



**TOWN OF LOS GATOS  
TOWN COUNCIL FINANCE COMMITTEE MEETING  
MARCH 11, 2019  
TOWN COUNCIL CHAMBERS – 110 E. MAIN STREET  
LOS GATOS, CA  
6:00PM**

*\*Steve Leonardis, Mayor*

*\*Barbara Spector, Council Member*

*Terry Duryea, Committee Member*

*Rick Tinsley, Committee Member*

**MEETING CALLED TO ORDER**

**ROLL CALL**

**ELECTION OF CHAIR AND VICE CHAIR**

**CONSENT ITEMS (TO BE ACTED UPON BY A SINGLE MOTION)** *(Items appearing on the Consent Calendar are considered routine and may be approved by one motion. Unless there are separate discussion and/or actions requested by the Board/Commission/Committee, staff, or a member of the public, it is requested that items under the Consent Calendar be acted on simultaneously. Any member of the Board/Commission/Committee or public may request to have an item removed from the Consent Calendar for comment and action.)*

1. Approve Council Finance Committee Meeting Draft Minutes of December 10, 2018.

**VERBAL COMMUNICATIONS** *(Members of the public may address the Committee on any matter that is not listed on the agenda. Unless additional time is authorized by the Committee, remarks shall be limited to three minutes.)*

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

2. Approve the Council Finance Committee Meeting Schedule for the Rest of the Calendar Year 2019
3. Recommend to the Town Council to adopt the proposed Internal Service Funds (ISF) Policy

**ADJOURNMENT**

**IN COMPLIANCE WITH THE AMERICANS WITH DISABILITIES ACT, IF YOU NEED SPECIAL ASSISTANCE TO PARTICIPATE IN THIS MEETING, PLEASE CONTACT THE CLERK DEPARTMENT AT (408) 354-6834. NOTIFICATION 48 HOURS BEFORE THE MEETING WILL ENABLE THE TOWN TO MAKE REASONABLE ARRANGEMENTS TO ENSURE ACCESSIBILITY TO THIS MEETING [28 CFR §35.102-35.104]**



**TOWN OF LOS GATOS  
COUNCIL FINANCE COMMITTEE  
AGENDA REPORT**

MEETING DATE: 03/11/2019

ITEM NO: 1

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**DRAFT  
MINUTES OF THE COUNCIL FINANCE COMMITTEE MEETING  
DECEMBER 10, 2018**

The Council Finance Committee of the Town of Los Gatos conducted a meeting on Monday, December 10, 2018, at 4:00 p.m.

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

**ROLL CALL**

Present: Mayor Rob Rennie, Council Member Barbara Spector, Committee Member Terry Duryea, and Committee Member Rick Tinsley.

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

**CONSENT ITEMS**

1. Approve Council Finance Committee Meeting Draft Minutes of October 1, 2018.
2. Recommend to the Town Oversight Committee Investing OPEB Assets in the California Employers' Retiree Benefit Trust (CERBT) Strategy 2.

**MOTION:** **Motion** by **Council Member Barbara Spector** to approve the Consent Items, exclusive of Item 2. **Seconded** by **Chair Rob Rennie**.

**VOTE:** **Motion passed unanimously.**

Arn Andrews, Assistant Town Manager, presented the staff report for Item 2. Committee members discussed the item. Staff addressed the Committee's questions.

**MOTION:** **Motion** by **Chair Rob Rennie** to recommend to the Town Oversight Committee Investing OPEB Assets in the California Employers' Retiree Benefit Trust (CERBT) Strategy 1 and not to move to the Strategy 2 as recommended by staff. **Seconded** by **Council Member Barbara Spector**.

**VOTE:** **Motion passed unanimously.**

**VERBAL COMMUNICATIONS**

Jak VanNada

- Commented that the Town's available surplus should be used to pay down the unfunded pension liability and recommended reporting budget to actual numbers instead of budget to budget when making comparisons.

**OTHER BUSINESS**

3. Recommend to the Town Council to review and accept the Draft Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2018.

Ahmed Badawi, the Town independent auditor, provided an overview of the audit process and the Town 2018 audit results.

The auditor and staff addressed the Committee member's questions. Committee discussed several sections of the CAFR, including the Management's Discussion and Analysis, and identified clarifications to the document.

Opened Public Comment.

Phil Koen

- Commented on the different sections of the CAFR and recommended that the Committee not recommend that the Town Council approve the CAFR.

Closed Public Comment.

**MOTION:**      **Motion by Chair Rob Rennie** to recommend to the Town Council to review and accept the Draft Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2018 with final typographical and other errors corrected and the additional clarification language recommended by the Committee members. **Seconded by Council Member Barbara Spector.**

**VOTE:**      **Motion passed unanimously.**

4. Discuss Budget Stabilization, Catastrophic, Internal Service Funds (ISF), and Compensated Absences Reserves.

William C Statler presented an analysis of the Town's Catastrophic and Budget Stabilization Reserves based on GFOA risk methodology.

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SUBJECT: DRAFT MINUTES OF THE COUNCIL FINANCE COMMITTEE MEETING OF  
DECEMBER 10, 2018

DATE: MARCH 7, 2019

Opened Public Comment.

Phil Koen

- Commented on information previously submitted regarding the City of Colorado Springs and the amount of risk the Town is willing to take.

Closed Public Comment.

Committee members asked questions which staff and Mr. Statler addressed. The Finance Committee discussed the matter and were in general agreement that the Town has too many Internal Service Funds and Reserves, and that this practice leads to “excess cash” being budgeted instead of being put towards a more productive use. Members believed that the excess dollars would be better used to address unfunded liabilities.

**ADJOURNMENT:**

The meeting adjourned at 7:08 p.m.

This is to certify that the foregoing is a true and correct copy of the minutes of the December 10, 2018 meeting as approved by the Council Finance Committee.

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Gitta Ungvari, Finance and Budget Manager

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**TOWN OF LOS GATOS  
FINANCE COMMITTEE REPORT**

MEETING DATE: 03/11/2019

ITEM NO: 2

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DATE: MARCH 7, 2019  
TO: COUNCIL FINANCE COMMITTEE  
FROM: LAUREL PREVETTI, TOWN MANAGER  
SUBJECT: APPROVE THE COUNCIL FINANCE COMMITTEE MEETING SCHEDULE FOR  
THE REST OF CALENDAR YEAR 2019

REMARKS:

Attached is the draft Council Finance Committee meeting schedule for the remainder of the calendar year.

Attachment:

1. Town Council Finance Committee Meeting Schedule for 2019

PREPARED BY: STEPHEN CONWAY  
Finance Director

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Reviewed by: Town Manager, Assistant Town Manager, and Town Attorney

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**TOWN COUNCIL FINANCE COMMITTEE**

**PROPOSED MEETING SCHEDULE**

**Calendar Year 2019**

**All Meetings Start at 6 p.m. in the Town Council Chambers**

June 10, 2019: Annual Investment Policy Review

September 9, 2019: Annual Pension/OPEB Review

December 9, 2019: Annual CAFR Review



**TOWN OF LOS GATOS  
COUNCIL FINANCE COMMITTEE REPORT**

MEETING DATE: 03/11/2019

ITEM NO: 3

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DATE: MARCH 7, 2019  
TO: COUNCIL FINANCE COMMITTEE  
FROM: STEPHEN CONWAY, FINANCE DIRECTOR  
SUBJECT: RECOMMEND TO THE TOWN COUNCIL TO ADOPT THE PROPOSED  
INTERNAL SERVICE FUND POLICY

**RECOMMENDATION:**

Recommend to the Town Council to adopt the proposed Internal Service Fund Policy

**BACKGROUND:**

The Town has a long history of using Internal Service Funds to allocate costs and accumulate funds to provide resources for critical Town-wide services, such as vehicle and equipment replacement, facilities repair and maintenance, information technology, general liability, and workers' compensation, among others. As part of its September 18, 2018 review of total cash balances, Town Council expressed an interest in looking more closely at the level of funding in the Town's various Internal Service Funds to determine whether the targeted funding level goals for each Fund need to be adjusted.

On December 18, 2018, the Town Council continued its discussion of municipal finance requirements and passed a motion directing staff to determine whether an Internal Service Fund Policy would be suitable for the Town, to draft a proposed Policy if warranted, and to bring the draft Policy to the Finance Committee for its recommendation to the Town Council.

As noted in the December 18, 2018 report to Town Council, municipalities are not required to establish formal policies for Internal Service Funds by governmental accounting standards nor is it a prevalent practice for most local governments. This does not preclude the Town from setting policies to accumulate financial resources for prudent financial management of its Internal Service Fund operations.

**PREPARED BY:** STEPHEN CONWAY  
Finance Director

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Reviewed by: Town Manager, Assistant Town Manager, and Town Attorney

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BACKGROUND (continued):

Presently the Town does not have a formal adopted policy regarding the Internal Service Fund reserves. However, the Town's Annual Operating and Capital Budget explains each Internal Service Fund program, including anticipated revenues and expenditures with generalized/specific descriptions of fund balance targets. For example, the FY 2018/19 Budget page D-17 includes a summary review of the Town's Liability Self-Insurance Fund (Program 1302). The Budget discusses the Fund's purpose and discloses the rationale for the fund balance target. In the specific case of general liability, the targeted fund balance was to maintain a fund balance capacity at a minimum of three times the annual operating expenses for the program.

The Government Finance Officers Association Financial Policies publication states that the purpose of a policy for Internal Service Funds is to ensure that the Funds can continue to provide the service without interruption (including replacement of equipment needed to provide that service). Because of the interest in potentially establishing an Internal Service Funds Policy, Attachment 1 contains a draft Policy for review and comment by the Town's Finance Committee. Staff recommends forwarding the proposed Policy to the full Town Council for approval.

DISCUSSION:

The proposed Policy would govern the Internal Services Funds for Equipment Replacement, Worker's Compensation, Liability Self Insurance, Information Technology, and Facilities Maintenance. The Policy would establish the criteria for each Internal Service Fund target, provide a mechanism for Internal Service Fund adjustments to the targeted fund balance levels, and identify measures for Fund replenishments or Fund rebates should total Fund balance fall above or below the targeted levels set by this Policy.

Each Internal Service Fund is intended to have enough resources to: (1) meet annual expenses, (2) maintain a reasonable fund balance for contingencies, and (3) save for longer term, anticipated expenditures. Therefore, the Policy enumerates minimum fund balance levels or "targets" for each Internal Service Fund based on Fund specific metrics, preventing the over-accumulation of resources. The Internal Service Fund Policy and cash flow forecasts are to be reviewed by the Town Council as part of the annual operating budget review and adoption process.

Proposed Policy Target Levels

As reported to Town Council in December 2018, Town staff reviewed or examined State and national surveys of cities that have formally established Internal Service Fund policies. For those cities who have established Internal Service Fund policies, there was a wide variety of approaches used to establish fund balance targets for each type of shared service or risk. In the absence of a wealth of adopted and consistent policies, staff endeavored to provide its own

DISCUSSION (continued):

recommendations for fund balance targets for each respective Internal Service Fund based upon:

- The expected stability of revenues and expenditures from year to year
- The exposure risk of large unanticipated claims
- The projected cash balances for each fund based upon an updated forecast for each Fund.

The following are summaries of each fund and the proposed policy recommendations for each respective Internal Service Fund.

**Equipment Replacement Fund.**

The Equipment Replacement Fund provides for the replacement of Town vehicles related, equipment, and vehicle-related technology with a value greater than \$10,000. The initial capital costs associated with an asset are charged to the Department program budget where the asset exists. The Department program having custody and utilizing the asset pays the replacement cost amortized over the life of the asset through internal service charges. These internal service charges accumulate the needed funding to replace the Town's vehicle and equipment assets at the end of their useful lives. The result of this funding structure is a smoothing of operating expenditures and a more accurate reflection of the actual cost of operations. Replacement is based on the vehicle meeting predetermined age and/or mileage criteria as set forth in the Town's Equipment Replacement Policy. To date, the Town maintains approximately \$6.8 million in base cost assets.

The latest update of cash flows based on scheduled replacements through FY 2028/29 is presented in Attachment 1 (see page 1). The schedule indicates adequate cash flows in the short term. In recent years staff has completed a detailed review of equipment needs (exclusive of IT which is a separate replacement schedule) and identified additional items acquired through one-time grants that also generate a future replacement need.

The March 2019 updated replacement schedule is expected to result in the Equipment Replacement Fund being in a deficit net position by FY 2024/25 of approximately \$0.4 million and climbing to approximately \$2.7M in total deficit in year 10 of the forecast. Unless free cash is gradually increased over the ten-year span of replacements, deficits will result and the Town will not meet its equipment replacement needs. Based on this cash flow forecast, staff recommends that projected working capital/free cash (total beginning cash balances plus anticipated future revenues for charges less annual replacement costs) in the Equipment

DISCUSSION (continued):

Replacement Fund be maintained to provide total projected replacement needs over a minimum of ten-year future replacement period updated annually as part of the budget process. Based on the updated forecast, to achieve the target balance, the Equipment Replacement Fund annual charges to Departments through the budget process will need to be augmented by approximately \$290K per year through the ten-year forecast period. Should the Town be able to achieve some additional amounts of repayment of monies used for completion of the Almond Grove that were previously taken from the Equipment Replacement fund in FY 2014/15 (\$450,00 is will be repaid in FY 18/19), the amount of annual increased charges could potentially be reduced.

**Worker's Compensation Fund**

The Town's Workers' Compensation Program provides for anticipated liabilities for workers' compensation benefits. The Town self-insures for benefits provided to Town employees and volunteers for work-related injuries up to \$250,000 and has excess insurance coverage for claims up to \$25 million. The Town belongs to the Local Agency Workers' Compensation Excess (LAWCX) Joint Powers Authority for the purpose of pooling for this excess insurance. A third-party administrator, Innovative Claims Solutions, Inc. (ICS), handles the Town's day-to-day workers' compensation claims administration. The revenues to fund the Workers Compensation program are derived as a percentage of salary each payroll period. Each Department pays a portion of the program's cost based on gross wages and level of risk for the various job classifications within the Department. The annual appropriation to this Fund represents the self-insurance premiums paid by the operating Departments. Service rates are established which maintain Fund balance capacity at approximately two and one-half times the annual operating expenditures. Any excess funds are returned through reduced rates and fund balance transfers as needed.

Current cash flow projections for the Worker's Compensation program through FY 2025/26 are presented in Attachment 1 (see page 2). The Worker's Compensation cash flow schedule indicates with current projected revenues paid by user Departments that the fund free cash position should stabilize at approximately \$500K per year and begin to decline below that level in FY 2026/27. Staff recommends that projected cash balances be maintained at a minimum of approximately one-third of actual unpaid claims payable and not to exceed one-half of the outstanding claims payable as of the most recent audited balance sheet date. Using this measure, the most recent claims payable as of June 30, 2018 is \$1,472,324 or approximately \$491,000 as a minimum and \$736,000 as a maximum "targeted" free cash balance for the Fund. Since projected free cash balances for the near term appear to be in the approximate range, no cash withdrawals would be recommended for this Fund.

DISCUSSION (continued):

**Liability Self Insurance Fund**

The Town is a member of an insurance pool, established to provide general liability, property insurance, and risk management services. The Town participates in a pooled liability plan which covers general liability claims up to \$5,000,000 plus \$15,000,000 in excess liability for total coverage of \$20,000,000 per occurrence. The Town has a deductible or uninsured liability of up to \$50,000 per claim. This self-insurance program is funded through Departmental charges based on established assessment rates per labor dollar expended.

Current cash flow projections for the Self Insurance Liability program through FY 2028/29 are presented in Attachment 1 (see page 3). Current cash flow projections indicate a gradual lowering of free cash balances from approximately \$1.4M on July 1, 2018 to a negative cash position by FY 2023/24. Observant of this trend, the proposed FY 2019/20 Operating Budget and other future Budgets will include higher rates charged to Departments to keep this critical program in a positive cash position. Staff recommends a similar target as that of the Worker's Compensation fund and that free cash balance be maintained at a minimum of approximately one-third of actual unpaid claims payable and not to exceed one-half of the outstanding claims payable as of the most recent audited balance sheet date. Using this measure, the most recent claims payable as of June 30, 2018 is \$131,743 or approximately \$44,000 to \$66,000 as a "targeted" free cash balance for the Fund. Since projected free cash balances are projected to be at a deficit, staff recommends no reduction of free cash balance until FY 2022/23 utilizing cash held in the fund to provide sufficient time for the Town's future Operating Budgets to be developed that can sustain higher levels of ongoing payments by the user Departments to keep the fund's free cash at its future target levels as recommended.

Based on the updated forecast and to achieve this balance, the Self Insurance Fund annual charges for liability costs to departments through the budget process are estimated currently to require augmentation by approximately \$223K per year through the ten-year forecast period to preserve working capital/ free cash balance at the approximate policy level minimums.

**Information Technology**

Information Technology Services (IT) supports the delivery of services to all the Town's employees and customers through the use of SMART technology (Sensible, Multi-modal, Accessible, Responsive, and Time-phased Technology). Key services include the maintenance, replacement, and upgrade of existing technology and the support for new information technology initiatives. The IT Program receives revenues through charges to General Fund and Special Revenue Departmental programs based on service and equipment replacement costs.

DISCUSSION (continued):

Rates charged recover current operating costs and build Fund balance capacity for future technology projects and the continued need to identify and invest in information technology opportunities.

Current cash flow projections for the IT program through FY 2028/29 are presented in Attachment 1 (see page 4). Current cash flow projections indicate a gradual lowering of free cash balances from approximately \$2.9M on July 1, 2018 to a negative cash position by FY 2021/22. Observant of this trend, future rates charged to Departments will increase in future Operating Budgets to keep this critical program in a positive cash position. Because this Fund provides ongoing IT services and also funds future replacement/upgrades of IT equipment, staff recommends a targeted working capital cash balance be maintained at a minimum of approximately one-third not to exceed a maximum of one-half of the current annual operating budget for the IT Fund. Using this measure, the most recent FY 2018/19 budget for the Town's IT Fund was adopted at the amount of \$911,775 or approximately \$303,925 to \$456,000 as a "targeted" free cash balance for the fund. Since projected free working capital cash balances are projected to be at a deficit, staff recommends no reduction of free cash balance until FY 2024/25 utilizing cash held in the fund to provide a funding bridge for sufficient time for the Town's future Operating Budgets to be developed sustaining higher levels of ongoing payments by the user Departments gradually adjusting charges to maintain the Fund's working capital free cash at its future target levels as recommended.

Based on the updated forecast and to achieve this balance, the IT Fund annual charges for liability costs to Departments through the budget process are estimated to require additional augmentation annually throughout the ten-year forecast to preserve working capital/ free cash balance at the approximate policy level minimums.

**Facilities Maintenance**

The Facilities Maintenance Fund provides services to ensure Town facilities are safe and functional for public and employee use. Services include custodial services, elevator maintenance, cell phone services, heating and ventilation systems, building improvements, facility security, and lighting systems. Facilities staff also plan, schedule, and manage small and large building facility projects, such as building remodeling, public access infrastructure improvements, floor covering, work space reconfigurations, roof repairs, heating and air conditioning system improvements, electrical services, and all other aspects required to keep the Town's facilities functional and safe. Revenues for this Fund are obtained through assessment chargebacks to Town Departments, based upon a percentage of square footage assigned to each Department. The Facilities Maintenance Program pays for all operating

DISCUSSION (continued):

expenditures, including utilities, repairs, and maintenance and the Departments in turn fund the program's expenditures through these chargebacks. The Town is preparing its Facilities Master Plan that will provide a comprehensive review of the future costs related to facilities replacement.

Current cash flow projections for the Facilities Maintenance program through FY 2028/29 are presented in Attachment 1 (see page 5). Cash flow projections currently indicate an average working capital free cash balance of approximately \$1.1M for the next eight fiscal years. The Town has historically targeted a working capital balance of approximately \$1.0M. This target reflects the Fund's history of a number of unanticipated facilities repair projects that have required a significant use of Facilities Fund balances including a FY 2005/06 \$495,000 budget adjustment for the Civic Center HVAC Chiller Repair, and cumulatively since FY 2008/09 an approximate \$1.4M in HVAC/Building Repairs and Upgrades for the Old Library HVAC and Upgrade project. Staff has recently updated its forecast for future unfunded facilities needs over the next eight years which total approximately \$1.5M. Staff recommends establishing a minimum balance of working capital free cash balance of \$1M not to exceed \$1.5M.

CONCLUSION

Staff is recommending that the Finance Committee recommend to the Town Council the adoption of the proposed Policy.

FISCAL IMPLICATIONS:

If the Policy is adopted by Town Council, the Proposed FY 2019/20 budget will identify suggested funding sources, including one-time revenues, to keep working capital/free cash balances at their required levels consistent with the Policy. Projections indicate that additional monies are needed due to the significant amounts of replacement expenditures expected over the next ten years for both the Town-wide equipment, IT, and annual liability program needs.

In response to the Council's discussion of Internal Service Funds in 2018, staff is proposing to close the Vehicle Maintenance Fund and Stores Fund (printing and photocopying) because they can be absorbed into the General Fund Operating Budget. The two funds are small and the Departmental charges typically meet the annual operating expenses. In the Proposed Operating Budget for FY 2019/20, staff will recommend placing any remaining closing net position (estimated to be approximately \$250K for each Fund) into an assigned General Fund reserve held for that business service.

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SUBJECT: RECOMMEND TO THE TOWN COUNCIL TO ADOPT THE PROPOSED INTERNAL  
SERVICE FUND POLICY

DATE: MARCH 11, 2019

Attachments:

1. Internal Service Fund Ten Year Forecast
2. Draft Internal Service Funds Policy

## Internal Service Funds Ten Year Forecast

EQUIPMENT REPLACEMENT FUND TEN YEAR FORECAST											
	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected
<b>Beginning Working Capital (Free Cash)</b>	\$ 2,328,270	\$ 2,708,970	\$ 835,417	\$ 1,076,344	\$ 1,058,031	\$ 1,281,345	\$ 660,885	\$ (325,097)	\$ (841,423)	\$ (1,265,727)	\$ (2,643,476)
<b>Revenues</b>											
From User Departments	610,000	628,300	647,150	666,560	686,560	707,160	728,370	750,220	772,730	795,910	819,790
Equipment Sharing Revenues	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Auction Revenue		20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000
Reimburse from GF (Almond Grove)	450,000										
<b>Total Resources</b>	<b>1,070,000</b>	<b>658,300</b>	<b>677,150</b>	<b>696,560</b>	<b>716,560</b>	<b>737,160</b>	<b>758,370</b>	<b>780,220</b>	<b>802,730</b>	<b>825,910</b>	<b>849,790</b>
<b>Expenses</b>											
Per Replacement Schedule	689,300	2,531,853	436,223	714,873	493,246	1,357,620	1,744,352	1,296,546	1,227,034	2,203,659	934,863
<b>Revenues (Under) Over Expenses</b>	<b>\$ 380,700</b>	<b>\$ (1,873,553)</b>	<b>\$ 240,927</b>	<b>\$ (18,313)</b>	<b>\$ 223,314</b>	<b>\$ (620,460)</b>	<b>\$ (985,982)</b>	<b>\$ (516,326)</b>	<b>\$ (424,304)</b>	<b>\$ (1,377,749)</b>	<b>\$ (85,073)</b>
<b>Projected Net Position</b>	<b>\$ 2,708,970</b>	<b>\$ 835,417</b>	<b>\$ 1,076,344</b>	<b>\$ 1,058,031</b>	<b>\$ 1,281,345</b>	<b>\$ 660,885</b>	<b>\$ (325,097)</b>	<b>\$ (841,423)</b>	<b>\$ (1,265,727)</b>	<b>\$ (2,643,476)</b>	<b>\$ (2,728,549)</b>
Assets 6/30/18 less pension amounts	\$ 2,345,816										
Less: Liabilities less pension amounts	(17,546)										
<b>Net Position 7/1/18 (less pension liability)</b>	<b>\$ 2,328,270</b>										

**ATTACHMENT 1**

<b>WORKER'S COMPENSATION SELF INSURANCE FUND TEN YEAR FORECAST</b>												
	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2027	FY 2028	FY 2029
	Projected											
<b>Beginning Working Capital</b>	\$ 825,562	485,746	527,380	557,888	576,186	581,113	571,431	545,813	502,845	441,018	358,719	254,229
<u>Revenues</u>												
From User Departments	878,386	1,320,746	1,373,576	1,428,519	1,485,660	1,545,086	1,606,889	1,671,165	1,738,012	1,807,532	1,879,833	1,955,027
<b>Total Resources</b>	<b>878,386</b>	<b>1,320,746</b>	<b>1,373,576</b>	<b>1,428,519</b>	<b>1,485,660</b>	<b>1,545,086</b>	<b>1,606,889</b>	<b>1,671,165</b>	<b>1,738,012</b>	<b>1,807,532</b>	<b>1,879,833</b>	<b>1,955,027</b>
<u>Expenses</u>												
Claims payments and Admin.	600,000	630,000	661,500	694,575	729,304	765,769	804,057	844,260	886,473	930,797	977,337	1,026,204
Insurance Premiums	236,000	247,800	260,190	273,200	286,859	301,202	316,263	332,076	348,679	366,113	384,419	403,640
Salary Reimbursement	149,000	156,450	164,273	172,486	181,110	190,166	199,674	209,658	220,141	231,148	242,705	254,841
All Other Program Expenses	233,202	244,862	257,105	269,960	283,458	297,631	312,513	328,139	344,546	361,773	379,861	398,855
Revenues (Under) Over Expenses	\$ (339,816)	\$ 41,634	\$ 30,508	\$ 18,298	\$ 4,927	\$ (9,683)	\$ (25,618)	\$ (42,968)	\$ (61,828)	\$ (82,299)	\$ (104,489)	\$ (128,512)
<b>Projected Net Position</b>	<b>\$ 485,746</b>	<b>\$ 527,380</b>	<b>\$ 557,888</b>	<b>\$ 576,186</b>	<b>\$ 581,113</b>	<b>\$ 571,431</b>	<b>\$ 545,813</b>	<b>\$ 502,845</b>	<b>\$ 441,018</b>	<b>\$ 358,719</b>	<b>\$ 254,229</b>	<b>\$ 125,717</b>
Assets 6/30/18 less pension amounts	\$ 2,326,665											
Less: Liabilities less pension amounts	1,501,103											
Net Position 7/1/18 (less pension liability)	\$ 825,562											

<b>SELF INSURANCE FUND TEN YEAR FORECAST</b>											
	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
	Projected	Projected	Projected	Projected							
<b>Beginning Working Capital</b>	\$1,401,991	1,136,817	857,311	567,324	266,441	(45,779)	(369,788)	(706,057)	(1,055,090)	(1,417,402)	(1,793,534)
<u>Revenues</u>											
From User Departments	376,187	383,090	394,580	406,420	418,610	431,170	444,110	457,430	471,150	485,280	499,840
Total Resources	376,187	383,090	394,580	406,420	418,610	431,170	444,110	457,430	471,150	485,280	499,840
<u>Expenses</u>											
Admin Premium and Insurance premium	541,661	557,911	574,648	591,888	609,644	627,934	646,772	666,175	686,160	706,745	727,947
Property Damage Insurance	31,500	33,075	34,729	36,465	38,288	40,203	42,213	44,324	46,540	48,867	51,310
Claims Paid	55,000	57,750	60,638	63,669	66,853	70,195	73,705	77,391	81,260	85,323	89,589
Other Program Expenses	13,200	13,860	14,553	15,281	16,045	16,847	17,689	18,574	19,502	20,478	21,501
Revenues (Under) Over Expenses	\$ (265,174)	\$ (279,506)	\$ (289,987)	\$ (300,883)	\$ (312,220)	\$ (324,009)	\$ (336,269)	\$ (349,033)	\$ (362,312)	\$ (376,132)	\$ (390,508)
<b>Projected Net Position</b>	\$1,136,817	\$ 857,311	\$ 567,324	\$ 266,441	\$ (45,779)	\$ (369,788)	\$ (706,057)	\$ (1,055,090)	\$ (1,417,402)	\$ (1,793,534)	\$ (2,184,042)
Assets 6/30/18 less pension amounts	\$1,424,107										
Less: Liabilities less pension amounts	(22,116)										
Net Position 7/1/18 (less pension liability)	\$1,401,991										

<b>INFORMATION TECHNOLOGY FUND TEN YEAR FORECAST</b>											
	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected
<b>Beginning Working Capital</b>	\$ 2,948,313	2,058,000	1,326,153	(130,744)	(1,106,182)	(2,479,012)	(4,229,012)	(5,540,617)	(7,189,614)	(9,061,976)	(10,073,016)
<b>Revenues</b>											
From User Departments/permits	334,478	344,512	354,848	365,493	376,458	387,752	399,384	411,366	423,707	436,418	449,510
<b>Total Resources</b>	<b>334,478</b>	<b>344,512</b>	<b>354,848</b>	<b>365,493</b>	<b>376,458</b>	<b>387,752</b>	<b>399,384</b>	<b>411,366</b>	<b>423,707</b>	<b>436,418</b>	<b>449,510</b>
<b>Expenses</b>											
IT Program Expenses Lic & Maint	\$ 469,875	\$ 483,971	\$ 498,490	\$ 513,445	\$ 528,848	\$ 544,714	\$ 561,055	\$ 577,887	\$ 595,224	\$ 613,080	\$ 631,473
IT Services and Equipment	262,774	592,388	1,313,254	827,487	1,220,440	1,593,038	1,149,933	1,482,476	1,700,845	834,377	852,363
One-time Capital Projects	492,142										
Revenues (Under) Over Expenses	\$ (890,313)	\$ (731,847)	\$ (1,456,897)	\$ (975,438)	\$ (1,372,830)	\$ (1,750,000)	\$ (1,311,604)	\$ (1,648,997)	\$ (1,872,362)	\$ (1,011,040)	\$ (1,034,325)
<b>Projected Net Position</b>	<b>\$ 2,058,000</b>	<b>\$ 1,326,153</b>	<b>\$ (130,744)</b>	<b>\$ (1,106,182)</b>	<b>\$ (2,479,012)</b>	<b>\$ (4,229,012)</b>	<b>\$ (5,540,617)</b>	<b>\$ (7,189,614)</b>	<b>\$ (9,061,976)</b>	<b>\$ (10,073,016)</b>	<b>\$ (11,107,340)</b>
Assets 6/30/18 less pension amounts	\$ 3,082,840										
Less: Liabilities less pension amounts	(134,527)										
Net Position 7/1/18 (less pension liability)	\$ 2,948,313										

<b>FACILITIES MAINTENANCE FUND TEN YEAR FORECAST</b>											
	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected	Projected
<b>Beginning Working Capital</b>	\$ 810,669	868,672	922,370	971,482	1,015,715	1,054,766	1,088,315	1,116,031	1,137,567	1,152,563	1,160,644
Revenues											
From User Departments	882,707	904,775	927,394	950,579	974,343	998,702	1,023,669	1,049,261	1,075,493	1,102,380	1,129,940
LG Recreation, NUMU, and Friends (Lease)	318,382	326,342	334,500	342,863	351,434	360,220	369,226	378,456	387,918	397,615	407,556
Construction Tax & Misc.	8,000	8,200	8,405	8,615	8,831	9,051	9,278	9,509	9,747	9,991	10,241
<b>Total Resources</b>	<b>1,209,089</b>	<b>1,239,316</b>	<b>1,270,299</b>	<b>1,302,057</b>	<b>1,334,608</b>	<b>1,367,973</b>	<b>1,402,173</b>	<b>1,437,227</b>	<b>1,473,158</b>	<b>1,509,986</b>	<b>1,547,736</b>
Expenses											
Facilities Program Expenses	1,151,086	1,185,619	1,221,187	1,257,823	1,295,557	1,334,424	1,374,457	1,415,691	1,458,161	1,501,906	1,546,963
<b>Revenues (Under) Over Expenses</b>	<b>\$ 58,003</b>	<b>\$ 53,698</b>	<b>\$ 49,112</b>	<b>\$ 44,234</b>	<b>\$ 39,051</b>	<b>\$ 33,549</b>	<b>\$ 27,716</b>	<b>\$ 21,536</b>	<b>\$ 14,996</b>	<b>\$ 8,080</b>	<b>\$ 773</b>
<b>Projected Net Position</b>	<b>\$ 868,672</b>	<b>\$ 922,370</b>	<b>\$ 971,482</b>	<b>\$ 1,015,715</b>	<b>\$1,054,766</b>	<b>\$1,088,315</b>	<b>\$1,116,031</b>	<b>\$ 1,137,567</b>	<b>\$ 1,152,563</b>	<b>\$ 1,160,644</b>	<b>\$ 1,161,416</b>
Assets 6/30/18 less pension amounts	\$ 908,645										
Less: Liabilities less pension amounts	(97,976)										
<b>Net Position 7/1/18 (less pension liability)</b>	<b>\$ 810,669</b>										

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<b>TITLE: Internal Service Funds Policy</b>		<b>POLICY NUMBER:</b>
<b>EFFECTIVE DATE:</b>		<b>PAGES: 4</b>
<b>ENABLING ACTIONS:</b>	<b>REVISED DATES:</b>	
<b>APPROVED:</b>		

**PURPOSE**

The Government Finance Officers Association Financial Policies publication states that the purpose of a policy for Internal Service Funds is to ensure that the Funds are able to continue to provide the service without interruption (including replacement of equipment needed to provide that service). The Town has a long history of using Internal Service Funds as a method to allocate costs and provide resources for critical Town-wide services, such as vehicle and equipment replacement, facilities repair and maintenance, information technology, general liability, and workers’ compensation, among others.

This Policy establishes the criteria for each Internal Service Fund target, provides a mechanism for Internal Service Fund adjustments to the targeted levels, and identifies measures for Fund replenishments or Fund rebates should total Fund balance fall above or below the targeted levels set by this Policy.

**BACKGROUND**

Internal Service Funds are used by the Town to allocate and account for the provision of specific goods and services that are required for the direct operation of the Town, which in turn enable the Town to provide services to the Los Gatos community. For example, the Equipment Replacement Fund provides for new patrol vehicles for the Police Department as well as other pieces of equipment that are used in the delivery of Town services. Departments that utilize the Fund pay a fee to the Fund commensurate to its utilization.

Internal Service Funds serve these important functions among others:

- Stabilize or smooth Departmental charges 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

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replacement and/or funding liabilities.

- Enable appropriate allocation of Town-wide costs to individual Departments and programs, which more readily establishes the true costs of various services like parks, public works, or public safety operations.

## **GUIDING PRINCIPLES**

Each Internal Service Fund is intended to have enough resources to: (1) meet annual expenses, (2) maintain a reasonable fund balance for contingencies, and (3) save for longer term, anticipated expenditures. Therefore, this Policy enumerates minimum fund balance levels or “targets” for each Internal Service Fund based on Fund specific metrics, preventing the over-accumulation of resources.

The Internal Service Fund Policy and cash flow forecasts are to be reviewed by the Town Council as part of the annual operating budget review and adoption process.

## **POLICY**

### Applicable Funds

The Town shall maintain and account for five separate Internal Service Funds for the following purposes:

- Equipment Replacement
- Worker’s Compensation
- Liability Self Insurance
- Information Technology
- Facilities Maintenance

### Working Capital/Free Cash Definition

For purposes of this Policy, working capital/free cash is defined as total cash position in the applicable Internal Service Fund less any current liability reported in the fund at the same audited balance sheet date.

### Equipment Replacement Internal Service Fund

The projected working capital/free cash is the total beginning cash balances plus anticipated future revenues for charges less annual replacement costs in the Equipment Replacement Fund. This Fund’s free cash balance is maintained to provide total projected replacement

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needs over a minimum of a ten-year future replacement period with the ten-year replacement forecast to be updated annually as part of the adopted budget process.

#### Workers Compensation Internal Service Fund

The projected free cash balance of the Workers Compensation Fund is maintained at a minimum of approximately one-third of actual unpaid claims payable and not to exceed one-half of the total outstanding claims payable as of the most recent audited balance sheet date. If the working capital/free cash balance exceeds the calculated minimum during any year of the ten-year forecast, the Fund shall be maintained at its current level if such a balance is needed to maintain minimum balances throughout the ten-year forecast period.

#### Liability Self Insurance Internal Service Fund

The annual update of working capital/free cash balance for the Liability Self-Insurance Fund is maintained at a targeted minimum of approximately one-third of actual unpaid claims payable and not to exceed one-half of the outstanding claims payable as of the most recent audited balance sheet date. If the working capital/free cash balance exceeds the calculated minimum during any year of the ten-year forecast, the Fund shall be maintained at its current level if such a balance is required to maintain minimum balances throughout the ten-year forecast period.

#### Information Technology Internal Service Fund

The annual update of working capital/free cash balance for the Information Technology Fund is maintained at a minimum of approximately one-third and not to exceed a maximum of one-half of the current annual operating budget for the IT Fund. If the working capital/free cash balance exceeds the calculated minimum during any year of the ten-year forecast, the Fund shall be maintained at its current level if such a balance is required to maintain minimum balances throughout the ten-year forecast period.

#### Facilities Maintenance Internal Service Fund

A minimum balance of working capital/free cash balance is \$1,000,000, not to exceed \$1,500,000 for the Facilities Maintenance Fund.

#### Replenishment of Unreserved Fund Balance

In keeping with the principles discussed in this Policy, when the level of any Internal Service Fund falls above or below the Policy targets as outlined here, the Finance 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 annually during the budget process in a manner that seeks to return the Internal Service Fund reserves to their Policy levels within the ten-year forecasted period prescribed for the Equipment Replacement, Workers Compensation, Liability Self Insurance, and Information Technology Funds and one (1) to three (3) years for the Facilities Maintenance Fund.

APPROVED AS TO FORM:

\_\_\_\_\_  
Robert Schultz, Town Attorney



**TOWN OF LOS GATOS  
COUNCIL FINANCE COMMITTEE REPORT**

MEETING DATE: 03/11/2019

ITEM NO: 3

DESK ITEM

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DATE: MARCH 11, 2019

TO: COUNCIL FINANCE COMMITTEE

FROM: STEPHEN CONWAY, FINANCE DIRECTOR

SUBJECT: RECOMMEND TO THE TOWN COUNCIL TO ADOPT THE PROPOSED  
INTERNAL SERVICE FUND POLICY

REMARKS:

Attachment 3 contains public comments received after distribution of the Staff Report and before 11:00 a.m. March 11, 2019.

Attachments previously received with the Staff Report:

1. Internal Service Fund Ten Year Forecast
2. Draft Internal Service Funds Policy

Attachment received with this Desk Item:

3. Public Comments received after distribution of the Staff Report and before 11:00 a.m. March 11, 2019

PREPARED BY: STEPHEN CONWAY  
Finance Director

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Reviewed by: Town Manager, Assistant Town Manager, and Town Attorney

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**To:**  
**Subject:** Response to Staff Memo to Finance Committee - Agenda Item #3  
**Attachments:** cash flows for FY 2010 - FY 2018 - exh #2.pdf; ATT00001.htm; City of Campbell - exh #5.pdf; ATT00002.htm; Pricing Internal Services - Exh #1.pdf; ATT00003.htm; Town of Los Gatos CAFR 2018 - exh #3.pdf; ATT00004.htm; Town of Los Gatos CAFR 2018 - exh #4.pdf; ATT00005.htm; Letter to FC - ISF.docx; ATT00006.htm

**From:** Phil Koen <[pkoen@monteropartners.com](mailto:pkoen@monteropartners.com)>

**Date:** March 9, 2019 at 2:00:56 PM PST

**To:** Steven Leonardis <[SLeonardis@losgatosca.gov](mailto:SLeonardis@losgatosca.gov)>, BSpector <[BSpector@losgatosca.gov](mailto:BSpector@losgatosca.gov)>, "  
Rick Tinsley

**Cc:** Marico Sayoc <[MSayoc@losgatosca.gov](mailto:MSayoc@losgatosca.gov)>, Rob Rennie <[RRennie@losgatosca.gov](mailto:RRennie@losgatosca.gov)>, Marcia Jensen <[MJensen@losgatosca.gov](mailto:MJensen@losgatosca.gov)>, Laurel Prevetti <[LPrevetti@losgatosca.gov](mailto:LPrevetti@losgatosca.gov)>, Stephen Conway <[sconway@losgatosca.gov](mailto:sconway@losgatosca.gov)>,"  
" < > Lee Fagot

< Maria Ristow <

**Subject:** Response to Staff Memo to Finance Committee - Agenda Item #3

Dear Members of the Finance Committee:

Attached please find a memo that responds to the Staff memo for agenda item #3. The information provided along with the attached exhibits is important to the discussion you will have regarding the Internal Service Fund.

I will be attending the meeting and will be happy to answer any questions you have on the attached.

Respectfully,

Phil Koen

ATTACHMENT 3

Dear Members of the Finance Committee,

This memorandum is offered to the Committee with the intent of providing critical information to assist your deliberation of the proposed Internal Service Fund Policy. The Staff memo written in support of the proposed policy, in my view, does not provide adequate background information and in some areas is materially misleading. I believe it is important the Finance Committee have an alternative point of view as they evaluate the proposed policy.

### **What is the purpose of Internal Service Funds?**

Let's start with the most basic question namely, "**What is the purpose of an Internal Service Fund?**" To answer this question we don't have to go any further than looking at page 107 of the Town's 2018 CAFR. There the Town states "Internal service funds are used to finance and account for special activities and service performed by a designed department for other departments in the Town **on a cost reimbursement basis**". The statement "on a cost reimbursement basis" is critical in that it discloses the pricing methodology used in charging for internal services.

The GASB states that "common examples of internal services include information technology, payroll, motor pool, budgeting, legal, accounting and human resources". **The Town currently has 7 internal service funds which on a combined basis holds \$10.7m in cash.** The management objective of establishing an internal service fund is to create a system where "internal prices" are assigned to these services and charged to departments that use the services. The management theory is this will lead to a healthy discussion about the "value" of the service provided and drive improvements to the service delivery. Additionally the pricing system can facilitate comparisons with alternative methods of delivery including outside providers. Therefore much care must be used in establishing "fair internal prices" to avoid obvious drawbacks such as acrimony and debate over the charge system and to facilitate external benchmarking.

### **Problem with the Town's Internal Service Funds**

For too long the Staff has pursued their own agenda and has purposely overcharged the user departments for the services they have consumed. This practice of "over charging" user departments has the negative effect of defeating the objective of driving improvement and more importantly has moved cash out of the general fund to the proprietary Internal Services Fund where it is "hidden" from the Town Council's view.

I have attached a GFOA Best Practices entitled "Pricing Internal Services" (exhibit #1). The Finance Committee should review this Best Practice and compare it to the proposed Policy. What is striking is nowhere in this Best Practice does it state that the goal of an internal service pricing system is to "**maintain a reasonable fund balance for contingencies and save for longer term anticipated expenditures**" (see page 2 of Staff memo). Rather the practice lists items such as "govern demand for a service, develop enterprise rate models, provide input for full-costing model, and promote discussion

about the value of the service provided”, etc. The Staff’s goal is self-serving and is driven by their desire to “hoard cash” which is out of sight from the Town Council.

And herein lies the problem we face today. **The Staff has intentionally shifted the Internal Service Funds from a management tool which was intended to charge departments for services consumed on a “cost recovery basis” to a stealth funding mechanism which purposely overcharges user departments thereby exporting cash and operating surpluses from the General Fund to the Internal Services Fund.** By doing this, the excess cash which should have been reported on the General Fund balance sheet as cash and an “unassigned” fund balance is “hidden” away in the Internal Services Fund balance sheet. Since the Staff never reports during the fiscal year on the status of the Internal Services Fund, the Town Council is not aware of the excess cash being accumulated in the Internal Services Fund which could be used for alternative needs. On the other hand, the Staff is fully aware of this.

I have attached a 9 year cash flow analysis (exhibit #2) of the Internal Services Fund which was developed using the Town’s CAFRs from FY 2010 through FY 2018. This 9 year cash flow analysis shows \$43.4m of cash was transferred in the form of “payments” from the General Fund to the Internal Services Fund. However, the total cash used by the Internal Service Fund to provide these services (including the payment of claims) was only \$40.0m. The net result was over this 9 year period, \$3.3m more cash than needed for “cost recovery” was inappropriately transferred from the General Fund to the Internal Services Fund.

A reasonable question to ask is **“Why would the Staff purposely over charge user departments for internal services”**. The answer is simple - the real purpose of the Internal Services Fund was to act as a “cookie jar reserve”. We don’t have to go any further to look at the magnitude of transfers in and out of the Internal Services Fund every year to arrive at this conclusion. For example, in FY 2016 over \$2m was transferred out of the Internal Services Fund back to the General Fund to help pay for the Almond Grove project. This past year over \$700k was transferred in to top up the “cookie jar reserve”. The Internal Services Fund has really acted as a “contingency fund” that the Staff could tap when needed.

Since this is a 9 year study, it addresses any “surprise” expenditure spikes that might occur. It also highlights that the Staff did not follow a “cost reimbursement” pricing scheme, but rather was employing a “cost plus contingencies and save for the longer term” pricing mechanism. Clearly there is a material difference in the pricing mechanism the Staff actually employed versus what was disclosed in the CAFR.

### **Historical cash flow analysis does not support cash flow forecast**

Let me now quickly address the “cash flow” summaries that were provided by the Staff. If you look at page 110 of the 2018 CAFR you will see a “combining statement of cash flows” (exhibit #3) for the Internal Services Fund. That format provides a detail explanation for **the change in cash** in the Internal Services Funds from the prior year to the current year. This is the real question we need to have answered – namely has there been an over reimbursement for services provided resulting in an excess of cash being transferred. Unfortunately the format that the Staff has used is not consistent with the format in the CAFR. As a result, it is impossible for the reader to look at past history and to evaluate the reasonableness of the numbers presented in the forecast.

For example, in reviewing the Equipment Replacement Fund cash flow forecast, the Staff analysis suggests that for the 9 year period FY 2019 through FY 2027, the Town will incur \$10.5m in equipment replacement payments (i.e. payments to suppliers). On the bottom of exhibit #2, I have presented for the 9 years starting with FY 2010 through FY 2018 the actual annual payments to suppliers for the Equipment Replacement Fund. These numbers are also derived from the annual CAFRs. Over that 9 year period, total payments to suppliers was only \$1.5m. It is hard to believe that the total payments to suppliers for the next 9 years is 7x the payments made over the prior 9 years.

However, the most striking issue is that projected “revenues” from user departments do not equal the “expenses” incurred to provide the services. **Again, the entire idea behind the Internal Services pricing mechanism is to bill “user departments” on a “cost recovery basis”.** By definition and design, there shouldn’t be any excess or shortfall of revenues over expenditures in the Internal Services Funds. If the transfer pricing mechanism doesn’t achieve this, then the charging system is being abused. By not fully recovering for cost, the Staff has reduced the charges in the General Fund and essentially exported an operating deficit from the General Fund to the Internal Services Fund.

Since the General Fund is where all reimbursements flow from, there isn’t any need to have excess cash in the Internal Services Fund. The proper control mechanism is for any reserves for “contingencies” to remain in the General Fund where they can be tapped on an “as required basis” using the contingency reserve balances.

What is also very curious is that the Internal Services Fund Statement of Net Position as of June 30, 2018 (exhibit #4) shows a total **net investment in equipment of only \$558,000**, with no net equipment investment reported in the Equipment Replacement Fund or the Information Technology Fund. How is this possible if one of the stated purposes for these funds was to replace rolling stock and IT equipment? I have also attached the most recent Statement of Net Position for the City of Campbell’s Internal Service Fund for comparison (exhibit #5). The City of Campbell has only 3 internal service funds (versus 7 for the Town) and as of June 30, 2017 carries a total \$1.6m net investment in capital assets.

This raises the obvious question as to where historically has the acquisition of capital assets been recorded. Furthermore, on page 3 of the Staff memo it states “the Town maintains approximately \$6.8m in base cost assets” for equipment. If this is correct, why aren’t these assets reflected in the Equipment Replacement Fund’s Statement of Net Position or in the combined total. The Staff memo doesn’t provide any answers.

Given the extremely low balance of net investment in equipment for the combined Internal Service Fund, it is a very safe assumption that historically the Internal Services Fund made little, if any capital acquisitions. Why should we be concerned about this? **The answer is, it informs us as to which fund actually made the expenditures.** One explanation is the General Fund made all equipment acquisitions not the Equipment Replacement Fund. If that is the case, then there is no need for the General Fund to transfer funds to the Internal Services Fund for the acquisition of replacement equipment and the forecast of cash disbursement is materially incorrect.

## **Conclusion**

The proposed policy needs more time to be fully vetted by the Finance Committee and members of the public. There simply has not been enough time to fully digest the material and deliberate this important policy. For years there is strong evidence that the pricing system for services provided by the Internal Service Fund has been abused. Additionally the Staff needs to reforecast the cash flows presented using a format that is consistent with the format used in the CAFR. This will enable everyone to easily compare the forecast to history and make a determination as to its reasonableness. The Staff also needs to explain why there is only \$558k reported as net equipment on the Internal Service Funds Statement of Net Position if the Town maintains approximately \$6.8m in base cost assets.

Lastly, in determining the appropriate level of cash to be held by the Internal Services Fund, it is very important to recognize that the Internal Services Fund obtains ALL of its cash from the General Fund through a "cost recovery" transfer pricing system. In reality, the ISF could run with a minimum level of cash since the General Fund can be freely accessed for any "unexpected" cash requirement. By doing this, the "excess cash" would remain in the General Fund presumably as an "unassigned" reserve balance and as such would be highly visible to the Town Council. This would increase overall visibility to the Town's cash assets and provide more control.

**So how would you establish a minimum level of total cash held by the Internal Service Fund?** A review of the 9 year historical cash flow shows that payments of suppliers averaged \$2.2m per year and payments for claims averaged \$1.0m per year. I have excluded payments to employees because beginning in this fiscal year the Staff removed all people related expenses from the Internal Service Fund and transferred them to the General Fund. **(This in its self is highly curious because as a result you lose one of the major benefits of having an Internal Service Funds which is the ability to compare internal pricing to outside suppliers and personal cost should be included in a "cost recovery" pricing mechanism).**

Adding these payments and applying a 2x safety factor to the \$3.2m sum, and adding an additional \$1m for an existing large workers compensation claim payable suggests that a cash balance of \$7.4m would be more than sufficient for the operation of the Internal Service Fund. **Using this methodology, there appears to be approximately \$3m in excess cash held in the Internal Services Fund as of June 30, 2018.**

Lastly, again referring to the GFOA Best Practice on Pricing Internal Services, it states "governments should also regularly review their internal charge rates against actual experience for appropriate adjustments. Governments should also develop guidelines to determine what will happen to excess funds should an internal charge generate recovery proceeds in excess of actual costs." None of this is discussed in the proposed policy before the Finance Committee. There is still much work to be done and critical answers provided before a rational policy can be recommended to the Town Council.

**Footnote:**

***Researching and writing this memo has taken over 12 hours of my valuable time. I believe it is accurate to the best of my knowledge and deserves a detailed discussion by the Finance Committee. It***

*is impossible for me or any concerned resident to fully comment on a very complex 8 page memo plus exhibits that the Staff has taken weeks to prepare in the 3 minutes allotted to speakers. And when residents do comment, the consistent trend has been no follow up questions are asked. This treatment has a chilling effect on any resident who is trying their best to help the Town. I urge this Committee to depart from the normal course of business and engage in an open and thoughtful discussion on this very important topic which impacts all residents.*



## BEST PRACTICE

# Pricing Internal Services

### BACKGROUND:

Internal services are those responsibilities a government provides to support its own internal operations. Common examples of internal services include information technology, payroll, motor pool, budgeting, legal, accounting, and human resources. Certain management objectives are served by creating a system to assign prices for the use of these internal services, which are then assessed to the departments that use the services. However, there is a cost to develop and maintain internal pricing systems. Governments must weigh the benefits of an internal services costing system against the cost and complexity of system design choices. Please note that this best practice is intended to apply to internal service charges regardless of whether it is accounted for in an internal service fund or as a general fund overhead allocation.

### RECOMMENDATION:

GFOA recommends that governments follow these steps when considering an internal service pricing system:

1. Identify goals of internal service pricing;
2. Develop allocation strategy;
3. Define level of costing detail;
4. Determine cost of service;
5. Decide basis of allocation; and
6. Consider potential drawbacks.

**Identify goals of internal service pricing.** As a first step, GFOA recommends that governments identify the goals they hope to achieve through a pricing system for internal services. The goals will guide the design of the system. Potential goals for a pricing system include:

- **Govern demand for a service.** If the customers of an internal service are not charged based on their level of use they may have an incentive to over-use the service. Alternatively, charges may cause customers to limit their use of the service.
- **Develop enterprise rate models.** Government enterprises (e.g., a water utility) may use services provided by the general government. A pricing system could provide an input into the rate model used to calculate fees for the customers of the enterprise.
- **Calculate indirect cost reimbursement for grants.** Some grants may allow indirect costs to be reimbursed. An internal pricing system provides support for the reimbursement request.
- **Provide input for full-costing model.** A full costing model provides the total cost of a given service, which enables better informed budgeting and planning. The full cost of a program is equal to the direct cost of program plus the indirect costs. Internal service pricing is essential to calculating indirect costs.
- **Promote discussion about the value of the service provided.** Charging customer departments for use of a service will raise questions about the value received from the service and what the best service delivery model is (e.g., centralized, decentralized, outsourced, etc.). A pricing

system can facilitate comparisons with alternative methods of service delivery, including outside providers.

- **Examine value of a shared service model.** Shared services are thought to deliver greater efficiency through economies of scale. A solid pricing model is important for determining if a shared service model is delivering on this promise.
- **Promote competition in service delivery.** Internal services could be run much like a private business, including service level agreements with customers and competition from outside providers (e.g., private firms). Accurate internal charges are essential for a level competitive field.<sup>1</sup>
- **Ability to customize service levels for different customers.** A detailed rate model makes it easier to provide a higher level of service to a customer that demands it because they can be charged a higher fee.

**Develop allocation strategy.** After the goals have been identified, the organization must decide which internal services will be priced and allocated to user departments. To make this decision, it may be useful to differentiate between market services and those that have more of a policy or regulatory character.

- **Market services** are those where the user departments play the role of consumer. Examples of market services include IT, fleet, and perhaps facilities.
  - The charges for market services have application to goals like promoting competition in service delivery, governing demand, and/or examining the value of a shared service model. Charging user departments for regulatory/policy services could be necessary for goals like developing a full costing system or calculating indirect cost reimbursement for grants.
- **Policy or regulatory services** are used to establish organization-wide policies or ensure compliance with standards. Users of these services cannot be as easily described as customers, but more accurately as regulated. Examples of policy/regulatory services include budgeting, internal auditors, or a chief executive.

**Define level of costing detail.** Governments need to determine the level of detail associated with costing services.

- A *low level* of detail might define internal services at the department level (e.g., finance department, IT department). A low level of detail might be sufficient for a costing system with limited goals, such as developing enterprise rate models or obtaining reimbursement for indirect costs under a grant.
- A *high level* of detail would define services at the level of programs or other subunits (e.g., the various subdivisions of finance and IT cited earlier). A high level of detail might be needed for goals like governing the demand for service or promoting discussions about the value of a service.

In summary, a higher level of detail will lead to a more accurate costing system since the activities represented by the internal service categories will be more specified. However, more detail also leads to a more complex internal services pricing system. The government must decide if greater complexity (and its associated costs) will be worth the benefits.

**Determine cost of service.** With the internal services identified at either a high or low level of detail, the next step is to determine the cost of the service. The elements of the cost that should be considered include:

- **Direct costs.** Direct costs are the most essential cost element. This includes the services personnel, materials, supplies, and contractors.
- **Interest costs from internal loans.** If the internal service takes loans from other parts of the government then a market interest rate may be applied.<sup>2</sup>

- *Services used from other support services.* A cost model can be designed such that the cost of the internal service reflects not only its direct costs, but also the indirect cost from other support services that it uses (e.g., an IT service uses payroll). This aspect of costing can be performed at varying levels of complexity methods that fully reflect how each internal service uses the services of other internal providers can become much more complex than those that provide less precise estimates.<sup>3</sup>

**Decide basis of allocation.** With cost of the service decided, the bases for allocating costs from the internal service to customers must be decided. Table 1 provides examples of internal services and cost allocation bases. Below are general principles that should be observed when determining bases.

- *Cause-and-effect relationship.* Costs should be allocated based on usage or causal factors relating to costs incurred by service provider. See Table 1 for examples of how cost bases for internal services can be related to the usage of various internal services.
- *Benefit received.* The basis for allocation should bear a relationship to the benefit the customer receives from the service. For example, while miles driven might be a good barometer of the benefit that police patrol receives from its vehicles, hours used might be a better measure for public works.
- *Fairness.* The method of cost allocation that will be used must be seen as fair and legitimate by the users of the costing system. The fee should be charged equitably based on use and other considerations.<sup>4</sup> Users must understand how the costs are calculated and should have a role in determining how the price system will be structured.<sup>5</sup>
- *Legal constraints.* State laws may place constraints on how charges are developed. For example, if the charge for providing a service exceeds the true cost of the service, it could be construed as a tax under the law. Also, federal regulations on grants may place limits on internal charges against grant programs.<sup>6</sup>

**Table 1 Examples of Internal Services Cost Allocation Bases**

Internal Service	Allocation Basis
Payroll processing	Number of employees, number of checks
Budgeting	Labor hours, size of budget
Insurance	Number of employees, experience
Legal services	Direct labor hours
Office space / rent	Square feet of space occupied
Procurement services	Number of P.O.s, dollar volumes, direct labor
Vehicle costs	Miles driven, hours used
Information technology	Number of devices, server time, number of calls to help desk, direct labor hours

A government might also consider the accounting mechanism for the internal charge. An internal service fund provides the most detailed accounting, but also entails the most administrative effort. If the goals of the internal charge are modest (e.g., not charging back to federal grants, full cost recovery is not a goal), then it may be easier to simply recognize the charge as a general revenue in the general fund (or some other fund as may be appropriate to the circumstances).

Governments should also regularly review their internal charge rates against actual experience for appropriate adjustments. Governments should also develop guidelines to determine what will happen to excess funds should an internal charge generate cost recovery proceeds in excess of actual costs.

**Consider potential drawbacks of internal costing systems.** Finally, governments should be aware of the drawbacks of internal costing systems below and should consider mitigating strategies.

- *Diminished trust between providers and customers.* A charge system could create a suspicion among customers about how charges are developed and/or administered, especially if the basis of the charges is not adequately communicated to customers.
- *Subverting processes or not using shared services.* If customers perceive charges to be too high or unfair, they may respond by developing their own service capabilities. This can lead to duplication of resources and wasted effort.
- *Acrimony and debate over the charge system.* Even if users do not subvert the system, a costing system that is viewed negatively by users could generate a great deal of debate and discussion energy that could be better spent on other pursuits.
- *Costs exceed the benefits of the system.* A precise internal costing system can be relatively complex. Complexity entails cost, such as training managers to use cost information. Whether this complexity and cost is worth it should be seriously considered in light of the goals for the system and system design choices.
- *Unmet expectations.* Managers can become frustrated with the system if they do not understand what it can and cannot accomplish. For example, if internal charges cause users to lower their consumption of a service they may see their per unit cost rise as the fixed cost of service is now allocated over a lower volume.

**Notes:**

<sup>1</sup> However, it should be noted that comparing internal charges to a potential external service providers proposed fee cannot be the basis for a sound outsourcing decision because the external providers proposed cost must be compared to the internal costs the government will avoid (i.e., no longer have to incur) by using the external provider (known as avoidable costs). For example, there may be overhead costs included in an internal charge that will not be eliminated (avoided) by using an external provider.

<sup>2</sup> If used, the interest rate should be consistent with any governing laws/regulations.

<sup>3</sup> For example, single step allocations are the least complex, but is less precise, while reciprocal allocations are more precise, but much more complex. For a complete explanation of these methods please consult. R. Gregory Michel. *Cost Analysis and Activity-Based Costing for Government*. (Chicago, Illinois: GFOA) 2004

<sup>4</sup> For example, the customer may provide value back to the internal service in some way that justifies a lower charge.

<sup>5</sup> IT governance systems are on example of a means for giving customer departments input into rate modeling decisions. See GFOAs publication *IT Budgeting and Decision Making* (2009)

<sup>6</sup> For example, the Federal Office of Management and Budget circular A-87 outlines standards for determining costs which can be charged to Federal grants and reimbursement contracts.

# Exhibit #3

## TOWN OF LOS GATOS INTERNAL SERVICE FUNDS COMBINING STATEMENT OF CASH FLOWS FOR THE FISCAL YEAR ENDED JUNE 30, 2018

	Equipment Replacement	Worker's Comp	Self Insurance	Stores	Information Technology	Vehicle Maintenance	Facilities Maintenance	Total
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>								
Receipts from customers	\$ 674,205	\$ 1,016,214	\$ 506,519	\$ 127,786	\$ 1,172,219	\$ 586,342	\$ 1,484,787	\$ 5,568,072
Payments to suppliers	(623,774)	(672,578)	(67,566)	(99,485)	(621,183)	(264,691)	(1,104,650)	(3,453,927)
Payments to employees	(11,516)	(116,874)	(174,351)	-	(503,918)	(234,832)	(330,352)	(1,371,843)
Claims paid	-	(224,835)	(244,772)	-	-	-	-	(469,607)
Net Cash Provided (Used) by Operating Activities	38,915	1,927	19,830	28,301	47,118	86,819	49,785	272,695
<b>CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES</b>								
Transfers Out	398,000	-	-	-	5,371	-	300,000	703,371
Net Cash Provided (Used) by Noncapital Financing Activities	398,000	-	-	-	5,371	-	300,000	703,371
Net Increase(Decrease) in Cash and Investments	436,915	1,927	19,830	28,301	52,489	86,819	349,785	976,066
Cash and investments - beginning of year	1,908,901	2,205,812	1,404,277	200,846	3,028,259	519,115	541,819	9,809,029
Cash and investments - end of year	\$ 2,345,816	\$ 2,207,739	\$ 1,424,107	\$ 229,147	\$ 3,080,748	\$ 605,934	\$ 891,604	\$ 10,785,095
<b>Reconciliation of Operating Income to Cash Flows from Operating Activities:</b>								
Operating Income	\$ 36,216	\$ (281,528)	\$ 109,329	\$ 27,353	\$ (94,893)	\$ 80,421	\$ (16,693)	\$ (139,795)
Adjustments to reconcile operating income to cash flows from operating activities:								
Depreciation								
Change in assets and liabilities:								
Receivables, net	1,589	(118,926)	-	-	(236)	(312)	25,752	(92,133)
Material and supplies	-	-	-	(173)	-	(2,818)	-	(2,991)
Deferred outflows of resources	-	(5,587)	(7,960)	-	(21,447)	(9,778)	(15,453)	(60,225)
Net pension liabilities	-	23,940	34,186	-	92,103	41,988	66,235	258,452
Deferred inflows of resources	-	1,851	2,638	-	7,107	3,243	5,111	19,950
Accounts payable	1,093	9,705	(1,849)	1,121	64,794	(24,775)	(12,192)	37,897
Accrued payroll and benefits	17	(117)	399	-	(310)	(983)	(3,932)	(4,926)
Claims payable	-	372,589	(116,913)	-	-	-	-	255,676
Due to other government	-	-	-	-	-	(167)	-	(167)
Cash Flows From Operating Activities	\$ 38,915	\$ 1,927	\$ 19,830	\$ 28,301	\$ 47,118	\$ 86,819	\$ 49,785	\$ 272,695

"Cookie jar reserve" being "topped up". These are transfers "in" not "out" as shown of the schedule !

# Exhibit #4

## TOWN OF LOS GATOS INTERNAL SERVICE FUNDS COMBINING STATEMENT OF NET POSITION JUNE 30, 2018

	Equipment Replacement	Worker's Comp	Self Insurance	Stores	Information Technology	Vehicle Maintenance	Facilities Maintenance	Total
<b>ASSETS</b>								
Cash & Investments	\$2,345,816	\$2,170,510	\$1,424,107	\$ 229,147	\$3,080,748	\$ 605,934	\$ 891,604	\$ 10,747,866
Restricted Cash & Investments	-	37,229	-	-	-	-	-	37,229
Receivables:								
Accounts	-	118,926	-	-	2,092	312	16,483	137,813
Materials, Supplies and Deposits	-	-	-	173	-	27,838	-	28,011
Equipment (Net)	-	-	-	-	-	-	558	558
<b>Total Assets</b>	<b>2,345,816</b>	<b>2,326,665</b>	<b>1,424,107</b>	<b>229,320</b>	<b>3,082,840</b>	<b>634,084</b>	<b>908,645</b>	<b>10,951,477</b>
<b>Deferred Outflows of Resources</b>								
Pension Plan Contributions	-	31,528	22,116	-	84,921	38,716	61,030	238,311
Pension related amounts Total Deferred	-	23,064	55,707	-	124,698	56,850	89,652	349,971
Outflows of Resources	-	54,592	77,823	-	209,619	95,566	150,682	588,282
<b>LIABILITIES</b>								
Accounts Payable	17,203	25,349	437	1,530	120,455	6,520	91,658	263,152
Accrued Payroll and Benefits	343	3,430	5,161	-	14,072	6,202	6,318	35,526
Due to Other Governments	-	-	-	-	-	-	-	-
Claims Payable	-	1,472,324	131,743	-	-	-	-	1,604,067
Net Pension Liabilities	-	255,060	363,674	-	979,569	446,588	704,016	2,748,907
<b>Total Liabilities</b>	<b>17,546</b>	<b>1,756,163</b>	<b>501,015</b>	<b>1,530</b>	<b>1,114,096</b>	<b>459,310</b>	<b>801,992</b>	<b>4,651,652</b>
<b>Deferred Inflows of Resources</b>								
Pension related amounts Total Deferred Inflows of Resources	-	4,312	6,146	-	16,555	7,549	11,898	46,460
	-	4,312	6,146	-	16,555	7,549	11,898	46,460
<b>NET POSITION</b>								
Net investment in capital assets	-	-	-	-	-	-	558	558
Restricted for:								
Workers compensation claims	-	37,229	-	-	-	-	-	37,229
Unrestricted	2,328,270	583,553	994,769	227,790	2,161,808	262,791	244,879	6,803,860
<b>Total Net Position</b>	<b>\$2,328,270</b>	<b>\$ 620,782</b>	<b>\$ 994,769</b>	<b>\$ 227,790</b>	<b>\$2,161,808</b>	<b>\$ 262,791</b>	<b>\$ 245,437</b>	<b>\$ 6,841,647</b>

# Exhibit #2

## All Internal Service Funds Cash Flow

	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	Total	9 Year Avg
Receipts from customers	4,284,506	4,112,411	4,634,501	4,623,639	4,825,667	5,118,776	5,037,681	5,205,539	5,568,072	43,410,792	4,823,421
Payment to suppliers	1,615,811	1,591,138	2,086,607	1,690,046	1,663,323	1,804,936	2,804,590	3,261,668	3,453,927	19,972,046	2,219,116
Payments to employees	1,006,528	957,430	1,089,249	1,046,526	1,046,994	1,185,715	1,291,788	1,350,806	1,371,843	10,346,879	1,149,653
Claims paid	941,241	805,668	1,564,032	1,222,145	1,882,855	1,595,212	696,808	527,488	469,607	9,705,056	1,078,340
>>Total Cash Used	3,563,580	3,354,236	4,739,888	3,958,717	4,593,172	4,585,863	4,793,186	5,139,962	5,295,377	40,023,981	4,447,109
Cash provided/(used) by activities	720,926	758,175	(105,387)	664,922	232,495	532,913	244,495	65,577	272,695	3,386,811	376,312
NetTransfers out/(In) of ISFs	567,180	382,939	73,546	378,030	497,463	1,189,171	2,031,333	295,680	(703,371)	4,711,971	
Cash flows from financing activities	136	(2,574)					(3,509)			(5,947)	
Net Increase/(decrease) in cash	153,882	372,662	(178,933)	286,892	(264,968)	(656,258)	(1,790,347)	(230,103)	976,066	(1,331,107)	
Beginning Cash	12,116,204	12,270,084	12,642,746	12,463,813	12,750,705	12,485,737	11,829,479	10,039,132	9,809,029		
Ending Cash	12,270,086	12,642,746	12,463,813	12,750,705	12,485,737	11,829,479	10,039,132	9,809,029	10,785,095		
Net Position (reference only)	11,616,679	11,873,250	11,251,487	11,371,893	10,934,182	8,432,573	6,635,429	6,278,071	6,841,647		
Cash as a % of Net Position	105.6%	106.5%	110.8%	112.1%	114.2%	140.3%	151.3%	156.2%	157.6%		

## Equipment Replacement Fund Cash Flow (only)

Receipts from customers	380,685	369,525	536,004	528,775	506,979	504,952	501,093	457,100	674,205	4,459,318	495,480
Payments to Suppliers	(16,272)	748	499,830	26,874	(44,026)	(23,495)	69,498	391,735	623,774	1,528,666	169,852
Payments to employees	9,186	9,289	10,230	9,387	7,246	6,922	8,863	9,862	11,516	82,501	9,167
Acquisition of Capital Assets							3,509			3,509	390
>>Total Cash Used	(7,086)	10,037	510,060	36,261	(36,780)	(16,573)	81,870	401,597	635,290	1,614,676	179,408
Cash Provided (used) by activities	387,771	359,488	25,944	492,514	543,759	521,525	419,223	55,503	38,915	2,844,642	316,071
Net Transfers Out/ (In) Equip Replace Fund	559,380	359,739	0	372,210	328,507	248,457	2,019,186	295,680	(398,000)	3,785,159	
Net increase/(decrease) in cash	(171,609)	(251)	25,944	120,304	215,252	273,068	(1,599,963)	(240,177)	436,915	(940,517)	
Beginning Cash	3,286,333	3,114,724	3,114,473	3,140,417	3,260,721	3,475,973	3,749,041	2,149,078	1,908,901		
Ending Cash	3,114,724	3,114,473	3,140,417	3,260,721	3,475,973	3,749,041	2,149,078	1,908,901	2,345,816		
Net Position (reference only)	3,096,960	3,093,890	3,133,400	3,260,531	3,429,643	3,675,029	2,148,005	1,894,054	2,328,270		
Cash as a % of Net Position	100.6%	100.7%	100.2%	100.0%	101.4%	102.0%	100.0%	100.8%	100.8%		

Source - Annual CAFRs

# Exhibit # 5

## CITY OF CAMPBELL, CALIFORNIA

### COMBINING STATEMENT OF NET POSITION INTERNAL SERVICE FUNDS

June 30, 2017

Campbell, which is about the same size and complexity as Los Gatos, has only 3 internal service funds, \$4.9m in cash and \$1.6m in Capital assets. Why are we so different?

	Motor Vehicle Pool	Workers' Compensation Self-Insurance	Information Technology Services	Totals
<b>ASSETS:</b>				
<b>CURRENT ASSETS:</b>				
Cash and investments	\$ -	\$ 3,953,451	\$ 740,370	\$ 4,693,821
Accounts receivable	-	-	30,000	30,000
Deposits	-	90,000	-	90,000
<b>TOTAL CURRENT ASSETS</b>	<b>-</b>	<b>4,043,451</b>	<b>770,370</b>	<b>4,813,821</b>
<b>NONCURRENT ASSETS:</b>				
Capital assets, net of accumulated depreciation	1,305,641	-	318,351	1,623,992
<b>TOTAL NONCURRENT ASSETS</b>	<b>1,305,641</b>	<b>-</b>	<b>318,351</b>	<b>1,623,992</b>
<b>TOTAL ASSETS</b>	<b>1,305,641</b>	<b>4,043,451</b>	<b>1,088,721</b>	<b>6,437,813</b>
<b>LIABILITIES:</b>				
<b>CURRENT LIABILITIES:</b>				
Accounts payable	22,548	10,639	18,340	51,527
Accrued payroll	7,509	-	10,215	17,724
Due to other funds	621,253	-	-	621,253
Compensated absences, current portion	19,862	-	22,901	42,763
Claims and judgments payable, current portion	-	268,676	-	268,676
<b>TOTAL CURRENT LIABILITIES</b>	<b>671,172</b>	<b>279,315</b>	<b>51,456</b>	<b>1,001,943</b>
<b>LONG-TERM LIABILITIES:</b>				
Compensated absences	12,264	-	41,334	53,598
Claims payable and judgments	-	2,554,324	-	2,554,324
<b>TOTAL LONG-TERM LIABILITIES</b>	<b>12,264</b>	<b>2,554,324</b>	<b>41,334</b>	<b>2,607,922</b>
<b>TOTAL LIABILITIES</b>	<b>683,436</b>	<b>2,833,639</b>	<b>92,790</b>	<b>3,609,865</b>
<b>NET POSITION:</b>				
Net investment in capital assets	1,305,641	-	318,351	1,623,992
Unrestricted	(683,436)	1,209,812	677,580	1,203,956
<b>TOTAL NET POSITION</b>	<b>\$ 622,205</b>	<b>\$ 1,209,812</b>	<b>\$ 995,931</b>	<b>\$ 2,827,948</b>

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**Subject:** Internal Service Fund - Equipment Replacement Fund  
**Attachments:** Exhibit #1.pdf; ATT00001.htm; Exhibit #2.pdf; ATT00002.htm; ISF - Equipment Replacement.docx; ATT00003.htm

**From:** Phil Koen <[pkoen@monteropartners.com](mailto:pkoen@monteropartners.com)>  
**Date:** March 10, 2019 at 8:39:13 PM PDT  
**To:** Steven Leonardis <[SLeonardis@losgatosca.gov](mailto:SLeonardis@losgatosca.gov)>, BSpector <[BSpector@losgatosca.gov](mailto:BSpector@losgatosca.gov)>, Rick Tinsley  
**Cc:** Laurel Prevetti <[LPrevetti@losgatosca.gov](mailto:LPrevetti@losgatosca.gov)>, Stephen Conway <[sconway@losgatosca.gov](mailto:sconway@losgatosca.gov)>

**Subject: Internal Service Fund - Equipment Replacement Fund**

Dear Member of the Finance Committee,

Attached please find a memorandum regarding the Equipment Replacement Fund.

Respectfully,

Phil Koen

Dear Members of the Finance Committee:

**Re: Internal Service Fund – Equipment Replacement**

The purpose of this memorandum is to provide the Committee with additional information regarding the proposed Internal Service Funds Policy and specifically the Equipment Replacement Fund.

**Background**

The stated purpose of the Equipment Replacement fund is to annually charge operating departments “user fees” which are sufficient to fund the regular replacement of vehicles and other equipment at the end of their economic life. Once an asset has been determined to be at the end of its economic life, the asset is disposed of and a replacement asset is acquired by this fund. The management concept is that the fund should act as a “strategic savings plan” for long term assets. Additionally by charging user departments an annual fee, this will normalize department budgeting for assets that have life-cycles greater than a year thereby facilitating level budgeting.

Currently the Town has 2 equipment related internal service funds – equipment replacement and vehicle maintenance. The proposed policy only discusses one fund, namely the equipment replacement. It is not clear as to whether or not the Staff intends to keep the vehicle maintenance fund or to combine it with the equipment replacement fund.

I previously provided the Committee with a 9 year cash flow analysis of the equipment replacement fund. In reviewing the analysis it is very clear that this fund has NOT been used solely to accumulate funds for the replacement of vehicles. There has been a consistent pattern of overcharging user departments which has resulted in an excessive amount of cash being transferred to this fund.

A review of the cash flow analysis shows that the fund received \$4.6m in fee payments while using \$1.6m to purchase equipment over the 9 year period. This resulted in an excess transfer of \$2.8m in cash to this fund from the General Fund.

The excess cash is routinely transferred out of the fund to other funds, such as the GFAR, to help pay for other capital projects. In FY 2016 \$1.6m was transferred out to help pay for the Almond Grove project. In essence the equipment replacement fund acts as a “cookie jar reserve fund” which Staff taps to fund other “non-equipment” initiatives.

**Problems with the Equipment Replacement Fund**

Currently the Equipment Replacement Fund does not operate in accordance with the stated purpose. If its purpose is to fund the replacement of equipment and to acquire such equipment, all assets acquired would be recorded in the fund’s Statement of Net Position.

Surprisingly, no equipment is recorded on the fund’s Statement of Net Position. This can only mean that the fund does not acquire assets. A reasonable guess is that historically the General Fund has acquired these assets. If that is the case, why do we need this fund? More on that in a minute.

Additionally, it appears that there is little budgetary control over this fund. For example, this current fiscal year the budget for Equipment Replacement Fund (Fund 631) can be found on schedule D-237, buried deep in the Parks & Public Works Department. I have attached the budget as exhibit #1.

As you can see there is a one line “use of funds budget” for “fixed assets” which totals \$1.6m. There is no detail offered as to what is actually being acquired or why. Whether or not the Town should spend these funds was never discussed by the Town Council at the time they approved the 2019 Budget because they had no clue that this existed. Think back to the question Council Member Jensen asked as to whether or not there was any additional funds for street maintenance and she was told “no”. Maybe a portion of this budget could have been postponed for a year? Unfortunately that discussion never happened.

Additionally at the bottom of the schedule there is a line item titled “total ending fund balance”. For whatever reason, this balance does not agree to the Statement of Net Position in the CAFR. It is simply inappropriate for that large of an expenditure not to have any supporting detail. It should also be pointed out that the \$1.6m “fixed asset” expenditure does not roll up to the General Fund or the GFAR. The only way to track whether or not if the expenditures are actually made is for the Staff to tell the Council.

And that is exactly the problem – the Staff does not regularly report on the status of these expenditures. The Equipment Replacement Fund is simply out of sight and out of mind. Imagine my surprise when I reviewed the Staff’s Internal Service Equipment Replacement Fund ten year forecast and noticed that for FY 2019 it is now projected that “replacement expenses” would only be \$689k. This is approximately \$1m less than what was budgeted! But even more surprising was the disclosure that the Fund was going to spend \$2.5m to replace equipment in FY 2020.

To the best of my knowledge the Council has never been told any of this. In fact at the Mid-Year Budget review, Staff never discussed the Equipment Replacement Fund. Don’t you think the Council should be briefed?

### **Conclusion**

It is very clear that in the past the Equipment Replacement Fund has not operated like any conventional internal service fund for equipment replacement. The fund has historically been used as a “cookie jar reserve” to be tapped whenever the Staff determines. Additionally, it appears no assets have ever been acquired by this fund.

Because this fund is ripe for misuse and by its very nature is not in the Council’s “line of sight” I recommend the Town DISCONTINUE the equipment replacement fund. There is no GASB requirement or GFOA best practice mandating the use of an equipment replacement fund.

The town can easily budget all equipment replacement (in FY 2019 this is now estimated to be approximately \$690k) as part of the annually CIP, just like other capital projects. That way the Council will have visibility into what is being acquired and can make the determination as to whether or not the timing is appropriate, just as they deliberate all other capital expenditures.

To insure that there is adequate funding available for the replacement of equipment, the Town can establish a general fund reserve and “assign” a specific amount of funds for future equipment

purchases. This is exactly what the Council did when they established the General Fund reserve for Open Space or Parking. By having this “assigned reserve” visible and in the General Fund, the Council will have better transparency into money available to spend for future equipment purchases. Today, there isn’t any visibility into this.

# Exhibit #1

## PARKS & PUBLIC WORKS DEPARTMENT Equipment Replacement Fund

### STATEMENT OF SOURCE AND USE OF FUNDS

	2014/15 Actuals	2015/16 Actuals	2016/17 Actuals	2017/18 Adopted	2017/18 Estimated	2018/19 Adopted
<b>SOURCES OF FUNDS</b>						
Beginning Fund Balance						
<i>Designated - Non-Point Assets</i>	\$ 207,831	\$ 207,831	\$ 207,831	\$ 207,831	\$ 207,831	\$ 207,831
<i>Designated - General Fund Assets</i>	3,221,812	3,467,197	1,940,173	1,686,225	1,686,225	1,786,466
Total Beginning Fund Balance	3,429,643	3,675,028	2,148,004	1,894,056	1,894,056	1,994,297
Revenues						
<i>Service Charge</i>	369,953	490,826	381,323	614,279	622,313	610,000
<i>Interest</i>	-	-	-	-	-	-
<i>Other Revenues</i>	134,999	10,267	77,366	10,000	50,170	10,000
Total Revenues	504,952	501,093	458,689	624,279	672,483	620,000
Transfers In						
<i>Transfer from Capital Projects</i>	-	-	-	-	98,000	-
<i>Transfer from General Fund</i>	15,000	-	-	300,000	300,000	450,000
<i>Transfer from MIS</i>	16,066	-	-	-	-	-
Total Transfers In	31,066	-	-	300,000	398,000	450,000
Total Revenues & Transfers In	536,018	501,093	458,689	924,279	1,070,483	1,070,000
<b>TOTAL SOURCE OF FUNDS</b>	<b>\$ 3,965,661</b>	<b>\$ 4,176,121</b>	<b>\$ 2,606,693</b>	<b>\$ 2,818,335</b>	<b>\$ 2,964,539</b>	<b>\$ 3,064,297</b>
<b>USES OF FUNDS</b>						
Expenditures						
<i>Salaries and Benefits*</i>	\$ 6,932	\$ 8,931	\$ 9,919	\$ 14,027	\$ 11,227	\$ -
<i>Operating Expenditures</i>	3,344	-	4,232	-	3,952	-
<i>Fixed Assets</i>	280,357	530,499	402,806	644,661	955,063	1,572,945
<i>Internal Service Charges</i>	-	-	-	-	-	-
Total Expenditures	290,633	539,430	416,957	658,688	970,242	1,572,945
Transfers Out						
<i>Transfer to General Fund</i>	-	1,488,687	-	-	-	-
<i>Transfer to Capital Projects</i>	-	-	295,680	-	-	-
Total Transfers Out	-	1,488,687	295,680	-	-	-
Total Expenditures & Transfers Out	290,633	2,028,117	712,637	658,688	970,242	1,572,945
Ending Fund Balance						
<i>Designated - Gas Tax Assets</i>	-	-	-	-	-	-
<i>Designated - Non-Point Assets</i>	207,831	207,831	207,831	207,831	207,831	207,831
<i>Designated - General Fund Assets</i>	3,467,197	1,940,173	1,686,225	1,951,816	1,786,466	1,283,521
Total Ending Fund Balance	3,675,028	2,148,004	1,894,056	2,159,647	1,994,297	1,491,352
<b>TOTAL USE OF FUNDS</b>	<b>\$ 3,965,661</b>	<b>\$ 4,176,121</b>	<b>\$ 2,606,693</b>	<b>\$ 2,818,335</b>	<b>\$ 2,964,539</b>	<b>\$ 3,064,297</b>

\* Personnel previously budgeted in the Vehicle Replacement Internal Service Fund are budgeted in the Finance Department General Fund Program beginning in FY 2018/19.

The \$955,063 fixed assets shown as a use of funds for FY 2018 does not agree to the CAFR Statement of Cash Flows (exhibit #2). That statement shows \$623,774 as payment to suppliers. Assuming the CAFR is correct, the FY 2019 budget has approximately \$1m increase in fixed asset expenditures with no supporting detail.

## Exhibit #2

### TOWN OF LOS GATOS INTERNAL SERVICE FUNDS COMBINING STATEMENT OF CASH FLOWS FOR THE FISCAL YEAR ENDED JUNE 30, 2018

	Equipment Replacement	Worker's Comp	Self Insurance	Stores	Information Technology	Vehicle Maintenance	Facilities Maintenance	Total
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>								
Receipts from customers	\$ 674,205	\$ 1,016,214	\$ 506,519	\$ 127,786	\$ 1,172,219	\$ 586,342	\$ 1,484,787	\$ 5,568,072
Payments to suppliers	(623,774)	(672,578)	(67,566)	(99,485)	(621,183)	(264,691)	(1,104,650)	(3,453,927)
Payments to employees	(11,516)	(116,874)	(174,351)	-	(503,918)	(234,832)	(330,352)	(1,371,843)
Claims paid	-	(224,835)	(244,772)	-	-	-	-	(469,607)
Net Cash Provided (Used) by Operating Activities	38,915	1,927	19,830	28,301	47,118	86,819	49,785	272,695
<b>CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES</b>								
Transfers Out	398,000	-	-	-	5,371	-	300,000	703,371
Net Cash Provided (Used) by Noncapital Financing Activities	398,000	-	-	-	5,371	-	300,000	703,371
Net Increase(Decrease) in Cash and Investments	436,915	1,927	19,830	28,301	52,489	86,819	349,785	976,066
Cash and investments - beginning of year	1,908,901	2,205,812	1,404,277	200,846	3,028,259	519,115	541,819	9,809,029
Cash and investments - end of year	\$ 2,345,816	\$ 2,207,739	\$ 1,424,107	\$ 229,147	\$ 3,080,748	\$ 605,934	\$ 891,604	\$ 10,785,095
Reconciliation of Operating Income to Cash Flows from Operating Activities:								
Operating Income	\$ 36,216	\$ (281,528)	\$ 109,329	\$ 27,353	\$ (94,893)	\$ 80,421	\$ (16,693)	\$ (139,795)
Adjustments to reconcile operating income to cash flows from operating activities:								
Depreciation	-	-	-	-	-	-	957	957
Change in assets and liabilities:								
Receivables, net	1,589	(118,926)	-	-	(236)	(312)	25,752	(92,133)
Material and supplies	-	-	-	(173)	-	(2,818)	-	(2,991)
Deferred outflows of resources	-	(5,587)	(7,960)	-	(21,447)	(9,778)	(15,453)	(60,225)
Net pension liabilities	-	23,940	34,186	-	92,103	41,988	66,235	258,452
Deferred inflows of resources	-	1,851	2,638	-	7,107	3,243	5,111	19,950
Accounts payable	1,093	9,705	(1,849)	1,121	64,794	(24,775)	(12,192)	37,897
Accrued payroll and benefits	17	(117)	399	-	(310)	(983)	(3,932)	(4,926)
Claims payable	-	372,589	(116,913)	-	-	-	-	255,676
Due to other government	-	-	-	-	-	(167)	-	(167)
Cash Flows From Operating Activities	\$ 38,915	\$ 1,927	\$ 19,830	\$ 28,301	\$ 47,118	\$ 86,819	\$ 49,785	\$ 272,695