CITY COUNCIL AGENDA REPORT

MEETING DATE: OCTOBER 18, 2011 **ITEM NUMBER:**

SUBJECT: **RESPONSES TO FINANCIAL REVIEW CONDUCTED BY HARVEY M. ROSE ASSOCIATES, LLC**

DATE: **OCTOBER 11, 2011**

FROM: **FINANCE DEPARTMENT /FINANCE ADMINISTRATION**

PRESENTATION BY: **BOBBY YOUNG, FINANCE AND I.T. DIRECTOR**

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RECOMMENDED ACTION

Provide direction to staff regarding analysis of the recommendations made by Harvey M. Rose Associates, LLC.

BACKGROUND/ANALYSIS

Throughout the month of May, City staff assisted Harvey M. Rose Assoc. (Rose) to conduct a financial review of the City's financial status as requested by the Orange County Employees Association (OCEA). On June 21, the City received the full financial review report provided by Rose. In the report, Rose identifies 10 specific measures the City could take to tap into additional resources. The following is a list of those items with the estimated dollar value.

1. $9.2 million - Reduce designation for Working Capital Reserve (General Fund – Fund Balance)
2. $2.9 million - Eliminate designation for Self Insurance Liability (General Fund – Fund Balance)
3. $3.5 million - Reduce designation for Compensated Absences (General Fund – Fund Balance)
4. $0.7 million - Reduce designation for Other Post Employment Benefits (General Fund – Fund Balance)
5. $4.2 million - Recognize additional FY 2011 fund balance (General Fund – Fund Balance)
6. $6.2 million - Refund excess Equipment Replacement reserves
7. ($0.8 million) - Buy-out Fire Truck Lease
8. $0.2 million - Eliminate Fire Truck Lease Purchase
9. $0.0 million - Recognize sufficiency of Liability Insurance reserves
10. $0.3 million - Borrow using Pension Obligation Bonds to fund pension UAAL

Before providing responses to each of the items above, staff has made some initial observations of the financial review.

First, it should be noted that the Comprehensive Annual Financial Statements (CAFR's) used by Rose had been audited and opined on by Mayer Hoffman McCann (MHM)¸ the City's contracted auditor, and no material misstatements have occurred. Auditors from MHM annually perform substantive testing on the accounting records, internal controls, and accounting procedures of the City's Finance Department. In comparison, the review performed by Rose was not an audit, but simply a financial review performed using analytical and trending analysis.

Second, it is the fiduciary responsibility of City Council, City management and City staff to ensure the financial stability of the City of Costa Mesa. Over many years, our predecessors have taken an approach of fiscal conservancy and prudent financial planning to ensure the availability of cash and reserves upon which we operate and count on today. These cash and reserves allow the City to achieve its highest priority: providing quality services to the public. Between 2008 and 2010, the recession cut in half the City's reserves and the unstable economy continues to threaten City revenue. The City of Costa Mesa's General Fund is made up of 40% sales tax revenue and 20% property tax revenue while 72% of the expenditure budget is comprised of current and retired employee salaries and benefits. At a time of uncertainty and diminished reserves, it is important to remain fiscally conservative and use prudent financial planning to ensure to continued financial stability.

Staff believes the recommendations/suggestions provided by Rose are not fiscally conservative and do not use prudent financial planning to ensure the financial stability of the City of Costa Mesa. As demonstrated in the last paragraph on page 17 of the report dated June 21, 2011, Rose states that:

<u>"Certainly, if the City moves forward with the use of significant reserves for operations, its cash position will weaken. Therefore, it is appropriate that the City manage its cash closely to ensure that it does not have a cash crisis in the future."</u>

Staff believes the 10 items - which Rose states will free up $26.4 million for spending - will weaken the City's cash position and may dictate a cash crisis in the future. This should not be a desire of the Costa Mesa community, City Council, City management or City staff.

Staff has prepared responses to the 10 recommendations presented by Rose to help City Council and public understand in more detail why some of them should <u>not</u> be considered viable, while detailing the impacts of taking action on the others.

1. Reduce designation for Working Capital Reserve (General Fund – Fund Balance) $9.2 million.

Summary: Rose's proposal is that the City reduce its capital reserve from 15% of its revenue budget to 10%. According to Government Finance Officers Assn.'s best practices recommendations, Costa Mesa's reserve should be 17%. It wouldn't be prudent to reduce the capital reserves more than they already have been.

Details: Rose contends that the City's annual Operating Reserve of $14.125 million (which is established by Costa Mesa Municipal Code Section 2-205) is set at the "high end of reserve levels recommended by the Government Finance Officers Association (GFOA)", and approximately $9.2 million could be re-appropriated by the City Council.

Attached is the Best Practice Recommendation for the Appropriate Level of Unrestricted Fund Balance in the General Fund (2002 and 2009 – Budget and CAAFR). As seen on page 2, 1st paragraph, 2nd sentence, GFOA recommends to "maintain unrestricted fund balance in their general fund no less than <u>two months</u> of regular general fund operating revenues or regular general fund operating expenditures". Two months of a 12-month fiscal year is 17%. At no point does it reference "between 5% and 15%," as stated by Rose in its review.

It should also be noted on page 1, 6th paragraph the GFOA Recommendation states: "Those interested primarily in a government's creditworthiness or economic condition are likely to favor increased levels of fund balance. Opposing pressures often come from unions, taxpayers and citizen's groups, which may view high levels of fund balance as <u>excessive</u>."

The City's current designation of $14.125 million is 15% of the adopted $94.6 million revenue budget. Therefore, staff not only believes the current designation is appropriate, but based on the entire GFOA best recommended practice, the current amount could be seen as too low.

In previous years, the City had the annual Operating Reserve and also an unreserved undesignated amount. These two amounts combined helped keep the General Fund's total undesignated reserve in excess of the GFOA recommendation. However, the City has used more than $30 million of total fund balance over the last three fiscal years, which decreased the amount of unreserved undesignated fund balance. At Council direction, staff has presented Financial and Budget policies that it hopes will increase future reserve amounts to once again exceed the GFOA minimum recommended amounts. Therefore, staff would not recommend any portion of the Operating Reserve (as set forth by Municipal Code) should be made available for appropriation.

2. Eliminate designation for Self Insurance Liability (General Fund – Fund Balance) $2.9 million.

Summary: Rose proposes that the City eliminate $2.9 million it has reserved in the General Fund for potential self insurance liabilities. As of June 30, 2010, the City's third-party claims administrators estimated that the City would potentially need approximately $10.2 million for outstanding claims. Should the City need to pay those claims, it only had $7.3 million available in the Self Insurance Fund. Eliminating the $2.9 million from the General Fund will mean the City will not have reserves if the payouts need to be made.

Details: Rose contends that since the City has established a Self Insurance Fund and the City pays for costs as they are incurred, the current reserves "are funded at sufficient levels to ensure solvency through the recession, so this designation is unnecessary."

While the City has established the Self Insurance Fund (separate from the General Fund) as of June 30, 2010, it did not have enough in reserve to cover the estimated current and long term liabilities, as calculated by the City's third party claims administrators. If the City should incur expenses in excess of available cash in the Self Insurance Fund, the City's General Fund would be responsible for any additional amounts due. Therefore, the remaining amount necessary is designated in the General Fund to ensure all potential liabilities could be paid.

Also, staff believes assuming these funds are available for another use because the current reserves "are funded at sufficient levels to ensure solvency through the recession" is not prudent financial planning with the City's best interest in mind. While the economic future of the City is still uncertain, use of these reserves in the short term may put the City in a poor financial position in the future. Staff would not recommend any amount is available for appropriation.

3. Reduce designation for Compensated Absences (General Fund – Fund Balance) $3.5 million.

Summary: Rose contends that the City does not payout all compensated absences on an annual basis, therefore it should reduce the amount reserved to pay employees due to them as of June 30, 2010 from $4.7 million to $1.2 million. Since the current reserve amount is only 75% of the actual potential liabilities ($6.3 million), it is not recommended to reduce the current amount reserved.

Details: This compensated-absences designation is to ensure that the City would be able to pay amounts owed to all employees should they separate from service with the City. The City does not budget for expected payouts because it does not know when those separations will occur. Over the course of the fiscal year, the total amount owed to employees could fluctuate based on activity, resulting in a different amount owed. Unfortunately, assuming that this money would be paid from budgeted "salary savings after a position is vacated" (as suggested by Rose) is not always the case and therefore should not be relied upon as a sound fiscal policy or financial planning approach when a potential liability exists.

It should be noted that as of June 30, 2010, the total amount of actual compensated absences for all employees was $6.3 million. In past years, the City designated 100% of the compensated absences amount. This was seen by staff as prudent financial planning for a potential liability. The amount designated as of June 30, 2010 was 75% (or $4.7 million) of the actual total because the City did not have available fund balance to meet the 100% amount and other fund balance designations. Staff believed reducing the designation to 75% was still providing the City with adequate financial planning. Staff believes reducing it to 19% (or $1.2 million), as recommended by Rose, would not be acceptable financial planning, and therefore would not recommend any amount is available for appropriation.

4. Reduce designation for Other Post Employment Benefits (General Fund – Fund Balance) $0.7 million.

Summary: Rose contends that since the City funds its current Other Post Employment Benefits (OPEB) on a pay as you go plan, it should eliminate the designation of the Annual Required Contribution (ARC). Staff believes if the City was required or chose to establish an irrevocable trust to fund OPEB obligations, the funds in this designation would be available for that purpose instead of appropriating for other expenses.

Details: For the City, the OPEB obligation is the retiree health insurance reimbursement program (Council Policy 300-1). Governmental Accounting Standards Board (GASB) Statement #43 allows agencies to pay for existing costs "as they go" or establish an irrevocable trust to fund the future liabilities. This GASB Statement does require the City to determine if a liability exists between the ARC and pay-as-you-go plan and record that liability as if the City had established an irrevocable trust. This requirement is part of GASBs effort to ensure governmental agencies are bringing potential OPEB liabilities onto the Government-Wide balance sheet.

To provide the most amount of cash flexibility, especially in uncertain economic times, the City has continued to pay the actual annual costs instead of prefunding liabilities in an irrevocable trust. Therefore, Rose is correct that the City does not currently fund the ARC. However, with this designation, should irrevocable trusts or mandatory funding of OPEB obligations be required by a federal agency, the Governmental Accounting Standards Board (GASB) or the City Council in the future, the City would have funds designated for this purpose. So while this designation is not legally required, staff believes it is prudent to maintain flexibility of reserves when determining the necessity of prefunding future OPEB obligations.

5. Recognize additional FY 2011 fund balance (General Fund – Fund Balance) $4.2 million.

Summary: Rose contends that since the average historical budget patterns of revenues and expenditures (independent of each other) calculate to show a surplus, the City should have a surplus amount at the end of the 2010-2011 fiscal year that could be appropriated in FY 2011-12. Unfortunately, simply using historical budget trends is not an accurate way to calculate a financial surplus in a given fiscal year and therefore should not be relied upon when establishing a budget in the next fiscal year.

Details: Rose included in its report (Table 2) a five-year historical trend of both budget and actual revenues and expenditures to determine if the City would have a surplus in FY 10-11. Staff believes this type of analysis is severely flawed. A surplus (or deficit) is calculated using current year revenues compared to current year expenditures. Using historical budget to actual amounts has nothing to do with current year amounts.

While Rose agrees with staff's mid-year budget review increase in revenues of $6.8 million, it did not take into consideration (based on information provided by City staff):
- a brightening economy that increased the City's Sales Tax revenue from January 2011 to June 2011 over the amount projected by staff at the January mid-year budget review.
- increases in the Transient Occupancy Tax (TOT) revenue due to hotel occupancy from January 2011 to June 2011 that exceeded staff's projected amount at the January mid-year budget review.

These two revenue items alone will more than likely cause the year-end actual revenue amounts to exceed the mid-year budget estimates.

Using historical information in Table 2 of the report, Rose assumes that since the City's actual expenditures for FY 08-09 and 09-10 "achieved annual savings" of 3.2% and 4.5% respectively (when compared to the original adopted budget amount), this trend will continue and the City should expect at least a 4.4% (or $4.2 million) savings in FY 10-11. Unfortunately, this analysis in only looking at the expenditure budget to actual results and not taking into account the actual revenue amount to determine a surplus or deficit. Based on Table 2, while FY 08-09 and FY 09-10 actual expenditures came in under budget, when compared to revenues, the City spent $14.6 million and $4.9 million, respectively, more than it brought in. Staff does not consider those two fiscal years to have achieved a "savings."

Staff believes to determine an annual surplus or deficit, revenues and expenditures should not be considered independently. They should be considered together since it is the net effect at the end of the fiscal year that will actually determine a surplus or deficit. That said, after a review of FY 10-11 projected year-end balances for both revenues and expenditures, it is likely the City will end with approximately a $3 million surplus. This is because revenue amounts increased with the economy and current year expenditures decreased with city employees contributing more their pension plans and budgeted staffing reductions made in July 2010. It is not due to staff's ability/inability to accurately project the City's annual revenues or expenditures at the time of budget adoption.

Also, analyzing staff's budgetary performance using only the original adopted budgeted amounts does not provide an accurate representation of the work and adjustments made by staff during the budget year and are included in the City's fiscal year end Comprehensive Annual Financial Report (CAFR). The City's annual budget is prepared almost 15 months in advance of the fiscal year end, which is why staff recommends adjustments in January (6 months in advance of year end) at the Mid-Year Budget Review.

6. Refund excess Equipment Replacement Fund (ERF) reserves $6.2 million.

Summary: Rose contends that the City should only reserve an amount necessary for 60 days working capital. In the report, Rose references Federal OMB Circular A-87 as its source for this contention. With approximately $15 million of assets accounted for in the ERF, staff does not believe 60 days working capital is a sufficient reserve for vehicle maintenance and replacement nor does it recommend using any amount for General Fund purposes at this time.

Details: Fact note - The City does charge the maintenance and replacement costs of two code enforcement vehicles to the Community Development Block Grant (CDBG), a federally funded program. The estimated replacement value of these two vehicles represent 0.35% of the total estimated replacement value of the City's entire fleet.

Office of Management and Budget (OMB) Circular A-87, Attachment C (attached) refers specifically to "State/Local-wide Central Service Cost Allocation Plans" and does so with the following overview, "Most governmental units provide certain services, such as motor pools, computer centers, purchasing, accounting, etc. to operating agencies on a centralized basis."

The City does not bill federal programs using a cost allocation plan. All costs billed are for actual costs incurred and not estimated costs of providing the service. This is especially true for vehicle maintenance services, which charges are "supported by formal accounting and other records that will support the propriety of the costs assigned to Federal awards." Thereby any reference to this Circular should not be considered valid in reference to the Equipment Replacement Fund.

With the general nature of the Circular to encompass all Cost Allocation Plans, staff believes Rose contention of utilizing the Circular's definition of working capital (up to 60 days cash expenses for normal operating purposes) is very limited and should not be used as the general policy for the entire Equipment Replacement Fund. The ERF was established to record both the maintenance and replacement cost of vehicles. In reference to the Circular's definition of working capital, staff believes only the maintenance portion of the fund would be considered the normal operating expenses, not the replacement portion. The City currently estimates that it has approximately $15 million in total assets to eventually be replaced with an unrestricted reserve of only $6.5 million (as of June 2010). Staff would hope that even the federal government would see a need for more than 60 days working capital to prudently plan for the eventual replacement of $15 million worth of assets.

Rose contents that the annual expense net depreciation less a 60-day working capital amount dictates a surplus. This analysis does not take into consideration the actual unrestricted reserve available in the ERF. Based on the FY 10-11 adopted budget, staff estimated an ending fund balance/unrestricted reserve amount of $5.2 million, but Rose states $6.2 million could be moved to the General Fund. Which raises the question, how can the ERF have more in excess reserves than it has in actual unrestricted reserve? Unfortunately it cannot. The ERF cannot give back to the General Fund more than it has immediately available.

Given the current value of total assets in the ERF and the unrestricted reserve available, staff would not recommend any amount is available for General Fund appropriation.

7. Buy-out Fire Truck Lease ($0.8) million.

Summary: Rose contends that the City should pay off the remaining balance on a lease agreement to purchase a fire truck in the amount of $760,000. In doing so, Rose believes this will "provide annual General Fund savings of nearly $220,000 in FY 2011-12 through FY 2015-16." However, since the General Fund is not charged directly for any debt payments, this would not directly reduce the General Fund budget.

Details: Paying off the fire truck lease agreement early will require the use of cash, which the Equipment Replacement Fund (ERF) has access to. However, while paying off the lease agreement will save interest that would otherwise be paid through 2015-16, it will not reduce the amount of internal rent charges to the General Fund. Staff calculates internal rent charges based on the cost, useful life, replacement cost of current equipment and the available cash balance of the Equipment Replacement Fund. It does not directly take into consideration a lease payment for a vehicle. Therefore, staff estimates no direct savings to the General Fund in FY 11-12, and since this payment would reduce available cash, it is likely future rental charges would stay consistent in FY 11-12 or increase.

8. Eliminate Fire Truck Lease Purchase $0.2 million.

Summary: As stated above in #7, the annual internal rent charges are calculated charges based on the cost, useful life, replacement cost of current equipment and the available cash balance of the Equipment Replacement Fund. It does not directly take into consideration a lease payment for a vehicle. Therefore, staff estimates no direct savings to the General Fund in FY 11-12, and since this payment would reduce available cash, it is likely future rental charges would stay consistent or increase.

9. Recognize sufficiency of Liability Insurance reserves.

Summary: Rose contends that the City should eliminate the designation for self insurance in the General Fund (as stated in #2 above), but—related to the Self Insurance Fund—acknowledges, "We do not suggest that these reserves be reduced further." Staff agrees that the Self Insurance Fund reserves should not be reduced.

Details: As of June 30, 2010 the Self Insurance Fund had available cash of $7.3 million and reported $10.2 million in total liabilities. Therefore, should the City be required to pay all outstanding liabilities, the difference of $2.9 million would be required to be paid by the General Fund. Staff agrees with the analysis by Rose, and does not recommend using any reserves currently established in the Self Insurance Fund. As stated in #2 above, given this current deficit, staff disagrees with Rose's contention that the City could eliminate the $2.9 million designation in the General Fund and use it for another purpose. It should be the City's desire to maintain fiscal stability when potential liabilities exist.

10. Borrow using Pension Obligation Bonds to fund pension UAAL $0.3 million.

Summary: Rose contends that the City should issue Pension Obligation Bonds (POB) for the advance payment of the unfunded actuarial accrued liability (UAAL) for the Fire Safety Plan to reduce the annual PERS contribution. While the potential exists, staff does not recommend anticipating a savings of any amount until further analysis can be completed.

Details: During the City's review of all PERS pension plans with consultant John Bartel, staff inquired of the logic to issue POBs for the Fire Safety Plan. At the time, Mr. Bartel did state that the possibility may exist, and likely with only the Fire Safety Plan because the plan is in a pool and has a "Side Fund." More financial analysis would need to be completed before determining if and how much of a savings would be generated. Along with the variables of interest rates and the markets, staff also recommends clearly defining the future of the Fire Safety Plan before making such an obligation.

With so much analysis to be completed and the uncertainty of the Fire Safety Plan, staff believes an estimate of any savings in FY 11-12 is presumptuous, and not something the City could plan on or determine is available for another purpose.

ALTERNATIVES CONSIDERED

Staff has not considered any alternatives at this time.

FISCAL REVIEW

Based on the recommendation action, there is no fiscal impact at this time.

LEGAL REVIEW

A legal review is not required for the recommended action.

CONCLUSION

Recently, the Orange County Employees Association (OCEA) requested a financial review of the City's financial status to be completed by Harvey M. Rose Associates, LLC. Throughout the month of May and June 2011, staff provided Rose with all requested documents to complete the review. On June 21, the City received the final report which included 10 items that Rose concluded could allow for the appropriation of approximately $26.4 million.

At this time, staff does not recommend taking action on any of the 10 items recommended by Rose. Staff believes many items are irresponsible and, as stated by Rose, have the possibility of putting the City into a cash crisis. While noting that the City's General Fund, Equipment Replacement Fund, and Self Insurance Fund all have reserves, staff believes those reserves should continue to be guarded until a clear economic recovery has occurred. It is only with prudent financial planning that the City can balance its budget and maintain fiscal stability.

BOBBY YOUNG
Finance and I.T. Director

Attachment(s):
1 – GFOA Best Practice "Appropriate Level of Unrestricted Fund Balance in the General Fund"
2 – Federal Office of Management and Budget (OMB) Circular A-87
3 – Previous Rose report dated September 21, 2004