

TITLE: General Fund Reserve Policy

POLICY NUMBER: 4-03

EFFECTIVE DATE: 05/16/2011

PAGES: 7

ENABLING ACTIONS:

REVISED DATES: 02/21/2017;
05/15/2018; 06/04/2019, 09/21/2021,
11/04/2025

APPROVED:

PURPOSE

The purpose of this Policy is to establish a target minimum level of designated reserves in the General Fund to:

- Reduce the financial impacts associated with a disaster or catastrophic event;
- Respond to the challenges of a changing economic environment, including prolonged downturns in the local, state, or national economy
- Demonstrate continued prudent fiscal management and creditworthiness and
- Define a replenishment plan and deposit hierarchy to maintain fiscal resilience.

BACKGROUND

The Town of Los Gatos has always maintained a high level of General Fund reserves, which has contributed to superior ratings by credit rating agencies; provided financial flexibility in economic downturns; contributed a source of investment income for General Fund operations; and assured financial coverage in the event of future emergencies.

General Fund operating expenditures refer to the recurring costs necessary to support the day-to-day delivery of public services. These include personnel costs such as salaries, wages, employee benefits, and pension contributions; contracted services like legal counsel, janitorial services, and IT support; and essential operational expenses such as utilities, office supplies, and insurance. They also encompass routine maintenance, minor repairs, and programmatic costs associated with departments like police, fire, parks and recreation, and community development. These expenditures are distinct from one-time or capital costs and are typically funded through general revenues such as property taxes, sales taxes, and service fees.

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GUIDING PRINCIPLES

Following sound financial practices and adhering to the Government Finance Officers of America (GFOA) recommendations, the Town's designated reserves include reserves for known and unknown contingencies, which take into consideration the:

- Diversity of revenue base
- Volatility of revenue structure
- Changes in political environment
- Frequency of operating surpluses/deficits
- Cash flow management practices

Transparency & Review

The General Fund Reserve Policy is to be reviewed periodically by the Town Council as part of the annual operating budget review and adoption process. Reserves are reported at the Monthly Financial and Investment Report.

POLICY

The fund balance is the difference between the assets and liabilities reported in a governmental fund. Under current accounting standards, there are five separate components of fund balance, each of which identifies the extent to which the Town is bound to honor constraints on the specific purposes for which amounts can be spent.

Government Accounting Standards Board (GASB) 54 includes a prescribed hierarchy based on the extent to which a city is bound by constraints for the use of the funds reported in governmental funds. GASB 54 provides the classification as non-spendable, restricted, committed, assigned and unassigned based on the relative strength of the constraints that control how specific amounts can be spent. The following definitions are provided in GASB 54:

- **Non-spendable**
These funds are not available for expenditures based on legal or contractual requirements.
- **Restricted**
These funds are governed by externally enforceable restrictions.
- **Committed**
Fund balances in this category are limited by the government's highest level of decision making (in this case the Town Council). Any changes of this designation must be done in the same manner that it was implemented.
- **Assigned**
For funds to be assigned, there must be an intended use which can be established by the Town Council or an official delegated by the council.
- **Unassigned**
This classification is the default for all funds that do not fit into the other categories.

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This, however, should not be a negative number for the General Fund. If it is, the assigned fund balance must be adjusted to offset the Unassigned Fund balance.

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

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

Committed Fund Balance

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

The Town currently sets aside funds into three omitted reserves to address unforeseen emergencies or disasters, significant changes in the economic environment, unfunded pension and Other Post-Employment Benefits (OPEB) obligations, and key infrastructure and capital projects. These include the Catastrophic Reserve, Budget Stabilization Reserve, and Pension (OPEB) Reserve.-The Town Council can commit other reserves by resolution.

Catastrophic Reserve

Funds reserved under this category shall be used to mitigate costs associated with unforeseen emergencies, such as a disaster or catastrophic event. Should unforeseen and unavoidable events occur that require the expenditure of Town resources beyond those provided for in the annual budget, the Town Manager or designee shall have authority to approve Catastrophic Reserve appropriations. The Town Manager or designee shall then present to the Town Council a budget amendment confirming the nature of the emergency and authorizing the appropriation of reserve funds. Reimbursements from the Federal Emergency Management Agency (FEMA) or other agencies shall be used to replenish the reserve.

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The Town currently commits to maintaining this reserve at a minimum of 12.5% of General Fund ongoing operating expenditures (minus one-time and pass-through expenditures).

Should a catastrophic disaster occur, the required reserve level should be adequate to meet the Town's immediate financial needs. For example, in the event of natural disaster, the Catastrophic Reserve would provide necessary coverage for basic operating expenses, including salary and benefits for safety and non-safety Town employees, while still meeting debt service obligations for approximately 60 days. This time frame would enable the Town to explore other available cash alternatives, including the use of internal service funds.

Budget Stabilization Reserve

Funds reserved under this category shall be used to mitigate annual revenue shortfalls due to changes in the economic environment and/or one-time uses that will result in future efficiencies and/or budgetary savings. Examples of "economic triggers" and one-time uses include, but are not limited to:

- An unplanned, major event such as a catastrophic disaster requiring expenditures which exceed the General Fund Catastrophic Reserve;
- Drop in projected/actual revenue of more than five percent in property or sales tax, or other economically sensitive revenues;
- Budgeted revenue taken over by another entity exceeding \$100,000;
- Loss of businesses considered to be significant-tax generators;
- Reductions or disruption in projected/actual revenue due to actions by the state/federal government which materially impact the Town's ability to fund current operations;
- Workflow/technical system improvements to reduce ongoing, personnel costs and enhance customer service;
- One-time maintenance of service levels due to significant economic/budget constraints; and
- One-time transitional costs associated with organizational restructuring to secure long-term personnel cost savings.

The Town currently commits to maintaining this reserve at a minimum of 12.5% of General Fund ongoing operating expenditures, including salaries and benefits (minus one-time and pass-through expenditures).

Pension/OPEB Reserve

Funds reserved under this category shall be used to further mitigate costs associated with pension and OPEB unfunded obligations. These funds will be used as a funding source for potential additional discretionary payments to pay down unfunded pension and other post-employment obligations, or held in the reserve account to be used as a supplemental funding source for increases to the annual pension and other post-employment costs resulting from future actuarial assumptions and investment market volatility, which may impair the Town's ability to continue existing operations.

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This Policy requires the Town to set aside additional annual discretionary payments (ADPs) to reduce the effective amortization period of the Town's pension unfunded actuarial liabilities from approximately 30 years to 20 years. To facilitate the implementation of this Policy, staff shall update the estimated unfunded amortization schedules in conjunction with the Town's and CalPERS actuaries. This process will coincide with the annual proposed budget process to determine the additional annual discretionary payment levels required to maintain the goal of lowering the amortization period from a 30-year to a 20-year amortization period for all prior year actuarial bases through 2018-19. The ADP was projected at \$390,000 for FY 2018-19 (subject to annual updates provided by CalPERS actuaries). Per Council direction ADPs will either be allocated directly to CalPERS, the Town's Pension IRS 115 Trust Fund, or the OPEB IRS 115 Trust Fund.

As part of the proposed budget for each forthcoming fiscal year, staff will strive to annually appropriate, to the extent possible, the amount of annual discretionary payments necessary to maintain the unfunded pension liability amortization shortening from 30 to 20 years.

In the event the annual amount required for additional discretionary payments is not available from operating revenues, the ADP shall be funded by a first lien on any one-time excess revenues above expenditures once other General Fund required reserve levels have been established at the appropriate levels as per the Town's General Fund Reserve Policy. If in any given year neither budgetary appropriations or a first lien on one-time excess revenues are sufficient to fund the annual ADP, that years ADP will be accrued to the following year until paid.

Additionally, effective upon the close of fiscal year 2015-16 and thereafter, if sufficient General Fund year-end savings are available and targeted reserve levels of 25% (12.5% for Catastrophic Reserve and 12.5% for Budget Stabilization Reserve) of the next fiscal year's operating budget and the funding the following year's proposed budget ADP have been met, upon final close of the fiscal year, a minimum of \$300,000 annually shall be deposited into the Pension/OPEB Reserve fund. In addition, Council can assign additional amount deposited to the Pension/OPEB Reserve with a formal Council action from available year end savings.

Assigned Fund Balance

Amounts that are constrained by the Town's intent to be used for specific purposes, but are neither restricted nor committed, should be reported as assigned fund balance. This Policy hereby delegates the authority to assign amounts to be used for specific purposes to the Town Manager, for the purpose of reporting to assign amounts in the annual financial statements, with annual ratification by the Town Council. A few examples of assigned fund balance follow.

- Encumbrances – material s and services on purchase order and contracts which are unperformed.

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- Reappropriations – appropriated by the Council for specific projects or programs that were not completed and not encumbered by year end.
- GASB 31 Adjustments – \$10,000 or higher unrealized investment gains that have been recorded in the financial statements in accordance with GASB 31.

Capital Special Projects Reserve

Funds reserved under this category are designated for key infrastructure and capital/special projects as identified in the Town 5-year Capital Improvement Plan, as there is no ongoing funding source to support the Town's capital needs.

Unassigned Fund Balance

At the end of each fiscal year, the Finance Department reports on the audited year-end budgetary fiscal results. Should actual General Fund revenues exceed expenditures and encumbrances, a year-end operating surplus shall be reported. Any year-end surplus which results in the General Fund balance exceeding the level required by this Reserve Policy shall be available for allocation for the following, subject to Council approval:

- Offset projected future deficits
- Anticipated intergovernmental fiscal impacts
- One-time funding, non-recurring needs

This policy allows for Unassigned fund balances and places no specific restriction on their use. The unassigned fund balance is established at \$4,000,000 with the FY 2025-26 budget process to cover needs and support ongoing operations during the upcoming fiscal year. Use of unassigned fund balances must be approved by the Town Council.

Upon funding any of the above reserve levels pursuant to this General Fund Reserve Policy, any remaining surplus of fiscal year revenues above expenditures shall be placed in the Unassigned Fund Balance. Upon closing the fiscal year, the Council can reassigned portion of the Unassigned Fund Balance for Town liabilities or initiatives.

Surplus Allocation Hierarchy

After funding carryforwards and legally restricted uses, year-end surpluses shall be allocated in the following order:

1. Catastrophic Reserve
2. Budget Stabilization Reserve
3. Pension/OPEB Reserve
4. Unassigned Fund Balance

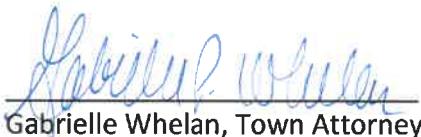
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5. Other Council-prioritized reserves

Replenishment of Reserves

In keeping with the principles discussed in this Policy, when either fund is used, Town Council will develop a 1 to 5 year reserve replenishment plan to meet the minimum threshold of 25% of General Fund ongoing, operating expenditures, excluding one-time expenditures. Temporary exceptions to the minimum may be allowed for one fiscal year with an adopted restoration schedule.

APPROVED AS TO FORM:



Gabrielle Whelan, Town Attorney