



**TOWN OF LOS GATOS  
FINANCE COMMISSION REPORT**

MEETING DATE: 07/12/2021

ITEM NO: 9

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DATE: July 7, 2021  
TO: Finance Commission  
FROM: Laurel Prevetti, Town Manager  
SUBJECT: Review of Market Fluctuation Reserve

**RECOMMENDATION:**

Review of Market Fluctuation Reserve.

**REMARKS:**

Staff utilizes the Reserve for Market Fluctuations to assign or reserve Town General Fund balance when substantial unrealized gains (market value of investment above its historical cost to the Town) on its operating portfolio are determined upon the last day of the fiscal year. Under the requirements of Governmental Accounting Standards Board (GASB) 31 this gain or loss must be included as part of the calculation of interest earned for the fiscal year.

GASB 31 was issued in 1997 as a direct response to investment losses incurred in 1984 by the City of San Jose (\$60M) and the 1994 Orange County bankruptcy. ) Both governments mentioned held substantial holdings in bonds that had market values below actual cost. When both governments were forced to liquidate investments ahead of their maturity date substantial losses were incurred. Under the accounting rules prior to the adoption of GASB 31, cities reported no loss on the financial statements until such time as the bonds were sold. Typically, market value declines are irrelevant because most municipalities held bonds to maturity so the government would receive the original par value for the bonds with no loss being recorded. However, if the governments were forced to sell the bonds prior to maturity, losses could result if the current prevailing interest rates at the time of the sale were unfavorable.

The GASB responded to this issue by adopting fair value measurement requiring that at year end the city must compare or “mark” its historical cost of investments against the market value

**PREPARED BY:** Stephen Conway  
Finance Director

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

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of those investments as determined at its fiscal year end date. If the market value is below cost, a negative interest earned adjustment is made to the city’s interest earned for the fiscal year. Conversely, if the market valuations exceed historical cost, a positive increase is added to the calculation of interest earned for the fiscal year.

The Town has utilized the Reserve for Market Fluctuations previously on three occasions. The historical information is presented below:

<b>Reserve for Market Fluctuations</b>	<b>Reserve Balance As Reported on FYE CAFR</b>
Fiscal Year Ended June 30, 2010	\$ 526,525
Fiscal Year Ended June 30, 2011	\$ 247,705
Fiscal Year Ended June 30, 2012	\$ -
Fiscal Year Ended June 30, 2013	\$ -
Fiscal Year Ended June 30, 2014	\$ -
Fiscal Year Ended June 30, 2015	\$ -
Fiscal Year Ended June 30, 2016	\$ -
Fiscal Year Ended June 30, 2017	\$ -
Fiscal Year Ended June 30, 2018	\$ -
Fiscal Year Ended June 30, 2019	\$ -
Fiscal Year Ended June 30, 2020	\$ 1,218,732

The Town had a substantial gain of market value above cost as of June 30, 2020 of approximately \$1.2 million. The Town’s investment strategy is essentially a “buy and hold” strategy for its investments. This means that the Town typically holds these investments till they mature and will receive the yield for these bonds and par amount over the life of the bonds. However, holding to maturity does mean that a favorable \$1.2 million position of unrealized market value above cost as of June 30, 2020, does not represent actual cash on hand.

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June 30, 2020 GASB 31 Mark to Market	Historical Cost	Market Value	
BNY Custody Account	\$ 46,578,670	\$ 47,797,402.30	Per BNY June 2020 Custody Acct Statement
BNY Custody Account-Dreyfus Gov Sec	\$ 145,920	\$ 145,919.90	Per BNY June 2020 Custody Acct Statement
Subtotal BNY	<u>\$ 46,724,590</u>	<u>\$ 47,943,322.20</u>	
LAIF	\$ 12,185,730	\$ 12,185,729.51	Per LAIF 6-30-20 Monthly Statements
Bank of the West Checking Account	\$ 15,285,669	\$ 15,285,668.55	Bank Balance Per BankWest Statement 6_30_20
Bank of the West Money Market	\$ 17,388	\$ 17,387.56	Bank Balance Per BankWest Statement 6_30_20
Subtotal LAIF & Bank of the West	<u>\$ 27,488,786</u>	<u>\$ 27,488,785.62</u>	
	<u>\$ 74,213,376</u>	<u>\$ 75,432,107.82</u>	
		<u>\$ 1,218,731.98</u>	Market Value Above Cost (Added to Interest Earned Calculation for FYE 6/30/20)

The recognition of \$1.2M in fiscal year 2020 interest revenue for substantial unrealized gains presents a problem for the financial statements in terms of its assigned reserves. For instance, for fiscal year ending (FYE) June 30, 2020, the \$1.2M in market value gains added to the interest earned calculation for FYE 2020 eventually flowed to increase total fund balances because there was a \$1.2 million of revenue recorded that wasn't actually received in terms of actual cash on hand. The result is that unless staff were to assign the \$1.2 million in unrealized gains to its Market Fluctuations reserve, under the Town's General Fund Reserve Policy, these unrealized gains would eventually flow to the Town's Reserve for Capital and Special projects indicating balances that are not actually available in cash to spend. To prevent this potential overstatement of assigned reserves available for actual expenditure, in years where staff recognizes substantial year-end gains of market value above the Town's original cost of its investments, staff assigns these unrealized gains in the Town's Reserve for Market Fluctuations.