

# CITY COUNCIL

For City Clerk's Use:

**APPROVED**       **DENIED**

Reso No. \_\_\_\_\_ File No. \_\_\_\_\_

Ord No. \_\_\_\_\_

**Agenda Item No.: 14**

**Date: December 9, 2015**

**TO:** Honorable Mayor and Members of the City Council

**FROM:** Sheryl Bennett, Director of Administrative Services  
Joan Ryan, Assistant Director of Finance

**SUBJECT:** 2015-2016 City Council Action Plan – Fiscal Management

**RECOMMENDATION:**

It is requested that Council approve Resolution 2015-215 to amend the City's Fund Balance policy to establish the appropriate General Fund target Reserve based on a risk-based analysis as recommended by the Government Finance Officers Association (GFOA).

**CORRELATION TO THE CITY COUNCIL ACTION PLAN:**

This item relates to the 2015-2016 City Council Action Plan regarding Fiscal Management.

**PREVIOUS ACTION:**

Council held a workshop on February 11, 2015, in which they developed goals for the 2015-16 City Council Action Plan. At the August 12, 2015, City Council meeting, Staff presented the strategies and a timeline to achieve the four primary goal categories; Council approved this plan. One of the primary goal categories of the plan is Fiscal Management. A specific goal of the Fiscal Management category is to set an appropriate Reserve for the General Fund. On October 28, 2015, Staff presented Council a strategy recommended by GFOA to evaluate an appropriate Reserve based on a risk factor analysis. Council approved of this strategy and directed Staff to return to Council with the outcome of this analysis which will be incorporated in the revised City Fund Balance Policy.

**BACKGROUND:**

Reserves provide a city with financial flexibility to respond to unexpected issues and offer a buffer during financial downturns. Maintaining a reserve balance allows a city to continue operations while responding to short-term problems, eliminating the need to reduce service levels when these temporary fluctuations occur. It also provides an organization time to address longer term problems while comprehensive response plans are developed. This eliminates the need to resort to extreme crisis actions. There is a misconception that a large reserve balance reflects the fiscal strength of an

organization. Better indicators of fiscal strength are the ability of an organization over time, to use ongoing revenues to adequately meet day-to-day service needs, capital improvements and debt service payments. A reserve balance is more an indicator of the ability of an organization to manage risk when faced with both temporary and longer term problems.

In comparing reserve levels between government agencies, it is important to recognize that “one size does not fit all”. In short, other than having a reserve at all, there is not a “right” level: it depends on the circumstances in each agency. Questions that should be asked when establishing reserve levels include the potential impact of risk (loss) and how much fiscal capacity (measured in time) does the organization think is prudent in developing and implementing plans to respond to unexpected circumstances. Several factors should be considered in determining a prudent reserve amount. By analyzing the risks that influence the level of reserves, the City can determine a reserve level that can hedge against uncertainty and loss. This is a sensitive issue, because money held in reserve is money not used for providing services to the community. On the other hand, insufficient reserves may put the City at risk during an unexpected event.

#### RISK-BASED ANALYSIS:

The Government Finance Officers Association (GFOA) provided cities access to a risk evaluation tool that can be used to help determine the right size of reserve for a city. This tool was used by City staff to reach a recommendation for a target reserve for the City’s General Fund. Below is the analysis of the risks that influence the level of reserves that the City’s General Fund will need to hedge against uncertainty and loss. These eight risk factors include: revenue stability, vulnerability to extreme events, liquidity, expenditure volatility, leverage, capital projects, other funds’ dependency, and growth. A score between 1 through 5 is assigned to these risk factors based on how important it is for the City to retain this risk through General Fund reserves. A score of 1 is very unimportant and a score of 5 is very important, indicating the greatest need to retain reserves. Below are the individual results for each of the risk factors facing the City of Escondido.

- 1. Risk Factor – Revenue Stability assigned a score of 4.** Volatile revenue sources call for higher reserve levels in order to avoid the need for sudden service cutbacks should revenues drop unexpectedly. Sales tax is the General Fund’s major revenue source and makes up 40 percent of total revenue. The other major revenue sources are property tax and other taxes that make up 26 percent and 14 percent of General Fund revenue, respectively. Sales tax volatility for the City is almost entirely due to economic cycles, as the City receives 30 percent of sales tax from new and used auto sales and 13 percent from construction materials. These revenue sources tend to rise and fall quickly during economic changes. During the worst two years of the Great Recession, General Fund revenue decreased by 15.4 percent or about \$12.4 million. Of this amount, \$8.4 million or 65 percent of this decline came from sales tax, which dropped 28 percent during this two year period. Property taxes also declined by about \$2 million but dropped by a slower rate of

about 9 percent. In the past, the City has been able to lower the risk of using reserves by reducing spending during downturns. This decreases the reserves needed to cover the full amount of the revenue decline. In addition, the City's other revenue sources have historically been more stable. The score of 4 was assigned to revenue stability because although the City's sales tax is volatile and makes up 40 percent of General Fund revenue, the City has demonstrated in past history that this risk can be mitigated by reducing costs thus reducing the need to use reserves. In addition, the City's other revenue sources are less volatile.

- 2. Risk Factor – Vulnerability to Extreme Events assigned a score of 4.** This factor concerns the extreme events (natural disasters) the City is vulnerable to, the public safety programs that must be funded during the occurrence of an extreme event, and the federal or state programs that would help and how long it would take to get assistance. The City is subject to extreme events, particularly wildfires, which pose a significant threat to life and property. Historical experience has demonstrated that the financial impacts of these events have been manageable in the long term with aid from Federal Emergency Management Agency (FEMA), California Office of Emergency Services (OES) and insurance. However in the short term, public safety programs must be funded and that is why a score of 4 was assigned to this risk.
- 3. Risk Factor – Liquidity assigned a score of 3.** A larger reserve may be needed to avoid cash flow problems if the flow of cash is not received equally during the year. For example, the City's General Fund historically has negative cash flow of about \$11 to \$15 million in the first half of the year, which is reversed in the second half of the year when cash flow has always been positive; the net effect for the year is a positive cash flow. The major reason for this negative cash flow during the first half of the year was the passage by the State legislators of the triple flip and property tax in lieu of Vehicle License Fee (VLF) that went into effect on July 1, 2004. These two revenues are now paid twice a year in January and May and total about \$20 million. Before 2004, these receipts were more evenly paid through-out the year as part of the monthly sales tax allocation and VLF payments. A score of 3 was assigned to the liquidity factor as the triple flip, which accounts for \$8.3 million in cash flow, ended in October 2015. In addition the City has cash of about \$115 million in all the other City funds that can be loaned to the General Fund in the short term to meet cash-flow needs.
- 4. Risk Factor – Expenditure Volatility assigned a score of 3.** This risk factor refers to potential spikes in expenditure, usually arising from special, non-recurring circumstances. Examples of this might include lawsuits against the City. Expenditures of a recurring nature should not be addressed through the use of reserves but accommodated in the operating budget. A score of 3 was assigned to expenditure volatility. The General Fund is projecting increased costs in the next five years due to PERS rate increases, negotiated salary increases, and other employee benefit increases; however, these increased costs have been built into the General Fund Financial Plan.

In addition, the City is facing several lawsuits that could entail settlement costs; however, reserves for these judgments are set aside in the General Liability Fund reserve.

- 5. Risk Factor – Leverage assigned a score of 3.** A highly leveraged City has less flexibility. Examples of leverage include long-term debt, pension obligations, unfunded asset maintenance and post-employment health care. High leverage may call for higher reserves. A score of 3 was assigned to the leverage risk factor for the General Fund. This is because the General Fund has always been able to meet its yearly debt service payments through the annual budget process, even during the past economic downturn. In addition, PERS has developed a plan for cities to meet their unfunded pension liability in 30 years, by ramping up rates for the next 5 years beginning in fiscal year 2015/16, along with a 20-year amortization period, and then a 5 year ramp down in rates. Staff is also recommending that the City meet any unfunded asset maintenance liability outside of general fund reserves.
- 6. Risk Factor – Capital Projects assigned a score of 2.** A City's capital improvement plan is used to determine if there are high priority projects without a funding source. A score of 2 was assigned to the capital projects risk factor for the City because it is not very likely that Council will allow reserves to be used as a funding source for major capital projects. A year-end General Fund surplus could be used as a funding source for capital projects with Councils approval.
- 7. Risk Factor – Other Funds' Dependence assigned a score of 3.** This risk factor identifies other funds that have significant dependence on the General Fund. Dependence will usually be indicated by regular operating transfers that are an unusually high percentage of the receiving funds expenditure budget. Funds that are dependent on the General Fund include the Vehicle Parking District, Reidy Creek Golf Course and Community Services. A score of 3 was assigned to the other funds' dependence risk factor as the percentage of expenditures transferred to other funds' from the General Fund is less than 1 percent of total operating expenditures.
- 8. Risk Factor – Growth assigned a score of 2.** This factor is only relevant if significant growth is a realistic possibility in the next three to five years. Rapid growth of a community could call for larger levels of reserves as there may be a timing difference for revenue to catch up to service level requirements (property tax revenue may not be received until a couple of years after development). A score of 2 was assigned to the growth risk factor for the General Fund as any future growth should only cause a minor imbalance between the timing of revenues and expenditures.

RECOMMENDATION:

Based on the results of this risk evaluation tool, the City faces a low to moderate level of risk needed to be retained through reserves. The General Fund should consider adopting a reserve target of

between 17 to 25 percent of General Fund operating revenues. Using Fiscal Year 2014/15 General Fund operating revenue of \$83.1 million, this will result in a target Reserve balance of \$14.1 to \$20.8 million. The current General Fund Reserve balance is \$16.9 million. With Council's approval of Resolution 2015-215, the City's Fund Balance Policy will be revised to include a General fund Reserve target of between 17 to 25 percent of General Fund operating revenues and direct staff to review the risk factor analysis every two years to determine if the Reserve target has changed. Attachment A shows the suggested changes to the Reserve section of the City's Fund Balance Policy.

Respectfully submitted,



Sheryl Bennett  
Director of Administrative Services



Joan Ryan  
Assistant Finance Director

## **Summary of Revisions to Reserve Section of City's Fund Balance Policy**

### **Committed Fund Balance**

The City Council, as the City's highest level of decision-making authority, may commit fund balance for specific purposes pursuant to constraints imposed by formal actions taken, such as an ordinance or resolution. These committed amounts cannot be used for any other purpose unless the City Council removes or changes the specified use through the same type of formal action taken to establish the commitment, a resolution. City Council action to commit fund balance needs to occur within the fiscal reporting period; however, the amount can be determined subsequently. The following will be classified as committed fund balance.

### **General Fund**

#### **Reserve**

**The City Council has established a target Reserve balance of between 17 to 25 percent of General Fund operating revenues** ~~The City will commit the remaining fund balance in the General Fund at year end~~ in order to maintain adequate levels of fund balance to mitigate current and future risks and to adequately provide for cash flow requirements and contingencies for unseen operating or capital needs the City. The Reserve balance is available to fund one-time unanticipated expenditure requirements, local disasters, or when actual revenue received is less than the amount budgeted resulting in an operating deficit in the General Fund.

When Reserve Funds are used the method for replenishing deficiencies including the source of funding and time period for replenishment to occur will be defined in the resolution.

The City Council may, by the affirming vote of three members, change the amount of this commitment and/or specific use of these funds.

**The City Council has directed staff to review the General Fund target Reserve risk factor analysis every 2 years to determine if the target Reserve balance has changed.**

RESOLUTION NO. 2015-215R

A RESOLUTION OF THE CITY COUNCIL OF  
THE CITY OF ESCONDIDO, CALIFORNIA,  
AUTHORIZING AN AMENDMENT TO THE  
ESCONDIDO FUND BALANCE POLICY TO  
ESTABLISH A GENERAL FUND TARGET  
RESERVE BALANCE

WHEREAS, the Governmental Accounting Standards Board ("GASB") has issued its Statement No. 54, Fund Balance Reporting and Governmental Fund Type Definitions, with the intent of improving financial reporting by providing fund balance categories that will be more easily understood; and

WHEREAS, the City Council of the City of Escondido has adopted Resolution No. 2012-133R, the Fund Balance Policy; and

WHEREAS, the Fund Balance Policy provides that the City Council may commit funds for specific purposes by taking formal action and these committed amounts cannot be used for any other purpose unless the City Council removes or changes the specific use through the same formal action to establish the commitment; and

WHEREAS, the City Council adopted Resolution No. 2015-174 that committed funds of \$16,892,319 to a General Fund Reserve to maintain adequate levels of fund balance to mitigate current and future risks and to adequately provide for cash flow requirements and contingencies for unseen operating or capital needs of the City; and

WHEREAS, the City Council desires at this time and deems it to be in the best public interest to amend the Fund Balance Policy and establish a General Fund target Reserve balance of 25 percent of General Fund operating revenues; and

Whereas, the City Council desires at this time and deems it to be in the best public interest to include in the Fund Balance Policy direction to staff to review the General Fund target Reserve risk factor analysis annually to determine if the Reserve target has changed;

NOW, THEREFORE, BE IT RESOLVED by the City Council of the City of Escondido, California, as follows:

1. That the above recitations are true.
2. That the City Council hereby adopts the modified attached Fund Balance Policy presented in Exhibit "A," attached to this Resolution and incorporated by this reference.

PASSED, ADOPTED AND APPROVED by the City Council of the City of Escondido at a regular meeting thereof this 9<sup>th</sup> day of December, 2015 by the following vote to wit:

AYES : Councilmembers: GALLO, MASSON, MORASCO, ABED

NOES : Councilmembers: NONE

ABSENT : Councilmembers: DIAZ

APPROVED:



SAM ABED, Mayor of the  
City of Escondido, California

ATTEST:



DIANE HALVERSON, City Clerk of the  
City of Escondido, California

RESOLUTION NO. 2015-215(R)

## **City of Escondido Fund Balance Policy**

### **Purpose**

This Fund Balance Policy establishes the procedures for reporting unrestricted fund balance in the General Fund financial statements. Certain commitments and assignments of fund balance will help ensure that there will be adequate financial resources to protect the City against unforeseen circumstances and events such as revenue shortfalls and unanticipated expenditures. The policy also authorizes and directs the Finance Director to prepare financial reports which accurately categorize fund balance as per Governmental Accounting Standards Board (GASB) Statement No. 54, Fund Balance Reporting and Governmental Fund Type Definitions.

### **Procedures**

Fund Balance is essentially the difference between the assets and liabilities reported in a governmental fund. There are five separate components of fund balance, each of which identifies the extent to which the City is bound to honor constraints on the specific purposes for which amounts can be spent:

- Nonspendable fund balance (inherently nonspendable)
- Restricted fund balance (externally enforceable limitations on use)
- Committed fund balance (self-imposed limitations on use)
- Assigned fund balance (limitation resulting from intended use)
- Unassigned fund balance (residual net resources)

The first two components listed above are not addressed in this policy due to the nature of their restrictions. An example of nonspendable fund balance is inventory. Restricted fund balance is either imposed by law or constrained by grantors, contributors, or laws or regulations of other governments. This policy is focused on financial reporting of unrestricted fund balance, or the last three components listed above. These three components are further defined below.

### **Committed Fund Balance**

The City Council, as the City's highest level of decision-making authority, may commit fund balance for specific purposes pursuant to constraints imposed by formal actions taken, such as an ordinance or resolution. These committed amounts cannot be used for any other purpose unless the City Council removes or changes the specified use through the same type of formal action taken to establish the commitment, a resolution. City Council action to commit fund balance needs to occur within the fiscal reporting period; however, the amount can be determined subsequently. The following will be classified as committed fund balance.

### **General Fund**

#### **Reserve**

The City Council has established a target Reserve balance of 25 percent of General Fund operating revenues in order to maintain adequate levels of fund balance to mitigate current and future risks and to adequately provide for cash flow requirements and contingencies for unseen operating or capital needs of the City. The Reserve balance is available to fund one-time unanticipated expenditure requirements, local disasters, or when actual revenue received is less than the amount budgeted resulting in an operating deficit in the General Fund.

When Reserve Funds are used the method for replenishing deficiencies including the source of funding and time period for replenishment to occur will be defined in the resolution.

The City Council may, by the affirming vote of three members, change the amount of this commitment and/or specific use of these funds.

The City Council has directed staff to review the General Fund target Reserve risk factor analysis annually to determine if the target Reserve balance has changed.

### **Special Revenue Funds**

#### **Center for the Arts**

The City will commit that portion of fund balance derived from charges for services generated from Arts Center Activities for the operations of the California Center for the Arts.

#### **Parks & Recreation**

The City will commit that portion of fund balance received from operating activities of City facilities (charges for services) for the operation of City parks and recreation facilities.

#### **Reidy Creek Golf Course Fund**

The City will commit that portion of fund balance received from operating activities of the golf course (charges for services) for the operation of the Reidy Creek Golf Course.

#### **Vehicle Parking District**

The City will commit that portion of fund balance provided by parking permit revenues for the maintenance and operation of City-owned public parking lots.

#### **Ryan Trust**

The City will commit monies received from the Frances B. Ryan Trust, which was established to create the Pioneer Room, a historical perspective of Escondido, to provide financing for its ongoing operation.

#### **Hegyí Trust**

The City will commit Funds received for the Hegyi Family Trust to be used to recognize library volunteers.

### **Assigned Fund Balance**

Amounts that are constrained by the City's intent to be used for specific purposes, but are neither restricted nor committed, should be reported as assigned fund balance.

This policy hereby delegates the authority to assign amounts to be used for specific purposes to the Finance Director for the purpose of reporting these amounts in the annual financial statements. A few examples of assigned fund balance follow.

#### **Continuing Appropriations**

Fund balance levels must be sufficient to meet funding requirements for projects approved in prior years and which must be carried forward into the new fiscal year.

**Debt Service**

Established to provide for future debt service obligations

**Unassigned Fund Balance**

These are residual positive net resources of the general fund in excess of what can properly be classified in one of the other four categories.

**Fund Balance Classification**

The accounting policies of the City consider restricted fund balance to have been spent first when an expenditure is incurred for purposes for which both restricted and unrestricted fund balance is available. Similarly, when an expenditure is incurred for purposes for which amounts in any of the unrestricted classifications of fund balance could be used, the City considers committed amounts to be reduced first, followed by assigned amounts and then unassigned amounts.

This policy is in place to provide a measure of protection for the City against unforeseen circumstances and to comply with GASB Statement No. 54.