contracts:** a list of all anticipated contracts and their dollar value is included in Appendix 2, p. 34, of the recommended FY 2021 Budget.

- **Fares and Taxes:** as stated on page 18 and in Appendix 3, the recommended FY 2021 Budget does not change fares, however TheRide will continue to develop a strategy for fares in 2021 as described on p. 31. Primary property tax rates in Ann Arbor and Ypsilanti are unchanged in 2021 budgeting. The expansion millage in Ann Arbor, Ypsilanti, and Ypsilanti Township were restored after voters approved renewal of the 0.7 mill rate in August 2018; see page 20 for property tax millage rate details.

- **Real Estate:** The FY 2021 budget includes funds for potential land acquisition as described on pages 25, 27, and 33, however the CEO acknowledges that only the Board can make the decision to purchase real estate. Staff are prohibited by Policy 2.5.9 from buying land without Board approval.

EXECUTIVE LIMITATIONS POLICY 2.4.2
Fails to place business decisions in a comprehensive, strategic context that illustrates progress towards Ends and compliance with Executive Limitations.
Degree of Compliance: In Compliance

EXECUTIVE LIMITATIONS POLICY 2.4.2: Interpretation
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.

EXECUTIVE LIMITATIONS POLICY 2.4.2: Evidence

Strategic Context: The strategic context for the annual budget has been guided in recent years by the Corporate Business Plan. At the onset of the pandemic, the COVID-19 Recovery Plan established a new multi-year plan to guide the organization during and after the pandemic. This plan illustrates strategic context for the budget by:

- Aligning priorities and resources towards the Board's written policy goals, and providing clear objectives for the recommended annual budget (pp. 7-9, 13, 18, 23, 25, 31),
- Establishing a situational awareness of the current status of the agency (pp. 11-17), and
- Explicitly connect proposed initiatives with specific policy goals of the Board (pp. 31-33).

A key missing piece of strategic context is a clear long-term plan for transit services. The need for this is recognized in the recommended FY 2021 Budget (p. 31). Long-term financial context is provided on p.23.

Comprehensiveness: The recommended FY 2021 Budget encompasses all elements of TheRide's business. It combines the operating budget (pp. 19-24) and capital budget (pp. 25-27) in one document. Existing services and infrastructure are funded and maintained (see "State of Good Repair" budget on p. 25, and details on pp. 32-33).

Risk is addressed in several parts of the recommended FY 2020 Budget, for example:

- Ensuring adequate reserves (pp. 13-14),
- A focus on addressing deferred maintenance (see "Facilities Rehabilitation," p. 32),
- Strengthening against risks of uncertainty and contingencies (pp. 21),
- Adjustments within various budget line times too numerous to list, and

- By placing the annual budget in the context of the COVID-19 Recovery Plan.

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 during budget development (p. 10).

EXECUTIVE LIMITATIONS POLICY 2.4.3: Omits credible projection of revenues and expenses, separation of capital and operational items, cash flow, and disclosure of planning assumptions.
Degree of Compliance: In Compliance

EXECUTIVE LIMITATIONS POLICY 2.4.3: Interpretation

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.

EXECUTIVE LIMITATIONS POLICY 2.4.3: Evidence

• **Operations:** The 2021 operating budget and 7-year forecast of revenues, expenses and cash flow for operating costs are presented on page 24 of the FY 2021 Budget. We believe that these projections are realistic in light of historic trends as seen on page 13 and assumptions starting on page 18, which include downscaling of revenue and expense during the pandemic and early recovery before gradual restoration by 2022. In general, forecasted revenues and expenses are expected to increase about 4% each year after 2022.

• **Capital:** The 2021 capital budget and 10-year forecast of capital expenses are presented on p. 26 of the recommended FY 2021 Budget. Planning assumptions for each project are summarized on pp. 32-33.

EXECUTIVE LIMITATIONS POLICY 2.4.4: Is unclear about long-term funding needs and growth projections.
Degree of Compliance: In Compliance

EXECUTIVE LIMITATIONS POLICY 2.4.4: Interpretation

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) provide for 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. utilities 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.

EXECUTIVE LIMITATIONS POLICY 2.4.4: Evidence

- **Operating Needs:** The recommended 2021 Budget contains the expenditures necessary to operate a reduced level of service as described in the "operations overview" on pp. 18-19. As noted, this is a temporary service plan (any permanent changes will require prior public review). Operating budget forecasting indicates service levels could be restored to near pre-pandemic levels by 2022. Forecasts of operational revenues and costs for 2022-2028 are provided on page 24, preceded by historic trends on p. 23.

- **Capital Needs:** As illustrated on pp. 25-26 of the recommended 2021 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 is populated by projects that meet longer-term expansion plans established before the pandemic. Impacts of capital projects on the operating budget are discussed on p. 29.

- **Risk:** Risks and mitigations are discussed in the 2021 Budget on page 21. Uncertain funding from the economic impact of coronavirus and a lack of clarity about how quickly and the degree to which services can be restored are major contingencies planned for in the recommended budget. As a mitigation of these risks, the draft budget is a careful, conservative baseline budget that can be amended as necessary to address new risks and opportunities during the fiscal year. CARES Act funding is available to fund unexpected pandemic-related costs.

- **Corporate Strategy:** The operational and capital projections in the 2021 Budget are further contextualized by the pandemic implications, timelines, work plan, and service restoration discussion provided in the COVID-19 Recovery Plan.

EXECUTIVE LIMITATIONS POLICY 2.4.5: Causes deficit spending.
Degree of Compliance: In Compliance

EXECUTIVE LIMITATIONS POLICY 2.4.5: Interpretation

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 Board. Specifically, ongoing operating costs cannot be funded by debt, drawing down the reserve (unrestricted net asset), 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.

EXECUTIVE LIMITATIONS POLICY 2.4.5: Evidence

The FY 20201 Budget:

- Is balanced (no deficit) with total expenses the same as total revenues (pp. 19-20).
- Creates no unfunded liabilities in FYs 2022-2028. There are no anticipated unfunded liabilities such as unfunded pensions or post-employment benefits in the FY2021 budget.

As illustrated on pp. 20-21, funding sources (i.e. revenues) do not include any contribution from the reserve or debt financing. The reserve (unrestricted net asset) is expected to remain at or above the reserve level target sufficient to support 2.5 months of operations (p. 28).

The AAATA carries no debt. This is validated by the 2019 audit conducted by UHY LLC (see Board Packet for March 2019), demonstrated on the balance sheets of the Quarterly Financial Reports, and most recently the Third Quarter reports from August 2020. These documents are available on TheRide's website.

EXECUTIVE LIMITATIONS POLICY 2.4.6:

Does not provide for adequate reserves.

Degree of Compliance: In Compliance

EXECUTIVE LIMITATIONS POLICY 2.4.6: Interpretation

I interpret this policy to mean that TheRide must have enough liquid financial resources available to prevent interruption to regular operations in the event of a temporary disruption to 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 government finance standards and agency history.

EXECUTIVE LIMITATIONS POLICY 2.4.6: Evidence

According the 2020 Third Quarter Financial Statements (August 2020), the reserve contained $10 million, or 2.5 months of operating expense. The reserve balance has been at or slightly above the target for four consecutive quarters, and is forecasted to remain at target level (see Projected Reserve Balance, p. 28). As noted under Policy 2.4.6 above, there are no plans to use the reserve to cover long-term revenue shortfalls resulting from the pandemic, because CARES Act funding is available for this purpose.

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. 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, especially during these times of economic uncertainty.

EXECUTIVE LIMITATIONS POLICY 2.4.7:
Provides less for Board prerogatives during the year than is set forth in the Cost of Governance policy.
Degree of Compliance: In Compliance

EXECUTIVE LIMITATIONS POLICY 2.4.7: Interpretation
I interpret this policy to mean that the budget must include funds for the Board to do its work and that the amount of funding be determined by the Governance Committee. Examples of past expenses in this area have included group and individual education and training, facilitators, and governance advisory consultation.

EXECUTIVE LIMITATIONS POLICY 2.4.7: Evidence
For FY2021 the Governance Committee accepted a staff recommended budget of $35,000, $5,000 less than was budgeted for FY2020. This amount is included within the “other expenses” category shown in the budget. While this line item is not called out specifically in the budget, the amount is budgeted in account 300-509-017 (Board Governance & Training).

EXECUTIVE LIMITATIONS POLICY 2.4.8:
Funds ongoing operations via debt or creates unfunded future obligations.
Degree of Compliance: In Compliance

EXECUTIVE LIMITATIONS POLICY 2.4.8: Interpretation
I interpret this policy to mean that, with respect to recurring operating expenses, the AAATA must live within its means and avoid over-extending ourselves financially. Using debt or creating future obligations (e.g. unfunded pension liabilities, etc.) in order to allow more spending today are not a transparent means of paying for existing services, and are prohibited. Specifically, we cannot borrow funds or otherwise leverage the Authority for the purpose of paying for ongoing operating costs such as payroll, fuel, bus services, geographic coverage, etc. Furthermore, we cannot create new expenses that will cause forecasted expenses to exceed reasonably foreseeable revenues. (This policy does not apply to capital projects where debt may be a reasonable means of financing large projects.)

EXECUTIVE LIMITATIONS POLICY 2.4.8: Evidence
AAATA has no debt, as is indicated in the FY2019 audited financial statements, liabilities, (see p. 7 of the audit report). The multiyear forecast presented in the budget (pp. 23-24) demonstrates that the CEO has not caused new obligations for the AAATA that cannot be funded with reasonably foreseeable revenues. While new costs have emerged from the pandemic, they are anticipated to be fully funded with federal CARES Act aid.

Monitoring Policy 2.4 Financial Planning & Budgeting

Guidance on Determining "Reasonableness" of CEO Interpretations

The International Policy Governance Association has developed the following guidance for Board members to use in deciding whether a CEO's interpretation is "reasonable":

An interpretation is deemed to be reasonable when it provides an operational definition which includes defensible measures and standards against which policy achievement can be assessed…

Defensible measures and standards are those that:

- *Are objectively verifiable (e.g., through research, testing, and/or credible confirmation of observable phenomena.)*
- *Are relevant and conceptually aligned with the policy criteria and the board's policy set.*
- *Represent an appropriate level of fulfillment within the scope of the policy.*

- "*What makes an Interpretation Reasonable and What are the Expectations for the Operational Definition: Policy Governance Consistency Framework Report Number 2".* International Policy Governance Association. June 11, 2016. Available on the IPGA website.

Board's conclusion on monitoring report

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 <u>or</u> is *not* making reasonable progress toward compliance

E. Cannot be determined.

Board notes: (If applicable)

The Board voted unanimously that the CEO is in compliance (A) at the September 24, 2020 AAATA Board meeting.