



INTERNAL AUDIT REPORT

DATE: May 18, 2016

TO: Jim Gray, Mayor

CC: Sally Hamilton, Chief Administrative Officer
Glenn Brown, Deputy Chief Administrative Officer
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FROM: Bruce Sahli, CIA, CFE, Director of Internal Audit
Jim Quinn, CIA, CISA, Internal Auditor

RE: Budget Cycle Evaluation

Background

LFUCG currently operates under an annual budget cycle. The Mayor's Office, in conjunction with the Department of Finance and the Division of Budgeting, submits the Mayor's Proposed Budget to the Council annually. The Council reviews the Mayor's Proposed Budget via small committees called Council Links, which then report their recommendations to the full Council. The full Council makes changes to the Mayor's Proposed Budget as they deem appropriate, then vote on its final approval. This process takes about six months to complete, and requires considerable effort from the



Department of Finance, the Division of Budgeting, the Mayor's Office, Departments and Divisions, and the Council.

The annual budget process is mandated by the LFUCG's Charter under Article 8-Budget and Financial Matters. The voters of Fayette County may amend the Charter as stated under Article 14-Amending the Charter.

The Internal Audit Board approved an evaluation of the LFUCG budget process to determine if this process appears to be the prevalent approach taken by municipalities, or if a biennial budget process (such as that used by the State of Kentucky) is becoming more commonplace among municipalities as a best practice. The evaluation also assessed the advantages and disadvantages of biennial budgets.

Scope and Objectives

The objectives of this evaluation were to:

- Survey city and county governments to identify those with biennial budget cycles
- Of those city and county governments with biennial budgets, attempt to determine their reasons for adopting this type of budget and the pros and cons they have identified
- Research independent online studies for other potential advantages and disadvantages of enacting a biennial budget cycle

Our evaluation included a review of selected city and county government websites to determine detailed current practices for budgeting. We also referred to independent studies and analysis of budget cycle practices which were more general in nature and included a more comprehensive survey of local governments.

The cities in our evaluation included the top 100 cities by 2014 population (Lexington is ranked 61st) which have adopted a biennial budget process, and various other cities regardless of population size that had recently adopted a biennial budget.



Statement of Auditing Standards

We conducted our evaluation in accordance with the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and perform our work to afford a reasonable basis for our judgments and conclusions.

SURVEY RESULTS

Top 100 Cities

We examined the top 100 cities by 2014 population to determine which cities were currently using a biennial budget cycle. Of the top 100 cities, only eight cities were using a biennial budget process. The remaining 92 cities were operating with an annual budget process. A list of the cities with biennial budgets and their size ranking is listed below:

San Francisco, CA (ranked 13th in size)
 Charlotte, NC (ranked 17th in size)
 Detroit, MI (ranked 18th in size)
 Seattle, WA (ranked 20th in size)
 Oakland, CA (ranked 45th in size)
 Cincinnati, OH (ranked 65th in size)
 Lincoln, NE (ranked 72nd in size)
 Richmond, VA (ranked 98th in size).

We sought feedback from these eight city governments regarding their experience with the biennial budget process. Several cities did not respond to our request for information.

The Oakland, California Budget Director stated that Oakland has used the biennial budget process for many years, and it has resulted in better planning. She also said the biennial budget process helps reduce political pressure because it provides greater financial stability and requires officials to take a longer term view regarding spending decisions. She explained that Oakland's biennial budget is \$2.4 Billion with over 100 funds and the budget process is very cumbersome, and therefore only having to go through the budget cycle every two years has been very beneficial.

The Finance Director for the city of Lincoln, Nebraska informed us they are in their third biennial budget process, and they chose the biennial process primarily for the time



savings. He said the experience has been mostly positive, with the advantages mostly realized in not having to use up staff and elected officials resources on an annual budget process. He said it has also allowed them to avoid the same budget battle every year. However, he noted that it can be difficult at times predicting expenditures for two years, and since the city doesn't have a labor agreement in place it's going to be difficult determining labor costs for the next two years. He also said that revenue stability is important for a biennial budget cycle, and since Lincoln obtains much of its revenue from sales taxes its revenue stream is usually fairly stable. He also said Lincoln basically implement two one-year budgets at a time, then make any necessary adjustments in the second year of the budget.

The former City Manager of Cincinnati approved of the biennial process. He said it allowed for a two year strategic view at where the city was headed, and provided a clear articulation of top priorities. He also stated that it provided a mechanism for covering project or initiative costs over two years by securing legislative approval during year one, and in the second year of the biennial you are simply making adjustments from the prior year. He cautioned that a biennial budget process does not insulate a city from the effects of an economic downturn, but noted that it keeps staff from having to go through the entire budget preparation process each year. He also noted that if a city budget has a civic engagement process attached to it, the biennial budget process can provide some public buy-in and allow some initiatives to survive a political transition.

Smaller Cities

We also conducted online research for additional cities which had fairly recently adopted a biennial budget process. We found the following five cities (with populations less than the top 100) that had recently enacted a two-year budget process:

Alameda, CA (adopted 2012)
Arlington, WA (adopted 2016)
Ashland, OR (adopted 2011)
Bellingham, WA (adopted 2015)
Gig Harbor, WA (adopted 2014)

We included these cities in our evaluation under the assumption that, despite their smaller size, they could provide insight into the advantages and disadvantages of the biennial budget process. We asked city officials why they adopted a biennial budget process, and



asked for information on specific advantages and disadvantages they encountered with the new process. Four of these five cities responded to our survey.

Some of the feedback we obtained from these four cities included:

“I love the biennial budget as does my staff. I think some of our elected officials (including the mayor) and members of the budget committee remain skeptical.”

City Administrator, Ashland, OR

“As a whole, I think the process has worked quite well for us so far.”

Finance Director, Gig Harbor, WA

“Right now I am on the fence as far as recommending for or against. In our case the benefits of the second year council process are somewhat negated by the extra finance behind the scenes impact. I hope that new software and knowledge by departments will increase the benefits in the city's second biennial budget, which we are just now starting.”

Finance Director, Bellingham WA

“What gets measured is what gets done. It's really important that you have those benchmarks so that you are able to hold people accountable, and a two-year budget cycle gives you time to do it.”

City Manager, Alameda, CA

Responders typically pointed to staff time savings and the longer term planning horizon as benefits obtained from the biennial budget process. They also noted difficulties with long range forecasting and aligning their financial software with a two-year budgeting process.

For more information on their experience, all comments and responses (including pros and cons) received from these four smaller cities are contained in the table entitled “Survey of Small Cities With Biennial Budgets” in Appendix A of this report. The City of Alameda, CA did not respond to our survey. We obtained information about that city's experience with biennial budgets from a newspaper article.

ADVANTAGES AND DISADVANTAGES TO A BIENNIAL BUDGET CYCLE

We also researched various independent sources and studies for the pros and cons of adopting a biennial budget cycle. Those sources cited many of the same advantages and



disadvantages noted in our survey. Below is a summary of the advantages and disadvantages noted in the various sources we reviewed. The Office of Internal Audit does not vouch for the completeness or accuracy of these sources, but the arguments presented therein appear reasonable and are provided for informational purposes and consideration:

Potential Advantages of Enacting a Biennial Budget Cycle:

- Long range planning: Biennial budgeting can improve long-range planning, as it requires forecasting revenue and expenditures up to 28 months in advance.
- Opportunities for staff redeployment: Biennial budgeting would free up various departmental administrative staff, the Council, and the Mayor's Office from annually preparing the budget, allowing them more time for other duties including the advantages of improving financial management and monitoring various government programs for effectiveness.
- Improvement in Financial Management: Primarily as a result of having more time in the off budget year. Financial staff can concentrate on other duties.
- Improvement in Program Monitoring and Evaluation: Primarily as the result of staff having more time to concentrate on measuring program effectiveness and assessing program outcomes during the off budget year.
- Policy Emphasis: Biennial budget cycles would allow Council to move from line-item consideration of the budget to a longer-range, more policy-driven approach (focusing more on outcomes and less on management).
- Better Link Between Long-Term Projects and Spending: With two-year appropriations providing more certainty in funding, departments can do a better job of adjusting spending levels to address needs for a longer time period. This gives departments and contractors more flexibility with expenditures and is particularly helpful with capital projects and capital expenditures.

Potential Disadvantages of Enacting a Biennial Budget Cycle:

- Departmental Oversight: Government departments and agencies may be less responsive to the Council and senior administration if they know their budgets are protected for two years. Monitoring of these departments may need to be expanded.
- Difficulty in Making Revenue and Expenditure Projections: An unstable local economy may make forecasting revenues and expenditures difficult. Also, various divisions, departments, and other governmental entities may not have the financial expertise to provide accurate projections.



- State and federal funding uncertainty: Funding from state and federal sources (usually in the form of grants) that operate on an annual budget cycle would make it difficult to predict funding levels from these sources up to 28 months in advance.
- Unforeseen events: The limited ability to predict future economic conditions and the inevitability of unforeseen events may lead to a budget that is biennial in name only. Biennial budgeting would only increase the risk of forecasting future revenue sources and operates best in times of stability and economic growth. Most cities with biennial budgets still make annual adjustments and annual appropriations where needed.
- Lack of Time Savings: Depending on the strength of restrictions or the willingness to avoid making changes in the off-year, biennial budgeting may not lead to appreciable savings in time for the Mayor's Office, Council, and administrative and legislative staff.
- Workload: Biennial budgets may only serve to raise the stakes of budget negotiations and how long they take. The workload of the budget staff during the first year of the biennial budget in particular may increase significantly and cause staff turnover.
- Software and Accounting changes: A biennial budget may require changes to the city's budgeting and accounting software, which may accrue additional programming and staff costs for conversion.
- Need for New Budget Processes: New policies and processes including a revised budget manual would be required.
- New Legislative Acts or Revisions May Be Needed: In order to accommodate the changes in the budget process, some revisions to current ordinances or the city charter may be required (a change to the Charter would be required for the LFUCG).

ANALYSIS

Municipalities' interest in biennial budget cycles is typically in response to several factors, including the increased time spent preparing and reviewing budgets, as well as the uncertainty of future revenues. Governments which have enacted a biennial budget cycle pass two-year spending plans, but often continue to appropriate funds on an annual basis (a "rolling" biennial budget). A more restrictive and less common form of the biennial budget is the "true" biennial budget, which appropriates funds for a two-year time period with limited mid-cycle or off-year reviews to adjust for unforeseen changes in revenues or expenditures. While there are some advantages associated with the biennial budget process, particularly in the areas of time savings, longer term financial and strategic planning, and program evaluation, most cities are still using an annual budget cycle process.



It also appears that some cities which have adopted a biennial budget process did so under extreme circumstances or significant unforeseen events. For instance, we noted in our review that many city governments in California switched to a biennial budget process upon the passage of Proposition 13, which severely reduced property taxes collected by these cities and forced them to deal with a much more uncertain revenue stream and take a longer term perspective in their budget formulation. Some responders to our survey who have recently adopted a biennial budget cycle also noted significant challenges in aligning their financial and budgeting systems with a new two-year process.

We found the GFOA's An Elected Official's Guide to Multi-Year Budgeting to be quite insightful, and this publication noted numerous effects of a biennial budget process. From this publication, it became apparent that the transition from an annual budget process to a biennial budget process could initially be a daunting task requiring a firm commitment to the process.

In addition, an article entitled, "State Experiences With Annual and Biennial Budgeting" published by the National Conference of State Legislatures in April 2011 indicated that the trend among state government for the past 70 years has been to abandon biennial budgeting. It noted 44 states enacted biennial budgets in 1940, while only 19 states have biennial budgets now. According to the article, this was attributed primarily to the shift in states from biennial to annual legislative sessions. Kentucky is one of 15 states with an annual legislative session and a biennial budget process. The other four states have a biennial legislative session coinciding with a biennial budget process. The article drew the following conclusion:

"There is little evidence that either annual or biennial state budgets hold clear advantages over the other. The evidence is inconclusive on the question whether biennial budgeting is more conducive to long-term planning than annual budgeting, although some evidence indicates that biennial budgeting is more favorable to program review and evaluation. Biennial budgeting is likely to reduce budgeting costs somewhat for executive agencies, but it also is likely to reduce legislators' familiarity with budgets. States with biennial budgets and biennial legislative sessions do not appear to give greater authority over budget revision to governors than other states. Forecasting is likely to prove more accurate in annual budget states than in biennial budget states, possibly reducing the need for supplemental appropriations and special legislative sessions. This study has found no convincing evidence that the length of the budget cycle, in itself, determines how efficiently a state enacts a budget and whether it requires extensive change during the



course of its administration.” Perhaps the most salient point of the article was as follows: “The success of a budget cycle seems to depend on the commitment of state officials to good implementation rather than on the method itself.” This statement would likely hold true for local governments as well, and generally agrees with the results of our evaluation.

CONCLUSION

Based upon the results of our evaluation, there is insufficient justification or precedent for the LFUCG to seek to adopt a biennial budget process. This conclusion is based upon our evaluation of the advantages and disadvantages of a biennial budget process, the fact that 92 of the largest 100 cities still use an annual budget process, the general trend even among states to return to an annual budget process, and the absence of any other evidence that would clearly demonstrate a distinct advantage to be gained by adopting a biennial budget process, which would require an approved change to the LFUCG Charter by the voters of Fayette County.



Appendix A. Survey of Small Cities with Biennial Budgets

CITY	YEAR ADOPTED	SURVEY RESPONDER	REASONS FOR ADOPTING	PROS	CONS	OTHER COMMENTS
Bellingham, WA	2015	Brian Henshaw, Finance Director	-Mayor was familiar with process -Planning time -Time Savings	-Accountability from departments -Time Savings	-Software not designed for biennial budget (operating with 2 one year budgets) -Many decisions must be made regarding long term planning, future year forecasts	Right now I am on the fence as far as recommending for or against. In our case the benefits of the second year council process are somewhat negated by the extra finance behind the scenes impact. I hope that new software and knowledge by departments will increase the benefits in the city's second biennial budget, which we are just now starting.
Gig Harbor, WA	2014	Dave Rodenbach, Finance Director	We decided to move to the biennial budget process in order to save the time and expense of going through the full budget process each year.	-Time and cost savings realized -City will benefit from a longer planning horizon -City Council and staff freed up to focus on other projects during the off-budget year	-Forecasting is more difficult (2 nd year) -A lot more work for the Finance Department in that all the budgeting worksheets must be changed; and the financial system will not handle a 2-year budget. This should get easier as we get more comfortable with it.	As a whole, I think the process has worked quite well for us so far.



CITY	YEAR ADOPTED	SURVEY RESPONDER	REASONS FOR ADOPTING	PROS	CONS	OTHER COMMENTS
Arlington, WA	2016	Kristin Garcia, Finance Director	n/a – see pros and cons.	<ul style="list-style-type: none"> -Budget process more efficient -Focus on strategic planning, long term forecasting and financial policies -Time better spent planning for the future and ensuring long financial sustainability -Better positioned to handle unanticipated changes 	<ul style="list-style-type: none"> -Reliance on forecasting and estimates -Need to do mid-year review process and make necessary adjustments -Heard that other cities is perceived lack of control especially from those cities adopting “true” biennial budget and departments can spend as they wish (To counteract this, they structured budget so each year is approved separately but allows capital project carryover from year 1 to year 2. Result is they still gain efficiency by not budgeting each year and council still has control). 	No other comments.
Ashland, OR	2011	Dave Kanner, City Administrator	n/a – see pros and cons.	<ul style="list-style-type: none"> -Staff time savings allows them to work on other projects in off year, including some major initiatives. -Two-year appropriation of funds allows for much greater flexibility in terms of scheduling expenditures (especially major capital projects) and developing more reliable revenue trends and forecasts. 	<ul style="list-style-type: none"> -Budget committee still requires off year meeting to discuss issues not discussed during budget review -Mayor believes in developing budget “expertise” in the citizen members of budget committee and they lose whatever knowledge they gain in two-year cycle. -Mayor believes it transfers too much expenditure authority to staff (believes staff can manipulate policy decisions without going back to policy makers for review). 	I love the biennial budget as does my staff. I think some of our elected (including the mayor) and members of the budget committee remain skeptical.



CITY	YEAR ADOPTED	SURVEY RESPONDER	REASONS FOR ADOPTING	PROS	CONS	OTHER COMMENTS
Alameda, CA	2013	John Russo City Manager, Fred Marsh City Controller <i>(taken from online article where these principals were interviewed).</i>	Promote fiscal discipline, long-term financial planning, and increased accountability.	<ul style="list-style-type: none"> -More conservative revenue and expenditure projections -Time savings in preparing budget -Improved funding and staffing certainty for government programs (causing boost in employee morale) -More long-term strategic and fiscal planning -Holds departments more accountable and fiscally responsible -Longer time for program evaluation 	None cited.	As part of the new process, the city planned to hire a consultant to develop enhanced program measures to “assess the quality of programs, to gauge progress in achieving key objectives, and to align resources with the council’s priorities.” As the City Manager pointed out, in government, “what gets measured is what gets done.” He went on to state, “It’s really important that you have those benchmarks so that you are able to hold people accountable, and a two-year budget cycle give you time to do it.”

