

CITY OF LA PALMA

Fund Balance Reserve Policy

Fund balance refers to the difference between assets and liabilities in the City's governmental funds balance sheet. This information is one of the most widely used elements of state and local government financial statements. Financial statement users examine fund balance information to identify the available liquid resources that can be used to pay down unfunded liabilities, finance capital improvements, or enhance the overall financial position of the City. Fund balance is a tool the City uses to have an effective long-term financial plan, as well as to ensure sufficient liquidity to meet its financial obligations in the short-term.

PURPOSE

There are two purposes to this policy:

1. To establish the financial reporting procedures for reporting unrestricted fund balance within the annual financial statements for the City's governmental funds (General Fund, Special Revenue Funds, and Capital Projects Funds). Unrestricted fund balance (comprised of Committed, Assigned, and Unassigned categories) is only reported within the City's governmental funds.
2. To provide guidance on maintaining reasonable levels of reserves in both governmental and proprietary funds. In addition, the policies will help guide current and future allocation levels to the five Internal Service Funds in a manner that maintains reasonable fund balance levels in each, without the funds being "over-allocated" in any given fiscal year.

FINANCIAL REPORTING

Overview

There are three categories of funds per generally accepted accounting principles:

- Governmental funds (e.g., the General Fund, Special Revenue Funds, and Capital Projects Funds)
- Proprietary funds (e.g., water and sewer enterprise funds, vehicle maintenance/replacement, insurance, and related internal service funds)
- Fiduciary funds (e.g., former Community Development Commission funds)

The Governmental Accounting Standards Board (GASB) Statement No. 54 governs the City's reporting of fund balance for governmental funds. This section is intended to meet those reporting requirements for governmental funds.

Governmental Fund Reporting

There are generally limitations on the purpose for which all or a portion of the resources of a governmental fund may be used. The force behind these limitations can vary significantly, depending upon their source. Consequently, the fund balance reported in the annual financial statements is categorized into five components whereby each component identifies the extent to which the City is bound to honor constraints on the specific purposes for which amounts in the fund can be spent. The five components of fund balance are as follows:

- **Nonspendable:** Resources that are 1) not in spendable form, such as inventories, prepaids, long-term receivables, or non-financial assets held for resale, or 2) required to be maintained intact such as an endowment.
- **Restricted:** Resources that are subject to externally enforceable legal restrictions; these restrictions would be either 1) externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments or 2) imposed by law through constitutional provisions or enabling legislation.
- **Unrestricted** (comprised of either Committed, Assigned, or Unassigned components):
 - **Committed:** Resources that are constrained to specific purposes by a formal action of the City Council such as an ordinance or resolution. The constraint remains binding unless removed in the same formal manner by the City Council.
 - **Assigned:** Resources that are constrained by the City's intent to be used for specific purposes, but that are neither restricted nor committed.
 - **Unassigned:** Within the General Fund, the residual resources, either positive or negative, in excess of what can be properly classified in one of the other four fund balance categories. Within all other governmental funds, the negative residual resources in excess of what can be properly classified as nonspendable, restricted, or committed.

When expenditures are incurred for purposes for which both restricted and unrestricted (committed, assigned, or unassigned) fund balances are available, the City's policy is to first apply restricted fund balance. When expenditures are incurred for purposes for which committed, assigned, or unassigned fund balances are available, the City's policy is to first apply committed fund balance, then assigned fund balance, and finally unassigned fund balance.

RESERVE BALANCES

The City of La Palma's Reserve Policies have two primary objectives:

1. **To determine the available liquid resources; and**
2. **To provide the information necessary to make informed financial decisions.**

The fund balance classifications of the City's General Fund are designed to clarify the extent to which the City is bound to honor constraints on the specific purposes for which amounts in the fund can be spent, rather than to simply represent the financial resources available for appropriation. The Emergency Reserve policies are designed to ensure that the City has adequate reserves for catastrophic emergencies, unexpected large expenditures, and both long- and short-term drops in revenue. The reserve policies, as applied to the five Internal Service Funds, are designed to provide guidance on maintaining a reasonable fund balance level in each fund. The goal of internal service funds is to provide enough liquidity in each to meet current as well as longer-term funding needs, while ensuring they are not overly funded to the extent ongoing operations are impaired by over-allocation.

The fund balance is only an approximate measure of liquidity or working capital. Therefore, it is necessary for the City to recognize how fund balance is constituted and isolate funds that are needed for longer-term obligations, discern what funds are restricted for specified purposes, and classify those funds that are not available at all.

NONSPENDABLE AND RESTRICTED FUND BALANCE: The first two classifications are subject to requirements outside the local governing body's control for financial decision-making and planning purposes. "Nonspendable" resources are essentially irrelevant because, by their nature, they are not liquid (i.e., land or similar non-cash assets). "Restricted" resources are of no discretionary value given the restrictions placed upon them by a third-party outside of the City's control (i.e., reserve funds required to be set aside for bond payments).

Nonspendable

Some of the assets that are included in determining the City's fund balance are inherently nonspendable:

- Assets that will never convert to cash, such as prepaid items and inventories.
- Assets that will not convert to cash within sixty (60) days from the start of the fiscal year, such as long-term loans receivable, and non-financial assets held for resale.
- Assets that must be maintained intact pursuant to legal or contractual requirements, such as an endowment.

Restricted

Restricted funds describe the portion of the fund balance that is subject to externally enforceable legal restrictions, these restrictions fall into three (3) categories:

- (i) Restrictions are imposed by parties altogether outside the scope of the City's governance:
 - Creditors (typically through a debt covenant)
 - Grantors (typically state, federal and other governmental agencies)
 - Contributors
 - Other governments.

(ii) Restrictions that arise when the authorization to raise revenues is conditioned upon the revenue being used for a particular purpose, such as:

- Gas taxes must be used for street repair
- Prop C must be used for fixed transit routes
- Prop A must be used for transit programs
- Measure R must be used for local street repair

(iii) Long-term loans receivable and non-financial assets that are collected can also be considered Restricted if the collected funds are subject to an externally enforceable restriction on how they can be spent.

Restricted Funds include, but are not limited to the following:

- **Gas Tax/Highway Users Tax**
- **Measure M2 Fund**
- **Air Quality Improvement/AB 2766 Fund**
- **Public, Educational, and Government (PEG) Fund**
- **Asset Seizure Fund**
- **Supplemental Law Enforcement Services Fund**
- **Service Authority for Abandoned Vehicles Fund**
- **Park Development Fund**
- **Housing Fund** (This fund was created through the dissolution of the La Palma Community Development Commission (CDC)).

Committed

Pursuant to an ordinance or a resolution, the City Council, as the City's highest level of decision-making authority, may commit fund balance for specific purposes. The commitment remains in effect until removed in the same manner in which the commitment was established. Although the Council's action to commit fund balance must occur prior to the end of the fiscal reporting period, the amount may be determined subsequently.

The City has established three commitments within the General Fund. The details of these commitments are explained within the Reserves Section of this document:

- Cash Flow Reserve of \$1,500,000. This amount is not intended to vary from year to year.

Although combined with the General Fund for financial reporting purposes, the following are shown as separate funds within the City's internal accounting records. It is the Council's intent to have the fund balance of these funds, as established within the City's internal accounting records, to be shown as committed fund balance on the annual financial statements. Further, it is the Council's intent that the fund balance commitments may be used only for the identified purposes.

- **Emergency Reserve Fund:** This fund balance commitment may be used in emergency situations. Such situations are identified within the Reserves section of this document.
- **Economic Development Fund:** This fund balance commitment may be used for economic development projects, including assistance with attracting, growing, and retaining businesses which promote the City's economic vitality and strengthen or diversify its tax base.

Assigned

Assigned funds describe the portion of General Fund reserves that reflect the use of resources by the La Palma City Council intended for unprogrammed and/or unfunded capital and infrastructure projects.

This policy delegates to the Administrative Services Director the authority to assign unrestricted fund balance amounts where the City's intent is for those amounts to be used for specific purposes. This delegation of authority is for the sole purpose of reporting these amounts in the annual financial statements.

It is the City's intent that the fund balances in the Capital Outlay Reserve Fund (COR) and in the One-time Projects Capital Projects Fund be considered to be Assigned Fund Balance for financial reporting purposes, as determined by the Administrative Services Director at the end of each fiscal year.

Unassigned

The General Fund may have net resources in excess of what is classified in one of the three previous categories. This amount is presented as the unassigned fund balance. Only the General Fund must report a positive unassigned fund balance; however, all other governmental funds can report a negative unassigned fund balance.

This policy logically dictates that any amount of fund balance classified as "unassigned" is in excess of 100% of General Fund expenditures since the "committed" and "assigned" amounts equal 100% of General Fund expenditures. This policy allows for "unassigned" funds in excess of 100% of General Fund expenditures and places no specific restrictions on their use. Each fiscal year when audited General Fund revenues exceed expenditures, a minimum of 25% of the year-end operating surplus will be allocated to the Emergency Reserve Fund. At the direction of the City Council, any remaining unassigned fund balance could be allocated for additional payments to the City's unfunded pension obligations, a pension stabilization fund, the Civic Center Replacement Fund, Other Post Employment Benefits (OPEB), or any other purpose the City Council deems appropriate, including leaving the funds in unassigned fund balance or putting the funds in the Emergency Reserve Fund.

Minimum Fund Balance Levels

The following governmental funds have a minimum fund balance level as of the end of each fiscal year:

- General Fund: A minimum fund balance of \$1,500,000 (comprised of a \$1,500,000 Cash Flow Reserve Commitment).
- The Emergency Reserve Fund (a committed component of the General Fund for financial reporting) should have a minimum fund balance of 50% of General Fund appropriations.

The General Fund's minimum fund balance policy is reported in the notes to the annual financial statements. The minimum fund balance is shown in the annual financial statements as unassigned fund balance except for those portions which reflect fund balance commitments as previously defined.

Cash Flow Reserve. This reserve policy establishes a commitment to maintain \$1,500,000 within the General Fund for cash flow purposes. Monies in excess of this amount will be transferred to other funds at the direction of the City Council after the end of each fiscal year and after the Comprehensive Annual Financial Report is completed.

Emergency Reserve Fund. This reserve policy establishes a commitment for an Emergency Reserve Fund with a minimum fund balance of 50% of General Fund Expenditures as of the beginning of each fiscal year. Appropriations from the Emergency Reserve commitment can only be made by formal City Council action, with the exception of interest earnings, which will be transferred to the General Fund.

Generally, appropriations and access to these funds will be reserved for emergency situations. Examples of such emergencies include, but are not limited to:

- Reduction in revenue equal to or greater than 20% of adopted General Fund appropriations
- An unplanned, major, catastrophic event such as a natural disaster requiring expenditures over 10% of General Fund adopted appropriations
- Unfunded and/or unpredictable State or Federal legislative or judicial mandates
- Any other unforeseen event that causes the City to expend funds in excess of 10% of General Fund adopted appropriations

Economic Development Fund. This reserve policy establishes a commitment for an Economic Development Fund with an initial fund balance of \$250,000 to be used for economic development projects, including assistance with attracting, growing, and retaining businesses which promote the City's economic vitality and strengthen or diversify its tax base

Capital Outlay Reserve Fund (COR). This reserve policy establishes an assignment for unprogrammed/unfunded capital and infrastructure projects with transfers into COR being calculated and made to demonstrate full funding of anticipated projects within the SFP planning period (11 years). Additional funding beyond the regular contribution may also be made to either lower future annual contributions or increase the Fund balance beyond the target level. These funds serve as a resource for all non-proprietary fund capital projects and supplements special revenue funds such as Streets and Measure M2. It can also be used for major emergency or unexpected repairs of the City's streets, hardscape, facilities, communication and technology systems, or other City-owned property and for funding infrastructure or capital projects which are not part of the approved Capital Improvement Program (CIP) (i.e., unfunded projects).

One-time Projects Fund. This reserve policy establishes an assignment for unprogrammed/unfunded non-recurring expenses, typically related to short-duration activities or one-time projects, which may include, but are not limited to: projects identified in the City's Capital Reserve Fund Improvement Plan; equipment replacement where the expected life of the equipment exceeds five years; technology replacements or upgrades, including energy conservation and communications; one time transfers or use to pay down already incurred unfunded liabilities; temporary use of reserves committed to provide additional resources for General Fund operations where a significant and temporary reduction in ongoing General Fund revenues is anticipated..

Civic Center Replacement Fund. This reserve policy restates a commitment to set aside funding for establishment of a new Civic Center. The fund was started with an initial fund balance of \$300,000. Each year during the budget process, the Administrative Services Director shall recommend a transfer amount from the General Fund to the Civic Center Replacement Fund. In addition, the loanbalances from the dissolved Community Development Commission were previously allocated to the Civic Center Replacement Fund as they are repaid to the City.

Utility Funds

The La Palma City Code establishes two utilities—water and sewer—and four utility related funds, two for operating expenditures and two for capital expenditures. The combined total of the operating expenditure and capital expenditure funds of each water fund shall retain an amount equal to five percent (5%) of the replacement value of the fixed assets of the utility for localized emergencies requiring unanticipated repairs to the system. The combined total of the operating expenditure and capital expenditure funds of each sewer fund shall retain an amount equal to ten percent (10%) of the replacement value of the fixed assets of the utility for localized emergencies requiring unanticipated repairs to the systems.

Special Gas Tax Street Improvement Fund. This fund is created in the City treasury a special fund to be known as the "Special Gas Tax Street Improvement Fund." All moneys received by the City from the State under the provisions of Sections 2106 through 2116 of the Streets and Highways Code (Streets and Highways Code §§ 2106—2116) for the acquisition of real property or interest therein, or the construction, maintenance or improvement of streets or highways other than State highways, shall be paid into such fund. All moneys in such form shall be expended exclusively for the purposes authorized by and subject to all of the provisions of Sections 2106 through 2116 of the Streets and Highways Code (Streets and Highways Code §§ 2106—2116).

Water and Sewer Funds. The Water Fund and Sewer Fund are created to fund the operating expenditures of each utility. Each fund shall be credited monthly with the calculated amount of moneys generated from the revenues of the utility which represent a fixed asset charge. Such amounts shall be estimated annually as part of the annual budget process, contained in and enumerated by the budget, and appropriated from such anticipated estimated revenues. Such moneys as are accumulated in each replacement fund shall be expended only under the following circumstances:

- By appropriation in the annual budget.
- By vote of four-fifths of the members of the City Council if at a time other than at the time of budget adoption.
- For specifically enumerated projects only.

Water and Sewer Capital Reserve Funds. The Water Capital Reserve Fund and the Sewer Capital Reserve Fund are created to fund the replacement value of utility fixed assets.

- The combined total of the two Water funds as enumerated in subsection (c)(1) and (c)(3) of this section shall retain an amount equal to five percent (5%) of the replacement value of the fixed assets of the water utility as a reserve within the funds.
- The combined total of the two Sewer funds as enumerated in subsection (c)(2) and (c)(4) of this section shall retain an amount equal to ten percent (10%) of the replacement value of the fixed assets of the sewer utility as a reserve within the funds.

The reserve amounts must be fully funded before moneys may be expended for projects, except that moneys may be expended from either capital reserve fund account on four-fifths' vote of the City Council. Such appropriation action by the City Council shall enumerate the nature of the emergency, make the emergency appropriation, and appropriate moneys for publicity of said emergency and the situation surrounding such emergency.

Replenishment of Reserves

In keeping with the principles discussed in this policy, when Fund Balance Reserve levels fall below the policy levels, the City Council, will develop a reserve replenishment plan to return the

reserves to their policy levels. This plan will seek to return the reserves to their policy levels within the Long Term Financial planning period and in most cases between one (1) to three (3) years, per City Council direction.

Internal Service Fund Reserves

Internal service funds are used to centrally manage and account for specific program activity in a centralized fund. The revenue (resources) for these funds generally comes from internal charges to Departmental operating budgets, based on different allocation methods depending on the internal service provided. Each of these internal service funds are classified as Proprietary funds in the City's annual financial statements (Comprehensive Annual Financial Report, CAFR). These funds have several functions:

- Normalizing departmental budgeting for programs and uses that have life cycles greater than one fiscal year, helping to facilitate level budgeting for expenditures that could be erratic from year to year (such as vehicles or technology replacement)
- Serve as a repository of a reasonable amount of savings to utilize for long-term asset replacement and/or funding liabilities
- Enable appropriate distribution of citywide costs to individual Departments and programs, which more readily establishes the true costs of various operations

The City of La Palma has five (5) Internal Service Funds:

- Employee Benefits
- Risk Management
- Vehicle and Equipment Replacement
- Facilities Maintenance
- Technology

The guiding purpose of each fund is to gather enough resources to meet annual expenses as well as maintain a reasonable fund balance for contingency purposes. Therefore, this policy will enumerate minimum fund balance levels for each internal service fund based on specific fund-type metrics. The intent of this policy is twofold:

- 1. To ensure sufficient resources exist in each internal service fund to pay for annual, ongoing expenses while maintaining a reasonable reserve to fund replacement purchases (i.e., annual vehicle replacement); and,**
- 2. Establish a fund balance level for each fund that is reasonable and prevents the over-accumulation of resources beyond what is needed for normal operating needs plus any amount required for emergency or contingency needs.**

Internal Service Fund Procedures

The following procedures will be utilized to establish reserve levels for each of the five Internal Service Funds:

Employee Benefits

This policy states that the fund balance level for the Employee Benefits fund will be calculated using 50% of the amount of compensated absences, as noted in the CAFR "Statement of Net Assets." This amount represents 50% of the total outstanding liability of all accrued employee vacation and sick time. Furthermore, while the CAFR "Statement of Net Assets" lists this liability as that "due within one year" versus "due beyond one year," it is prudent to establish a fund balance level based on the total amount of compensated absences, regardless of when the liability can reasonably be expected to be converted to an expense.

Using "compensated absences" as a measurement for appropriate fund balance allows for one type of liability to be covered. Being able to show how the "compensated absences" liability could be fully covered, if in the highly unlikely scenario the entire amount needed to be converted to an expense, is a useful metric upon which to base a reserve level policy.

Risk Management

This internal service fund is responsible for allocation costs related to the City's insurance coverage. The City of La Palma is a member of the California Joint Powers Insurance Authority (CJPIA). This pooled insurance joint powers authority (JPA) allows La Palma, as a small city, to receive insurance coverage at a reasonable amount.

Therefore, this policy establishes a reserve amount of \$1,000,000. This reserve level provides sufficient funding to cover annual insurance expenses while providing additional funds for any unseen, emergency needs (i.e., contingency reserve) such as an adverse legal judgment, a large one-time deductible payment, or other similar one-time expense. It should be noted that the City's Emergency Reserve Commitment (as established in this policy) could also be utilized as a further source of funds in the event of a large insurance related claim.

Vehicle Replacement

The City has a fleet of rolling stock and other equipment that is maintained and replaced through the Vehicle internal service fund. The City's Police, Public Works, and Recreation and Community Services Departments comprise the largest users of and contributors to the Vehicle internal service fund. This fund receives operating resources from Departments in order to fund the regular replacement of major pieces of equipment (primarily rolling stock) at their economic obsolescence.

This policy establishes a reserve level equal to one-third (33%) of the replacement value of all rolling stock. The definition of rolling stock includes such equipment as Police patrol vehicles, Public Works utility trucks, and Recreation and Community Services utility vehicles. The replacement value shall be that updated and used annually as part of the budget development process. This metric was chosen since the average, annual total replacement value of vehicles for the past seven years has been approximately \$200,000. The one-third of the replacement

value reserve level would actually be three times higher than this seven year historical actual expenditure amount. Setting the reserve level at one-third of the replacement value of all rolling stock will provide sufficient funds should there be a need for a one-time, larger than normal expenditure related to fleet services.

Facilities Maintenance

The Facilities internal service fund is responsible for costs related to routine maintenance (i.e., custodial services) of City Hall, Police Building and Central Park offices and community center. The City maintains a long-term, facilities master plan that is utilized to guide long-range budgeting for major building expenses. Capital projects are funded out of the Capital Outlay Reserve Fund.

This reserve policy establishes a reserve level in the amount of \$50,000, which represents a reasonable contingency for unanticipated maintenance issues which do not rise to the capital project level.

Technology

The City's computer network, communications system (i.e., telephone), desktop and peripheral hardware, and technology software expenses are accounted for in the Technology internal service fund. This fund is utilized for periodic replacement of desktop computers, the annual expense related to enterprise-wide software licenses (i.e., Microsoft Office), upgrades to servers and networks, and maintenance and upkeep of the communications (i.e., telephones) system.

The reserve level established for this internal service fund shall be the full replacement value of the City's entire technology network except for the 800 MHz system, as determined annually through the budget development process. A percentage of the 800 MHz system value will be added to the full replacement value of all other technology annually over 20-years beginning in FY 2017-18 at ten percent. The percentage shall increase each year by ten percent until one-hundred percent of the 800 MHz system's value is reached. Choosing this reserve level metric does not suggest the funds would be used to completely replace the technology in use. Instead, it is a useful measure to allow for periodic upgrades and enhancements to the City's collection of information and communications technology, while also providing sufficient funds to meet annual operating costs.

Replenishment of Internal Service Fund Reserve Levels

In keeping with the principles discussed in this policy, when the reserve level of any Internal Service Fund falls below the policy levels as outlined here, the Administrative Services Director will adjust allocations to those Internal Service Funds which have insufficient reserve levels beginning with the immediately succeeding fiscal year from when the reserve deficiency occurs. Allocation levels will be adjusted through the budget process in a manner that seeks to return the Internal Service Fund reserves to their policy levels within one (1) to three (3) years.

SUMMARY

Components of the Fund Balance

Nonspendable Fund Balance

- Inherently nonspendable
- Portion of net resources that cannot be spent because of their form
- Portion of net resources that cannot be spent because they must be maintained intact

Restricted Fund Balance

- Externally enforceable limits on use
- Limitations imposed by creditors, grantors, contributors, or laws and regulations of other governments
- Limitations imposed by law through constitutional provisions or enabling legislation

Committed Fund Balance

- Council/Agency Self-imposed Limitations set in place prior to the end of the fiscal year
- Limitation imposed at highest level of decision making that requires formal action at the same level to remove

Assigned Fund Balance

- Limitation resulting from intended use
- Intended use established by the Administrative Services Director

Unassigned Fund Balance

- Total fund balance in the General Fund in excess of nonspendable, restricted, committed and assigned fund balance (surplus)
- Excess of nonspendable, restricted, and committed fund balance over total fund balance (deficit)

Use of Fund Balance

- Restricted
- Committed
- Assigned

GLOSSARY

State and local governments use three broad categories of funds: *governmental* funds, *proprietary* funds, and *fiduciary* funds.

Governmental funds include the following.

- *General* fund. This fund is used to account for general operations and activities not requiring the use of other funds.
- *Special revenue* funds are required to account for the use of revenue earmarked by law for a particular purpose. State and federal fuel tax revenues require special revenue funds, because federal and state laws restrict these taxes to transportation uses.
- *Capital projects* funds are used to account for the construction or acquisition of fixed assets such as buildings, equipment and roads. Depending on its use, a fixed asset may instead be financed by a special revenue fund or a proprietary fund. A capital project fund exists only until completion of the project. Fixed assets acquired and long-term debts incurred by a capital project are assigned to the government's *General Fixed Assets* and *Long-Term Debts*.
- *Debt service* funds are used to account for money that will be used to pay the interest and principal of long-term debts. Bonds used by a government to finance major construction projects, to be paid by tax levies over a period of years, require a debt service fund to account for their repayment.

The debts of special assessment and proprietary funds are serviced within those funds, rather than by a separate debt service fund.

- *Special assessment* funds account for public infrastructure improvements financed by special levies against property holders. Sidewalk and alley repairs often rely on special assessments.

Proprietary funds include the following.

- *Internal service* funds are used for operations serving other funds or departments within a government on a cost-reimbursement basis. A printing shop, which takes orders for booklets and forms from other offices and is reimbursed for the cost of each order, would be a suitable application for an internal service fund.
- *Enterprise* funds are used for services provided to the public on a user charge basis, similar to the operation of a commercial enterprise. Water and sewage utilities are common examples of government enterprises.

Fiduciary funds are used to account for assets held in trust by the government for the benefit of individuals or other entities. The employee pension fund, created by the State of Maryland to provide retirement benefits for its employees, is an example of a fiduciary fund. Financial statements may further distinguish fiduciary funds as either *trust* or *agency* funds; a trust fund generally exists for a longer period of time than an agency fund