

OC PUBLIC LIBRARIES

Preliminary Financial Review



Office of the Performance Audit Director

April 15, 2008

I. Introduction

The Orange County Public Library (OCPL) system is a special district governed by the Board of Supervisors that provides library services throughout the County for its participating members (cities and unincorporated areas). Some of the participating members have requested that OCPL explore options to expand the level of service within their respective city. During the process of examining this request, the Board identified OCPL financial issues to be reviewed further.

As a result, on April 1, 2008, the Board of Supervisors directed the Office of the Performance Audit Director to conduct a quick review of several financial issues related to OCPL. These included, but were not limited to:

- ☐ Budgeting process and expense budget allocation philosophy
- ☐ Long-term strategic financial planning and system sustainability
- ☐ Capacity for capital improvements for city participants in the OCPL system
- ☐ Human capital appraisal of budgeting staff

The Office of the Performance Audit Director was instructed to provide a preliminary report on these financial issues by April 11, 2008. This document serves as that report.

II. Methodology

The timeframe for this assignment necessitated the quick review of pertinent documents and discussions with high value sources.

Documents reviewed include:

- Orange County Public Library Annual Business Plans for 2005, 2006, and 2007
- Various spreadsheets prepared for internal OCPL use regarding finance and operations
- Financial history of OCPL from FY 00-01 through FY 06-07 from County Budget Reporting and Analysis Support System (BRASS)
- Orange County Board of Supervisors Resolution No. 96-903 and accompanying Agenda Staff Report, which created a separate OCPL Department, established a Library Advisory Board, and created the Cost-Revenue Equity Allocation Formula for branch libraries
- OCPL Organizational Chart
- County Counsel Opinion regarding City withdrawal from the OCPL System
- OCPL Facilities Maintenance Plan
- OCPL Strategic Financial Plan (SFP) for FY 07-08 through FY 12-13
- OCPL Branch Library Operating Funds Allocation Formula
- Library Needs Assessment Study Report for the City of Irvine prepared by Arroyo Associates, Inc., October 2006.
- 25-Year Forecast of OCPL Finances, prepared by OCPL staff
- California Public Library Statistics FY 2005-06 Data File

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- Summary of projected OCPL Branch Costs for FY 07-08
- Memorandum sent from Wally Kreutzen, Assistant City Manager of Irvine, to Supervisor Bill Campbell regarding OCPL, dated March 10, 2008.

Interviews/Meetings/Correspondence with:

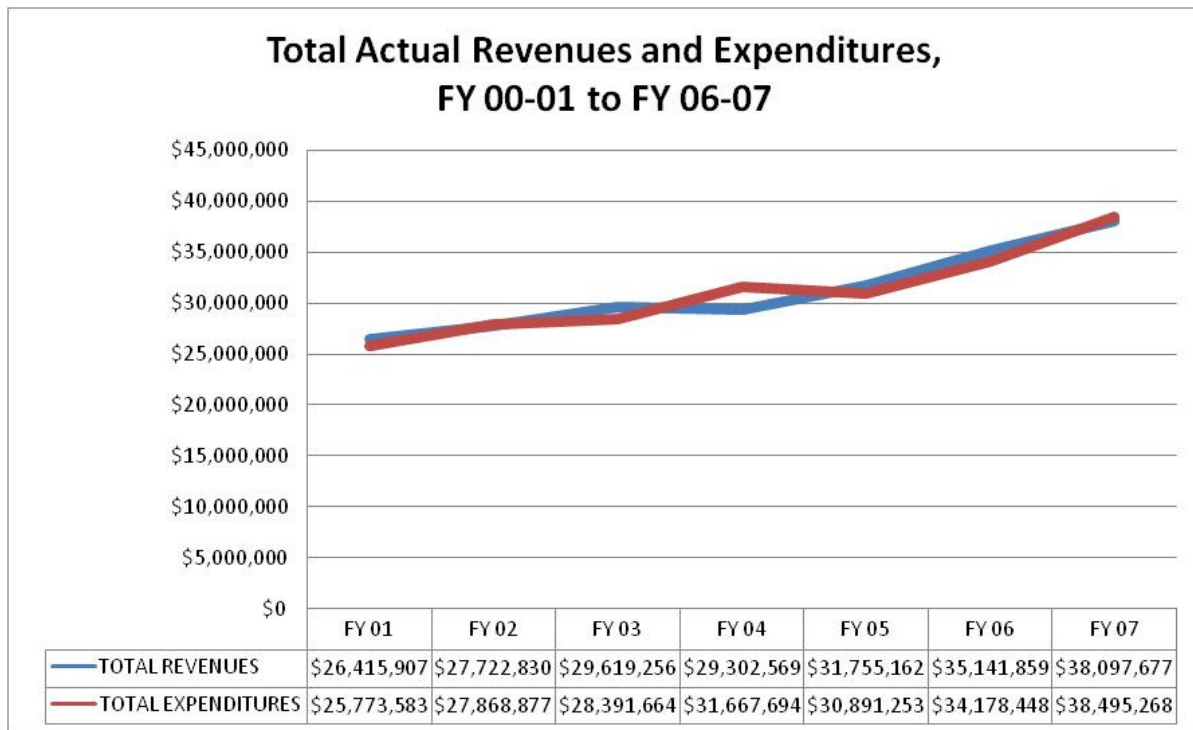
- Supervisor John Moorlach
- Supervisor Bill Campbell and Executive Assistant staff
- Steve Dunivent, Deputy CEO
- Alisa Drakodaidis, Deputy CEO
- Frank Kim, CEO/Budget
- Anil Kukreja, CEO/Budget
- Bill Castro, Auditor-Controller
- Bill Davies, Auditor-Controller
- Nick Chrisos, County Counsel
- Helen Fried, Acting County Librarian
- John Adams, former County Librarian
- Dave Sankey, Library Financial
- Steve Siemion, Library Financial
- Bob Genzel, Library Facilities
- Pamela Baird, City of Irvine

III. Current OCPL Financial Environment

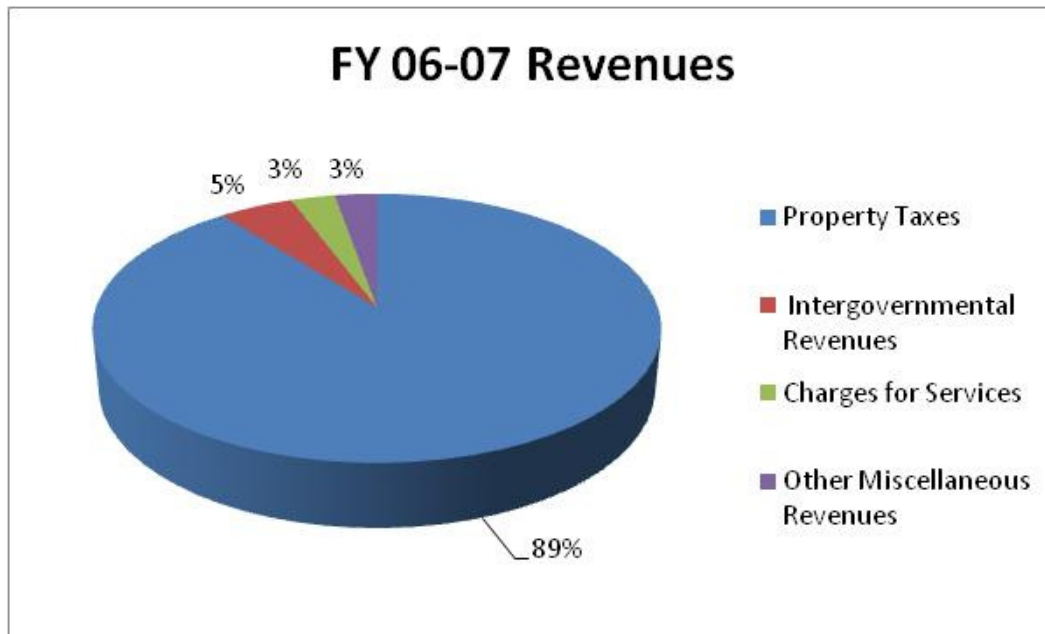
Overview

OCPL operates on a tight budget. In fact, as demonstrated in the chart below, Actual Total Expenditures have minimally exceeded Actual Total Revenues in three of the last six fiscal years. In two of the years there was sufficient Fund Balance Available (FBA) from the prior year to cover the slight operating deficit. However, in one of the years (FY 03-04) there was not enough FBA to cover the difference between expenditures and revenues and OCPL carried a very small, negative FBA into the next year. OCPL is cognizant of their limited resources; however the intense demand for services in the OCPL system results in full expenditure of revenues available every year with very little margin for error.

Though Total Revenues have increased by 7-8% per year, largely due to aggressive growth in property values, OCPL still does not have enough resources to meet its customer demands in the areas of books and materials, facilities maintenance, or contingency reserves.



Total Revenues



Relevant Facts:

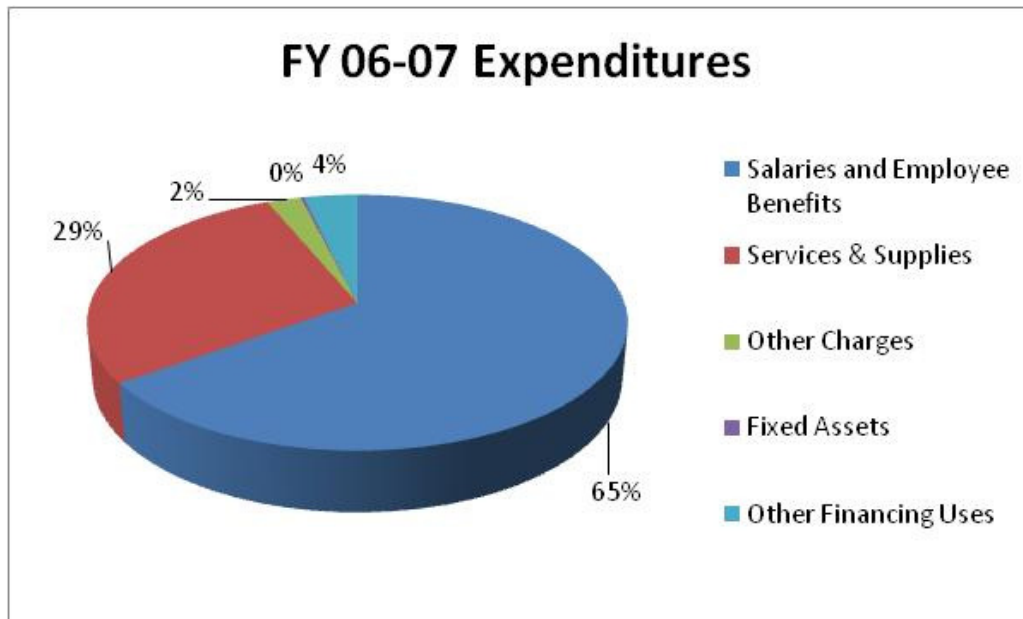
-In FY 06-07 Total Property Tax Revenues comprised approximately 89% of All Revenues received by OCPL. This is consistently the case.

-From FY 00-01 to FY 06-07, Total Property Tax Revenues grew by an average of 11% per year.

-Total Intergovernmental Revenues have decreased from FY 00-01 to FY 06-07 by a total of 44%, from \$3.37 million to \$1.87 million. This reduction was caused primarily by a reduction in State subventions.

-Total Charges for Services have remained in the \$1.1 to \$1.2 million range from FY 00-01 to FY 06-07.

Total Expenditures



Relevant Facts:

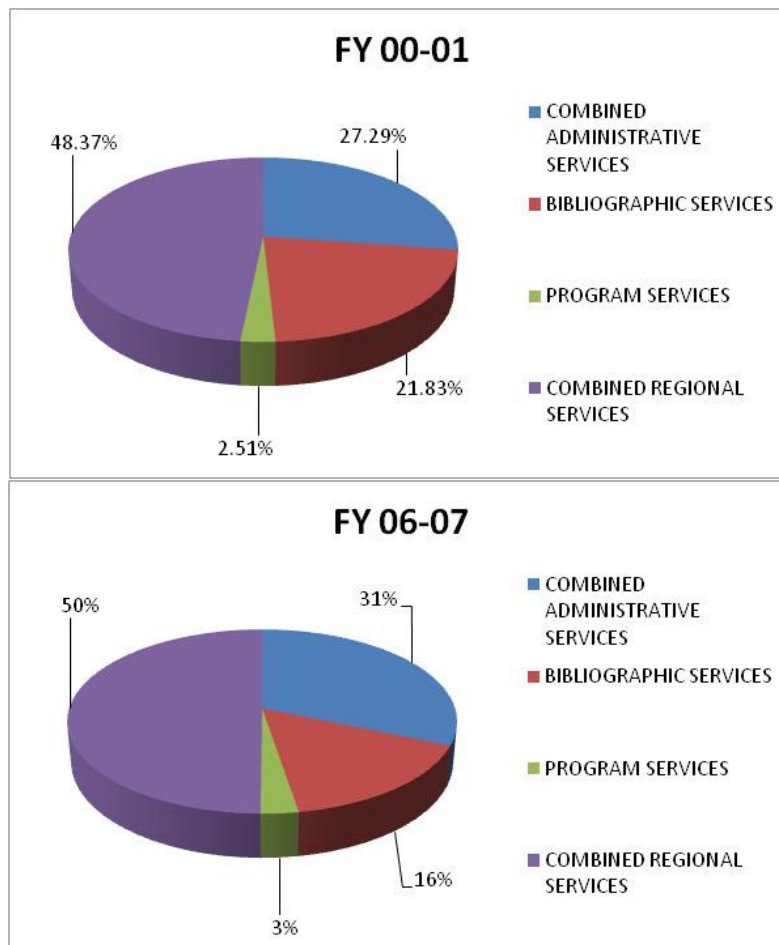
-From FY 00-01 to FY 06-07 Total Actual Expenditures for OCPL grew by an average 8.2% per year. The most significant component of Total Expenditures is Salary and Benefits for employees (both at headquarters and at the branch libraries).

-From FY 00-01 to FY 06-07, Total Salary and Benefit expenditures grew by an average 11% per year. By comparison, expenditures for Services and Supplies (which does not include Facility Maintenance projects over \$150K), grew by an average of 4.2% per year. Total Expenditures for Facilities Maintenance projects over \$150K (aka Other Financing Uses) grew from \$877,813 in FY 00-01 to \$1.44 million in FY 06-07 (a total increase of 64%). However, spending on facilities maintenance is much more variable year-to-year when compared to other categories of expenditure. Moreover, this amount is minimal in light of the limited number of buildings that are able to be maintained with these monies.

-In terms of staffing, OCPL has grown from 383 positions in FY 00-01 to 432 positions in FY 06-07, an increase of 49 positions or 12.79%. The overwhelming majority of this increase (42 positions) was used to augment Branch Library Services.

Administrative Expenses

One of the areas of study included in the Board directive for this review is the size of the Combined Administrative Services category of expenditure relative to Total Expenditures. Combined Administrative Services includes a variety of items, such as Information Technology, Human Resources, Fiscal and Purchasing Services, the County Librarian's Office, and Administrative and Facilities Services. At OCPL Combined Administrative Services also includes any significant capital expenditure, such as facility repair. For comparison the two charts below illustrate the percentage of Total Expenditures that is allocated to the different OCPL Service Lines, for both FY 00-01 and FY 06-07. As is apparent, the percentage of Actual Total Expenditures allocated to Combined Administrative Services increased modestly (from 27.29% to 31%), as did the percentage of Actual Total Expenditures allocated to Combined Regional Services (from 48.37% to 50%). Combined Regional Services represents the total amount needed to staff and supply the branch libraries. In contrast, the percentage allocated to Bibliographic Services, which includes the Books and Materials budget, decreased from 21.83% to 16%.



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Total spending on Combined Administrative Services grew significantly from \$7,032,811 in FY 00-01 to \$12,082,671 in FY 06-07. This increase represents an average annual growth of almost 12%. This increase is driven largely by higher salary and benefit costs. The chart below illustrates where significant increases in Salaries and Benefits and Services and Supplies have occurred from FY 00-01 to FY 06-07, both in Administrative Services and other OCPL Service Lines. The expenditure for books and materials is incorporated in the Services and Supplies budget of Bibliographic Services. Overall, this chart demonstrates that though relatively few positions were added in Administration over the last six years, Salary and Benefit expenditures have grown substantially, driven largely by salary and wage increases, health insurance costs, and retirement expenses. Also of note is the 1.48% average annual decline in the Bibliographic Services, Services and Supplies budget, which is comprised mostly of books and materials spending. Thus, while service area population has been rising, spending on books and materials has been falling. Lastly, at the branch libraries, the amount of money spent on services and supplies as been declining by approximately 1% per year over the last six years.

OCPL Service Lines		FY 00-01 to FY 06-07			
		Avg. Annual Growth in Actual Total Expenditures for Salaries and Benefits	Avg. Annual Growth in Actual Total Expenditures for Services and Supplies	Increase in Total Number of Positions	Avg. Annual Increase in Salary and Benefit Exp. Per Employee
Administration		11.60%	16.49%	5	8.93%
	County Librarian's Office	20.70%	-21.89%	1	8.24%
	Admin. & Facilities Services	19.25%	11.55%	4	11.69%
	Information Services	9.46%	33.73%	1	6.56%
	Fiscal & Purchasing	7.68%	2.64%	0	7.68%
	Human Resources	4.87%	-16.73%	-1	9.18%
Bibliographic Services		10.74%	-1.48%	-1	11.57%
Program Services		20.32%	-3.42%	3	9.23%
Branch Libraries		10.50%	-1.04%	42	7.10%

Annual Budget Process

Although there is a formal budget procedure that was approved by the Library Advisory Board (LAB) in September 2005, OCPL staff verified that they have modified this approach. According to OCPL staff, the first step in the process is to determine the resources available to OCPL for the following fiscal year. As noted, the majority of revenues come from property taxes, and OCPL works with CEO-Budget as well as various economic forecasts to estimate available revenue. In terms of

allocation, the foremost priority of OCPL during budget preparation is maintenance of current branch library operating hours.

OCPL does not have a formula or system for allocating central administrative costs across branch libraries. OCPL did prepare a preliminary system for allocating these costs in response to a request from the City of Irvine, and they are in the process of refining this allocation system. Once branch operating costs and central administrative costs are covered, the balance of available resources is allocated to (1) books and materials spending, and (2) facilities maintenance costs. As such, spending on these items is modified (usually down) in order to balance the budget on an annual basis and in the five-year Strategic Financial Plan (SFP).

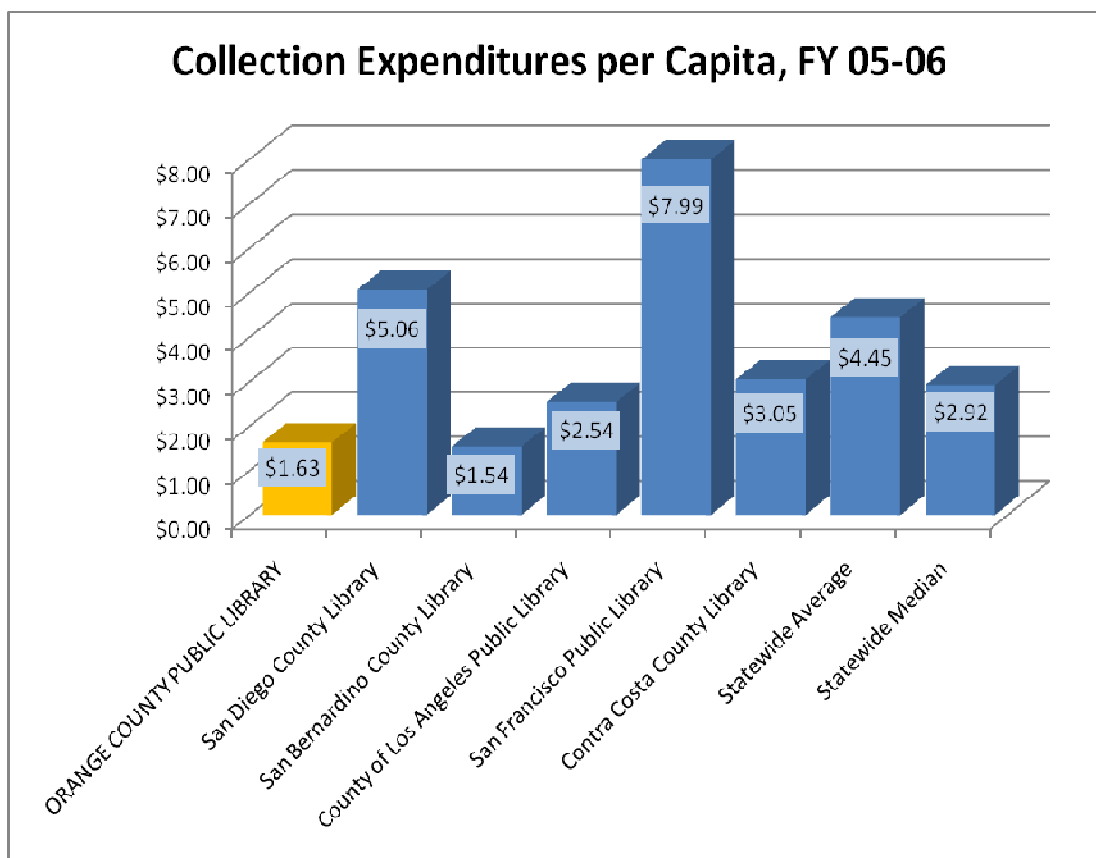
The Role of the Library Advisory Board (LAB)

In 1996, the County Board of Supervisors resolved to establish OCPL as a new department by separating it from the County General Services Agency, and to establish a Library Advisory Board to provide member cities with a more direct mechanism for communicating with the County Board of Supervisors. The LAB is comprised of 23 voting members (one from each of the 21 cities in the system, plus two County Supervisors representing the unincorporated area of the County), and two ex officio, non-voting members. Each participating area agrees to an additional tax assessment in order to fund the OCPL System. The LAB is charged with “recommending positions on policy, operations, and strategic planning issues to the Board of Supervisors.” Any recommendation made by the Library Advisory Board that requires Board approval is put on the County Board Agenda. However, the County Board of Supervisors can only override an LAB recommendation with a 4/5 vote, unless the recommendation pertains to budget, personnel or collection development issues which, statutorily, may not be delegated.

The LAB recommended and the Board of Supervisors approved the existing Cost-Revenue Equity Allocation Formula to provide each member city with a proportionate allocation. This formula (which utilizes city population, property tax revenues collected in a particular city, and materials circulation in a particular city) is used to determine the number of days per week that libraries in a particular city will be open. Libraries can be open between five and seven days per week, depending on the results of the Allocation Formula. Each year, OCPL Administration attempts to increase the previous year’s total operating budget for branch libraries by an inflation factor (typically 2-3%), and works with regional service managers to determine if that inflated level will be sufficient to sustain the current operating hours. If the necessary level of spending exceeds the total amount allotted to the city, then that City is provided additional resources. This funding comes from cities where the necessary level of operating expenditures is below the amount allocated to the city per the Allocation Formula. As such, there are “donor” and “receiver” cities. The LAB has considered modifying the Allocation Formula in the past, but was unable to come to agreement on a new methodology. The majority of cities that sit on the LAB and participate in OCPL are “receiver” cities. The City of Irvine is the largest “donor” city by orders of magnitude.

The LAB recommended a policy several years ago that OCPL should accrue reserves to cover various expenses in the event of a cash shortage. The LAB set an operating reserve target of 10% of Total Expenditures. Currently the reserve is at approximately \$2.5 million, which is only 6% of the Total Expenditures budgeted for FY 07-08. For this reason, over the next several years OCPL will attempt to set aside part of its budget toward growing their reserves if the funds are available after core

business needs are covered. In addition, the LAB has recently encouraged OCPL to increase its annual spending on books and materials to reach the State average. The chart below shows the Total Collection Expenditures per capita in FY 05-06 (the most recent data available) for OCPL, select County Library Systems, as well as the Statewide Median and Average.



Requests for Staffing Increases to Cover Expanded or New Libraries

The context for this discussion includes the Cost-Revenue Equity Allocation formula that determines the operating hours for libraries in each member city. This formula also indicates how much money should be allocated to a particular member city. However, the actual resources needed to maintain the existing levels of service at the various branch libraries may be above or below this allocation. Because the total budget for branch libraries is a zero-sum system, any additional resources needed in one branch will have to come from other branches.

Under the previous County Librarian there was a policy in place that if a member city built a new branch library, OCPL would staff the facility. Due to system fiscal constraints, the Interim County Librarian has taken a slightly more conservative approach by indicating that if the request for additional staffing will result in a negative financial impact on other branch libraries, then the Library Advisory Board should review the request. There are some expansions currently in process which OCPL does not believe will have a significant budgetary impact on other branches in the system. For instance, the City of Laguna Niguel is paying for a 3,500 square foot expansion to the Laguna Niguel branch. As another example, the Friends of the San Juan Capistrano Branch Library are trying to gather funds to add a 3,000 square foot wing to the existing facility. Lastly, the City of Tustin is

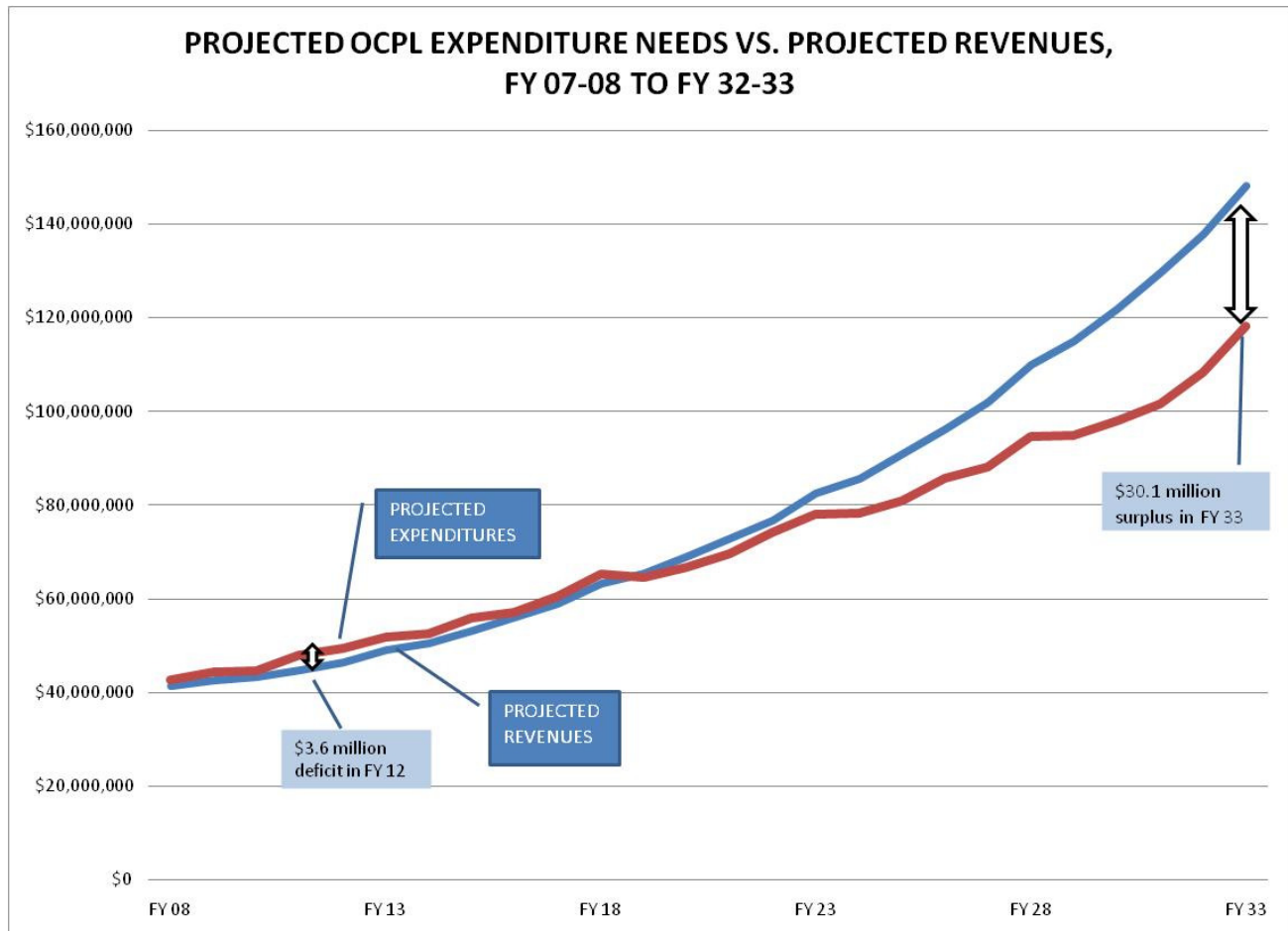
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building a new 30,000 square foot facility to replace the existing 15,000 square foot building. Though this is a sizeable increase in the size of the Tustin branch library, certain technology and design elements at the new facility are believed to allow for similar levels of staffing, and therefore the increase in space is not expected to impact the funding pool for all branches. The initial request from the City of Irvine was for additional OCPL staffing for a 300,000 square foot facility at the Great Park, as well as two 20,000 square foot libraries elsewhere in Irvine. This request has been modified to just two 20,000 square foot facilities. Given that Irvine is a “donor” city, the Interim County Librarian has determined that funding would have to be taken from other branch libraries if such a request were granted. As such, the Interim County Librarian scheduled a meeting between the City of Irvine and the Library Advisory Board to discuss their request. This meeting was cancelled, and no further discussion has taken place.

According to the 2007-08 Cost-Revenue Equity Allocation Formula the City of Irvine is allowed \$3,978,566 in order to fund its branch libraries. However, Irvine only required \$2,826,933 to maintain its existing levels of service at its three branches. Therefore, Irvine may request to utilize up to an additional \$1,151,633 in order to staff and supply libraries in the City. This calculation does not take into account the money spent on books and materials, facilities maintenance, or administrative services. Of course, by allocation system design this \$1,151,633 is currently being used other branch libraries that would likely have to reduce hours of operation if this money was redirected back to the City of Irvine.

Long-Term Financial Planning

Other than preparation of the five-year Strategic Financial Plan (SFP) required by the CEO, it does not appear that OCPL conducts any systematic long-term financial planning. The recent 25-Year Plan, which was prepared over the course of six business days, was the result of a request made by Supervisor Campbell to ascertain the long-term financial condition of the OCPL system. In contrast to the SFP, the 25-Year Plan included the true needs of OCPL with respect to (1) facility maintenance, (2) materials spending to reach the statewide average, and (3) reaching the 10% operating reserve target established by the LAB. This analysis projected operating deficits each year from FY 09-10 through FY 17-18. As shown in the chart below, the greatest deficit is expected in FY 11-12 (\$3.6 million). Of course, the 25-Year Plan is highly dependent on a set of assumptions, the most significant of which is property tax growth. From FY 06-07 to FY 12-13, Total Property Tax Revenues going to OCPL are estimated to grow by an average of only 5% per year (5% from FY 08-09 to FY 09-10, 4% for each year from FY 09-10 to FY 11-12, then 6% from FY 11-12 to FY 12-13). These projected growth rates are provided by the CEO's Office and the California State University at Fullerton economic forecast.



Capital Planning

At current funding levels OCPL cannot adequately fund either a stable building maintenance or capital improvement program over the next several years. In fact, OCPL administrative staff does not prepare a Capital Improvement Plan because they do not have sufficient funds to cover their annual facilities maintenance costs, let alone build new facilities. The facilities function at OCPL maintains a list of facilities maintenance needs that extends out approximately three to five years. These projects are ranked [in order of priority] according to (1) safety, (2) building preservation, and (3) aesthetics. OCPL Facilities works with OC Public Works-Facilities Operations to monitor the HVAC systems and battery systems. OCPL Facilities also conducts control inspections of electrical/mechanical systems every other year. As part of the FY 07-08 County budget process, OCPL staff requested assistance from the CEO's office to make various mandated ADA upgrades at library facilities. The CEO's office provided a one-time, \$1.5 million allocation of General Fund money to make these upgrades.

IV. Preliminary Examination of OCPL System Sustainability

During this review, several important observations were noted in regard to the long term sustainability of the OCPL system. These observations are identified as having potentially significant short- to mid-term consequences and should be more fully examined in the near term. These observations include:

System Needs are on the Increase

As the population of Orange County continues to grow, the demand for library services increases. As previously stated, several cities have identified a shortage of sufficient library space and materials to meet citizen demand. In a comprehensive study commissioned by the city of Irvine in 2006, the general conclusion was that the quality of services provided by OCPL is good, but the quantity of services could be increased, specifically in terms of library space. This conclusion was documented by a comprehensive benchmark study of services and space provided by various comparable library systems in the state, both on a city and county level. For example, the square feet per capita of library space for OCPL is 0.23 (including the newly opened Wheeler Library) compared with the benchmark county library average of 0.295 discussed in the Arroyo Associates, Inc.; and expenditures per capita is \$20.93 for OCPL compared with the benchmark county library average of \$25.95 per capita.

OCPL has worked extensively to address additional space requirements within their financial constraints. Just recently, the Katie Wheeler Library in the City of Irvine opened, and new/expanded facilities are in various stages of development in the cities of Tustin, Laguna Niguel, and San Juan Capistrano. Due a lack of available funding, the construction of many of these new facilities has been/will be paid for with city or non-profit funding, and OCPL is slated to staff and operate the facilities. Notwithstanding these efforts, pressures to expand continue.

In addition, a discussion of the physical condition of existing library facilities indicates insufficient funding to adequately maintain and protect its aging physical assets on a prudent schedule. OCPL appears to do a good job of identifying its needs in this area and is doing what they can with the limited funds available. Unfortunately, it is predicted that there will be insufficient funding for

necessary maintenance expenditures going forward. As such, the state of OCPL facilities will continue to deteriorate unless other funding is secured.

Revenue Growth is on the Decline and non-Diversified

As previously identified, Property Taxes are the chief revenue source for the system (89% for FY 06/07). Over the previous six years, these taxes have increased on average 11% per year. However, recent economic conditions have significantly lowered the growth rate assumption in the mid-term. Accordingly, Property Tax growth projections used in planning documents are 5% in FY 08/09 and 09/10, 4% in years 10/11 to 12/13, and 6% thereafter. In addition, there is always the potential that the State, in the current economic climate, could again shift property taxes away from local governments (although because of recent legislation it would have to pay it back in the future). If these reduced growth projections are realized, the OCPL system will face severe funding shortfalls in maintaining its current system, and it will certainly not be able to expand services or have any long-term capital improvement program.

In addition, the system maintains minimal reserves, currently at \$2.5 million. Intermittent attempts have been made to set aside money, a practice which has been difficult to adhere to given critical expense needs.

Meaningful Long-term Strategic Planning Has Been Minimal

During our brief examination of financial planning tools, the most apparent observation is the lack of identification, communication, and development of a plan to address the potential shortfalls in the near future as a result of the projected decline in growth of property tax revenue. While County systems are set up to identify future financial issues, it appears that little use of these opportunities was made. Examples that illustrate this observation include:

- Absence of discussion in the last three Business Plans of potential future property tax growth declines and its significant impact on operating activities. Similarly, there is no discussion of OCPL's below average offerings in expenditures and space per capita when compared with benchmark systems throughout the state. Lastly, Business Plans also make no mention of OCPL's inability to acceptably cover its needed facilities maintenance costs, now or in the future.
- The development of a 5-year Strategic Financial Plan (SFP) which does not identify or discuss looming financial issues, but rather seeks to balance expenses to revenue.
- Non-participation by OCPL in the County Strategic Priority process to identify and/or request large scale budget augmentations for systems needs.
- The recent initiation of a long term (25-year) Financial Plan called for by the Board of Supervisors (rather than internally) based on increased systems requirements for materials, facilities maintenance, capital improvements, and adequate level of reserves.
- Consistent responses from the majority of those interviewed indicate a lack of awareness of long term financial conditions, and therefore minimal proactive steps have been taken to address those issues in response to slowing Property Tax growth.

Culture Impediments

Library staff members that were interviewed appear to be qualified in their specific assignments. Work products reviewed and interviews demonstrate quality in task-oriented assignments. Improvement can be made, however, in the areas of long term strategic planning, particularly in identifying future issues, and in developing and pursuing strategies to address those issues.

Although unempirical, interviews may suggest a certain mindset that hampers initiative in this area. This perceived mindset recognizes the reality of libraries as non public health and safety services that often bear the brunt of initial government cuts in downward economic cycles. As a result, there appears to be little expectation of assistance and therefore a corresponding inclination not to request it. This expectation may be partially driven by financial realities that discourage non General Fund departments from asking for General Fund resources. Obviously, this mindset, if accurate, is not conducive to strategic visioning or the development of alternatives to address system challenges.

Preliminary System Sustainability Conclusions

1. If reduced Property Tax growth slows to the level predicted, OCPL cannot sustain a quality library system at its current service levels in the near to mid-term.
2. The existing and anticipated financial condition of OCPL significantly reduces the possibility of picking up the operating costs of library expansions or newly constructed facilities, without a corresponding negative impact on other branch library operations.
3. Additional efforts should be made to further refine strategic planning data and to identify alternatives to address revenue shortfalls.
4. The current allocation formula process should be re-evaluated to ensure equity system wide.
5. A strong administrative manager within the OCPL structure is necessary to begin this process and ensure it is carried through to implementation. The placement of OCPL into the new Community Resources Department may expand personnel options in this area.

V. Other Issues

During the course of our review, other significant issues were noted that warrant mention:

Notification of Library Advisory Board

The issues discussed in this report and decisions on how to proceed will affect the entire library system. As such, this group should be appraised and input obtained from the entire body before implementation of major changes to the library system.

Withdrawal of Participating Cities from the OCPL System

Given the recent contemplation of some “donor” cities to leave the OCPL system, a brief examination of this issue was completed with County Counsel assistance. The general conclusion, based on California Revenue and Taxation Code, is that any proposed withdrawal can only be completed if the Board of Supervisors and the city council of the withdrawing city each adopt a Resolution to accept a negotiated exchange of property tax revenue. Further evaluation and discussion of this issue is available from County Counsel.

VI. Next Steps

Based on the findings of this preliminary review of OCPL financial issues, the following recommendations are made for Board consideration:

1. OCPL staff and the CEO’s office should further refine a long term (potentially over 10 years) strategic financial plan for the library based on minimum but sufficient operating needs, including such areas as: acceptable materials ratios, acceptable space ratios, full funding of the facility maintenance budget, and establishment of a prudent reserve level. Identify strategies for overcoming projected deficits over the next 10 years.
2. OCPL should obtain the necessary human resources to ensure effective strategic planning, and fully implement proactive strategies for achieving long term system sustainability. Utilize the expanded administrative resources of the new Community Resources Department to assist in this effort.
3. Hire a consultant using General Fund monies to revisit the Cost-Revenue Equity Allocation formula to ensure equity between participating cities and the County. Included in this consultant’s report should be a “best practices” section that describes where allocation mechanisms are working well in other library systems.
4. OCPL, the CEO, and County Counsel should confirm and memorialize their determination as to whether a City within the system is entitled to its full allocation as determined by the finalized allocation formula, regardless of the current level of service.
5. The CEO and the Board of Supervisors should begin discussions as to the level of financial commitment the County is willing to make to address any library shortfalls from reduced Property Tax growth, and/or shifting of resources amongst branch libraries.
6. As necessary, advise and seek input on issues with the Library Advisory Board prior to final decisions being made.

The Office of the Performance Audit Director is available to discuss any aspects of this report.