

FINANCIAL POLICY

OVERVIEW

This document establishes policies of overall financial management, budget development, and fiscal administration for the City of Los Altos. Included herein are statements and principles designed to guide the City in maintaining its financial stability.

Formal adopted financial policies assist elected officials and staff in the development of fiscal management practices, save time and energy in making financial decisions, promote public confidence, and provide continuity over time. While these policies will be updated periodically, they provide the basic framework for many of the financial decisions that the City will address. They support long-term planning and enhance the City's effectiveness.

This document discusses the most important elements of financial management in one comprehensive centralized format and is organized into the following areas of discussion:

- General Financial Principles
- Operating Budget
- Capital Improvements Program
- Revenues
- Expenditures
- Cash and Investment Management
- Debt Management
- Fund Balances and Reserves
- Financial Reporting and Audit
- Internal Control of the Financial Enterprise System
- Annual Review and Update
- Exhibits



GENERAL FINANCIAL PRINCIPLES

It is the overall policy of the City of Los Altos to:

- Provide financial information in a relevant, thorough, timely fashion, and in a format that effectively communicates financial status to Council, citizens, and City employees.
- Manage its financial resources in a responsible and planned manner.
- Establish and maintain prudent fund balance levels.
- Maintain financial reporting in compliance with current governmental accounting standards.
- Promote and implement a relevant and strong system of internal financial controls to manage significant risks and monitor the reliability and integrity of financial and operating reporting.
- Promote constructive and proactive financial decision making.
- Integrate long-term operating and capital resources planning.
- Allow for uncertainties and maintain a posture of financial flexibility.
- Develop programs in a manner that supports the City's long-term ability to cover costs and provide the level and quality of service required by its citizens.
- Manage debt responsibly.

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- Establish and maintain investment policies in accordance with State law.

OPERATING BUDGET

The budget will be adopted by the City Council no later than June 30th of each year. The City Manager may develop and present a biennial budget. The City should strive to develop a multi-year financial plan (a five-year forecast) that is updated as part of the periodic budget process.

A balanced provisional operating budget will be presented to City Council for review and adoption. A “balanced budget” means that recurring expenditures do not exceed recurring revenues. Total expenditures should not exceed total revenue plus available funds. Available funds may include the use of fund balances on hand. The city adheres to a structurally balanced budget in that ongoing revenues are matched to ongoing expenses and one-time or cyclical revenues cover one-time expenses to manage to a net zero or positive bottom line.

Funds may not be expended for a new fiscal year until the budget for that fiscal year has been adopted by City Council.

One-time revenue sources are not to be relied upon to fund ongoing operations.

Budgetary control is maintained at the fund level:

- The City Manager may make budget transfers between departments or programs as long as those changes do not increase overall appropriations within any one given fund. Transfers between funds, overall increases in fund appropriations, and overall increases in project budgets can only be made through City Council action. Transfers between departments should be reported to the City Council as part of the budget update process, either at mid-year or at the proposal of a new budget term
- Department heads are held directly responsible and accountable for developing and managing their operational budgets. Their level of control is held at the department level. Departments that operate programs among different funds are limited to the appropriation levels within any one fund.

Operating expenditure appropriations not spent during the fiscal year lapse at year- end, except for:

- Encumbrances or commitments, as in the form of finalized Purchase Orders, made during the fiscal year that have not been completed at year- end.
- Appropriations for capital improvement projects and ongoing grants with a life-cycle beyond one year.

Governmental funds use the modified accrual basis of accounting while proprietary and fiduciary fund types are budgeted on a full accrual basis of accounting. The Annual Comprehensive Financial Report (ACFR) presents City’s finances on a generally accepted accounting principles (GAAP) basis and the City’s budget is prepared in conformance with these standards.

The City budget must comply with the annual determination of the City’s appropriations limit calculated in accordance with Article XIII B of the Constitution of the State of California and adopt an annual resolution to this effect.

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CAPITAL IMPROVEMENT ~~AND MAJOR MAINTENANCE~~ PROGRAM

The City will develop and maintain a five-year capital improvement ~~project and major maintenance~~ plan (CIMMP) to be updated annually in conjunction with the operating budget. The CIMMP should reflect the current and changing needs of the community as well as enhance the quality of the community's quality of life.

All projects within the CIMMP are to be tracked systematically and reported to management quarterly. CIMMP tracking reports should clearly display budget-to-actual performance by project, fund category and project status.

A capital program typically involves the purchase or construction of major fixed assets such as land, buildings and any permanent improvement including additions, replacements and major alterations having a long-life expectancy. Additionally, capital projects may apply to 1) expenditures that take place over two or more years and require continuing appropriations beyond a single fiscal year; 2) systematic acquisitions over an extended period of time or 3) scheduled replacement of specific elements of physical assets. Generally, only those items costing \$10,000 or more are considered as capital projects. Vehicles purchases will also be included in this program when a fleet replacement plan is established.

The City also identifies projects in the Major Maintenance Program each year. Those projects mainly apply to 1) up-grade and maintain all buildings at current, competitive standards; 2) address code and safety issues, mechanical, electrical and plumbing systems, exterior and structural shortcomings, cosmetics, and immediate landscape issues; 3) the dollars are not to be spent to alter buildings or to renovate; 4) dollars should extend the life of whatever is being corrected for cycle of life designated for the building (typically ten years).

Capital improvements that specifically benefit a select group of users and/or are fee- for-service based are to be financed through user fees, service charges, special assessments and taxes, or development impact fees.

Capital improvements that specifically benefit a fee-for-service enterprise operation (such as Sewer) are to be financed through the service fees generated within that operation and fund. Such fees should be supported by periodic updates to the related utility master plan.

Transfers of resources into the CIP fund will be evaluated on an annual basis dependent upon the existence of available surplus dollars.

The City should strive to maximize the use of capital grants and state subventions in funding capital improvements before tapping general revenue sources.

REVENUES

The City will strive to maintain a diversified and stable revenue base to minimize the impact of economic fluctuation.

The City will seek out, apply for, and effectively administer federal, state, and other grants that address the City's current operating and capital priorities.

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Independent user-fee studies should be performed and updated periodically (three to five years) to ensure the proper balance of costs and service charges. The City should strive to cover the full cost of providing non-tax and discretionary fee-based service operations except to the extent that City Council approves defined subsidy levels by program area.

Operating departments are to review public services to identify and determine those appropriate for fee collection. Recommendations for new fees are to be presented to the City Council as fees are periodically updated.

Operating departments are to review existing fees periodically and recommend adjustments, if necessary, to ensure they reflect all direct and reasonable indirect costs of providing such services. Enterprise operations will be self-supporting and shall reimburse the General Fund for any and all material and services provided on their behalf.

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EXPENDITURES

Expenditures are to be budgeted and controlled so as to not exceed estimated revenues plus the approved and planned use of fund balances accumulated in prior years.

The City will conduct a mid-year financial status review to determine if projected revenues and expenditures meet target levels. If an operating deficit is projected at year-end, the City should evaluate the need for immediate corrective and/or mitigating actions, including operating or capital expenditure reductions and/or activate the use of established contingency balances. The deferral of essential and scheduled operational expenditures into the following fiscal year or the use of short-term loans and transfers to balance the budget should be avoided.

The City should implement a formal purchasing system, principles, and guidelines to ensure that expenditure levels are kept in check in the course of any fiscal year.

CASH AND INVESTMENT MANAGEMENT

The Financial Commission will review the City's investment policy annually and make recommendations to the City Council when appropriate.

The responsibility of investing City funds rests with the Finance Director who is to exercise due diligence to adhere to the investment policy. The Finance Director will present to the City Council quarterly investment reports presenting a summary of the portfolio status and compliance with the conditions set forth in the investment policy.

DEBT MANAGEMENT

The City should plan the use of debt in a manner that sustains financing payments at manageable levels.

The City will seek to maintain a high credit rating through sound financial practices as a basis for minimizing borrowing costs.

The City will make every effort to use pay-as-you-go financing for capital improvement projects. Debt financing for a project can be used if the overall project cost exceeds anticipated available resources and/or if the cost of financing is favorable as compared to the use of City investment holdings over the financing term.

The City will monitor all forms of debt annually in conjunction with the budget preparation process and report concerns and remedies, if necessary, to City Council.

The City will diligently monitor its compliance with bond covenants.

The City will not issue long-term debt to finance current operations. Debt financing should only be used for long-term capital improvement projects with a useful life exceeding the term of the financing and for which the project revenues or specific identified revenue sources are sufficient to service the long-term debt.

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The City will use a lease-purchase method of financing for equipment if the lease rates are more favorable than the City's expected overall investment rate of return.

The City will not incur general obligation indebtedness for public improvements which exceed in aggregate 15% of the assessed value of all real and personal property of the City as specified in the California Government Code Section 43605.

FUND BALANCE

GOVERNMENT FUND TYPE DEFINITIONS

The City's governmental fund types include the general fund, special revenue funds, capital projects funds, and debt service funds. GASB has clarified the definitions of these funds as follows:

GENERAL FUND

The General Fund should be used to account for and report all financial resources not accounted for and reported in another fund.

SPECIAL REVENUE FUNDS

Special revenue funds are used to account for and report the proceeds of specific revenue sources that are restricted or committed to expenditure for specified purposes other than debt service or capital projects. The restricted or committed proceeds of specific revenue sources should be expected to continue to comprise a substantial portion of the inflows reported in the fund. Other resources (investment earnings and transfers from other funds, for example) also may be reported in the fund if those resources are restricted, committed, or assigned to the specified purpose of the fund. Governments should discontinue reporting a special revenue fund, and instead report the fund's remaining resources in the general fund, if the government no longer expects that a substantial portion of the inflows will derive from restricted or committed revenue sources.

CAPITAL PROJECTS FUNDS

Capital projects funds are used to account for and report financial resources that are restricted, committed or assigned to expenditure for capital outlays, including the acquisition or construction of capital facilities and other capital assets. Capital projects funds exclude those types of capital-related outflows financed by proprietary funds or for assets that will be held in trust for individuals, private organizations or other governments.

DEBT SERVICE FUNDS

Debt service funds are used to account for and report financial resources that are restricted, committed or assigned to expenditure for principal and interest, even if it is being accumulated for future years' payments. Debt service funds should be used to report resources if legally mandated.

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FUND BALANCE CLASSIFICATIONS

Fund balance is defined as the difference between assets and liabilities. Beginning in FY2010-2011, the City is required to reclassify fund balances into the following five categories to comply with the Governmental Accounting Standards Board Statement (GASB) No. 54, Fund Balance and Governmental Fund Types.

NONSPENDABLE

This is a portion of fund balance not available for appropriations by its nature or external restriction. Examples are inventories and donations that require intact principal values.

SPENDABLE: RESTRICTED

The restricted portion of fund balance is subject to externally enforceable legal restrictions. Examples are Gas Tax revenues and grant proceeds.

COMMITTED

The committed portion of fund balance is constrained by the limitations imposed through formal City Council action. Only formal City Council action can remove or modify a previously committed amount.

ASSIGNED

The Assigned portion of fund balance is established for intended use by either the City Council or its designee, such as the City Manager. No formal City Council action is needed to remove the intended use. GAAP required reserves, such as the Other Post-Employment Benefits (OPEB) reserve, belong to this category. The Fiscal Policy and State Revenue Stabilization policy balances belong to this category.

UNASSIGNED

The Unassigned portion of fund balance is that remaining after the non-spendable, the restricted, the committed, and the assigned fund balances are identified and recorded.

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GOVERNING BODY ORDER OF FUND UTILIZATION

The City of Los Altos will use GASB's definitions of fund balance for the annual financial reports (audits) and for all other financial reporting. For all financial planning purposes, the term Budgetary Fund Balance will be used and will include any portion of the fund balance that is available for appropriation. Portions of the fund balance not available for appropriation will be identified as follows.

The City of Los Altos policy establishes the order of use of unrestricted resources as follows:

The City shall strive to use the most restricted fund balances prior to utilizing those that are less restricted. The following order of use reflects this guideline:

- Nonspendable (if funds become spendable)
- Restricted
- Committed
- Assigned
- Unassigned

SPECIAL REVENUE CLASSIFICATIONS

Only the General Fund has an unassigned category since money remaining in any other fund is automatically designated or assigned to the purposes of that fund. Under the new GASB 54 rules, if the balance of a Special Revenue Fund is not formally restricted or committed by fiscal year end, then it must be reported as part of the General Fund for fiscal year end audited financial statement purposes. For some of the City's special revenue funds, this necessitates the City Council to provide direction on the intended use of resources for the future. Staff recommends that the City Council adopt the following list of the City's Special Revenue Funds and their expected fund balance classifications:

- Vehicle Impound Fund – Restricted to Public Safety Use
- Supplemental Law Enforcement Fund – Restricted by State Statute
- Gas Tax Funds – Restricted by State Statute
- Proposition 1B – Restricted by State Statute
- Storm Drain Deposits – Restricted to Storm Drain Use
- Community Development Block Grants – Restricted by Federal/State Statute
- Downtown Parking Fund – Restricted by Council Action
- In-Lieu Park Fee – Restricted by State Statute
- Traffic Impact Fee – Restricted by State Statute
- Estate Donation Fund – Restricted by Council Intent
- Transportation Development Act (TDA) Funds – Restricted by State Statute
- Measure B Fund – Restricted by State Statute
- Vehicle Registration Fund - Restricted by State Statute
- PEG Fees Fund – Restricted by State Statute
- Public Art Fund - Restricted by Council Intent
- AB- 1379 CASP Fee- Restricted by State Statute

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In addition, GASB 54 allows the City Council authority to "assign" ending fund balances or bestow this authority to a City officer or designee. To provide the City with the most flexibility in financial reporting, the City Manager is given authority to assign resources and ending fund balances.

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FUND BALANCE POLICY LEVELS

PURPOSE

The City of Los Altos (City) has enacted the Fund Balance policies in an effort to ensure financial security through the maintenance of a healthy fund contingency balance that guides the creation, maintenance, and use of resources for financial stabilization purposes. The City's primary objective is to maintain a prudent level of financial resources to protect against reducing service levels or raising taxes and fees due to temporary revenue shortfalls or unpredicted one-time expenditures. The City also seeks to maintain the highest possible credit ratings which are dependent, in part, on the City's maintenance of a healthy fund balance.

GENERAL FUND

The City's fiscal goal is to maintain annual expenditure increases at a sustainable growth rate, and to limit expenditures to anticipated revenue in order to maintain a balanced budget. The Council directed target is to maintain an unrestricted fund balance within the range of not less than 17% of annual operating expenditures for the fiscal year with a multi-year goal of achieving a 20% unrestricted fund balance level for the reasons noted below. This level of coverage includes General Fund balance amounts specifically assigned for annual Emergency and Operating Reserve as discussed and defined further below:

- To provide funding to cover approximately two (2) months of operating expenses with the goal of achieving three months coverage in the long term.
- To provide the liquidity necessary to accommodate the City's uneven cash flow, which is inherent in its periodic tax collection schedule.
- To provide the liquidity to respond to contingent liabilities.
- To adhere to Government Finance Officers Association (GFOA) recommendation that a minimum General Fund unrestricted fund balance to be maintained of no less than either two (2) months of regular operating revenues or expenditures.

EMERGENCY AND OPERATING RESERVE

~~These balances are hereby defined as assigned by the City Council to allow the City to weather unpredicted cyclical and rapid downturns in the economy. These funds would be available for use in such conditions to mitigate negative economic fiscal impacts or State takeaways and can be activated within any one budget cycle through Council action. An economic downturn would entail a projected and/or sudden drop in core revenues (major tax and service revenue loss) of equal to or greater than 5% (including the impact of inflation) and/or a change in economic parameters (such as interest rates, debt service rates, commodity prices, pension rates) that cause a material change in expenditures of 5% or more, or the occurrence of a local natural disaster or unexpected financial claim requiring the immediate use of cash balances.~~

INTENDED USES FOR RESERVE

- Interruptions in cash inflows

Examples include the State holding back on or altering tax disbursements, loss of sales

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tax receipts of a one time nature, or a significant economic slowdown. If the cash inflow interruption is of an ongoing nature, reserve use is limited to a consecutive two-year period, not to exceed 40% of the beginning reserve balance.

• Emergencies

In the event of an emergency or disaster such as earthquakes, fires, floods or other such emergencies, the entire balance may be used to temporarily fund recovery costs. It is understood that all aid assistance options will be sought to fund recovery efforts or reimbursement of the Contingency Reserve for fronting of recovery costs.

OTHER CRITERIA FOR USE

A majority vote from the City Council is required to determine that it is necessary to use the Contingency Reserve for any of the uses listed above. With the exception of the emergency scenario, the reserve contingency balance allocated for other intended uses shall not exceed 50% of the required balance in any given year.

REPLENISHMENT PLAN

Unless a repayment plan is pre-established at the time reserves are allocated, Staff shall bring for Council consideration a replenishment plan, within 60-days of allocation from the reserve. It would be Council's expectation that every effort would be made to replenish the reserve as soon as it is financially feasible and practical to do so.

CALPERS UNFUNDED ACCRUAL LIABILITY (UAL) & OTHER POST-EMPLOYMENT BENEFITS (OPEB) FUNDING

The City conducted actuarial studies to comply with GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Post-Employment Benefits* and GASB Statement No. 68, *Accounting and Financial Reporting for Pensions* to determine the City's obligations). The studies concluded that the City should set aside annual funding for those obligations and the City has maintained internal funding of UAL and OPEB obligations for this purpose..

SEWER FUND BALANCES

The City should maintain the balances in the Sewer Fund at a level sufficient to accommodate operating and capital needs. The Sewer Master Plan has set this reserve at 25% of annual expenditures, including estimated capital improvements. This level of funding should be established pursuant to the performance of a utility fund rate-study and/or master plan and are to be used for unanticipated operating and capital needs, and to level future rate increases. Multi-year fee studies for this fund should be updated periodically as a basis for defining the revenue sources necessary to maintain system infrastructure and required services levels. As a result of the periodic fee or master plan studies, adjustments to user charges may be necessary to maintain recommended fund balance levels.

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WORKERS' COMPENSATION AND LIABILITY INSURANCE FUNDING

Periodic actuarial studies of self-insured workers' compensation and general liabilities will be conducted to ensure that proper levels of liabilities are accrued for claims and that rates charged to operating departments are appropriate.

EQUIPMENT REPLACEMENT FUNDING

An equipment replacement fund will be maintained to provide for the timely replacement of vehicles and other operating capital equipment. This fund is to be reviewed on an annual basis and rates charged to the using departments based on the depreciation guidelines established in this policy.

FINANCIAL REPORTING AND AUDIT

The City's accounting and financial reports are to be maintained in conformance with GAAP.

An annual financial audit will be performed by an independent public accounting firm familiar with municipal government activities. The independent auditor will issue an audit opinion to be included in the City's Annual Comprehensive Financial Report (ACFR). Additionally, the auditor will present the ACFR and discuss audit findings to the Financial Commission. The City encourages the rotation of audit service providers on a periodic basis.

The City is encouraged to submit the Annual ACFR and Popular Annual Financial Report (PAFR) to State and/or National Government Finance Professional organizations (Government Finance Officers' Association's Certification of Achievement for Excellence in Financial Reporting - California Society of Municipal Finance Officers ACFR Award) for independent review and evaluation.

Internal financial status reports are to be issued on a periodic and timely basis – no less than quarterly and be made readily available citywide.

CAPITAL ASSETS

At the time of Acquisition, capital assets are valued at historical cost or estimated historical cost if actual historical cost is not available. Donated capital assets are valued at their estimated fair market value on the date donated. Then the assets will be recorded at the depreciated value based on the depreciation schedule.

The City is to record the depreciation equipment, buildings and facilities, and infrastructure as follows and in line with internally established capitalization guidelines:

CAPITALIZATION THRESHOLDS

- | | |
|---------------------------------------|-----------------------|
| • Land purchases | Any value |
| • Equipment | \$5 10,000 |
| • Buildings and facility improvements | \$25,000 |
| • Infrastructure | \$100,000 |

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DEPRECIATION

Depreciation will be recorded on a straight-line basis over the following estimated useful lives:

- Equipment 3 – 10 years
- Site Improvements other than buildings 30 – 50 years
- Buildings 50 years
- Infrastructure 30 – 100 years

In June 1999, the GASB issued Statement No. 34 which requires the inclusion of infrastructure capital assets in local governments' basic financial statements. In accordance with GASB Statement No. 34, the City included all infrastructure into the Basic Financial Statements. The City defines infrastructure as the basic physical assets that allow the City to function. The assets include streets, sewer, and park lands. Each major infrastructure system can be divided into subsystems. For example, the street system can be subdivided into pavement, curb and gutters, sidewalks, medians, streetlights, landscaping and land. These subsystems were not delineated in the basic financial statements. The appropriate operating department maintains information regarding the subsystems.

Interest accrued during capital asset construction, if any, is capitalized for the business type and proprietary funds as part of the asset cost.

INTERNAL CONTROL FOR FINANCIAL ENTERPRISE SYSTEM

The City works with Bay Cities Joint Powers Insurance Authority to conduct periodic cybersecurity audits. All cybersecurity measures are in accordance with City and State laws and industry best practices.

Financial system access control is in place. Only authorized individuals can access critical financial systems and data.

The City holds regular training sessions to raise awareness among employees about the importance of cybersecurity and to educate on best practices. These training sessions include topic such as phishing attacks, social engineering, safe browsing habits and the proper handling of sensitive data.

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