

Section 4: Finance

Chapter 18: Authority and Internal Controls

Introduction

Oversight and governance of financial affairs is among the most important responsibilities of municipal elected officials. Inadequate oversight can lead to abuses such as embezzlement, misuse of and/or misappropriation of funds, and general loss of esteem for the municipality and its officials. Excessive control or oversight can render your city or village ineffective and incapable of delivering important services.

Local elected officials are given the responsibility and authority to establish financial policies for their municipality. For example, only the elected governing body of a municipality can levy property taxes, establish fees and charges for utility services, levy special assessments, incur debt, establish spending levels, and determine independent audit requirements. Appointed officials may recommend policies in these matters but the final authority to enact financial policy is reserved for the governing body of elected officials. They fulfill these responsibilities through their budgets, ordinances, and resolutions, all of which must be enacted by at least a majority vote of the body. (Check your charter for the vote requirement for your city or village.)

This chapter provides a brief overview of the very complex and pervasive subject of municipal finance in Michigan. It is essential that elected officials turn to the

resources at their disposal (e.g., manager, finance officer, assessor, treasurer, accountant, attorney, and independent auditor) to fulfill their duties and responsibilities.

Limitations on Local Authority

Authority and responsibility for municipal financial policies are established by the Michigan Constitution, state statutes, federal statutes, state and federal administrative codes, and city and village charters. These instruments, along with case law, grant certain authority on one hand and limit it on the other.

State Limitations

Municipal elected officials have become acutely aware of the limits imposed by the Michigan electorate through constitutional provisions which limit the authority of local officials to levy property taxes.

Constitutional revisions adopted in the late 1970s (known as the Headlee Amendments) limited local authority by:

- requiring local voter approval for increasing tax rates above the rates then authorized by law or charter, and
- rolling back or decreasing millage rates so the total amount of taxes paid on existing property increases by no more than the rate of inflation during periods when property values increase by more than the rate of inflation.

If one class of property has declining or stagnant market values and another class has spiraling increases, the total roll for the taxing unit may not increase more than the rate of inflation. And the taxing authorities are not required to reduce the millage rate. In many local units, residential property values have spiraled upward while other classes stagnated. As a result, residential taxpayers found little or no relief from the Headlee roll back requirements.

Again in 1994 the Michigan electorate amended the Constitution with Proposal A. This amendment defined a special class of property, *Homestead*, which is treated differently than the other classes of property (e.g., commercial, industrial, non-homestead residential, agricultural, etc.). Homesteads are exempt from the local school tax of 18 mills. No other class has this exemption. Schools were provided with state funds, generated by the state sales tax, to offset this loss of revenue.

In addition, Proposal A requires each parcel to be taxed on the basis of its taxable value which is to be limited to an annual increase of "...the rate of inflation or five percent, whichever is less." This limitation is imposed for each parcel.

Prior to Proposal A, properties were taxed on the basis of their state equalized value which was set at 50 percent of market value and adjusted upward or downward as the market value changed.

The local assessor now maintains two columns on the tax roll: the state equalized value and the taxable value. Taxes are levied on the taxable value. As long as the property continues under the same ownership, the taxable value of the parcel may only increase at the rate of inflation or five percent, whichever is less. However, upon sale or transfer of the property to another owner, the state equalized value (SEV) becomes the new taxable value.

By shifting school financing from the property tax to the sales tax, the reduced potential captured revenue through tax increment financing has had a negative side effect on certain financing authorities for future programs. The full effect of Proposal A is still unknown. Some believe it has had an inflationary effect on home values. Others believe that the reverse will be true in the future when new owners find the accumulated state equalized value (SEV) entered into the roll of taxable value for their payment of taxes. It also remains to be seen what its full impact will be on local units of government.

State Statutes

State statutes also limit the authority of local officials in administering their financial affairs in matters ranging from procedures to be followed by local governing bodies in advertising the annual budget hearing to the use of motor fuel taxes on local street systems; from debt limits to fidelity bonding requirements for local treasurers; from the annual audit to creating special financing authorities.

State statutes control almost every aspect of municipal finance. Local officials should seek advice and counsel

from their own local resources when embarking upon changes of policy and practices in the conduct of the financial affairs of their local government.

Case Law

Case law issuing from the judicial system also imposes controls and limitations on local officials. For example, a state court adjudicated a disputed special assessment which was levied upon owners of homes in a platted subdivision with streets emptying out into a major thoroughfare which was to be improved with special assessment financing. The court set aside the special assessment on the subdivision homeowners because in the opinion of the court:

- a. the benefit derived from the improvement was a general benefit to the community and not a special benefit to homes in the subdivision, and
- b. special assessments may only be levied for direct benefits (i.e., the street upon which their homes fronted) and such may not be levied for indirect benefits (for the major thoroughfare to which their frontage street connected). See *Jonson v Inkster*, 401-MICH-263, Michigan Supreme Court, 1977.

A second example has had perhaps an even greater impact on municipal finance. In 1998, the Michigan Supreme Court ruled that the City of Lansing's stormwater service "fee" was unconstitutional, declaring that the fee was actually a "tax" under the Headlee Amendment to the Michigan Constitution that required a vote of the city's electorate.

The ruling in *Bolt v City of Lansing* has significant implications for municipalities statewide. (See CH 22 Special Assessments and User Fees for more information on *Bolt*.)

Case law in municipal liability has been a source of concern for the financial stability of municipal units of government. Indeed, the creation of liability risk pools, including that of the Michigan Municipal League, is a response to case law.

Again, as elected officials establish policies affecting the financial affairs of their local unit of government, they must heed the advice of financial experts and their legal counsel.

Local Limitations

City and village charters, ordinances, and resolutions of policy are instructive to uninitiated elected officials. These local instruments often reflect provisions of the State Constitution, state statutes, and other regulatory requirements of the higher levels of government. Indeed, they must be in compliance with them. Careful review and drafting by legal counsel and financial administrators should ensure compliance.

Local charters establish millage limits, debt limits, and the fiscal year. They often spell out purchasing and contracting authorities, budget requirements, audit requirements and reporting of financial condition on a regular basis. Duties and responsibilities for financial management of the unit of government are usually assigned by the all-important local charter.

Charters often spell out the minimum requirements for the annual budget document including:

- presentation of proposed revenues and expenses in detail sufficient to effectively control the financial management of the municipality;
- presentation of actual audited revenues and expenses for the last fiscal year;
- revenues and allocations for the current fiscal year and actual expenses to date;
- separate presentation of operating and capital budget accounts;
- procedure and deadline for adoption including (a) advertisement, (b) opportunity for public review and (c) public hearing; and
- procedure for amendment and reallocation after adoption.

Purchasing and contracting requirements of charters usually include provisions that (a) limit authority to acquire without approval of the governing body, (b) require advertisement in approved publications, and (c) require receipt of sealed bids which are to be opened in public.

These are but two examples of charter limits and grants of authority. Ordinances and/or resolutions are often necessary to implement state statutory requirements and those of local charters.

City/village ordinances and/or resolutions limit and regulate financial management in more detail than is permitted or desirable by local charters. These are more easily amended than the local charter and greater detail can be accomplished.

Ordinances and resolutions may deal with such areas as administering blanket purchase orders, countersignatures on checks, depositories for funds, and credit card control. Again, local ordinances can be instructive for the uninitiated. Although they have little of the appeal found in best seller novels, they should be regarded as required reading for the novice elected official. And a refresher reading by seasoned officials is suggested. Although attention has been given to limitations on the authority of local governments and their elected officials in the foregoing, much still remains as discretionary authority to be exercised by them.

Financial Controls—Internal Management

After the city or village council has approved the annual budget and allocated funds for specific purposes, financial controls should be in place to assure compliance with the council's wishes, as well as compliance with laws, charters, and ordinances. These controls include an accounting system from which regular financial reports are extracted and transmitted to managers, administrative officers, department heads, and the governing body for review and examination. Charters and ordinances of some units require monthly financial reports, others quarterly.

In reviewing these periodic reports, elected officials should first determine if the reports permit them to carry out their responsibilities. Does the report provide budget allocations as approved and expenses as they are incurred to date? Are any budget allocations over spent? Are there allocations not being used? Is it necessary to reallocate funds to provide services as planned? Is the rate of expenditures in some budgetary accounts such that they will be over expended by the end of the fiscal year?

Financial reports can also be used as strategic planning tools. They provide opportunities for mid-year budget reviews and planning sessions. As a starting point for the preparation of the next budget, councils can review the progress of current projects and programs. They can also provide input for the planning and funding of projects in the next year of the capital improvement plan.

Finally, internal financial controls should reduce opportunities and temptations for fraud or embezzlement. Separating duties of employees and mid-level administrators is sometimes necessary. It is wise to have checks signed and counter-signed by persons from two separate lines of authority such as the treasurer and the clerk. Internal controls should be examined periodically by the independent auditor to keep systems updated with current technologies, especially in automated environments.

Purchasing State Statute

There are no longer any state statutes requiring public bids on municipal contracts. 1993 PAs 167 & 168 which required municipalities to seek competitive bids for purchases over \$20,000 in order to receive state shared revenue money, were repealed in 1996. The state has relegated the task of developing public purchasing guidelines to local governments.

Charter Provisions

Local government officials must look to their charter for purchasing guidelines and restrictions. A charter may establish who is responsible for purchasing (such as the manager or administrator) and include the maximum dollar amount that can be appropriated before advertising for competitive bids. Other local control mechanisms for the allocation of municipal funds are through ordinances and policies. In recent years, in order to set more realistic spending limits, some municipalities have amended their charters (which requires review by the governor and a vote of the electors) to allow the purchasing function to be legislated by local ordinance.

Local Ordinances

Legislation has a major impact on the services that can be provided to residents. The activities conducted in public procurement are restricted to those authorized by law. Therefore, many public entities have an ordinance that defines important parameters of the purchasing process. Well-written legislation will allow the purchasing department flexibility in using criteria in addition to price as evaluation tools.

This ordinance may discuss how responsibility for the purchasing function flows. For example, the ordinance may state that the organization's executive branch (manager, mayor, administrator, etc.) may enter into contracts based on the recommendation of the purchasing director with approval of the legislative body for certain dollar limits.

Ordinances will vary in the level of detail included. Some will establish a dollar amount for obtaining both written bids and legislative approval for purchase transactions; advertising requirements; and outlining the circumstances in which competitive bidding is not required. Ordinances may further detail specific responsibilities of the purchasing function such as encouraging competition; promoting standardization in the use of like products throughout the organization; barring vendors from bidding opportunities; and disposal of obsolete property. Some organizations have socially motivated buying policies, such as local preferences or disadvantaged business programs.

In these cases, authorization for such programs will often be addressed within this enabling legislation.

The Independent Audit

The annual report of the independent auditor is provided especially for the governing body of the local unit of government. It is intended to provide an independent review of financial management practices of the local unit by professional public accountants.

The state requires an audit either annually or biannually, depending on the size of your municipality. Certain funding sources (e.g., grants and federal/ state funds) may also require an annual audit.

The audit report provides opinions of the auditor as to whether:

- financial management practices are being conducted according to generally accepted accounting principles;
- financial reports are presented fairly and accurately; and
- financial management has complied with applicable laws and regulations.

The auditor may provide a management letter which provides opinions on potential problems with financial systems and controls. The letter may also provide suggested improvements. Comments on the opinions and suggested improvements by the chief administrative official or manager should be provided to the elected governing body. As part of the normal services of the independent auditor, tests of financial controls should be conducted to assure adherence to laws and regulations. Such tests should also be designed to uncover weak systems which may provide opportunity for fraudulent behavior including embezzlement.

It is impractical to pay for tests of all such control systems annually. It is suggested, however, that the auditor independently and without prior knowledge of municipal officials, select one or two aspects of the system to test. For example, the auditor may select to examine a random sample of all checks issued for purchases of items having a price range of \$1,000 to \$5,000 for compliance with purchasing regulations and ordinances. By annually selecting a limited number of test subjects in addition to those for which potential

problems are apparent, continued improvements in these systems can be expected.

By now you have probably concluded that the financial responsibilities of local elected officials aren't getting any easier and they are growing in importance. Good financial planning and management is a way of life. Good, sound systems and practices are the product of a series of decisions over a period of years. They are not the product of a short-term budget crunch or a financial crisis with quick-fix solutions. The task is to make thoughtful policy decisions with a view toward continual improvements over a period of time.

Local elected officials should always seek advice and counsel from their chief financial officer, assessor, manager, and municipal attorney when embarking upon changes of policy and practices in the conduct of the financial affairs of their local government.

Chapter by League staff.