TOWN OF LOS GATOS
FINANCE COMMISSION SUBCOMMITTEE AGENDA
JULY 29, 2021
110 EAST MAIN STREET
LOS GATOS, CA
4:00 PM

Loreen Huddleston, Chair
Stacey Dell, Vice Chair
Matthew Hudes, Council Member

IMPORTANT NOTICE REGARDING THE JUL 29, 2021 FINANCE COMMISSION SUBCOMMITTEE MEETING

This meeting is being conducted utilizing teleconferencing and electronic means consistent with State of California Executive Order N-29- 20 dated March 17, 2020, regarding the COVID- 19 pandemic. In accordance with Executive Order N-29- 20, the public may only view the meeting online and not in the Council Chamber.

PARTICIPATION

If you are interested in providing oral comments real-time during the meeting, you must join the Zoom webinar.

- Join from a PC, Mac, iPad, iPhone or Android device: Please click this URL to join. https://losgatosca-gov.zoom.us/j/89294291103?pwd=S2lPUWVaaXdzOHA2NnZWQmVOdkFydz09 Passcode: 824453. You can also type in 89294291103 in the "Join a Meeting" page on the Zoom website at https://zoom.us/join.
- Join by Telephone: Dial: 877-336-1829 US Toll-free or USA 636 651 0002 US Toll Conference code: 986172

During the meeting:

- When the Chair announces the item for which you wish to speak, click the "raise hand" feature in Zoom. If you are participating by phone on the Zoom app, press *9 on your telephone keypad to raise your hand. If you are participating by calling in, press #2 on your telephone keypad to raise your hand.
- When called to speak, please limit your comments to three (3) minutes, or such other time as the Chair may decide, consistent with the time limit for speakers at a Commission meeting.

If you are unable to participate in real-time, you may email to PublicComment@losgatosca.gov with the subject line "Public Comment Item #__ " (insert the item number relevant to your comment) or "Verbal Communications – Non Agenda Item." Comments will be reviewed and distributed before the meeting if received by 11:00 a.m. on the day of the meeting. All comments received will become part of the record.

TOWN OF LOS GATOS
FINANCE COMMISSION SUBCOMMITTEE MEETING AGENDA
JULY 29, 2021
110 EAST MAIN STREET
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4:00 PM

REMOTE LOCATION PARTICIPANTS (*The following Subcommittee Members are listed to permit them to appear electronically or telephonically at the Finance Commission Subcommittee meeting: CHAIR LOREEN HUDDLESTON, VICE CHAIR STACEY DELL, AND COUNCIL MEMBER MATTHEW HUDES. All votes during the teleconferencing session will be conducted by roll call vote.)*

MEETING CALLED TO ORDER

ROLL CALL

CONSENT ITEMS *(Items appearing on the Consent Items are considered routine Town business and may be approved by one motion. Any member of the Subcommittee may request to have an item removed from the Consent Items for comment and action. Members of the public may provide input on any or multiple Consent Item(s) when the Chair asks for public comments on the Consent Items. If you wish to comment, please follow the Participation Instructions contained on Page 1 of this agenda. If an item is removed, the Chair has the sole discretion to determine when the item will be heard.)*

1. Approve Minutes of the June 30, 2021 Finance Commission Subcommittee Meeting

VERBAL COMMUNICATIONS *(Members of the public are welcome to address the Subcommittee on any matter that is not listed on the agenda. To ensure all agenda items are heard and unless additional time is authorized by the Chair, this portion of the agenda is limited to 30 minutes and no more than three (3) minutes per speaker. In the event additional speakers were not able to be heard during the initial Verbal Communications portion of the agenda, an additional Verbal Communications will be opened prior to adjournment.)*

OTHER BUSINESS *(Up to three minutes may be allotted to each speaker on any of the following items.)*

2. Receive Information on Town Financial Policies, Procedures, and Processes
3. Discuss Current Annual Report Formatting and Forward and Recommendations to the Finance Commission

ADJOURNMENT

TOWN OF LOS GATOS
FINANCE SUBCOMMITTEE
AGENDA REPORT

MEETING DATE: 7/22/2021

ITEM NO: 1

DRAFT
Minutes of the Finance Subcommittee Meeting
June 30, 2021

The Finance Subcommittee of the Finance Commission of the Town of Los Gatos conducted a regular meeting via teleconference via COVID-19 Shelter in Place Guidelines on Wednesday, June 30, 2021, at 4:00 p.m.

MEETING CALLED TO ORDER AT 4:00 P.M.

ROLL CALL
Present: Chair Loreen Huddleston, Commissioner Stacey Dell, and Council Member Matthew Hudes. (All participating remotely.)
Absent: None

Staff Present: Town Manager Laurel Prevetti, Assistant Town Manager Arn Andrews, Finance Director Stephen Conway, Finance and Budget Manager Gitta Ungvari.

CONSENT ITEMS (TO BE ACTED UPON BY A SINGLE MOTION)
None.

VERBAL COMMUNICATIONS
None.

OTHER BUSINESS
1. Appoint Vice Chair.

MOTION: **Motion** by **Commissioner Huddleston** to nominate Stacey Dell for Vice Chair. **Seconded** by **Commissioner Dell.**

VOTE: **Motion passed unanimously.**

2. Identify and Discuss Goal(s) of the Subcommittee.

Subcommittee members discussed the goals of the Subcommittee. The Subcommittee prefers to perform a deeper dive into narrow topics. In addition, the Subcommittee can research issues identified by the Finance Commission and Town Council and report back for the full Commission. The Subcommittee sees its role as an information gathering body as opposed to recommending body.

Opened Public Comment.

None.

3. Identify and Discuss the Potential Work Plan Items for the Sub-Committee.

The Finance Subcommittee would like to understand the Town's financial processes, procedures, and policies. The Subcommittee would like to better understand the development of the Annual Financial Report, Budget, and budget assumptions. Staff volunteered to draft flowcharts and provide links to policies. The Finance Subcommittee would also work any items as appropriate.

Opened Public Comment.

None.

4. Identify and Discuss Subcommittee Schedule and Other Operational Parameters.

The Finance Subcommittee decided to conduct a regular monthly meeting. Staff will coordinate with the Subcommittee members on the exact schedule of the meetings.

ADJOURNMENT:
The meeting adjourned at 5:09 p.m.

This is to certify that the foregoing is a true and correct copy of the minutes of the June 30, 2021 meeting as approved by the Finance Subcommittee.

____
Gitta Ungvari, Finance and Budget Manager

TOWN OF LOS GATOS

FINANCE COMMISSION SUBCOMMITTEE REPORT

MEETING DATE: 07/29/2021

ITEM NO: 2

DATE:	July 21, 2021
TO:	Finance Commission Subcommittee
FROM:	Laurel Prevetti, Town Manager
SUBJECT:	Receive Information on Town Financial Policies, Procedures, and Processes

RECOMMENDATION:

Receive Information on Town Financial Policies, Procedures, and Processes.

BACKGROUND:

On June 30, 2021, the Finance Commission Subcommittee requested information regarding the process steps to prepare the Town's primary financial documents. Staff volunteered to prepare process flow diagrams and associated narrative for the next meeting. In addition, Subcommittee members also asked staff to identify other relevant existing financial policies, procedures, and processes.

The Town has a wide variety of financial policies, processes, practices, and procedures which can be segregated between Council adopted policies and internal procedures and processes. This report provides information related to both areas.

This report is organized as follows:

- Overview of the Relationship between the Comprehensive Annual Financial Report and the Annual Budget Process
- Operating Budget Preparation
- Capital Budget Process
- Overview of Internal Accounting and Financial Reporting
- Accounting Activities
- Financial Reporting and Comprehensive Annual Financial Report Process
- Council Adopted Financial Policies

PREPARED BY: Arn Andrews
Assistant Town Manager

Reviewed by: Town Manager, Town Attorney, and Finance Director

If the Subcommittee wishes to have any elements of the report broken out in greater detail, staff can provide this at subsequent meetings.

DISCUSSION:

Overview of the Relationship Between the Comprehensive Annual Financial Report and the Annual Operating and Capital Budget Processes

As previously noted at Finance Commission and Subcommittee meetings, the Town follows a financial rhythm which starts with the adoption of the completed Comprehensive Annual Financial Report (Annual Report) and the identification of any surpluses or deficits resulting at year end of the prior fiscal year. This year end information is integrated into Council's annual discussion of Strategic Priorities to provide budget direction for the potential use(s) of any surpluses in the next fiscal year's budget.

Subsequently, the Council considers the Mid-Year Budget Review for the current fiscal year, evaluating revenue and expenditure trends for the first six months against the adopted Budget. Typically, at the same evening as the Mid-Year Review, the Council receives an updated Five-Year Forecast with sensitivity analysis for major revenue and expenditure assumptions. The Council is provided the opportunity to give budget direction based on the forecast.

All of these discussions inform the development of the following year's Proposed Operating and Capital Budgets. The illustration in Attachment 1 summarizes the annual year end closure and how it relates to development of Operating and Capital Budgets.

Operating Budget Preparation

As illustrated on the following pages, the development of the Operating Budget is a compilation of yearlong endeavors. While not represented in the flow chart, the evaluation of the Mid-year Budget becomes the basis of the Five-Year Forecast (Attachment 2) because it contains the most current data on revenues and expenditures. The Forecast enables the Town to evaluate the Town's longer-term fiscal condition to help guide policy, programmatic planning, and budget decisions. Its purpose is to identify financial trends, potential shortfalls, and other issues so the Town can proactively address them and budget accordingly.

The Forecast contains detailed information that contributes to the preparation of the annual Operating Budget, including the Town's "Base Case" Five Year Forecast, its data sources, and budget assumptions. In addition, the Forecast utilizes empirical data from our hoteliers/AirBNB, County Tax Assessor, Sales Tax consultant, and CalPERS (on the expense side) among other sources. The assumptions utilized in developing the most recent Forecast can be found starting on page A-21 of the FY 2021/22 Proposed Operating Budget.

DISCUSSION (continued):

Operating Budget Development Process

Team-Based Approach: Program budgets & work plans are developed with each Department's Director, Analyst, and Program Manager's oversight and expertise (guided by Town Management & the Finance Department)

TOWN OF Los GATOS CALIFORNIA

Start

September/October/November/December

The Town Council determines and refines initiatives and directives for the upcoming budget year.

January

Town Council identifies budget assumptions, directives, and initiatives through its Strategic Priorities.

Each Town Department identifies and analyzes its program revenue & expenditure projections; budget assumptions, directives, initiatives & goals; Department & program work plans; and asset, internal services & staffing requests in coordination with the Finance Department & Town Management.

February

First draft of staffing requests from Departments due to Finance Department and are reviewed and finalized.

First draft of asset, internal service requests, and expenditure requests due from Departments.

Internal service requests reviewed with the responsible program managers and first draft of internal service budgets due to Finance Department.

Approved staffing, assets, internal services & program expenditures requests incorporated into a first draft budget.

March

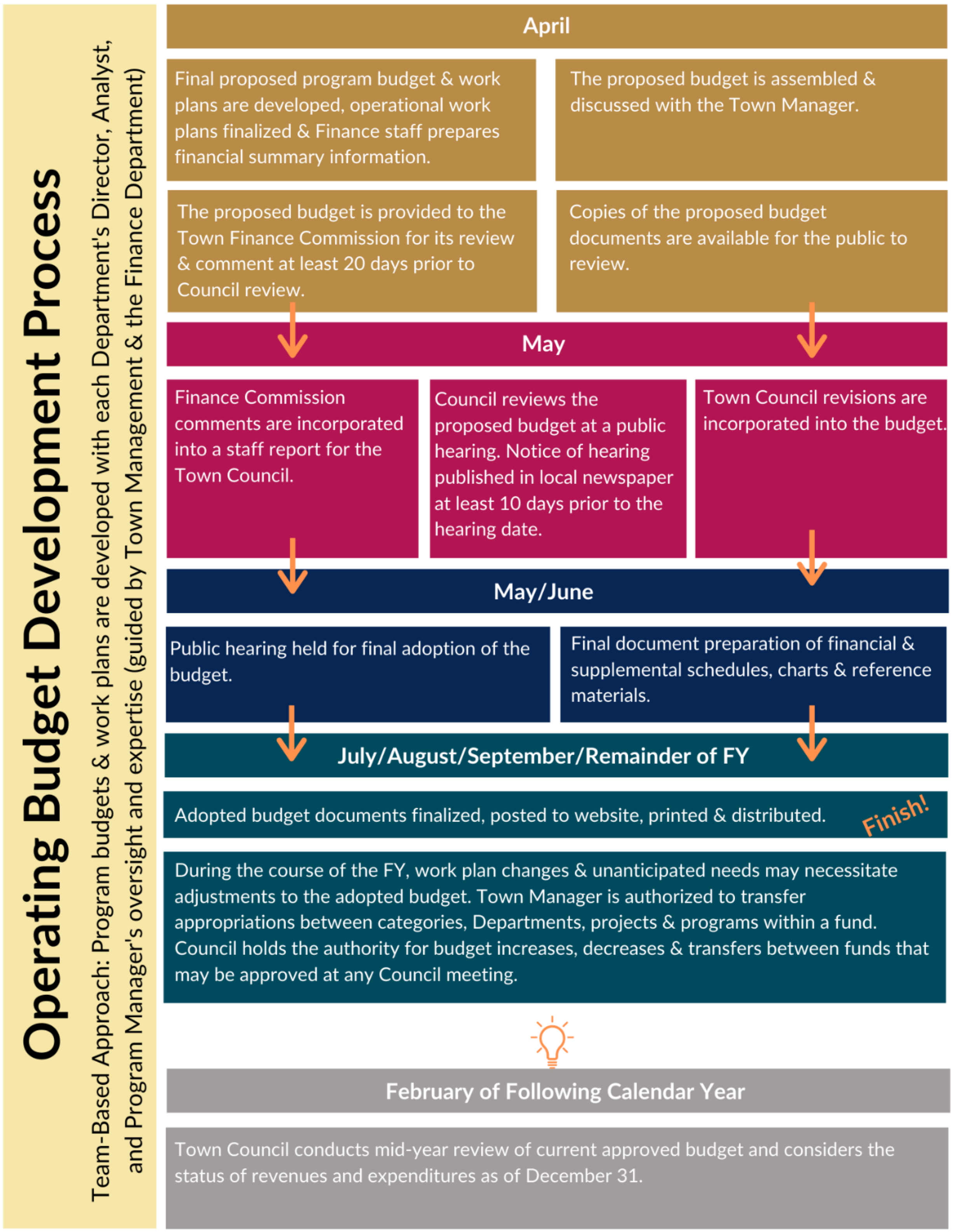
First draft Operating Budget reviewed, analyzed & discussed with Town Manager.

First draft Budget briefings with Town Manager, Department Heads & analysts to determine Department/program revisions.

Second draft budget revisions & work plans due to Finance Department. Briefing and revisions with Town Manager and Departments.

Program narratives, financial & supplemental schedules, financial summaries, and charts prepared.

DISCUSSION (continued):

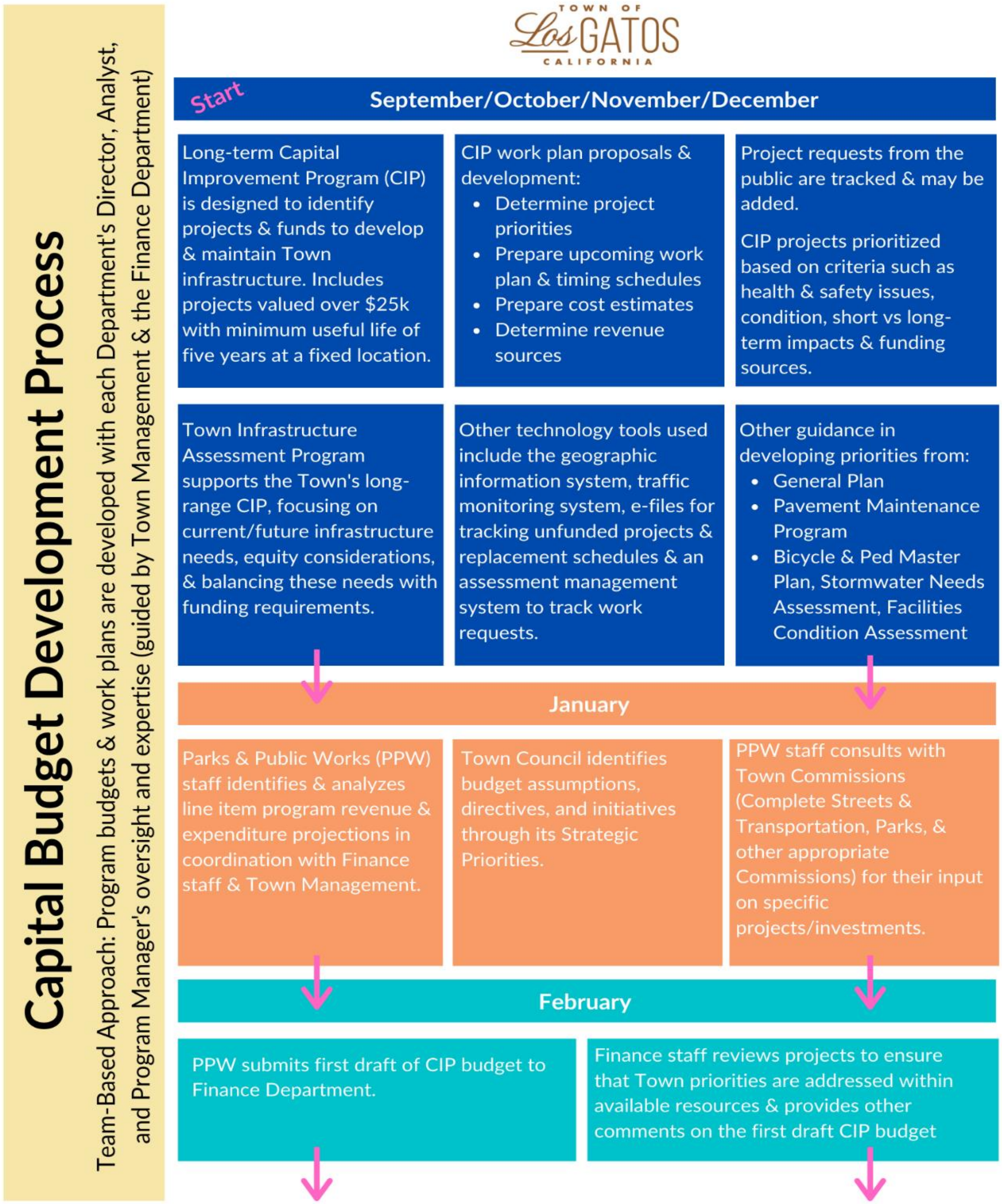


DISCUSSION (continued):

Capital Budget Preparation

The Capital Improvement Program (CIP) is a comprehensive five-year plan designed to identify projects to develop and maintain the Town's infrastructure, consistent with the Town Council Core Goals of high quality infrastructure, community character, public safety, fiscal stability, good governance, and civic enrichment. The CIP development process is illustrated on the following pages.

DISCUSSION (continued):



DISCUSSION (continued):

Capital Budget Development Process

Team-Based Approach: Program budgets & work plans are developed with each Department's Director, Analyst, and Program Manager's oversight and expertise (guided by Town Management & the Finance Department)

March

- First draft reviewed, analyzed & discussed with PPW, Finance & Town Manager.
- PPW revises CIP to address comments from Manager, including funding and project modifications, priorities & work plans.
- Finance & PPW prepare financial & supplemental schedules, charts & reference materials.

April

- PPW develops final proposed program budget & work plans & finalizes capital work plans.
- Finance staff prepares financial summary information.
- Proposed CIP budget assembled by Finance and discussed with PPW, Finance & Town Manager.
- Proposed CIP budget provided to Finance Commission for review & comment at least 20 days prior to Council review.
- Copies of the proposed budget documents are available for the public to review.
- Proposed CIP presented to Planning Commission for determination of General Plan consistency as required by State law.

May

- Finance Commission & Planning Commission comments are incorporated into a staff report for the Town Council.
- Council reviews the proposed Capital Budget & Capital Improvement Plan for the five-year period at a public hearing. Notice of hearing published in local newspaper at least 10 days prior to the hearing date.
- Town Council revisions are incorporated into the budget.

May/June

- Public hearing held for final adoption of the budget.
- Final document preparation of financial & supplemental schedules, charts & reference materials.

July/August/September/Remainder of FY

Adopted budget documents finalized, posted to website, printed & distributed. Finish!

During the course of the FY, work plan changes & unanticipated needs may necessitate adjustments to the adopted budget. Town Manager is authorized to transfer appropriations between categories, Departments, projects & programs within a fund. Council holds the authority for budget increases, decreases & transfers between funds that may be approved at any Council meeting.

DISCUSSION (continued):

Overview of Internal Accounting and Financial Reporting

The Town's finance accounting activities center around the process of assembling, analyzing, classifying, and recording data relevant to financial transactions and events that affect the government's financial position. The Finance Department also publishes financial reports including annual budgets, capital improvement plans, and audited annual financial reports which utilize the financial information thus assembled and provided to the Los Gatos residents as required by State law. Accounting and financial reporting activities are complementary rather than identical endeavors.

The audit is conducted in two phases, interim and final audit. The interim audit is conducted in late spring prior to the fiscal year end, testing internal controls and processes. The final audit is conducted after the close of the fiscal year in the fall after all financial transactions of the year audited are completed and entered to the Town's financial system.

Accounting Activities

During each fiscal year, Finance staff enters all financial transactions on a monthly basis to the Town's financial system/general ledger. These entries include recurrent postings from all of the Town's financial system modules such as payroll, accounts payable, cash receipts, and accounts receivable; and monthly journal entries as per the normal monthly accounting cycle. Provided below are high level discussions of Town revenue and expense financial activities and volumes of selected transaction activity to better describe the overall Town financial activity typically encountered in a fiscal year.

Revenues
Revenues are typically recorded from the following major sources. Cash receipts recorded through Departmental public counter cash registers, checks received by mail to the Finance Department, online charges by the use of credit cards, and wire transfers received by the Town. The majority of wire transfers are from the County of Santa Clara or the State of California. Five Departments have cash registers at locations where services are delivered to the public.

The Finance Department also creates invoices for miscellaneous services and receivables to assist the Departments who need to bill their customers for services provided. Internal controls required for cash receipts include the daily cashing out of all cash registers with Departmental deposits reconciled against the register reports generated by the Town's financial system. The Finance Department verifies the Departmental deposits as a redundant check to ensure accuracy of the deposit. Once deposits are verified, a combined deposit package is prepared for submittal to the bank.

DISCUSSION (continued):

Presented below is a table of revenues by type and descriptions of the typical sources of this revenue paid to the Town.

Type of Revenues				
Wire Transfers	Checks (Receivables or Other Items)	Credit Card Received at public counters	Online Payments	Cash
SCC County-Property Tax State of CA-Sales Tax	Services to the public including building, planning, public works, library and police and business licenses/hotel tax	Services to the public including building, planning, public works, library police, and business license tax.	Park reservations and some building and planning permits.	Services to the public including building, planning, public works, library and police

To provide some insight into the transactions recorded through the cash receipts received through the Town's cash registers, below are tables depicting cash receipts volume activity for the past two fiscal years ending June 30, 2020 and June 30, 2021. FY 2019/20 volumes indicate a partial fiscal year impact by the COVID pandemic and Town offices were closed for many public counter transactions during FY 2020/21.

FY 2019/20							
Cash Registers	**Cash**	**Check**	**Credit Card**	**Online Building & Planning**	**Online School Bus/Library Fine**	**Total**	**Daily Avg - 260 Working Day**
Finance Department	$ 2,209	$ 11,934,848	$ -	$ -	$ -	$ 11,937,057	$ 45,912
Building/Planning Department	$ 13,279	$ 2,721,884	$ 682,462	$ 418,609	$ -	$ 3,836,234	$ 14,755
Engineering Department	$ 1,030	$ 654,108	$ 82,373	$ -	$ 13,479	$ 750,990	$ 2,888
Library Department	$ 7,254	$ 97	$ 3,543	$ -	$ 688	$ 11,583	$ 45
Police Department	$ 6,558	$ 65,786	$ 21,077	$ -	$ -	$ 93,420	$ 359
Parks & Public Works Department	$ 9,694	$ 42,224	$ 4,210	$ -	$ -	$ 56,128	$ 216

FY 2020/21							
Cash Registers	**Cash**	**Check**	**Credit Card**	**Online Building & Planning**	**Online School Bus/Library Fine (Discontinued)**	**Total**	**Daily Avg - 260 Working Day**
Finance Department	$ 2,748	$ 11,877,804	$ -	$ -		$ 11,880,552	$ 45,694
Building/Planning Department	$ 0	$ 883,654	$ -	$ 3,032,599		$ 3,916,253	$ 15,063
Engineering Department	$ -	$ 444,672	$ -	$ -		$ 444,672	$ 1,710
Library Department	$ -	$ -	$ -	$ -		$ -	$ -
Police Department	$ 3,884	$ 38,387	$ 6,711	$ -		$ 48,982	$ 188
Parks & Public Works Department	$ -	$ 14,501	$ -	$ -		$ 14,501	$ 56

DISCUSSION (continued):

Expenditure Activities
Town expenditures and disbursements typically originate from four primary sources: payroll direct deposits, accounts payable for approved purchase orders and agreements, credit cards for approved card holder dollar limits, and wires out for disbursements (such as bi-weekly pension payments due to CalPERS, debt service payments to trustees to make debt service payment to bondholders, and pre-funding deposits made to CalPERS for OPEB and pension liabilities). All disbursement requests (invoices, use of Town credit cards, timesheets) are reviewed and approved by the Departments' management and are forwarded to the Finance Department for final approval and processing. Additional nonrecurring miscellaneous wires require three levels of approval including the approval by the Town Manager. Provided below is a table illustrating approximate transaction volume for each disbursement method.

Type of Disbursements				
Descriptions	Credit Card	Wire Transfers	Direct Deposit	Checks
Approximate Annual Volume	Approximately 1,700 annual transactions (average transaction amount was $66 for FY 20/21)	Approximately 250 transactions In FY 20/21.	4,836 payroll direct deposit slips issued In FY 20/21	Approximately 7,000 annual accounts payable entries entered 3,120 checks issued

Financial Reporting and Comprehensive Annual Financial Report Process

Subsequent to June 30 of each Fiscal Year (FY), staff opens period 13 of the prior fiscal year. Period 13 is utilized in the Town's financial system to make accrual journal entries affecting the general ledger of the prior fiscal year. Entries are typically generated from the actions necessary to complete the close of the Town's fiscal year as delineated by Finance Department staff's use of the Town's fiscal year closing checklist. The checklist specifies the required closing entries necessary to be generated for all general ledger account balances at the close of each FY. This checklist is reviewed and updated by all Finance staff each year before commencement of the fiscal year closing activities. Typical closing entries include the accrual of expenditures made in the new fiscal year for expenses that per the invoices were actually incurred in the prior fiscal year.

Revenues received early in the new fiscal year are carefully reviewed to record them as prior fiscal year revenues if they were actually earned the prior fiscal. Changes to accrued liabilities and receivables are also journalized and adjusted at fiscal year-end. Additionally, the Town

DISCUSSION (continued):

calculates and records changes to its fixed assets and infrastructure including additions and deletions of infrastructure and calculation of annual depreciation.

Upon completion of all required journal entries to period 13, a preliminary final general ledger trial balance is prepared that is provided to the Town's independent Auditor. This trial balance is used by the Auditor typically in late September or early October each fiscal year as they conduct the final phase of their audit.

Finance Department staff uses the same trial balance provided to the Auditor to prepare the Town's preliminary financial statements. These statements are prepared using a trial balance downloaded from the Town's financial system. The financial report model is a custom staff-developed Excel model. This is typical for most smaller governments who have the skill and knowledge to prepare their own financial statements but not necessary more costly financial management systems.

Upon completion of the final audit, the Town's independent Auditor use the final trial balance to prepare the draft financial statements on their own proprietary system. The draft financial reports that were independently prepared by the Auditor are delivered to Town Finance Department staff for review. Staff's review of the Auditor's draft financials has been made more effective through the ability of staff to compare the Auditor's draft financial statements to staff's draft financial statements derived using its Excel based model. This redundant parallel procedure has proven to be an effective double check of the draft financials prepared by the Auditor. Any differences in the draft financials are identified and then resolved between the Auditors and the Finance Department staff.

Simultaneously to the development of the draft financials, Finance Department staff prepares the draft Introductory section of the Comprehensive Annual Financial Report (Annual Financial Report or Annual Report) which includes the Town Manager's Transmittal Letter. Finance Department staff also prepares the entire Statistical Section of the Annual Report. Concurrently, Finance Department staff utilizes its internal financials to initiate preparing the Management's Discussion and Analysis (MD&A) section of the financial statements. The MD&A provides the financial statement reader more in-depth analysis of the Town's financial reports and includes comparisons to balances reported in the prior fiscal year.

The Auditor then assists staff in developing draft footnotes that provide additional information relating to the balances reported on the draft financials and other pertinent information regarding the Town's financial position. Finance Department staff assists in this effort by providing updates to the notes and reviewing all notes with any edits and or additions or deletions agreed upon between staff and the Auditor. The Town Manager's Office reviews and provides comments/edits on the administrative draft of the entire Annual Report.

DISCUSSION (continued):

Upon completion of the three primary sections of the Annual Report (Introduction, Financial, and Statistical sections) and review by the Town Manager's Office, a final draft is prepared by the Auditor for review by the Town's Finance Commission. Once the document is ready for the Finance Commission, it is publicly available for the entire community. Upon completion of the Commission's review, any edits are made by the Auditor prior to submittal to the Town Council.

Beginning in 2021, the Town will be following the additional requirements of Measure A which provides for the Finance Commission to identify specific recommendations and comments. The Town Manager is required to respond in writing to the Commission's recommendations and comments. As needed, the Auditor may need to participate in these responses. These comments and responses are provided to the Commission.

The Commission's comments and recommendations and the Manager's responses are provided to the Town Council in its consideration to receive the Annual Report. This Council meeting is typically the last meeting in December. The Final Annual Report is archived to the Town's Financial Transparency website along with past Annual Reports, Budgets, and other related information.

Council Adopted Policies

All of the following Policies are available on the Town's website. In addition, several are published annually with the Proposed Operating Budget to provide additional transparency on the direction that is followed for the Town's financial matters. The page numbers for those listed below correlate to the FY 2021/22 Proposed Operating Budget.

GASB 54 Fund Balance Policy – This Policy ensures the correct identification and classification of fund balances in accordance with Government Accounting Standards Board (GASB) Statement No. 54.
https://www.losgatosca.gov/DocumentCenter/View/13771/GASB-54-Fund-Balance-Policy?bidId=

General Fund Reserve Policy (A-35) – This Policy establishes minimum levels of designated reserves within the General Fund.
https://www.losgatosca.gov/DocumentCenter/View/18897/4-03-General-Fund-Reserve-Policy?bidId=

Investment Policy/Operating Portfolio (A-45) – This Policy ensures that residual operating funds are invested in accordance with applicable sections of the California Government Code and

DISCUSSION (continued):

other elements of the Policy. The Finance Commission reviews it annually and provides recommendations to the Town Council.
https://www.losgatosca.gov/DocumentCenter/View/17859/4-02-Investment-Policy?bidId=

IRS Section 115 Pension Trust and OPEB Investment Policy (A-55) – This Policy ensures appropriate fiduciary oversight and investment of the Town's pension and Other Post-Employment Benefits assets domiciled in IRS Section 115 Trusts.
https://www.losgatosca.gov/DocumentCenter/View/20141/4-04-IRS-Section-115-Pension-Trust-and-California-Employers-Retiree-Benefit-Trust-CERBT-Investment-Policy?bidId=

Long Term Debt Policy (A-41) – This Policy sets forth debt management objectives and parameters for issuing and administering Town-issued debt.
https://www.losgatosca.gov/DocumentCenter/View/17858/4-01-Long-Term-Debt-Policy?bidId=

Attachments:
1. Annual Report and Budget Cycle
2. Five-Year Forecast

	Prior FY (2019/20)	Current FY (2020/21)	Next FY (2021/22)
December	**June 30, 2020 Annual Report (AR)** finalized and presented for Council approval. **AR** surpluses assigned per the Council Reserve Policy as of June 30, 2020		
January		Council deliberates **Strategic Priorities** and **Budget** direction for FY 2021/22. Review of Five-year Forecast and assumptions. Council determines if previously assigned surpluses should be reallocated for FY 2021/22.	
February		Council considers **Mid-Year Budget** adjustments through 12/31/2020 for FY 2020/21 Budget.	
April		Finance Commission review and comment on Proposed FY 2021/22 **Operating & Capital Budgets.**	
May		Public hearing on FY 2021/22 **Operating & Capital Budgets**	
June		Council adoption of the FY 2021/22 **Operating & Capital Budgets**	End of **June 30, 2021 Annual Report** period
July			Start of new FY 2021/22 **Operating Budget** year
December			**June 30, 2021 Annual Report** finalized and presented for Council approval. **AR** surpluses assigned per the Council Reserve Policy as of June 30, 2021

All Council deliberations and actions include opportunities for public input

TOWN OF LOS GATOS
COUNCIL AGENDA REPORT

MEETING DATE: 02/16/2021
ITEM NO: 13

DATE:	February 10, 2021
TO:	Mayor and Town Council
FROM:	Laurel Prevetti, Town Manager
SUBJECT:	Discuss the Five-Year Forecast, Provide Direction on the Other Budget Assumptions, and Provide any Specific Direction for the Preparation of the Town's Fiscal Year 2021/22 Operating and Capital Budgets

RECOMMENDATION:

Discuss the Five-Year Forecast, provide direction on the other budget assumptions, and provide any specific direction for the preparation of the Town's Fiscal Year 2021/22 Operating and Capital Budgets.

BACKGROUND:

An important aspect of the Town's budget development process is taking a multi-year approach to understand revenue and expenditure trends over time. Serving as the foundation of the budget planning process (Attachment 1), the Town develops a Five-Year Financial Forecast ("Forecast") beginning in the late fall of each year. The Forecast enables the Town to evaluate the Town's fiscal condition and to help guide policy, programmatic planning, and budget decisions. Development of a financial forecast as part of the budget development process has been identified as a best practice by the Government Financial Officers Association (GFOA).

The Forecast takes a forward look at the Town's General Fund revenues and expenditures and is updated regularly. Its purpose is to identify financial trends, potential shortfalls, and other issues so the Town can proactively address them and budget accordingly. It does so by projecting out into the future the fiscal results of continuing the Town's current service levels and policies. This process helps to provide a snapshot of what the future may look like as a result of the decisions made to date.

PREPARED BY: Arn Andrews
Assistant Town Manager

Reviewed by: Town Manager, Town Attorney, and Finance Director

110 E. Main Street Los Gatos, CA 95030 ● (408) 354-6832
www.losgatosca.gov

ATTACHMENT 2

BACKGROUND (continued):

The initial Forecast is predicated on estimates derived from the Mid-Year Budget and includes updates to Town revenues and expenditures based on the Mid-Year end of year projections. Like any forecast the first year of the Forecast's revenue estimates is the most critical in the process as they ultimately define the expenditure limitations for the upcoming budget year.

This report contains detailed information that contributes to the preparation of the annual budget, including the Town's "Base Case" Five Year Forecast, its data sources, and budget assumptions. This report also provides two additional forecast scenarios utilizing a sensitivity analysis for three of the major revenue assumptions and forecasted pension contributions. These additional forecast scenarios illustrate the effects on future budgets of a more optimistic scenario ("Greater Growth") and a pessimistic one ("Lower Growth"). Comments from the Finance Commission are also provided for Council consideration.

The Five-Year Financial Forecast is not a budget, nor a proposed plan. The Five-Year Financial Forecast sets the stage for the upcoming budget process and is a tool in facilitating both the Town Council and Town Manager in establishing priorities and allocating resources appropriately.

DISCUSSION:

The Pandemic's Economic Impacts Informed an Updated Forecast Last Year

As we consider the development of the Five-Year Forecast, it is helpful to provide context on the development of the Forecast that informed the current adopted FY 2020/2021 Operating Budget. On January 21, 2020, the Town Council received the following initial Five-Year Forecast which became the basis of Strategic Priority planning and budgetary considerations. The development of that original forecast did not anticipate the unforeseen economic impacts associated with the local, national, and global effects of COVID-19.

Original 5 Year Forecast "Base Case"	2020/21 Forecast ($M)	2021/22 Forecast ($M)	2022/23 Forecast ($M)	2023/24 Forecast ($M)	2024/25 Forecast ($M)
Original Surplus/Deficit	$0.5	$1.7	$1.6	$2.3	$3.1

On May 19, 2020, staff presented an updated Five-Year Forecast and the Proposed Operating Budget which included significant revisions to growth projections for the Town's primary revenues of property tax, sales tax, and transient occupancy tax (TOT). The revised revenue projections were made in close consultation with the Santa Clara County Assessor, Town sales tax consultant MuniServices, and a review of national and regional hospitality research. The

DISCUSSION (continued):

net result of these revenue changes alone accounted for a $1.8 million swing from the original FY 2020/21 base case revenue projections and an additional $2.6 million revenue reduction in FY 2021/22 relative to the base case projection.

Net Changes in Revenues to Base Case	2020/21 Forecast ($M)	2021/22 Forecast ($M)
Sales Tax MuniServices COVID-19 Scenario	($0.98)	($1.02)
TOT Shock Scenario	($0.4)	($0.1)
Property Tax Slow/No Growth Scenario	($0.4)	($1.5)
Totals	($1.78)	($2.62)

In addition to reassessing revenue growth, the proposed Five-Year Forecast anticipated increases in the Town's pension obligations. Given volatility in financial markets at the time, it was anticipated that CalPERS would not achieve its assumed investment rate of return of 7% in FY 2019/20. Staff assumed a 0% return for the updated Forecast. The combined effects of changing these budget assumptions in conjunction with others is illustrated in the following updated Five-year Forecast.

Updated COVID-19 Effects Scenario	2020/21 Forecast ($M)	2021/22 Forecast ($M)	2022/23 Forecast ($M)	2023/24 Forecast ($M)	2024/25 Forecast ($M)
Surplus/Deficit	$0.0	$0.0	($0.6)	($0.1)	($0.7)

The total Five-Year Forecast revisions resulted in an initial estimate of $9.2 million in total surpluses through FY 2024/25 ultimately becoming $1.4 million in deficits through FY 2024/25, for a total Forecast period reduction of $10.6 million.

As the summary table on the next page shows, the Town's financial condition continues to be impacted by the unprecedented effects of global, national, and regional pandemic mitigation measures. While the pandemic will continue to present a degree of uncertainty and complexity the Town has positioned itself well to address these challenges. Attachment 2 contains for the full Five-Year Forecast "Base Case" for revenues and expenditures.

DISCUSSION (continued):

Scenario Surplus/Deficit	2021/22 Forecast ($M)	2022/23 Forecast ($M)	2023/24 Forecast ($M)	2024/25 Forecast ($M)	2025/26 Forecast ($M)
Greater Growth Scenario	($1.3)	$0.8	$1.6	$2.4	$3.1
Base Case Modest Growth	($2.0)	($0.4)	$0.0	$0.2	$0.3
Less Growth Scenario	($2.7)	($1.4)	($1.5)	($1.7)	($2.0)

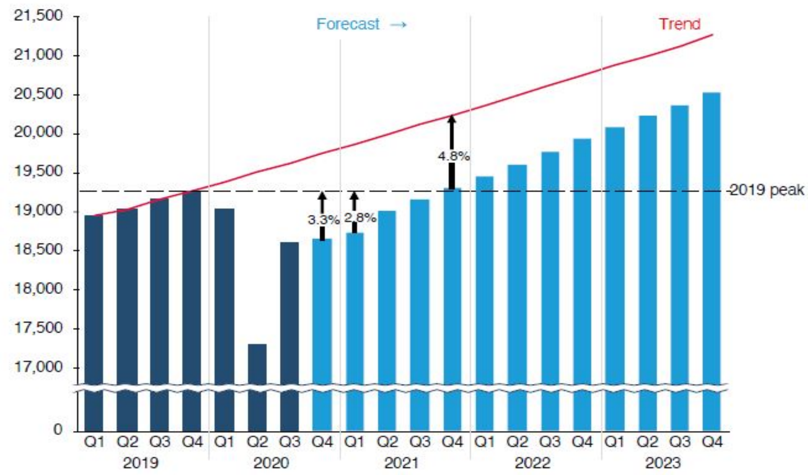
National and Local Economic Backdrop

The UCLA Anderson School of Business publishes an annual economic forecast for the nation and California. The results of the forecast are utilized as a portion of the macroeconomic basis of the Five-Year Forecast development. The December 2020 report establishes data for a 2020-2023 forecast period (see Attachment 3).

Because of rising COVID infections and continued social distancing, the UCLA Anderson Forecast is projecting slower growth in real Gross Domestic Product (GDP) for Quarter (Q) 4 2020 and Q1 2021, of 1.2% and 1.8% seasonally adjusted annual rate (SAAR), respectively. According to its Forecast, this would leave the economy 3.3% and 2.8%, respectively, below its peak in Q4 2019. With the introduction of mass vaccinations, the forecast assumes robust growth in Q2 2021 of 6.0% SAAR, and then consistent growth above 3% well into 2023. The UCLA Anderson Forecast is expecting the economy to reach its previous peak by the end of 2021. It is important to note that even with growth accelerating in Q2 2021, this still leaves GDP 4.8% below the trend of where the economy likely would have been without the COVID shock (UCLA Forecast, Attachment 2 Exhibit 2).

<u>DISCUSSION (continued)</u>:

Exhibit 2 Real GDP levels and trends, $ Billions SAAR

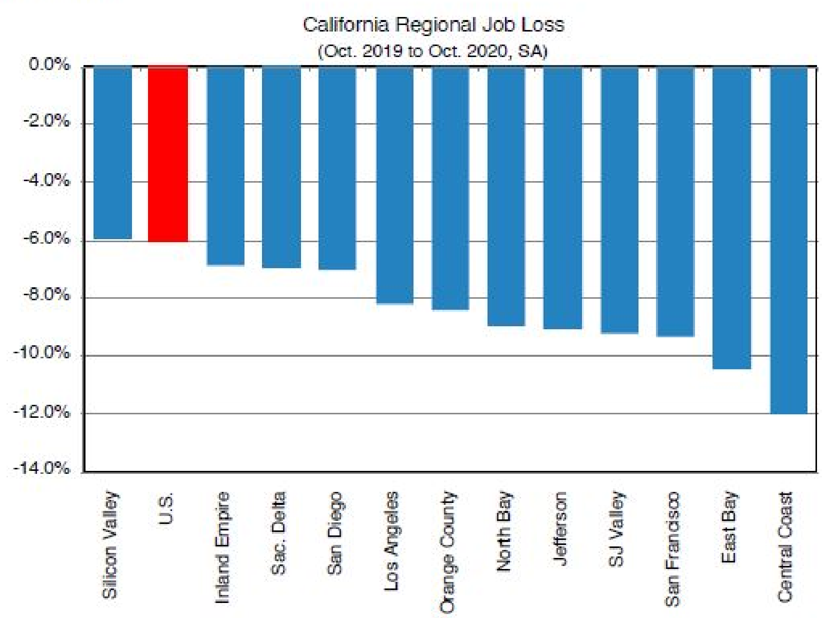


Source: U.S. Department of Commerce, Bureau of Economic Analysis and UCLA Anderson Forecast
Notes: Real GDP growth rate, seasonally adjusted annual rate.

The Report notes that for California, the impacts of the COVID led recession and subsequent job losses have not been equally distributed throughout the State. Regionally, areas less exposed to losses in tourism and with greater adaptability to remote work have been less impacted.

As the Forecast chart below illustrates, Silicon Valley had the lowest regional job losses in the State.

California Regional Jobs Loss



DISCUSSION (continued):

In addition, the Forecast states that "Looking to the future, the forecast for the state is for the technology sectors, residential construction, and logistics to lead the recovery, and for California post-pandemic to grow faster than the U.S." This assessment should continue to bode well for economic recovery in Silicon Valley and Los Gatos. While much of the nation and the region has experienced significant financial hardship as a result of the pandemic, the Report notes that "…For those fortunate to maintain employment and income during this pandemic, their financial situation is better than before. Home values have increased, equity values have increased, and limited consumption opportunities during the past nine months mean that these households have been able to accumulate at least an additional $1.6 trillion in savings." Given the socioeconomic composition of Los Gatos, the Town should benefit from the Report's forecasted trends.

Operating Revenue Trends and Five-Year Forecast Scenarios

The Town is highly dependent on three economically sensitive revenues comprising 65% of General Fund forecasted revenues. Following are summaries of the Town's major revenues of property tax, sales tax, and transient occupancy tax (TOT). To provide context for the development of the FY 2021/22 Five-Year Forecast, the prior year's growth assumptions and resulting revenue projections are provided. With that context, updated growth assumptions are provided for each revenue source, and the resultant projected revenues for the new Forecast period. The revenue assumptions provided are informed by the County Tax Assessor, the Town's sales tax consultant, and direct communication with the Town's hospitality industry. In addition, alternative forecast scenarios will be developed for these three revenue streams. Please see Attachment 4 for a description of all revenue categories with a comprehensive listing of revenue forecast assumptions.

Finance Commission Comments

On February 8, 2021, the Finance Commission had an opportunity to review the base case revenue growth assumptions and subsequent projections as presented below. At the Commission meeting, there was considerable discussion about the amount of uncertainty that still exists due to the vagaries of continued COVID spread, variant mutations, vaccination supply, and public health mitigation responses. Two Commissioners felt the base case growth assumptions reflected reasonable conservatism. Two other Commissioners thought that while the base assumptions are potentially reasonable, they would continue to err on the side of additional conservatism.

DISCUSSION (continued):

Property Tax

Property tax is the single largest revenue source for the Town and comprised approximately 28% of total Town projected revenues for FY 2020/21. As the following table illustrates, Los Gatos has benefited from the economic expansion as evidenced by year-over-year (YOY) roll growth in property assessment since 2011. For the 10-year period, the average annual growth rate was 6.10%.

Los Gatos Assessment Roll Growth
(values in billions)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Roll	8.37	8.68	9.46	9.99	10.63	11.54	12.29	13.15	13.84	14.90
Percent Growth	1.30	3.67	9.06	5.62	6.40	8.56	6.54	6.95	5.23	7.70

Source: Santa Clara County Assessors Annual Reports

The County of Santa Clara provides property tax collection updates and projections throughout the year. The following table illustrates the most recent estimates relative to the Adopted FY 2020/21 Budget and 2019 actuals. The current County estimate indicates a modest deviation from budget of approximately $700,000 (3.74%)unrelated to COVID which is primarily the result of the Redevelopment Agency (RDA) residual payment decrease, which the County has already retained, and staff modeling a 50% reduction in Educational Revenue Augmentation Fund (ERAF) payments from the County estimate.

	FY 2019 Actual	FY 2020-21 Adopted Budget	County Estimate with ERAF	County Estimate 50% ERAF
Property Tax Revenue & Vehicle License Fee Backfill	$18.4 M	$18.7 M	$18.9 M	$18.00 M

The Town has been monitoring developments regarding the normal distribution of excess ERAF funds. A portion of property tax revenue goes to the ERAF to support local school districts. When the amount contributed to ERAF is more than the minimum cost of funding local schools, excess funds have traditionally been returned to the county, cities, and special districts. Five counties, including Santa Clara, have been using a redistribution allocation formula for years that is now being contested by the State. The Town's Adopted FY 2020/21 Budget had ERAF base revenue estimated at $433,000. However, the most recent County property tax estimate included $1.8 million of additional excess ERAF funds. If the State is successful in contesting

DISCUSSION (continued):

ERAF distribution of excess funds, the result would be a negative impact on budgeted revenues. Given that the distribution of the excess ERAF funds is a binary outcome, staff is modeling a 50% reduction in ERAF into yearend.

The following table illustrates the growth projections utilized for development of the FY 2020/21 Five-Year Forecast for property tax and corresponding estimated revenues. In addition, the Forecast estimated additional property taxes of $350,000 in FY 2021/22 and $700,000 per year thereafter from Phase One development of the North 40 starting in year 2022/23 of the Forecast.

Property Tax	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast	2024/25 Forecast	2025/26 Forecast
Proposed Growth	0%	3%	3%	3%	3%
Estimated Revenues	$19.1 M	$19.9 M	$20.4 M	$21.0 M	$20.8 M

Given the continued low supply of housing inventory and the unanticipated residual benefits of remote workers relocating to less urban environments, staff is anticipating continued modest growth in property tax in the coming year and years ahead.

The UCLA Anderson Forecast provided the following assessment of the housing market: “We forecast that housing will remain strong well into 2023. Home builder confidence is at a record, and permits and housing starts continue to increase. Underlying this are five factors.

First, interest rates are likely to remain low for an extended period of time, which will fuel demand for home purchases. Second, without COVID concerns, sellers who were reluctant to put their homes on the market this past year may enter the market and relieve current inventory constraints. This is likely to be a case where supply begets demand, and the increased options induce more people to become buyers.

Third, we’ll have more clarity on whether working from home will be sustainable over the longer-term once pandemic constraints are no longer binding. This clarity is likely to induce additional rounds of people relocating away from urban cores to suburbs and larger homes. Fourth, there’s a demographic bubble of millennials aging into their prime earning and home-buying years. This demographic shift will continue to fuel higher demand for home purchases.

And fifth, as unemployment begins to come down and there’s less economic uncertainty, buyers who were reluctant to enter the market this past year may be more likely to enter to

DISCUSSION (continued):

take advantage of continued low mortgage rates. As for where housing markets will be red-hot, there are a lot of unknowns. Once the economy fully reopens, urban cores will regain some of the amenity value lost during the pandemic, but demographic shifts, with millennials starting families, and continued opportunities to work from home will make the suburbs more attractive."

The following table illustrate the growth factors recommended for development of the FY 2021/22 Five-Year Forecast.

Property Tax	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast	2024/25 Forecast	2025/26 Forecast
Proposed Growth	2.5%	2.5%	3%	3%	3%

For purposes of the Forecast, the "Base Case" utilizes a growth factor of 2.5% to 3.0% and the "Greater Growth" and "Lower Growth" scenarios utilize a 2% differential from the Base Case. In addition to the growth factor, staff continues to assume $350,000 additional North 40 revenue in FY 2021/22 and an additional $700,000 in FY2022/23 due to the project's construction and sales schedule. Base non-residual excess ERAF revenue is forecasted at $400,000 annually until further direction received from the County. FY 2022/23 also anticipates an additional $500,000 RDA residual allocation representing the current allocation calculation of Santa Clara County.

Property Tax (Property Tax & VLF)	2021/22 Forecast ($M)	2022/23 Forecast ($M)	2023/24 Forecast ($M)	2024/25 Forecast ($M)	2025/26 Forecast ($M)
Greater Growth Scenario	$18.6	$20.2	$21.2	$22.4	$23.5
Base Case Modest Growth	$18.3	$19.5	$20.0	$20.7	$21.3
Less Growth Scenario	$17.9	$18.7	$18.	$19.1	$19.2

Sales Tax

Sales tax is the second largest revenue source for the Town and comprised approximately 12% of total Town projected revenues for FY 2020/21. The table on the next page illustrates the most recent projections from the Town's sales tax consultant MuniServices relative to the Adopted FY 2020/21 budget and 2019 actuals.

DISCUSSION (continued):

	FY 2019/20 Actual	FY 2020/21 Adopted Budget	January 26, 2021 MuniServices Estimate
Base Sales Tax & District Tax	$7.5 M	$8.0 M	$7.7 M

The current estimate indicates a deviation from budget of approximately $300,000 (3.75%); however, staff will continue to monitor MuniServices updates into the close of the year and adjust as appropriate. The table below provides the MuniServices forecasted COVID growth factor used for development of the FY 2020/21 Five-Year Forecast.

Base Sales Tax & District Tax	2021/22 Forecast ($M)	2022/23 Forecast ($M)	2023/24 Forecast ($M)	2024/25 Forecast ($M)	2025/26 Forecast ($M)
MuniServices COVID Scenario	$8.10	$8.20	$8.40	$8.50	$8.60

For the FY 2021/22 Five-Year Forecast, staff is utilizing the MuniServices Conservative scenario. The Conservative scenario assumes that approved vaccines become available on a limited basis 2021 Q1, and treatment options will improve. In addition, the scenario assumes more cases and more fatalities, delays in approving and distributing vaccines, problems with vaccines, and partial modified Stay-At-Home orders stay in effect until 08/31/21. The tables below have been segregated between estimates for the base sales tax and the Town's dedicated District Tax to better illustrate the variability between them.

Base Sales Tax	2021/22 Forecast ($M)	2022/23 Forecast ($M)	2023/24 Forecast ($M)	2024/25 Forecast ($M)	2025/26 Forecast ($M)
Conservative	$ 7.26	$7.48	$7.64	$7.79	$7.93
Most Likely	$7.38	$7.61	$7.78	$7.94	$8.09
Optimistic	$7.49	$7.74	$7.92	$8.09	$8.25

DISCUSSION (continued):

Measure G 1/8 District Tax	2021/22 Forecast ($M)	2022/23 Forecast ($M)	2023/24 Forecast ($M)	2024/25 Forecast ($M)	2025/26 Forecast ($M)
Conservative	$1.00	$1.03	$1.05	$1.07	$1.09
Most Likely	$1.02	$1.04	$1.07	$1.09	$1.11
Optimistic	$1.04	$1.06	$1.09	$1.11	$1.13

While staff doesn't necessarily concur with some of MuniServices vaccination and Shelter-In-Place duration assumptions, given the significant unknowns related to the pandemic, staff believes it is appropriate to default to the most conservative scenario. The UCLA Andersen Forecast notes "…our assumption is that households will not only resume their consumption of services, but those that accumulated savings during the pandemic will overcompensate for the past year by consuming more services than they normally would. We expect a significant surge in spending on restaurants, recreation, travel, and accommodation…" Again, given the socioeconomic composition of Los Gatos, the Town should benefit from the Report's forecasted trends.

Transient Occupancy Tax

TOT is an important revenue source for the Town and comprised approximately 3.4% of total Town projected revenues of $2.3 million for FY 2020/21. The following table illustrates TOT year-end collection estimates, the Adopted FY 2020/21 Budget, and FY 2019/20 actuals.

	FY 2019/20 Actual	FY 2020/21 Adopted Budget	Year-end Estimate
TOT	$1.87 M	$2.30 M	$0.7 M

As the table illustrates, to date TOT has experienced the most significant percentage decline relative to Budget. The FY 2020/21 Five-Year Forecast modeled a steep contraction with subsequent rebound for a net 15% reduction in TOT revenues from the prior January 21, 2020 initial forecast projection over the course of the year. However, in addition to the initial Shelter-in-Place (SIP) and Stay-at-Home restrictions instituted on March 17, 2020, on November 28, 2020, Santa Clara County issued new mandatory directives which included that hotels and other lodging facilities will be open only for essential travel and for use to facilitate isolation or

DISCUSSION (continued):

quarantine. Given that the November restrictions remain as of this writing, staff anticipates that the current Health Order will continue to degrade TOT revenues for the remainder of the year resulting in year-over-year (YOY) declines of 69%.

The table below illustrates the growth projections utilized for development of the FY 2020/21 Five-Year Forecast for TOT and corresponding estimated revenues.

TOT	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast	2024/25 Forecast	2025/26 Forecast
Proposed Growth	-5%	0%	0%	0%	0%
Estimated Revenues	$2.2 M	$2.2 M	$2.2 M	$2.2 M	$2.2 M

Unlike sales tax forecasts which predict an acceleration of revenues tied to pent up consumer demand, the Town's TOT revenue has historically been primarily driven by business travel. Given the uncertainty around physical business travel resuming at prior levels, as opposed to a continuation of remote work and online meeting forums, staff is recommending modest growth for base case development of the FY 2021/22 Five-Year Forecast. However, given the significant reduction to the revenue base compared to prior revenue history staff is providing a base growth scenario and an additional more optimistic growth scenario.

TOT	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast	2024/25 Forecast	2025/26 Forecast
Base Growth Scenario	30%	20%	5%	5%	5%
Estimated Revenues	$0.8 M	$0.9 M	$1.0 M	$1.0 M	$1.1 M
Base Growth Scenario	50%	20%	5%	5%	5%
Estimated Revenues	$1.1 M	$1.3 M	$1.3 M	$1.4 M	$1.5 M

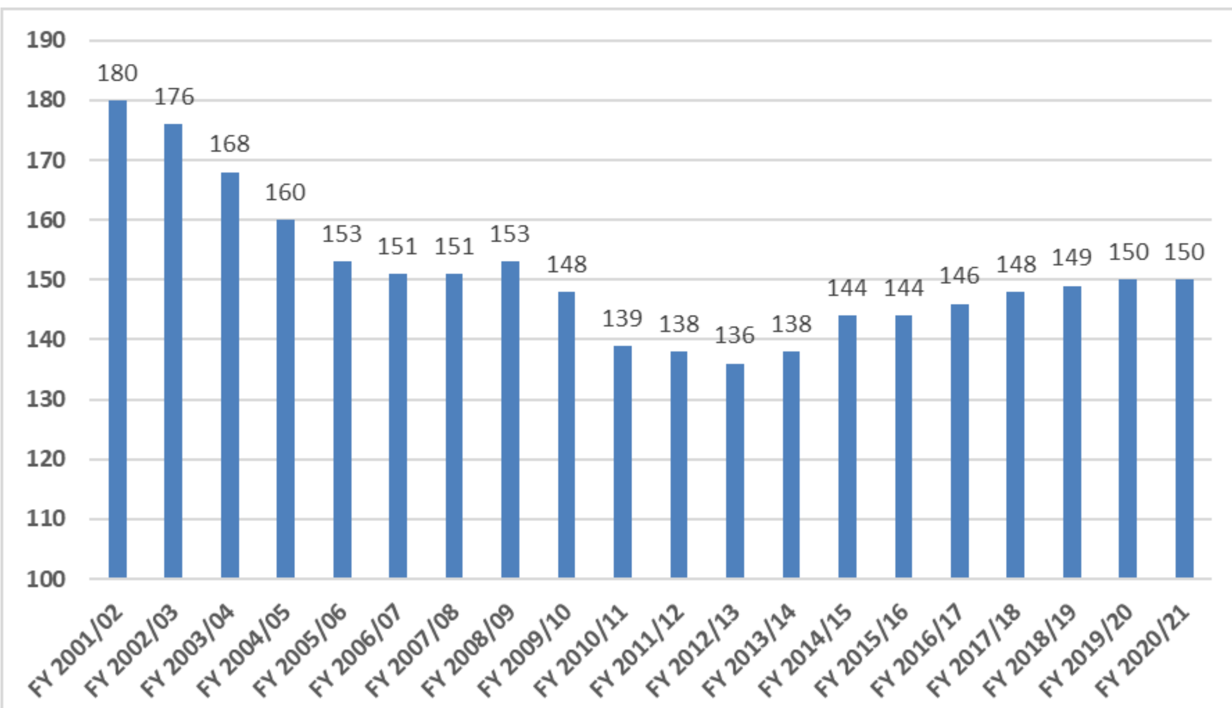
Operating Expense Trends and Five-Year Forecast Scenarios

Forecasts of future operating expenditures take into account two key factors: cost escalation and new operating expenditures. New operating expenditures refer to costs created by new or enhanced service programs approved during the annual budget process.

DISCUSSION (continued):

Cost escalation refers to largely unavoidable increases in the cost of doing business. It includes inflation, multi-year contract costs, health care costs, and unfunded State mandates. Cost escalation also includes other unavoidable cost increases unique to a government organization, such as a rise in wages consistent with collective bargaining agreements and annual pension payments mandated by CalPERS. The Town has three bargaining units, including the Town Employees' Association (TEA), the American Federation of State, County and Municipal Employees (AFSCME), and the Police Officers' Association (POA) and the unrepresented Management and Confidential groups.

For FY 2020/21, General Fund Operating expenditures (not including debt payment and transfers out) were programmed at $47.9 million. The delivery of Town services is highly dependent on labor which comprises 59.5% of budgeted General Fund expenditures and 41% of budgeted total expenditures for FY 2020/21. Given the high dependence on labor for service delivery the Town has helped manage salary escalation (and benefits) through the maintenance of lower staffing levels. As the table below illustrates, since 2001 the Town has reduced its full-time employees by 16.7% to 150 FTE employees.



In addition, the Town's bargaining groups have helped manage employee costs as evidenced by participating in wage freezes and unpaid furloughs for several years to assist in achieving balanced budgets after the 2008 recession. It should also be noted that since 2000 the Town's bargaining groups have received salary increases of 51.50% (AFSME), 56.00% (TEA), 56.00%

DISCUSSION (continued):

(Confidential), 61.25% (POA), 46.00% (Management), respectively. This compares to inflation in the San Francisco Statistical Area of 66.84% over the same time period.

Mandated pension payments to CalPERS has consistently been one of the major cost drivers for the Town over the past decade with persistent unanticipated increases in pension costs. The Town's plans over the past several decades, like all other CalPERS participants, have experienced unfavorable investment returns, changes in actuarial assumptions, and demographic changes which have outweighed any positive plan experiences. The outcome of these unfavorable economic and demographic results is the development of unfunded pension and OPEB obligations for the Town. To address the escalation in pension costs, previous Councils have allocated additional discretionary pension funding totaling $12,800,000 million. These additional discretionary payments will ultimately yield an approximate additional $11,700,000 in contribution savings.

The Town and its bargaining groups have also worked to contain benefit costs. The Town closed the CalPERS retiree Tier 1 benefit for non-safety employees and created a new Tier 2 for non-safety new employees in 2012, implemented the Public Employees' Pension Reform Act (PEPRA) for all new non-classic employees starting in 2013, and participates in the CalPERS discounted prepayment option.

In addition to the management of the Town's pension obligations, prior Council's and the Town's bargaining groups have worked to curb cost escalation in Other Post-Employment Benefits (OPEB). In 2009, the Town initiated prefunding of the retiree healthcare benefit and has since established approximately $23.5 million in OPEB assets from zero in 2009. In 2016, the Town's bargaining groups approved the introduction of dependent cost sharing and a reimbursement cap to Medicare eligible employees, and in 2018 the elimination of the Town's existing retiree healthcare benefit prospectively.

While these collective measures have helped to slow the growth in salary and benefit expenses, the Forecast anticipates continued increases in the Town's pension obligations.

Provided below are the expense assumptions for salary and benefits and alternate case scenarios for pension contributions. The majority of other expenses are assumed to increase at 3% per annum. Detailed expenditure assumptions and factors can be found in Attachment 5.

DISCUSSION (continued):

Salary and Benefits

Salary

The Town has historically budgeted vacant and non-sworn positions at top step of the range for the position. Sworn and management positions are budgeted at one step higher of current step in anticipation of any merit increases expected to be awarded in the upcoming fiscal year. Based on Council's direction, for FY 2020/21 salaries were budgeted at actual salary plus a one step increase, which was a significant budgeting methodology change from previous practice. This methodology will be continued for the development of FY 2021/22.

For the Forecast, positions are budgeted at the actual rate of pay of employees including benefits as of December 2020. Then, by position, salary costs are updated in accordance with the applicable Memorandum of Understanding (MOU) between the Town and its bargaining units. The Memoranda of Understanding that outline the individual agreements between the Town and each unit related to compensation, health benefits, leave time, and grievance procedures will expire with TEA and AFSCME on June 30, 2021. POA's MOU will expire on September 30, 2021. The Management and Confidential groups are unrepresented.

In addition to the economic terms of the MOUs, the Forecast assumes step increases for employees in applicable positions, and merit increases for Management and Confidential employees. As is the Town's practice, no general wage adjustments are included in the Forecast starting in 2021/22 due to the expiration of bargaining group MOUs. The Forecast will be updated accordingly based on labor negotiations with the Town's unions at that time.

(values in millions)

Salaries (Current MOUs)	2021/22 Forecast ($M)	2022/23 Forecast ($M)	2023/24 Forecast ($M)	2024/25 Forecast ($M)	2025/26 Forecast ($M)
Base Case	$19.7	$19.7	$19.9	$20.1	$20.2

Pension and Other Benefits

For purposes of the Forecast, staff utilizes data provided by CalPERS in the annual actuarial valuations and then in consultation with the Town's Actuary (Bartel Associates) and CalPERS updates the projections to include data not included. Given that actuarial valuations lag by

DISCUSSION (continued):

about a year the CalPERS 2019 valuation would not have captured the 4.7% CalPERS investment return for FY 2019/20, the current CalPERS investment return year to date, or the Town's $3.5 million additional discretionary payment from July 2020. The following table illustrates the forecast for pension and other benefits. The projections for the Town's OPEB payments are derived from Bartel Associates.

Pension & Other Benefits	2021/22 Forecast ($M)	2022/23 Forecast ($M)	2023/24 Forecast ($M)	2024/25 Forecast ($M)	2025/26 Forecast ($M)
Base Case	$11.4	$11.4	$11.2	$11.5	$11.8

As we move closer to the final development of the Proposed FY 2021/22 Operating Budget, staff will generate an updated pension forecast utilizing an investment return which more closely approximates CalPERS returns at that time versus the plans current 7.0% assumed return. Any update will not impact the initial years of the forecast due to lags in actuarial reporting but will be exhibited starting in the third year of the forecast.

Given that investment returns have one of the largest impacts contribution variability CalPERS provides projected employer Unfunded Actuarial Liability (UAL) contributions under alternate investment returns. As the table below illustrates returns higher than the expected return of 7% result in lower UAL contributions and returns lower than 7% result in higher UAL contributions.

UAL Town Contributions (Misc & Safety)	2021/22 Forecast	2022/23 Forecast	2023/24 Forecast	2024/25 Forecast	2025/26 Forecast
Greater Investment Return Scenario (12%)	N/A	$5,004,000	$4,971,000	$4,751,000	$3,860,000
Base Investment Return Case (7%)	$4,756698	$5,172,000	$5,476,000	$5,783,000	$5,626,000
Less Investment Return Scenario (1%)	N/A	$5,392,000	$6,138,000	$7,110,000	$7,838,000

CalPERS Actuarial Valuations as of June 30, 2019

For the year ending June 30, 2019, the Public Employees Retirement Fund (PERF) returned 6.7%. The table below illustrates the historic investment returns for five years, ten years, twenty years, and thirty years.

DISCUSSION (continued):

CalPERS Compound Annual Rates of Return	5 Years	10 Years	20 Years	30 Years
Geometric Return	5.8%	9.1%	5.8%	8.1%

Five-Year Financial Forecast Alternative Scenarios

The tables below present the "Base Case" forecast contrasted against the two alternative scenarios of "Greater Growth" and "Lower Growth." As illustrated in the tables, even modest changes to the "Base Case" forecast can result in either additional surpluses or deficits during the forecast period.

(values in millions)

Original 5 Year Forecast "Base Case"	2021/22 Forecast ($M)	2022/23 Forecast ($M)	2023/24 Forecast ($M)	2024/25 Forecast ($M)	2025/26 Forecast ($M)
Total Revenues, Transfers & Use of Reserves	$42.7	$44.2	$45.1	$46.1	$47.2
Total Expenses & Allocations	$44.7	$44.6	$45.1	$45.9	$46.9
Original Surplus/Deficit	($2.0)	($0.4)	$0.0	$0.2	$0.3

Alternative Scenario "Greater Growth"	2021/22 Forecast ($M)	2022/23 Forecast ($M)	2023/24 Forecast ($M)	2024/25 Forecast ($M)	2025/26 Forecast ($M)
Total Revenues & Transfers	$43.4	$45.4	$46.7	$48.3	$50.0
Total Expenses & Allocations	$44.7	$44.6	$45.1	$45.9	$46.9
New Surplus/Deficit	($1.3)	$0.8	$1.6	$2.4	$3.1

DISCUSSION (continued):

Alternative Scenario “Lower Growth”	2021/22 Forecast ($M)	2022/23 Forecast ($M)	2023/24 Forecast ($M)	2024/25 Forecast ($M)	2025/26 Forecast ($M)
Total Revenues & Transfers	$42.0	$43.2	$43.6	$44.2	$44.9
Total Expenses & Allocations	$44.7	$44.6	$45.1	$45.9	$46.9
New Surplus/Deficit	($2.7)	($1.4)	($1.5)	($1.7)	($2.0)

CONCLUSION:

The Town Council should review and discuss the elements and assumptions of the initial Five-Year Forecast and other budget considerations. While the “Base Case” Forecast estimates deficits at this time, it is based on assumptions that are subject to change given the significant unknowns related to COVID and as shown with the alternative growth scenarios. As the Forecast is not a budget, there are no specific budget balancing recommendations being proposed at this time. The Town Manager will bring forward for Council consideration in May a balanced proposed FY 2021/22 budget.

At this time, the preparation of the FY 2021/22 Operating and Capital Budgets is taking into account the Town’s current economic reality and long term fiscal picture, as well as maintaining the Town’s high level of municipal services. This is considered a “status quo” approach with no major new initiatives or staffing. Key budget principles include:

- Develop and recommend a balanced budget that maintains service levels;
- Position for multi-year recession
- Continue to make progress on Strategic Priorities identified by the Town Council; and
- Identify opportunities to enhance service delivery through new revenue sources, technology, and open government.

Staff looks forward to answering the Town Council’s questions and receiving any direction for the preparation of the proposed FY2021/22 Operating and Capital Budgets that results from the discussion. The Council may also discuss budget assumptions. For reference, the current status of the Town’s Capital Improvement projects are contained in Attachment 6. The Draft FY 2021/22 Operating and Capital Budgets will be available in May with the budget hearing tentatively scheduled for May 18, 2021.

COORDINATION:

This Report was prepared by the Town Manager's Office in coordination with the Finance Department.

ENVIRONMENTAL ASSESSMENT:

This is not a project defined under CEQA, and no further action is required.

Attachments:
1. Annual Budget Process
2. Base Case Five-Year Forecast
3. UCLA Anderson School 2020/23 Economic Forecast
4. Forecast Revenue Assumptions
5. Forecast Expense Assumptions
6. Capital Improvement Project Status

TOWN OF LOS GATOS

FINANCE COMMISSION SUBCOMMITTEE REPORT

MEETING DATE: 07/29/2021

ITEM NO: 2

ADDENDUM

DATE:	July 28, 2021
TO:	Finance Commission Subcommittee
FROM:	Laurel Prevetti, Town Manager
SUBJECT:	Receive Information on Town Financial Policies, Procedures, and Processes

REMARKS:

Attachment 3 contains public comment received after the July 23, 2021 distribution of Subcommittee Staff Report.

Attachments received with Staff Report:

1. Annual Report and Budget Cycle
2. Five-Year Forecast

Attachment received with Addendum

3. Public Comments

PREPARED BY: Arn Andrews
Assistant Town Manager

Reviewed by: Town Manager

From: Phil Koen [redacted]
Sent: Monday, July 26, 2021 3:04 PM
To: Laurel Prevetti <LPrevetti@losgatosca.gov>; loreen[redacted]
stacey.dell[redacted]
Cc: Ron Dickel [redacted]; Kyle Park [redacted]; ricktinsley[redacted]
Matthew Hudes <MHudes@losgatosca.gov>; Rob Rennie <RRennie@losgatosca.gov>
Subject: Agenda Item #2 - Finance Committee Subcommitee meeting July 29, 2021

Dear Subcommittee Members,

I would like to recommend that the subcommittee review the attached Town financial practices for areas of improvement. I am particularly focused on the Town's use of reserves to "balance" an operating budget. This is inconsistent with GFOA's best practices which recommends that "governments adopt rigorous policies, for all operating funds, aimed at achieving and maintaining a structurally balanced budget'. The best practices further states "the policy should include parameters for achieving and maintaining structural balance when recurring revenues are equal to recurring expenditures in the adopted budget".

I have attached the financial policies for the City of Los Altos for your review. The City of Los Altos has adopted the GFOA best practice and requires the presentation to City Council for review and approval a "balanced provisional budget" with total projected expenditures not exceeding total estimated revenues. Additionally, the City of Los Altos prepares an rolling two year operating budget. This should be also adopted by the Town.

Please let me know if you have any questions.

Phil Koen

FINANCIAL PRACTICES

REVENUE

- The Town maintains a diversified revenue base that is locally generated to shelter the community from fluctuations in any one revenue source.
- The Town audits and collects all locally generated taxes.
- The Town establishes and maintains all user charges and fees based on the cost of providing services.

BUDGETING and EXPENDITURE

- The Town Council considers and adopts an annual balanced budget effective from July 1st to June 30th of the following calendar year. A balanced budget requires current year operating expenses to be fully funded by current year revenues and identified undesignated/unreserved fund balance.
- Fund Balance Reserves are used only for non-recurring "one-time" and capital projects and not for on-going operations.
- Long-term debt is confined to capital improvements or special projects that cannot be financed from current revenues.
- The Town Manager is authorized to implement the programs as approved in the adopted budget. Within a specific fund the Town Manager may transfer appropriations between categories, Departments, projects, and programs as needed to implement the adopted budget.
- With the approval of the Town Manager, unexpected appropriations may be carried forward to the next fiscal year provided funds have been previously encumbered for a specific purpose.
- The annual budget includes a $100,000 Designated Contingency for non-recurring, unanticipated expenditures. The Town Manager may approve expenditures from this contingency if needed during the fiscal year.
- A capital outlay (fixed asset) purchase is any single item or piece of equipment which costs more than $10,000 and has an expected useful life exceeding one year.
- A mid-year budget report is submitted to the Town Council to provide information on the status of the Town's financial condition.

FUND BALANCE RESERVES

Reserves are established, dedicated, and maintained annually to meet known and estimated unknown future liabilities through actions of the Town Council.

Restricted fund balance is either imposed by law or constrained by grantors, contributors, or other governmental.

℘ FINANCIAL PRACTICES ∞

- IRS 115 Trust is established for the mitigate the Town's unfunded pension obligation

- The specific Fund Balance Reserves include but are not limited to a restricted Reserve for:

  - A fully funded workers' compensation and unemployment insurance
  - Liability insurance including one year's premium payment to the insurance carrier or pool

- Reserves are maintained at a minimum of 25% of General Fund ongoing operating expenditures, equally divided between the Catastrophic Reserve (12.5%) and the Budget Stabilization Reserve (12.5%).
- When either Reserve drops below the minimum, per Town Council adopted policy, Town Council is required to develop a one to five-year reserve replenishment plan to meet the minimum threshold of 25% of General Fund ongoing, operating expenditures, excluding one-time expenditures.
- A Reserve is maintained for the depreciation and replacement of equipment.

- A Reserve is maintained for the maintenance of buildings.

- Pension/Other Post Employment Benefits (Pension/OPEB) Reserve is maintained to use as a supplemental funding source to pay down unfunded pension and other post employment liabilities.

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

- Compensated Absences – A reserve is maintained annually to fund 50% of all vested hours of vacation earnings.

- Open Space – Town Council established this reserve in FY 1998/99 with an initial balance of $500,000 to be used for the preservation of open space, connection of open space trails, the definition of the southern boundary of the Town with passive open space, and protection of unique natural features.

- Sustainability – Established by Town Council in FY 2008/09 budget by closing the Solid Waste Management Fund and placing the initial residual fund balance of $296,554 in a General Fund reserve dedicated for conservation, recycling, and sustainability.

- Authorized Carry forward - A reserve is maintained for materials and services on approved purchase order and contracts which were issued but not finalized or fulfilled as of the end of the fiscal year but for which funds will be carried forward to the following fiscal year.

- Vehicle Maintenance and Stores Residual – A reserve established to hold the residual fund balances transferred to the Town's General Fund upon closing the Vehicle Maintenance and Stores Internal Service Funds for future Council reallocation.

- Surplus Property – A reserve established for placing the proceeds from surplus property sales until further Town Council reallocation.

- Capital/Special Projects Reserve – Funds reserved under this category are designated for key infrastructure and capital/special projects as identified in the Town's 5-year Capital Improvement Plan, as there is no ongoing funding source to support the Town's capital needs. The Council may also allocate funds from this Reserve for other purposes.

CAPITAL IMPROVEMENT

Capital Improvement Projects are funded by the following revenue sources:

- Available General Fund Reserves
- Gas Taxes
- Construction Fund Fees
  - Utility
  - Capital
  - Parks
- Storm Drain Basin Fees
- Grant Funding
- Other state and federal funding sources as they become available

- The multi-year plan for capital improvements is updated annually. Future capital expenditures will be projected annually for a 5-year period based on changes in Council priorities or replacement of the infrastructure.

- The annual Capital Improvement Plan is based on the multi-year Capital Improvement Program.

- The Town coordinates the development of the Capital Improvement Plan with the development of the Operating Budget.

- The Town identifies the estimated costs and potential funding sources for each capital project proposed prior to its submittal to the Town Council for approval.

- Capital projects financed by issuing bonds are paid back within a period not to exceed the useful life of the project.

- The Town Manager is authorized to implement the projects as approved in the adopted Capital Improvement Plan. Within a specific fund, the Town Manager may transfer appropriations between projects as needed to implement the adopted Capital Improvement Plan.

Los Altos Monument

FINANCIAL POLICY

OVERVIEW

This document establishes policies of overall financial management, budget development, and fiscal administration for the City of Los Altos. Included herein are statements and principles designed to guide the City in maintaining its financial stability.

Formal adopted financial policies assist elected officials and staff in the development of fiscal management practices, save time and energy in making financial decisions, promote public confidence, and provide continuity over time. While these policies will be updated periodically, they provide the basic framework for many of the financial decisions that the City will address. They support long-term planning and enhance the City's effectiveness.

This document discusses the most important elements of financial management in one comprehensive centralized format and is organized into the following areas of discussion:

General Financial Principles	Debt Management
Operating Budget	Fund Balances
Capital Improvements Program	Financial Reporting
Revenues	Annual Review and Update
Expenditures	Exhibits
Cash Management	

GENERAL FINANCIAL PRINCIPLES

It is the overall policy of the City of Los Altos to:

- Provide financial information in a relevant, thorough, timely fashion, and in a format that effectively communicates financial status to Council, citizens, and City employees.
- Manage its financial resources in a responsible and planned manner.
- Establish and maintain prudent fund balance levels.
- Maintain financial reporting in compliance with current governmental accounting standards.
- Promote and implement a relevant and strong system of internal financial controls to manage significant risks and monitor the reliability and integrity of financial and operating reporting.
- Promote constructive and proactive financial decision making.
- Integrate long-term operating and capital resources planning.
- Allow for uncertainties and maintain a posture of financial flexibility.
- Develop programs in a manner that supports the City's long-term ability to cover costs and provide the level and quality of service required by its citizens.
- Manage debt responsibly.
- Establish and maintain investment policies in accordance with State law.

FINANCIAL POLICY

OPERATING BUDGET

The budget will be adopted by the City Council no later than June 30th of each year. The City Manager may develop and present a biennial budget. The City should strive to develop a multi-year financial plan (a five-year forecast) that is updated as part of the periodic budget process.

A balanced provisional operating budget will be presented to City Council for review and adoption with total projected expenditures not exceeding total estimated revenues. Should it be necessary, City Council may approve a planned use of accumulated fund balances in prior years for inclusion in the budget.

Funds may not be expended for a new fiscal year until the budget for that fiscal year has been adopted by City Council.

One-time revenue sources are not to be relied upon to fund ongoing operations.

Budgetary control is maintained at the fund level:

- The City Manager may make budget transfers between departments or programs as long as those changes do not increase overall appropriations within any one given fund. Transfers between funds, overall increases in fund appropriations, and overall increases in project budgets can only be made through City Council action. Transfers between departments should be reported to the City Council as part of the budget update process, either at mid-year or at the proposal of a new budget term
- Department heads are held directly responsible and accountable for developing and managing their operational budgets. Their level of control is held at the department level. Departments that operate programs among different funds are limited to the appropriation levels within any one fund.

Operating expenditure appropriations not spent during the fiscal year lapse at year-end, except for:

- Encumbrances or commitments, as in the form of finalized Purchase Orders, made during the fiscal year that have not been completed at year- end.
- Appropriations for capital improvement projects and ongoing grants with a life-cycle beyond one year.

Governmental funds use the modified accrual basis of accounting while proprietary and fiduciary fund types are budgeted on a full accrual basis of accounting. The Comprehensive Annual Financial Report (CAFR) presents City's finances on a generally accepted accounting principles (GAAP) basis and the City's budget is prepared in conformance with these standards.

The City budget must comply with the annual determination of the City's appropriations limit calculated in accordance with Article XIIIB of the Constitution of the State of California and adopt an annual resolution to this effect.

CAPITAL IMPROVEMENT PROGRAM

The City will develop and maintain a five-year capital improvement project plan (CIP) to be updated annually in conjunction with the operating budget. The CIP should reflect the current and changing needs of the community as well as enhance the quality of the community's quality oflife.

All projects within the CIP are to be tracked systematically and reported to management quarterly. CIP tracking reports should clearly display budget-to-actual performance by project, fund category and project status.

Capital improvements that specifically benefit a select group of users and/or are fee- for-service based are to be financed through user fees, service charges, special assessments and taxes, or development impact fees.

Capital improvements that specifically benefit a fee-for-service enterprise operation (such as Sewer) are to be financed through the service fees generated within that operation and fund. Such fees should be supported by periodic updates to the related utility master plan.

Transfers of resources into the CIP fund will be evaluated on an annual basis dependent upon the existence of available surplus dollars.

The City should strive to maximize the use of capital grants and state subventions in funding capital improvements before tapping general revenue sources.

REVENUES

The City will strive to maintain a diversified and stable revenue base to minimize the impact of economic fluctuation.

The City will seek out, apply for, and effectively administer federal, state, and other grants that address the City's current operating and capital priorities.

Independent user-fee studies should be performed and updated periodically (three to five years) to ensure the proper balance of costs and service charges. The City should strive to cover the full cost of providing non-tax and discretionary fee-based service operations except to the extent that City Council approves defined subsidy levels by program area.

Operating departments are to review public services to identify and determine those appropriate for fee collection. Recommendations for new fees are to be presented to the City Council as fees are periodically updated.

Operating departments are to review existing fees periodically and recommend adjustments, if necessary, to ensure they reflect all direct and reasonable indirect costs of providing such services.

Enterprise operations will be self-supporting and shall reimburse the General Fund for any and all material and services provided on their behalf.

EXPENDITURES

Expenditures are to be budgeted and controlled so as to not exceed estimated revenues plus the approved and planned use of fund balances accumulated in prior years.

The City will conduct a mid-year financial status review to determine if projected revenues and expenditures meet target levels. If an operating deficit is projected at year-end, the City should evaluate the need for immediate corrective and/or mitigating actions, including operating or capital expenditure reductions and/or activate the use of established contingency balances. The deferral of essential and scheduled operational expenditures into the following fiscal year or the use of short-term loans and transfers to balance the budget should be avoided.

FINANCIAL POLICY

The City should implement a formal purchasing system, principles, and guidelines to ensure that expenditure levels are kept in check in the course of any fiscal year.

CASH MANAGEMENT

The Financial Commission will review the City's investment policy annually and make recommendations to the City Council when appropriate.

The responsibility of investing City funds rests with the Finance Director who is to exercise due diligence to adhere to the investment policy. The Finance Director will present to the City Council quarterly investment reports presenting a summary of the portfolio status and compliance with the conditions set forth in the investment policy.

DEBT MANAGEMENT

The City should plan the use of debt in a manner that sustains financing payments at manageable levels.

The City will seek to maintain a high credit rating through sound financial practices as a basis for minimizing borrowing costs.

The City will make every effort to use pay-as-you-go financing for capital improvement projects. Debt financing for a project can be used if the overall project cost exceeds anticipated available resources and/or if the cost of financing is favorable as compared to the use of City investment holdings over the financing term.

The City will monitor all forms of debt annually in conjunction with the budget preparation process and report concerns and remedies, if necessary, to City Council.

The City will diligently monitor its compliance with bond covenants.

The City will not issue long-term debt to finance current operations. Debt financing should only be used for long-term capital improvement projects with a useful life exceeding the term of the financing and for which the project revenues or specific identified revenue sources are sufficient to service the long-term debt.

The City will use a lease-purchase method of financing for equipment if the lease rates are more favorable than the City's expected overall investment rate of return.

The City will not incur general obligation indebtedness for public improvements which exceed in aggregate 15% of the assessed value of all real and personal property of the City as specified in the California Government Code Section 43605.

FUND BALANCE

GOVERNMENTAL FUND TYPE DEFINITIONS

Governmental fund types include the general fund, special revenue funds, capital projects funds, debt service funds and permanent funds. GASB has clarified the definitions of these funds as follows:

FINANCIAL POLICY

GENERAL FUND

The General Fund should be used to account for and report all financial resources not accounted for and reported in another fund.

SPECIAL REVENUE FUNDS

Special revenue funds are used to account for and report the proceeds of specific revenue sources that are restricted or committed to expenditure for specified purposes other than debt service or capital projects. The restricted or committed proceeds of specific revenue sources should be expected to continue to comprise a substantial portion of the inflows reported in the fund. Other resources (investment earnings and transfers from other funds, for example) also may be reported in the fund if those resources are restricted, committed, or assigned to the specified purpose of the fund. Governments should discontinue reporting a special revenue fund, and instead report the fund's remaining resources in the general fund, if the government no longer expects that a substantial portion of the inflows will derive from restricted or committed revenue sources

CAPITAL PROJECTS FUNDS

Capital projects funds are used to account for and report financial resources that are restricted, committed or assigned to expenditure for capital outlays, including the acquisition or construction of capital facilities and other capital assets. Capital projects funds exclude those types of capital-related outflows financed by proprietary funds or for assets that will be held in trust for individuals, private organizations or other governments.

DEBT SERVICE FUNDS

Debt service funds are used to account for and report financial resources that are restricted, committed or assigned to expenditure for principal and interest, even if it is being accumulated for future years' payments. Debt service funds should be used to report resources if legally mandated.

PERMANENT FUNDS

Permanent funds should be used to account for and report resources that are restricted to the extent that only earnings, and not principal, may be used for purposes that support the reporting government's programs. Permanent funds do not include private-purpose trust funds, which should be used to report situations in which the government is required to use the principal or earnings for the benefit of individuals, private organizations, or other governments.

FUND BALANCE CLASSIFICATIONS

Fund balance is defined as the difference between assets and liabilities. Beginning in FY2010-2011, the City is required to reclassify fund balances into the following five categories to comply with the Governmental Accounting Standards Board Statement (GASB) No. 54, Fund Balance and Governmental Fund Types.

FINANCIAL POLICY

NONSPENDABLE

This is a portion of fund balance not available for appropriations by its nature or external restriction. Examples are inventories and donations that require intact principal values.

SPENDABLE: RESTRICTED

The restricted portion of fund balance is subject to externally enforceable legal restrictions. Examples are Gas Tax revenues and grant proceeds.

COMMITTED

The committed portion of fund balance is constrained by the limitations imposed through formal City Council action. Only formal City Council action can remove or modify a previously committed amount.

ASSIGNED

The Assigned portion of fund balance is established for intended use by either the City Council or its designee, such as the City Manager. No formal City Council action is needed to remove the intended use. GAAP required reserves, such as the Other Post-Employment Benefits (OPEB) reserve, belong to this category. The Fiscal Policy and State Revenue Stabilization policy balances belong to this category.

UNASSIGNED

The Unassigned portion of fund balance is that remaining after the non- spendable, the restricted, the committed, and the assigned fund balances are identified and recorded.

GOVERNING BODY ORDER OF FUND UTILIZATION AND SPECIAL REVENUE CLASSIFICATIONS

ORDER OF UTILIZATION

The City of Los Altos will use GASB's definitions of fund balance for the annual financial reports (audits) and for all other financial reporting. For all financial planning purposes, the term Budgetary Fund Balance will be used and will include any portion of the fund balance that is available for appropriation. Portions of the fund balance not available for appropriation will be identified as follows.

The City of Los Altos policy establishes the order of use of unrestricted resources as follows:

The City shall strive to use the most restricted fund balances prior to utilizing those that are less restricted. The following order of use reflects this guideline:

- ☐ Nonspendable (if funds become spendable)
- ☐ Restricted
- ☐ Committed
- ☐ Assigned
- ☐ Unassigned

FINANCIAL POLICY

SPECIAL REVENUE CLASSIFICATIONS

Only the General Fund has an unassigned category since money remaining in any other fund is automatically designated or assigned to the purposes of that fund. Under the new GASB 54 rules, if the balance of a Special Revenue Fund if not formally restricted or committed by fiscal year end, then it must be reported as part of the General Fund for fiscal year end audited financial statement purposes. For some of the City's special revenue funds, this necessitates the City Council to provide direction on the intended use of resources for the future. Staff recommends that the City Council adopt the following list of the City's Special Revenue Funds and their expected fund balance classifications:

Vehicle Impound Fund - Restricted to Public Safety Use

Supplemental Law Enforcement Fund - Restricted by State Statute

Gas Tax Funds - Restricted by State Statute

Proposition 1B - Restricted by State Statute

Storm Drain Deposits - Restricted to Storm Drain Use

Community Development Block Grants - Restricted by Federal/State Statute

Downtown Parking Fund - Restricted by Council Action

In-Lieu Park Fee - Restricted by State Statute

Traffic Impact Fee - Restricted by State Statute

Estate Donation Fund - Restricted by Council Intent

Transportation Development Act (TDA) Funds - Restricted by State Statute

In addition, GASB 54 allows the City Council authority to "assign" ending fund balances or bestow this authority to a City officer or designee. To provide the City with the most flexibility in financial reporting, the City Manager is given authority to assign resources and ending fund balances.

FUND BALANCE POLICY LEVELS

PURPOSE

The City of Los Altos (City) has enacted the Fund Balance policies in an effort to ensure financial security through the maintenance of a healthy fund contingency balance that guides the creation, maintenance, and use of resources for financial stabilization purposes. The City's primary objective is to maintain a prudent level of financial resources to protect against reducing service levels or raising taxes and fees due to temporary revenue shortfalls or unpredicted one-time expenditures. The City also seeks to maintain the highest possible credit ratings which are dependent, in part, on the City's maintenance of a healthy fund balance.

FINANCIAL POLICY

GENERAL FUND

The City's fiscal goal is to maintain annual expenditure increases at a sustainable growth rate, and to limit expenditures to anticipated revenue in order to maintain a balanced budget. The Council directed target is to maintain an unrestricted fund balance within the range of not less than 17% of annual operating expenditures for the fiscal year with a multi-year goal of achieving a 20% unrestricted fund balance level for the reasons noted below. This level of coverage includes General Fund balance amounts specifically assigned for annual Emergency and Operating Reserve as discussed and defined further below:

- To provide funding to cover approximately two (2) months of operating expenses with the goal of achieving three months coverage in the long term.
- To provide the liquidity necessary to accommodate the City's uneven cash flow, which is inherent in its periodic tax collection schedule.
- To provide the liquidity to respond to contingent liabilities.
- To adhere to Government Finance Officers Association (GFOA) recommendation that a minimum General Fund unrestricted fund balance to be maintained of no less than either two (2) months of regular operating revenues or expenditures.

EMERGENCY AND OPERATING RESERVE

These balances are hereby defined as assigned by the City Council to allow the City to weather unpredicted cyclical and rapid downturns in the economy. These funds would be available for use in such conditions to mitigate negative economic fiscal impacts or State takeaways and can be activated within any one budget cycle through Council action. An economic downturn would entail a projected and/or sudden drop in core revenues (major tax and service revenue loss) of equal to or greater than 5% (including the impact of inflation) and/or a change in economic parameters (such as interest rates, debt service rates, commodity prices, pension rates) that cause a material change in expenditures of 5% or more, or the occurrence of a local natural disaster or unexpected financial claim requiring the immediate use of cash balances.

GENERAL FUND OTHER POST-EMPLOYMENT BENEFITS BALANCES

The City conducted an actuarial study to comply with GASB Statement No. 45, Accounting and Financial Reporting by Employers for Post-Employment Benefits and to determine the City's obligation for the other post-employment benefits (OPEB). The study concluded that the City should set aside annual funding for this obligation and the City has maintained internal funding of OPEB obligations for this purpose. Additionally, the City will conduct an actuarial update every two to three years to maintain the current status of this valuation.

SEWER FUND BALANCES

The City should maintain the balances in the Sewer Fund at a level sufficient to accommodate operating and capital needs. The Sewer Master Plan has set this reserve at 25% of annual expenditures, including estimated capital improvements. This level of funding should be established pursuant to the performance of a utility fund rate-study and/or master plan and are to be used for unanticipated operating and capital needs, and to level future rate increases. Multi-year fee studies for this fund should be updated periodically as a basis for defining the revenue sources necessary to maintain system infrastructure and required services levels. As a result of the periodic fee or master plan studies, adjustments to user charges may be necessary to maintain recommended fund balance levels.

WORKERS' COMPENSATION AND LIABILITY INSURANCE FUNDING

Periodic actuarial studies of self-insured workers' compensation and general liabilities will be conducted to ensure that proper levels of liabilities are accrued for claims and that rates charged to operating departments are appropriate.

EQUIPMENT REPLACEMENT FUNDING

An equipment replacement fund will be maintained to provide for the timely replacement of vehicles and other operating capital equipment. This fund is to be reviewed on an annual basis and rates charged to the using departments based on the depreciation guidelines established in this policy.

FINANCIAL REPORTING

The City's accounting and financial reports are to be maintained in conformance with GAAP.

An annual financial audit will be performed by an independent public accounting firm familiar with municipal government activities. The independent auditor will issue an audit opinion to be included in the City's Comprehensive Annual Financial Report (CAFR). Additionally, the auditor will present the CAFR and discuss audit findings to the Financial Commission. The City encourages the rotation of audit service providers on a periodic basis.

The City is encouraged to submit the Annual CAFR to State and/or National Government Finance Professional organizations (Government Finance Officers' Association's Certification of Achievement for Excellence in Financial Reporting - California Society of Municipal Finance Officers CAFR Award) for independent review and evaluation.

Internal financial status reports are to be issued on a period c and timely basis – no less than quarterly and be made readily available citywide.

The City is to record the depreciation equipment, buildings and facilities, and infrastructure as follows and in line with internally established capitalization guidelines:

Capitalization Thresholds

- Land purchases at any value
- Equipment - $5,000
- Buildings and facility improvements - $25,000
- Infrastructure - $100,000

FINANCIAL POLICY

Depreciation

Depreciation will be recorded on a straight-line basis over the following estimated useful lives:

- Equipment 3 - 10 years
- Site Improvements other than buildings 30 - 50 years
- Buildings 50 years
- Infrastructure 30 - 100 years

BEST PRACTICES

Achieving a Structurally Balanced Budget

Adopt rigorous policies, for all operating funds, aimed at achieving and maintaining a structurally balanced budget

Most state and local governments are subject to a requirement to pass a balanced budget. However, a budget that may fit the statutory definition of a "balanced budget" may not, in fact, be financially sustainable. For example, a budget that is balanced by such standards could include the use of non-recurring resources, such as asset sales or reserves, to fund ongoing expenditures, and thus not be in structural balance. A true structurally balanced budget is one that supports financial sustainability for multiple years into the future. A government needs to make sure that it is aware of the distinction between satisfying the statutory definition and achieving a true structurally balanced budget.

GFOA recommends that governments adopt rigorous policies, for all operating funds, aimed at achieving and maintaining a structurally balanced budget. The policy should include parameters for achieving and maintaining structural balance where recurring revenues are equal to recurring expenditures in the adopted budget.

As a first step, the government should identify key items related to structural balance. These include: *recurring and non-recurring revenues, recurring and non-recurring expenditures, reserves*.

Recurring revenues are the portion of a government's revenues that can reasonably be expected to continue year to year, with some degree of predictability. Property taxes are an example of recurring revenue. A settlement from a lawsuit is a good example of non-recurring revenue.

Some revenue sources may have both non-recurring and recurring components. These sources require finance officials to exercise judgment in determining how much of the source is truly recurring. For instance, a government may regularly receive sales tax revenues, but a large part of its base may be made up of retailers with highly volatile sales. In this case, it may be prudent to regard unusually high revenue yields as a non-recurring revenue under the assumption that such revenues are unlikely to continue, making it imprudent to use them for recurring expenditures. Another example might be building permit revenues in a period of high growth in the community. Governments should review their revenue portfolio to identify non-recurring revenues and revenues with potentially volatile components, such as the examples above.

Recurring expenditures appear in the budget each year. Salaries, benefits, materials and services, and asset maintenance costs are common examples of recurring expenditures. Capital asset acquisitions are typically not thought of as recurring because although some capital assets may be acquired every year, they are not the same assets year after year. In general, recurring expenditures should be those that you expect to fund every year in order to maintain current/status quo service levels. In general, a government has a greater degree of flexibility to defer non-recurring expenditures than recurring ones.

Reserves are the portion of fund balance that is set aside as hedge against risk. The government should define a minimum amount of funds it will hold in reserve.2 This serves as a "bottom line measure" to help determine the extent to which structural balance goals are being achieved. If reserves are maintained at their desired levels, it is an indication that the organization is maintaining a structurally balanced budget. If reserves are declining, it may indicate an imbalance in the budget (e.g., if reserves are being used to fund on-going expenditures). It should be noted that reserves levels are not a perfect measure of structural balance, but are a good and readily available measure.

With the forgoing terms defined, a government should adopt a formal policy calling for structural balance of the budget. The policy should call for the budget to be structurally balanced, where recurring revenues equal or exceed recurring expenditures. The policy should also call for the budget presentation to identify how recurring revenues are aligned with or not aligned with recurring expenditures.[3]

For a variety of reasons, true structural balance may not be possible for a government at a given time. In such a case, using reserves to balance the budget may be considered but only in the context of a plan to return to structural balance, replenish fund balance, and ultimately remediate the negative impacts of any other short-term balancing actions that may be taken. Further, the plan should be clear about the time period over which returning to structural balance, replenishing reserves, and remediating the negative impacts of balancing actions are to occur.[4]

Notes:

- Note that this Best Practice excludes non-operating funds like capital and debt funds. While governments should ensure that these funds are financially sustainable as well, the specific recommendations found in this Best Practice may not always be a match to the circumstances of non-operating funds.
- Please note that the best practice is not advocating that recurring revenues be formally allocated or "earmarked" to recurring expenditures, but rather is advocating that the budget presentation provide transparency as to whether recurring revenues and recurring expenditures are balanced.

Board approval date: Tuesday, February 28, 2012

Additional resources

AWARDS

Distinguished Budget Presentation Award Program

MORE INFO

BEST PRACTICES

Budget Monitoring

MORE INFO

BEST PRACTICES

Public Engagement in the Budget Process

MORE INFO

BEST PRACTICES

Capital Budget Presentation

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Item 2.

GFOA

Government Finance Officers Association

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TOWN OF LOS GATOS
FINANCE COMMISSION
SUBCOMMITTEE REPORT

MEETING DATE: 07/29/2021

ITEM NO: 3

DATE:	July 22, 2021
TO:	Finance Commission Subcommittee
FROM:	Laurel Prevetti, Town Manager
SUBJECT:	Discuss Current Annual Report Formatting and Forward and Recommendations to the Finance Commission

RECOMMENDATION:

Discuss current Annual Report formatting and forward any recommendations to the Finance Commission.

DISCUSSION:

On June 30, 2021, the Finance Commission Subcommittee requested that staff agendize a discussion of the Comprehensive Annual Financial Report (Annual Report) format for the July Subcommittee meeting.

https://www.losgatosca.gov/DocumentCenter/View/26586/FY-201920-CAFR?bidId=

PREPARED BY: Arn Andrews
Assistant Town Manager

Reviewed by: Town Manager, Town Attorney, and Finance Director