CITY OF NEWPORT NEWS

OFFICE OF THE CITY MANAGER

October 10, 2017

TO: The Honorable City Council

FROM: City Manager

SUBJECT: Fourth Quarter FY 2017 Financial Report

This year-end report describes the budgetary performance of revenues and expenditures for FY 2017 and was prepared by the Department of Budget and Evaluation. The Fourth Quarter Financial Report uses preliminary and unaudited results of operations for the financial year ending June 30, 2017. While the final steps for closing the fiscal year are not complete, this report provides City Council a reasonably accurate estimate of the FY 2017 results for the General Fund. The official and final accounting statements will be issued in the November/December timeframe, when the City publishes its Comprehensive Annual Financial Report (CAFR).

For the Fourth Quarter, the combined results were an overall revenue shortfall of $3.3 million, and an expenditure savings of $3.3 million, for a net year-end result of $0. Since FY 2015, there has been estimated approximately $5 million of General Fund Balance reserves as a revenue source for each fiscal year. These reserves have not been used to balance the year-end budget, as there was sufficient revenue generated and expenditure savings to end each year positively. To achieve a balanced year-end, the amount of $3.8 million of the $5.2 million budgeted use of reserves for FY 2017 will be recognized to bring the fiscal year to a net zero balance. This is the first time since FY 2002 has fund balance reserves been required to balance an annual operating budget. The circumstances that required the use of fund balance are detailed below.

Revenues

There were mixed results from the Fourth Quarter FY 2017 Revenues; some performed higher than forecasted, while other continued to lag. Generally, local taxes and fees demonstrated stronger activity, with some elements below the estimates.

With the second half of the Current Real Estate Tax collections for FY 2017, the City has received a total of $172,471,094 from this major revenue source. Included in this figure was estimated a total of $1.9 million in Real Estate Tax Relief ($1 million for Current Real Estate Tax revenue that is deferred for qualified elderly/disabled citizens and $950,000 tax relief for eligible disabled veterans). Taking into consideration the actual value of the three tax relief programs of almost $2.3 million combined (which includes $200,000 for the new tax exemption program that was initiated after the beginning of the fiscal year), total Current Real Estate Tax receipts were below the adopted budget estimate of $175,271,541 (when adjusted for tax relief) by $2.8 million. While this revenue shortfall is 1.6% less than estimated, when developing this budget for FY 2017, $2 million was added to the base for anticipated real estate growth that did not materialize. FY 2017 marks the first fiscal year that Current Real Estate Tax revenue estimates were not met nor exceeded since the recession began in late calendar 2008.

FY 2017 was a good year for Personal Property Tax receipts, both for Current and Delinquent Tax collections. By the end of the fourth quarter, a combined $1.9 million more than the $53.1 million estimate had been received, or 3.7% higher than estimated.

Machinery and Tools Taxes was another revenue stream anticipated for additional growth this fiscal year based on prior performance and anticipated expansion. The anticipated growth has not materialized; by the end of the third quarter, the projected revenue was to be short of the $22.9 million estimate by $300,000. The year-end results were a shortfall of $358,000.

Consumer sensitive revenues of sales, meals, and lodging taxes were projected to be consistently stable each quarter, with the anticipation that each would meet or exceed their individual revenue estimate, within minor fluctuations. This remained true throughout the fiscal year, with the actual revenue gain higher than anticipated, again through stronger receipts in the fourth quarter. Sales Tax revenue collection slightly underperformed to the estimate, as the estimate also included anticipated new retail growth. The Sales Tax revenue was $403,000 less than the estimate of $24.7 million. Actual Sales Tax revenue increased by an average of $84,000 per month over FY 2016 collections. Meal Tax receipts were exceptional, exceeding by $957,000 more than the $24.8 million estimate. This showed that dining outside the home is 3.9% higher than first anticipated, in turn is compounded on the 6.4% growth experienced for this revenue for FY 2016. Both Sale and Meal taxes are highly responsive consumer revenue streams, and when taken as a whole seem to indicate continued stabilization in certain areas of the local economy.

In other local economy generated revenue, there were mixed results. Business Professional and Occupational Licenses (BPOL) taxes ended the fiscal year $607,000 lower than the $17.3 million anticipated receipts. The Professional and Contractor Services BPOL tax categories had stronger than anticipated showing, exceeding the revenue estimates by over $447,000. The remaining major BPOL segments (Retail, Wholesalers, and Repairs) were under by $498,000. The largest under collection of $556,000 was that associated with prior year collections, penalties, and interest.

As the FY 2017 General Fund budget was being formed, approximately $3 million of additional revenue was estimated based on anticipated economic expansion; it is the major factor contributing to what appears to be an overall under collection for revenues in FY 2017. Early in the fiscal year, it was clear that the expansion was not to occur. Therefore, all quarterly projections included anticipation of the full use of the budgeted fund balance amount, as revenue to cover expenditures. At the end of the fiscal year, the fund balance use was less than estimated at $3.8 million.

With the exception of estimated economic expansion revenue, in general, revenue activity for FY 2017 showed improved results in most areas. Revenue estimates for the current fiscal year are based on realistic anticipated collections. The increases were conservative, in light of past performance and lingering economic pressures that are still affecting all levels of government. The local consumer sensitive taxes are showing sustained growth. When taken from a longer view, the City's revenues performed within the parameters set for FY 2017.

Expenditures

Like FY 2017 revenues, the expenditure category faced several challenges, coupled with one-time costs. Continuation of monitoring the hiring of vacant positions and closely controlled spending by departments has resulted in a total projected savings of about $3.3 million, or 0.7% below budget, prior to any final adjustments.

Included in the year end results is the aggregate cost of employees' selection of using up to 40 hours of Paid Personal Leave (PPL) as part of compensation for one week's pay as part of the transition to Bi-Weekly payroll. While beneficial in reducing this outstanding liability on the City's overall balance sheet, it was a critical employee benefit that was not budgeted in FY 2017. For the General Fund, the cost of the one-time use of PPL for Bi-Weekly pay conversion was $1.6 million (without the associated fringe benefits cost) and $500,000 for all other funds.

In FY 2017, the employee compensation categories are overspent. As detailed in the quarterly reports, the Fire and Police Departments continue to experience higher than average vacancy rates. This condition, plus providing a full staff complement on all fire apparatus, resulted in the Police and Fire Departments' operating budgets to be overspent by a projected $4.7 million. These two special conditions, and plus the use of PPL for the Bi-Weekly pay conversion, salary expenses were over the $142 million budget by $650,000, or one half of one percent. When combined with anticipated fringe benefits shortfall of over $456,000, the combined employee compensation category is anticipated to be overspent by $1.1 million or 0.5%.

In January 2017, Hampton Roads Transit (HRT) notified the City that based on the Cost Allocation Agreement for cost sharing among the six participating localities HRT's allocation to Newport News for the FY 2016 true-up of year-end expenses was $1,004,627. The City was given the option to pay this unexpected, unanticipated cost over a period of three years; however this option came with additional financing fees over and above the $1 million true-up amount. While not desirable to pay this unforeseen amount in an already challenging fiscal year, it was an appropriate action to pay the cost immediately and avoid future compounded expense.

The final expenditure pressure that was experienced in FY 2017 was utilities costs. First, the full year cost of operating the new Police South Precinct building was absorbed in the budget at a cost of approximately $223,000. Second, the cost of Streetlight operations exceeds the budget of $2.2 million by $220,000.

Final Adjustments

Prior to final modifications required for year-end closing, and based on the necessity of using General Fund Reserves to balance the budget, no General Fund surplus will be generated at year-end. As a reminder, in prior fiscal years, when revenues exceeded expense, a year-end surplus was used as an additional contribution to the Cash Capital Fund, helping to meet the City's self disciplined obligation to fund unexpected needs or projects with cash. Without this infusion of year-end surplus, this limits the City's ability to have ready access to funds without either having to use General Fund Balance reserves or to acquire additional debt for projects.

The City's General Fund Balance Policy requires an increase to the undesignated/unassigned of 7.5% of the actual General Fund revenues for the previous fiscal year; it has been the actual practice of the City to establish an Undesignated/Unassigned General Fund Balance growth of 11% or more, whenever possible. This contribution will occur at year-end as usual. This intentional action is a signal to the bond rating agencies that it is part of the City's overall strong financial management to build reserves.

Conclusion

This combined year-end projection does not reflect year-end write offs for bad debts or other unanticipated accounting charges that may change the year-end status.

While it is difficult to face a year-end result that required use to General Fund reserves to balance, we were faced with some extraordinary, one-time expenses, tied to somewhat overly optimistic revenue projections. This is a challenging situation for the City to be in at year-end that we do not want to experience again.

As part of operating budget process for the current fiscal year (FY 2018) adjustments were made to more accurately reflect revenue trends and to amend expenditures as necessary. It is my direction that we will control costs, including hiring staff if necessary, to avoid any use of reserves in the current year. We will scrutinize all costs to ensure the best value for the expense, and prolong equipment replacement if necessary to ensure expenditures meet the projected revenues.

We may benefit from increased revenues, as the local economy seems to be showing careful but consistent elements of growth. We will not have a full gauge of the revenues until the second quarter report in January 2018, but until then, we will strictly manage our expenditure levels.

Cynthia D. Rohlf

CDR:LJC

Attachment

cc: Lisa J. Cipriano, Director, Department of Budget and Evaluation