KNN public finance

MEMORANDUM

Date: May 13, 2016

To: Bruce Moe, Finance Director
City of Manhattan Beach

From: Mark Young, Managing Director
KNN Public Finance

Re: **Review of the City of Manhattan Beach's Reserve Fund Policy**

A REVIEW OF GOVERNMENTAL RESERVES AND FUND BALANCE

There is probably no single number in a local government's financial statements that attracts more attention and discussion—especially from rating agencies and other outside observers—than fund balance. This accounting term represents a component of the balance sheet derived from the modified accrued accounting that is the basis for generally accepted accounting principles (GAAP) of a city's General Fund (and other "governmental" funds). It consists of liquid assets (such as cash and investments) and less liquid assets (such as receivables). The fund balance reconciles the difference between a government's assets and its liabilities, and serves as a key measure of financial strength. Positive fund balance suggests that an agency has resources to apply to the various contingencies that can challenge a local government. A growing fund balance means that a government is earning more than it spends, and is better preparing itself for a rainy day.

There is no real consensus as to what is the appropriate amount for a government's reserves. Rating agencies measure reserves and compare results to State-wide and national averages, but such medians are not meant to be prescriptive. Organizations such as the GFOA provide some guidance on the matter, but it is (appropriately) general. For example, for many years the GFOA recommended that "general-purpose governments, regardless of size, maintain unrestricted fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures", which would be about 17%. But the GFOA noted that the adequacy of unrestricted fund balance in the general fund should be assessed based upon a government's own specific circumstances. The tool employed the following section is a further attempt by the GFOA to assist in this examination of specific circumstances.

USING THE GFOA RESERVE ANALYSIS WORKSHEET

Determining the appropriate size for a municipal reserve requires quantifying the various risks that face the City, from the anticipated (the need for capital expenditures) through the cyclical (economic downturns) and highly uncertain events (like natural disasters). The GFOA has developed a tool to assist an agency in assessing its risks, which they refer to as "The Triple-A Approach:"

1300 Clay Street, Suite 1000 | Oakland, CA 94612 | Main 510-839-8200 | Fax 510-208-8282
1451 Quail Street, Suite 200 | Newport Beach, CA 92660 | Main 949-346-4900 | Fax 510-208-8282
5757 W. Century Boulevard, Suite 700 | Los Angeles, CA 90045 | Main 310-348-2901 | Fax 510-208-8282
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- Accept that we are subject to uncertainty, including events that we haven't even imagined.
- Assess the potential impact of the uncertainty. Historical reference cases are a useful baseline.
- Augment the results, as the range of uncertainty we really face will almost always be greater than we assess it to be, so we should augment that range. Historical reference cases provide a baseline, but that baseline may not be adequate to account for all future possibilities.

We find that this approach helps to craft a reserve policy based on the specific risk exposure of a jurisdiction, while recognizing the imprecision of attempting to quantify the uncertain. The GFOA tool, like the exercise of putting together our report, offers an opportunity for reflection and dialogue on the topic, providing a foundation for decision makers to build the policies that they determine are appropriate for their own jurisdiction.

City staff reviewed the GFOA worksheet, and scored the various risk factors contained in the tool examining risks (such as "extreme events," revenue and expenditure volatility, capital needs, and other factors that can create financial pressure). This scoring was reviewed with KNN, and some of the scores revised. (See Attachment for this revised worksheet.) Some of the issues raised by the analysis that are worth highlighting are:

- The City's revenue structure includes a mix of revenue types, including the very stable property tax base (representing the City's largest recurring revenue source) and more volatile revenues, such as sales tax (the City lost a significant sales tax producer, 4% of total receipts in April 2015), transient occupancy tax, business license fees and building permit and plan check fees.
- Capital costs, including parking, streets, storm drains and stormwater mitigation and fire station 2, will continue to require support from the General Fund.
- Other large expenditure risks may come from liability claims and increased pension costs.
- Like all California communities, you are exposed to earthquake and other natural disaster risk.

Based on the scoring of the various components, the worksheet suggests that the City's risk profile was "moderate to high." At this level of risk, the GFOA advises that a city "consider adopting a reserve target somewhat higher than the GFOA minimum (e.g. establish a reserve goal of 26-35% of revenues/expenditures)." Based on your risk level, the GFOA does not recommend investing "excessive analytical effort in determining an exact reserve." For a variety of reasons, including increased pension costs and significant capital expenditures, we would recommend that the City set a target at the high side of that range—35%—as its minimum reserve.

With estimated reserves for FY15/16 expected to be $17,559,147, and FY 15/16 budgeted expenditures at $63,565,162, the City currently has an unassigned balance of 27.6%, at the low range of the recommended goal. The City should also consider reviewing its current policy of a minimum 20% reserve balance in light of the results from the GFOA worksheet.

I am available to discuss our recommendation with you, the City Manager or members of the City Council.