TOWN OF LEXINGTON
AD HOC FINANCIAL POLICY COMMITTEE
REPORT TO BOARD OF SELECTMEN

FOREWORD

The Selectmen's charge to the Committee (See Exhibit A.) seeks recommendations that will improve the Town's fiscal policies. To develop a context for its recommendations, the Committee first reviewed the fiscal realities of the recent past and evaluated current financial policies. We believe the Town:

- **Is not investing enough each year to maintain its fixed asset base.** The Town's "cash capital" policy is subject to political will. Funding capital reinvestment has been a lower priority than sustaining Town services. The cash available for capital investment has been used consistently to balance the operating budget, resulting in deferred maintenance, while forcing the Town to rely on within-levy debt to renew and replace fixed assets.

- **Has seen the costs of Town services grow faster each year than the growth in property tax receipts.** Proposition 2½ limits annual growth in the tax levy to 2.5%, plus new growth in the Town's tax base.

- **Has demonstrated its willingness to sustain services and finance major capital projects by passing both operating and debt exclusion overrides of Proposition 2½**.

- **Has not set aside reserves to buffer the impact of declines in state aid and local receipts during economic downturns.** Since they reflect the general business cycle, these two key revenue sources are the Town's most volatile.

- **Does not have adequate mechanisms to respond to fluctuations in volatile expenses** other than the Appropriation Committee's historically modest Reserve Fund and supplemental appropriations from "Free Cash."

- **Relies on Free Cash as its primary reserve,** although calculating Free Cash requires evaluating several items on the Town's June 30 balance sheet, and the amount is neither confirmed nor available for appropriation until the late fall, after it is certified by the State's Department of Revenue.

- **Does not have adequate reserves to absorb the financial consequences of certain major claims and liabilities**, such as multiple workers' compensation claims or extraordinary medical expenses.

- **Does not yet know the magnitude of the liability for retiree health benefits nor does the Town have a plan to fund this liability.**

- **Has a Aaa debt rating,** but no stated policies articulating target levels for within-levy or outside-the-levy borrowing, for annual debt service for within-levy debt, or for long-term versus short-term debt.

- **Does not engage in long-term financial planning or modeling,** yet such an exercise would identify the most significant budget drivers and focus efforts to contain costs and/or generate additional revenue.

In response to these realities, we suggest the following goals:

- **Maintain the Town's investment in its physical assets, but use debt prudently to do so.**
- **Establish reserves to buffer the impacts of declining revenues, volatile expenses, and of specific incidents and events not fully covered by insurance.**
- **Quantify and meet post retirement obligations.**
- **Maintain the Town's Aaa credit rating and follow coherent borrowing policies.**
- **Address the Proposition 2½ dynamic - that the annual increase in expenses will probably continue to outpace the allowed growth in annual property tax receipts.**

To advance these goals, the Committee respectfully submits these financial policy recommendations for your consideration.

March 15, 2006

FINANCIAL POLICY RECOMMENDATIONS

CAPITAL FINANCING POLICIES

A. **Objectives** Preserve the Town's fixed asset base and ensure that the Town's buildings, facilities, and equipment efficiently and effectively support the Town's programs and operations.

B. **Financial Policies** To achieve these objectives, the Town should provide consistent and stable funding sources for the timely and periodic renewal and/or replacement of building systems, building envelope components, vehicles, and equipment.

1. **Establish and fully fund one or more Asset Renewal and Replacement Reserves** funded by annual General Fund appropriations linked to the value of the Town's General Fund fixed assets. Rigorous analysis as described in Exhibit C should be the basis for "fully funding" these reserves. The Committee recommends that the Board of Selectmen establish at least two separate funds, one for buildings and one for equipment.

2. **Appropriate funds annually from these Asset Renewal and Replacement Reserves** for specific building renewal projects and for the replacement of vehicles and equipment. These renewal reserves should not be used to pay debt service for within-levy debt.

3. **Pending the rigorous analysis recommended above, target 2% of annual General Fund revenues as an interim goal for funding building renewal projects and equipment replacements** The Committee prefers appropriations from either this cash allocation or from Asset Renewal and Replacement Reserves rather than short-term borrowing to renew and replace assets. This funding policy ensures that future taxpayers are not unfairly burdened with the entire cost of such renewal and replacement investments. The reserve funding mechanism spreads the costs of such investments over several years without incurring borrowing costs.

4. **Continue the policy of seeking debt exclusion overrides** to finance the replacement of Town buildings and major facilities and the construction of new facilities to expand or upgrade Town programs.

FINANCIAL POLICY RECOMMENDATIONS

RESERVE POLICIES

A. **Objective** Enable the Town to sustain service levels despite the adverse financial impacts of economic downturns and of unforeseen and extraordinary expenses.

B. **Financial Policy** Achieve this objective by adequately funding a portfolio of stabilization funds, reserve funds, and continuing balance accounts that will stabilize the annual operating budget. This policy represents a change in course from the Selectmen's ten-year goal voted in 1997 to establish adequate financial reserves by building "Free Cash" to 5% of the tax levy.

1. **Build a Stabilization Fund large enough to buffer the General Fund from the impact of two to three years of reduced state aid and declining local receipts.** The Committee prefers a Stabilization Fund designated specifically as a "rainy day" fund rather than building "Free Cash" because:

- Town meeting must take specific action to either add monies to or appropriate funds from a Stabilization Fund. A two-thirds vote of town meeting is required for either action.
- A Stabilization Fund designated for operations and funded by Town meeting appropriations clearly segregates funds for this intended purpose.
- The amount in this Stabilization Fund is known to all Town and external constituencies, will not fluctuate during the fiscal year, and is not subject to adjustment or certification.
- Such a Stabilization Fund and the level of funding would be subject to public discussion, debate, and scrutiny – a very healthy and open process for establishing key financial policies.

During the economic downturn affecting fiscal years 2003 through 2005, the town lost nearly $4.8 million from its two most volatile sources, state aid and local receipts.

	($000)				
Source	**FY2002**	**FY2003**	**FY2004**	**FY2005**	**Three-year Revenue Loss**
State Aid	$9,603	$9,465	$7,709	$7,871	$3,764
Local Receipts	10,118	10,095	8,978	10,247	1,034
Total	**$19,721**	**$19,560**	**$16,687**	**$18,118**	**$4,798**

Sources: Revenue Summary, Town Manager's FY 2006 Recommended Budget, February 9, 2005, and Warrant to the 2006 Annual Town Meeting

State aid has not yet recovered to FY2002 levels. For FY2007, the Town Manager projects state aid to be only $8.7 million, still $900,000 less than FY2002 aid. The Town would have needed a Stabilization Fund approaching $7 million to replace these revenues lost during this three-year economic decline ($4.8 million) and to offset the state aid shortfalls ($1.9 million) during the two following years of economic recovery. If and when the Town draws monies from such a Stabilization Fund, then the Selectmen should also present a plan for replenishing the fund.

FINANCIAL POLICY RECOMMENDATIONS

RESERVE POLICIES (CONTINUED)

2. **Determine the annual appropriation to the Appropriation Committee's Reserve Fund by a rigorous analysis of historically volatile expense items or of those expenses that have the potential to be volatile during the upcoming budget year.** The Committee believes that there would most likely be 15 to 20 line items with significant volatility, and for each, the potential impact should be estimated and probability-weighted.

The Committee recommends funding the Appropriation Committee's Reserve Fund at a much higher level than the historical level of $150,000, in conjunction with the following sound financial practices**:**

- Build the operating budget based on line-by-line analyses of historical revenues and expenses and of factors affecting income and expense projections.
- Do not budget for contingencies within departmental or program budgets, except for introducing an emergency building maintenance and repairs contingency. More precise budgeting with a somewhat larger Reserve Fund will minimize the inclination to create contingency funds within departmental budgets. Better to have one larger Reserve Fund than to continue the historical pattern of flexible departmental budgets and a smaller Reserve Fund.
- Acknowledge that the Reserve Fund may fund school as well as municipal expenses that meet the criteria of "extraordinary and unforeseen" expenses.

A Reserve Fund of up to 0.5% of the annual General Fund budget may be prudent to provide a reserve for "extraordinary and unforeseen" municipal and school expenses as set forth in M.G.L. Ch. 40 §6. A specific target should be established after analyzing the volatile expenses as recommended above.

3. **Establish, fund, and monitor "continuing balance accounts" – accounts which are not closed at the end of each fiscal year – to protect against the financial consequences of certain risks and liabilities.**

a. The Board of Selectmen should establish and adequately fund "continuing balance accounts" to address the following potential risks, claims, and liabilities:

Workers' Compensation Claims for Police, Fire, and other town and school employees

Property Damages and Liability Claims for uninsured losses and claims not covered by deductibles

Compensated Absence Payments made to town and certain school employees eligible to "buy back" sick days upon retirement

Extraordinary Health Insurance Claims that do not reach the Town's $90,000 stop-loss threshold per employee, retiree, or dependent. The Town is self-insured against such claims and could be forced to appropriate supplemental funds in any year with extraordinary major claims.

RESERVE POLICIES (CONTINUED)

b. The Board of Selectmen should monitor the funding levels in the following existing "continuing balance accounts" to ensure that reserves are adequate, but not over-funded, and take action if analysis demonstrates that adjustments should be made:

Board of Assessors' Overlay for Tax Abatements

Health Insurance Claims Trust, the trust fund to cover incurred-but-not-yet-reported claims. Auditing guidelines require the Town to maintain 10 to 20% of the annual claims paid – roughly two months of annual claims.

4. **Target a Free Cash balance of 0.3 to 0.6% of General Fund revenues at June 30 of the current year when the Board of Selectmen votes the budget for the coming fiscal year.** The Town should consider Free Cash as a check book balance and de-emphasize reliance on Free Cash as a reserve in favor of the portfolio of reserves, including the Stabilization Fund, as recommended above. The Committee believes that relying on Free Cash as the Town's primary "rainy day" fund is problematic because:

- Free Cash is the available fund balance in the General Fund at a moment in time, June 30, as certified by the State's Department of Revenue.
- Free Cash is not available for appropriation until certified by the State's Department of Revenue – often as late as November or December – for the preceding June 30.
- The level of Free Cash can not be known with certainty during the fiscal year. The Town can only estimate what Free Cash will be at June 30 by recording any proposed or actual appropriations by Town Meeting and by forecasting actual revenues and expenses versus revenue estimates and appropriations.
- Each year Town Meeting votes to appropriate a sum of money from available funds - Free Cash – to balance the operating budget and reduce the tax rate. The remaining funds constitute an undesignated reserve. Town Meeting does not vote to establish a specific amount for this undesignated residual reserve.
- Free Cash is not a reserve that appears in the Town's financial statements. The amount of Free Cash is derived from various balance sheet accounts.
- The Department of Revenue's Free Cash certification is an administrative, accounting process, not driven by management discretion or policy imperatives. This administrative process is neither readily understood nor transparent as a financial policy.

Until the Town funds this recommended portfolio of reserves, the Committee would prefer to transfer any Free Cash exceeding this target to the Stabilization Fund or to continuing balance accounts rather than apply such Free Cash to balance future budgets.

TOWN OF LEXINGTON
AD HOC FINANCIAL POLICY COMMITTEE
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FINANCIAL POLICY RECOMMENDATIONS

POST-EMPLOYMENT BENEFIT POLICIES

A. **Objectives** Define and adequately fund the Town's pension and health benefit responsibilities and obligations to its retired employees.

B. **Financial Policies for Pension Obligations** The Board of Selectmen and Town Meeting should continue to support the Retirement Board's track record of prudent judgment and actions.

1. **Continue the current practice of bi-annual actuarial valuations of the Contributory Retirement System.**

2. **Contribute to the Retirement System annually so as to amortize the unfunded accrued pension liability no later than 2015.**

3. **Ensure that annual contributions thereafter are sufficient to fully fund 100% of the actuarial liabilities.**

4. **Conduct an actuarial study of any early retirement incentive program, retirement contribution "holiday," or other proposal affecting either retirement benefits or contributions – prior to accepting such programs - to determine the actuarial liability to the retirement system and impact on the Town's annual retirement contribution.**

C. **Financial Policies for Health Benefit Obligations** The Committee understands that in the near future the Governmental Accounting Standards Board will require full disclosure of this liability in the Town's financial statements. The Board of Selectmen should take timely action to determine the magnitude of this liability and to develop a funding strategy for this obligation.

1. **Engage a firm to conduct an actuarial valuation of the health benefit obligations to retirees and current employees, quantify this liability, and generate funding options.**

2. **To the extent possible, consult the Retirement Board in developing a strategy to fund the actuarial liability for such health benefit obligations.** The Town should take advantage of the Board's exemplary track record and expertise in managing the Town's contributory retirement system.

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FINANCIAL POLICY RECOMMENDATIONS

DEBT MANAGEMENT POLICIES

A. **Objectives** Prudently use debt as a funding source for preserving, renewing, or adding to the Town's physical assets. Do not borrow to finance operations. Ensure the lowest possible cost to the Town of short- and long-term borrowing.

The Committee recognizes that borrowing is a means of transferring current costs of capital investments to future taxpayers, those who will presumably benefit from the use of the asset being financed.

B. **Financial Policies** To meet these objectives, the Committee recommends that the Town:

1. **Pursue the current and recommended financial policies necessary to maintain a Aaa bond rating.** The Aaa rating by the municipal bond rating agencies essentially guarantees that the Town may borrow at the lowest tax-exempt rates available in the marketplace. The Town's bond rating is a consequence of all of its financial practices and policies, including maintaining an adequate and appropriate Stabilization Fund, Appropriation Committee Reserve Fund, continuing balance accounts, and reserves for replacement. Thus, the Aaa rating criteria also provide industry benchmarks and an external incentive for maintaining fiscal discipline.

2. **Gradually phase out the Town's recent practice of issuing within-levy debt to finance small-ticket capital spending for the annual renewal and replacement of building components, vehicles, and equipment.** Debt service for within-levy borrowing consumes dollars otherwise available to maintain services. Excessive within-levy borrowing could trigger the need for larger or more frequent operating overrides and unfairly burden future taxpayers.

   a. Appropriate cash or funds from asset renewal and replacements reserves – rather than issue short-term debt - to replace building components, vehicles, and equipment.

   b. Use short-term borrowing only as "bridge" financing – bond anticipation notes or BANs – to anticipate the issuance of long-term debt for capital projects.

   The Committee recognizes that the Town has used within-levy borrowing recently to renew and replace assets because available revenues have been used to balance operating budgets, and there have been no asset renewal reserves. Phasing out within-levy borrowing for capital items is linked to committing cash and/or establishing and funding appropriate reserves.

3. **Restrict long-term borrowing to large scale capital projects – new buildings, total building renovations, land purchases, etc. - where the capital investment is large and cannot be smoothed or divided over several years.**

   a. Ask the voters to approve debt excluded from Proposition 2½ limitations for such large scale projects.

   b. Ensure that the maturity of issued debt does not exceed the expected life of the asset financed.

FINANCIAL POLICY RECOMMENDATIONS

OVERRIDE POLICIES

A. **Objective** Enable the voters to choose the level of services and the scope and scale of significant capital projects, such as new buildings and major renovations, by proposing operating overrides and debt exclusions of the Proposition 2½ tax levy limitations.

The Town's costs to educate children and to deliver Town services are likely to increase at an annual rate that exceeds core inflation rates. Each year these escalating costs are likely to exceed the Town's ability to raise tax revenue within the limits of Proposition 2½. The Town also needs to undertake major capital projects, such as the replacement or renovation of four elementary schools and construction of a new DPW facility and school administration building.

B. **Financial Policies** The overrides necessary to sustain town services and fund large scale capital projects should be governed by the following policies:

1. **Include specific amounts to balance future budgets when proposing periodic, multiyear operating overrides.** If the Board of Selectmen propose an override designed to sustain Town services for more than one year, then the Selectmen should disclose fully the amount raised by the override to be carried over to balance future budgets.

2. **Continue the policy of seeking voter-approved debt exclusion overrides to finance major new construction projects or significant renovations**.

FINANCIAL POLICY IMPLEMENTATION STRATEGIES

IMPLEMENTATION STRATEGIES

A. **Objective** Make a smooth transition from current financial policies to the recommended policies without adversely affecting the Town's ability to deliver services valued by the community or to preserve and revitalize the various classes of Town assets.

B. **Maintaining the Town's Investment in its Physical Assets**

1. **Undertake detailed analyses of the various classes of the Town's fixed assets to quantify the annual level of investment needed to sustain each asset class.** The Committee recommends three steps in this analytic process:

Step 1: Consider defining the following asset classes for analyses:

(1) School buildings and facilities
(2) School vehicles and equipment
(3) School technology
(4) Town buildings and facilities
(5) Town technology
(6) DPW equipment
(7) Fire apparatus
(8) Other Town vehicles and equipment
(9) Roads and streets

Step 2: Identify and assess the best practices for financing renewal and replacement of fixed assets used by other governmental entities and non-profit organizations. (See Exhibit C for a discussion of some such practices.)

Step 3: Determine which best practice is most appropriate for each asset class and apply that method to establish what the annual funding level should be and whether cash appropriations or an Asset Renewal and Replacement Reserve is appropriate. For vehicles, equipment, and technology - assets with shorter useful lives and generally predictable replacement costs - depreciation funding may be most appropriate. (See Exhibit D, Capital Financing Sources and Issues.)

2. **Give highest priority in the FY 2007 Capital Budget to critical building and facility renewal projects and timely replacement of vehicles and equipment.** For example, at the November special town meeting, the School Committee outlined a program of critical building renewal projects that they have since detailed for consideration at the 2006 annual town meeting.

3. **Defer the establishment of Asset Renewal and Replacement Reserves until FY 2008** to allow time to identify and analyze asset classes, study reserve funding options, and assess the impact on Town finances of alternative funding levels. These analyses and studies should be completed by October 1, 2006, to ensure adequate time to define the policies that will govern the development of the FY 2008 budget.

IMPLEMENTATION STRATEGIES (CONTINUED)

4. **Increase cash appropriated for asset renewal and replacement from General Fund revenues, but cap the percentage of General Fund revenues applied to within-levy debt service at FY 2008 levels.** As noted under Capital Financing Policies above, we propose an initial target of 2% of revenues for asset renewal and replacement until detailed analysis establishes a specific funding target. This is a transition strategy. The Committee recognizes that in the short term the Town must rely on within-levy debt to finance capital investments. However, the Committee strongly prefers cash and asset renewal reserves as funding sources for asset renewal and replacement.

   In FY 2007 the Town will pay $3.7 million in principal and interest for within-levy debt. If the Town were not to issue any further within-levy debt, then annual debt service would decline to $1.9 million by FY 2010. The Town should seize this opportunity to gradually reduce the General Fund's within-levy debt service obligations and reallocate these funds to capital renewal and replacement.

C. **Building a "Rainy Day" Stabilization Fund**

1. **Preserve the $1,522,111 balance anticipated in the Stabilization Fund as of June 30, 2006.**

2. **Target between $400,000 and $700,000 as the projected level of Free Cash as of June 30, a level consistent with the recommended Free Cash target range of 0.3% to 0.6% of General Fund revenues.**

3. **Add $2,650,000 to the Stabilization Fund at the 2006 Annual Town Meeting by approving the appropriation proposed by the Town Manager and supported by the Board of Selectmen.** This appropriation would build the Stabilization Fund to nearly $4.2 million, thus allowing the recommended reduction in estimated Free Cash without adversely affecting the Town's overall financial reserves.

4. **Continue to allocate between $500,000 and $1 million each year until the Stabilization Fund reaches roughly 7% of the prior year's General Fund revenues.**

5. **Consider approaching the voters to approve a Proposition 2½ override to set aside monies to establish or add to a Stabilization Fund as a "rainy day" fund or as an asset renewal and replacement reserve.** The Proposition 2½ statute was amended in 2003 to enable the voters of any city or town to approve operating overrides to place monies in a Stabilization Fund. Passage of such an override would enable the Board of Selectmen to use its taxing authority in subsequent years to build reserves until a target level is reached. For example, if voters approved a $300,000 operating override in 2007 to add to a Stabilization Fund, then in each following year, the Selectmen could vote to raise this authorized tax levy capacity, plus the allowable 2.5% growth, to build up the reserves in that Stabilization Fund. The Town could use this mechanism to build the Stabilization Fund to a targeted level.

IMPLEMENTATION STRATEGIES (CONTINUED)

D. Establishing and Funding "Continuing Balance Accounts"

The Committee commends the Town Manager for identifying the need for targeted reserves and for proposing in his FY2007 Budget that the Town establish continuing balance accounts for uninsured liabilities and for worker's compensation. The Committee recommends that the Board of Selectmen extend this initiative to all potential claims and liabilities listed above in paragraph 3. under Reserve Policies. To do so, the Selectmen should commission a study that will:

1. Quantify the Town's financial exposure to each potential liability.
2. Confirm whether a continuing balance account or some other reserve is appropriate for managing each risk.
3. Establish a desired funding level for each continuing balance account or reserve.
4. Develop a multiyear funding strategy to achieve the desired balance in each account or reserve.

The Selectmen should strive to complete this analysis by October 1, 2006, so that the results of the study could be considered in developing the FY 2008 Budget.

E. Instituting Long Range Financial Planning and Modeling

The Committee recommends that the Board of Selectmen undertake an ongoing long-term financial planning and modeling exercise projecting the Town's finances over a five- to fifteen-year period. The Committee believes that many of the long-term drivers of the Town's finances can be quantified by using an historical trend analysis as a basis for forecasting. Therefore, it should be possible to perform longer term financial projections with some level of precision.

As a base case, the model should assume that:

1. The Town will maintain its current level of services.
2. Property taxes (absent overrides) will grow at the limits of Proposition 2½ (a 2.5% increase from the prior year's tax levy plus taxes on an assumed level of new growth.)
3. Local receipts and state aid will reflect economic cycles.
4. Historical trends in the growth of specific operating expenses will prevail.
5. The Town will pay the debt service on existing outstanding debt , and the voters will approve debt exclusion overrides for the major capital projects on the horizon.
6. The Town will make its annual contributions to the Retirement System, and after quantifying its post-employment health insurance obligations, will begin to make annual payments to amortize these liabilities.
7. The Town will follow this Committee's recommendations by allocating cash and establishing asset renewal funds to maintain the Town's physical assets and by building a

portfolio of reserves, including the Stabilization Fund, continuing balance accounts, and the Appropriation Committee's Reserve Fund.

IMPLEMENTATION STRATEGIES (CONTINUED)

E. Instituting Long Range Financial Planning and Modeling (Continued)

The Board of Selectmen and the appropriate boards and committees could use this model to develop reasonable best-case and worst-case scenarios and answer some key questions, such as:

- Which expense drivers have the most significant impacts on future budget deficits?
- What level of property taxes will be necessary to maintain the current level of services and meet other commitments?
- Can this level of property tax be raised within Proposition 2½ limitations?
- If not, what level of property tax increases will the voters have to approve to sustain current service levels?
- Alternatively, if the required level of property taxes appears difficult or undesirable to achieve, what strategies can the Town pursue to raise other revenues or aggressively manage down expenses?

The Committee recognizes that the Town is operating in a very challenging fiscal environment, and that annual budget decisions are extremely difficult. Accordingly, we believe that this planning and modeling exercise would be easier to complete outside of the normal annual budget process, possibly through the work of another committee that the Selectmen would appoint.

F. Correcting Policy Exceptions

The Committee recognizes that from time to time the Board of Selectmen will propose actions to Town Meeting that deviate from these financial policies. When so doing, the Selectmen should also describe their strategy for taking corrective actions to reinstate the policy.

TABLE OF EXHIBITS

EXHIBIT A

COMMITTEE CHARGE AND MEMBERSHIP

Selectmen's Ad Hoc Financial Policy Committee

Members: 7
Appointed By: Board of Selectmen
Length of Term: Recommendations should be made by December 2005

Description: This Committee will recommend to the Board of Selectmen fiscal policies that seek to ensure structurally balanced budgets and adequate reserves while accommodating the possibility of operating overrides among other means to ensure the consistent delivery of balanced services. Specifically, this Committee will address:

- A Reserve Policy by examining existing reserve funds (stabilization, overlay, enterprise) and recommending appropriate funding levels, circumstances under which funds can be drawn upon, timelines for replenishment, and suggestions for additional reserve funds if warranted.
- A Free Cash Policy that defines appropriate targets and timelines for accumulating free cash as well as the circumstances under which free cash can be appropriated.
- A Debt Management Policy by defining appropriate levels (ratios) of debt (both exempt and within levy), the appropriate use of bond anticipation notes (BANs) in funding capital projects, and if not otherwise addressed
- A 'Cash' Capital Policy that defines the small capital projects loosely referred to as 'cash capital,' currently funded within the tax levy, and recommends a funding mechanism for these expenses.

Criteria for Membership: Knowledge and interest in fiscal policies

Reference: Charge adopted by the Board of Selectmen at its meeting on June 27, 2005.

Members:

Paul Asquith; William Dailey, Jr.; Peter Enrich; Alan Fields; Michael Kennealy; Paul Lapointe, Chair; and Robert Rieth *(through November 2005)*

Liaisons:

Board of Selectmen, Jeanne Krieger; School Committee, Tom Griffiths; Appropriation Committee, Deborah Brown; Capital Expenditures Committee, Charles Lamb

Staff:

Town Manager, Carl Valente; Budget Officer, Michael Young; Management Intern, Thomas Watkins

EXHIBIT B

DEFINITIONS OF CAPITAL EXPENDITURE TERMS

Capital Expenditure
A major, non-recurring expenditure that meets ***all*** *of the following criteria:*

- *Massachusetts General Laws permit the Town to issue bonds to finance the expenditure;*
- *The expenditure is $25,000 or more for a single item, or five times this threshold ($125,000) for a capital program consisting of multiple units of less than $25,000;*
- *The expenditure will have a useful life of 10 years or more for buildings or building components and five years for vehicles and equipment;*
- *Planning, engineering, or design services may be considered capital when such services are integral to a construction, renewal, or replacement project that meets the criteria for a capital expenditure.*

Examples of a capital expenditure include:

Acquisition of land for a public purpose;

Rehabilitation, renovation, or repair of a building, facility, water or sewer lines, or equipment;

Construction of, or addition to, a public building, playfields. or other town facility.

Fixed Asset
Any tangible asset with a useful life exceeding one year that generally accepted accounting practices require the Town to record in its schedule of fixed assets.

EXHIBIT C

DISCUSSION OF CAPITAL FINANCING FUNDING STRATEGIES

The Town may consider several alternatives for establishing the level of investment needed to maintain its physical asset base and for funding these investments. Some approaches are appropriate for buildings and other facilities; others are applicable to vehicles and equipment.

DEVELOP MULTIYEAR RENEWAL AND REPLACEMENT PLANS.

Though most organizations develop multiyear capital budgets, some focus extra effort on long-term (10 years or longer) asset renewal and replacement plans for classes of fixed assets: buildings, operating and maintenance equipment, vehicles, computer equipment, etc. For each asset class, these plans determine the annual allocations to renewal and replacement reserves necessary to fully fund the plan.

CONDUCT FACILITIES AUDITS AND ASSESSMENTS.

Many organizations commission facilities audits conducted by design and construction professionals experienced in performing such audits. These audits determine the anticipated useful lives of the building envelope components; HVAC, plumbing, and electrical systems; and any other building systems whose failure would compromise the operation and function of the building. These professionals conduct physical inspections in the field; develop schedules for the systematic replacement of such systems and components; estimate renewal and replacement costs; and use this data to establish the annual funding levels needed to build the reserves to support the renewal and replacement program.

> **The Town should consider pilot programs of facilities audits for selected buildings. For example, the Board of Selectmen might audit the former Munroe School and the East Lexington Library to determine the condition of these buildings and any upgrades needed to bring each building up to functional and regulatory standards.**
>
> **The School Committee could retain a firm to conduct facilities audits of the four elementary schools not yet replaced. These audits would identify the renewal and replacement investments needed over the next ten years or so. For the Committee and the community, these audits would highlight the costs of delaying the replacement of each of these schools and could inform the decision as to the sequence of these school renewal projects.**

FUND DEPRECIATION (USING HISTORICAL COSTS AS A BASIS).

If the useful life of a building were 40 years, then annual depreciation would be 2½ % ($1/40^{th}$ of the useful life) of the original cost of the building. If the useful life of a fire truck were 16 years, then annual depreciation would be 6.25% of the original cost ($1/16^{th}$ of the useful life). Some organizations treat depreciation as an operating expense and set aside funds equal to depreciation each year to establish reserves to replace these assets.

MAINTAIN INFLATION-ADJUSTED RESERVES (USING REPLACEMENT VALUES AS A BASIS).

Some assets have particularly long useful lives, and in some cases replacement costs rise faster than core inflation rates. Such is true of buildings and other facilities. If an institution were to rely on replacement reserves to replace such assets, then the annual "depreciation" funding should be adjusted annually to reflect replacement values.