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Matthew Hudes <MHudes@losgatosca.gov>; Rob Rennie <RRennie@losgatosca.gov>
Subject: Agenda Item #2 - Finance Committee Subcommittee meeting July 29, 2021

Dear Subcommittee Members,

I would like to recommend that the subcommittee review the attached Town financial practices for areas of improvement. I am particularly focused on the Town's use of reserves to "balance" an operating budget. This is inconsistent with GFOA's best practices which recommends that "governments adopt rigorous policies, for all operating funds, aimed at achieving and maintaining a structurally balanced budget". The best practices further states "the policy should include parameters for achieving and maintaining structural balance when recurring revenues are equal to recurring expenditures in the adopted budget".

I have attached the financial policies for the City of Los Altos for your review. The City of Los Altos has adopted the GFOA best practice and requires the presentation to City Council for review and approval a "balanced provisional budget" with total projected expenditures not exceeding total estimated revenues. Additionally, the City of Los Altos prepares an rolling two year operating budget. This should be also adopted by the Town.

Please let me know if you have any questions.

Phil Koen

FINANCIAL PRACTICES

REVENUE

- The Town maintains a diversified revenue base that is locally generated to shelter the community from fluctuations in any one revenue source.
- The Town audits and collects all locally generated taxes.
- The Town establishes and maintains all user charges and fees based on the cost of providing services.

BUDGETING and EXPENDITURE

- The Town Council considers and adopts an annual balanced budget effective from July 1st to June 30th of the following calendar year. A balanced budget requires current year operating expenses to be fully funded by current year revenues and identified undesignated/unreserved fund balance.
- Fund Balance Reserves are used only for non-recurring “one-time” and capital projects and not for on-going operations.
- Long-term debt is confined to capital improvements or special projects that cannot be financed from current revenues.
- The Town Manager is authorized to implement the programs as approved in the adopted budget. Within a specific fund the Town Manager may transfer appropriations between categories, Departments, projects, and programs as needed to implement the adopted budget.
- With the approval of the Town Manager, unexpected appropriations may be carried forward to the next fiscal year provided funds have been previously encumbered for a specific purpose.
- The annual budget includes a \$100,000 Designated Contingency for non-recurring, unanticipated expenditures. The Town Manager may approve expenditures from this contingency if needed during the fiscal year.
- A capital outlay (fixed asset) purchase is any single item or piece of equipment which costs more than \$10,000 and has an expected useful life exceeding one year.
- A mid-year budget report is submitted to the Town Council to provide information on the status of the Town’s financial condition.

FUND BALANCE RESERVES

Reserves are established, dedicated, and maintained annually to meet known and estimated unknown future liabilities through actions of the Town Council.

Restricted fund balance is either imposed by law or constrained by grantors, contributors, or other governmental.

FINANCIAL PRACTICES

- IRS 115 Trust is established for the mitigate the Town's unfunded pension obligation
- The specific Fund Balance Reserves include but are not limited to a restricted Reserve for:
 - ▶ A fully funded workers' compensation and unemployment insurance
 - ▶ Liability insurance including one year's premium payment to the insurance carrier or pool
- Reserves are maintained at a minimum of 25% of General Fund ongoing operating expenditures, equally divided between the Catastrophic Reserve (12.5%) and the Budget Stabilization Reserve (12.5%).
- When either Reserve drops below the minimum, per Town Council adopted policy, Town Council is required to develop a one to five-year reserve replenishment plan to meet the minimum threshold of 25% of General Fund ongoing, operating expenditures, excluding one-time expenditures.
- A Reserve is maintained for the depreciation and replacement of equipment.
- A Reserve is maintained for the maintenance of buildings.
- Pension/Other Post Employment Benefits (Pension/OPEB) Reserve is maintained to use as a supplemental funding source to pay down unfunded pension and other post employment liabilities.

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. Examples of assigned fund reserves:

- **Compensated Absences** – A reserve is maintained annually to fund 50% of all vested hours of vacation earnings.
- **Open Space** – Town Council established this reserve in FY 1998/99 with an initial balance of \$500,000 to be used for the preservation of open space, connection of open space trails, the definition of the southern boundary of the Town with passive open space, and protection of unique natural features.
- **Sustainability** – Established by Town Council in FY 2008/09 budget by closing the Solid Waste Management Fund and placing the initial residual fund balance of \$296,554 in a General Fund reserve dedicated for conservation, recycling, and sustainability.
- **Authorized Carry forward** - A reserve is maintained for materials and services on approved purchase order and contracts which were issued but not finalized or fulfilled as of the end of the fiscal year but for which funds will be carried forward to the following fiscal year.
- **Vehicle Maintenance and Stores Residual** – A reserve established to hold the residual fund balances transferred to the Town's General Fund upon closing the Vehicle Maintenance and Stores Internal Service Funds for future Council reallocation.
- **Surplus Property** – A reserve established for placing the proceeds from surplus property sales until further Town Council reallocation.

⌘ FINANCIAL PRACTICES ⌘

- Capital/Special Projects Reserve – Funds reserved under this category are designated for key infrastructure and capital/special projects as identified in the Town’s 5-year Capital Improvement Plan, as there is no ongoing funding source to support the Town’s capital needs. The Council may also allocate funds from this Reserve for other purposes.

CAPITAL IMPROVEMENT

Capital Improvement Projects are funded by the following revenue sources:

- Available General Fund Reserves
- Gas Taxes
- Construction Fund Fees
 - ▶ Utility
 - ▶ Capital
 - ▶ Parks
- Storm Drain Basin Fees
- Grant Funding
- Other state and federal funding sources as they become available
- The multi-year plan for capital improvements is updated annually. Future capital expenditures will be projected annually for a 5-year period based on changes in Council priorities or replacement of the infrastructure.
- The annual Capital Improvement Plan is based on the multi-year Capital Improvement Program.
- The Town coordinates the development of the Capital Improvement Plan with the development of the Operating Budget.
- The Town identifies the estimated costs and potential funding sources for each capital project proposed prior to its submittal to the Town Council for approval.
- Capital projects financed by issuing bonds are paid back within a period not to exceed the useful life of the project.
- The Town Manager is authorized to implement the projects as approved in the adopted Capital Improvement Plan. Within a specific fund, the Town Manager may transfer appropriations between projects as needed to implement the adopted Capital Improvement Plan.



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	Debt Management
Operating Budget	Fund Balances
Capital Improvements Program	Financial Reporting
Revenues	Annual Review and Update
Expenditures	Exhibits
Cash Management	

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

FINANCIAL POLICY

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 with total projected expenditures not exceeding total estimated revenues. Should it be necessary, City Council may approve a planned use of accumulated fund balances in prior years for inclusion in the budget.

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 Comprehensive Annual Financial Report (CAFR) 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.

CAPITAL IMPROVEMENT PROGRAM

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

FINANCIAL POLICY

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

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.

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.

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.

FINANCIAL POLICY

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 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.

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

GOVERNMENTAL FUND TYPE DEFINITIONS

Governmental fund types include the general fund, special revenue funds, capital projects funds, debt service funds and permanent funds. GASB has clarified the definitions of these funds as follows:

FINANCIAL POLICY

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.

PERMANENT FUNDS

Permanent funds should be used to account for and report resources that are restricted to the extent that only earnings, and not principal, may be used for purposes that support the reporting government's programs. Permanent funds do not include private-purpose trust funds, which should be used to report situations in which the government is required to use the principal or earnings for the benefit of individuals, private organizations, or other governments.

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.

■ FINANCIAL POLICY

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.

GOVERNING BODY ORDER OF FUND UTILIZATION AND SPECIAL REVENUE CLASSIFICATIONS

ORDER OF 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

FINANCIAL POLICY

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

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.

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.

FINANCIAL POLICY

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.

GENERAL FUND OTHER POST-EMPLOYMENT BENEFITS BALANCES

The City conducted an actuarial study to comply with GASB Statement No. 45, Accounting and Financial Reporting by Employers for Post-Employment Benefits and to determine the City's obligation for the other post-employment benefits (OPEB). The study concluded that the City should set aside annual funding for this obligation and the City has maintained internal funding of OPEB obligations for this purpose. Additionally, the City will conduct an actuarial update every two to three years to maintain the current status of this valuation.

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

FINANCIAL POLICY

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.

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

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 Comprehensive Annual Financial Report (CAFR). Additionally, the auditor will present the CAFR 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 CAFR 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 CAFR 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.

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 at any value
- Equipment - \$5,000
- Buildings and facility improvements - \$25,000
- Infrastructure - \$100,000

FINANCIAL POLICY

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



BEST PRACTICES

Achieving a Structurally Balanced Budget

Adopt rigorous policies, for all operating funds, aimed at achieving and maintaining a structurally balanced budget

Most state and local governments are subject to a requirement to pass a balanced budget. However, a budget that may fit the statutory definition of a "balanced budget" may not, in fact, be financially sustainable. For example, a budget that is balanced by such standards could include the use of non-recurring resources, such as asset sales or reserves, to fund ongoing expenditures, and thus not be in structural balance. A true structurally balanced budget is one that supports financial sustainability for multiple years into the future. A government needs to make sure that it is aware of the distinction between satisfying the statutory definition and achieving a true structurally balanced budget.

GFOA recommends that governments adopt rigorous policies, for all operating funds, aimed at achieving and maintaining a structurally balanced budget. The policy should include parameters for achieving and maintaining structural balance where recurring revenues are equal to recurring expenditures in the adopted budget.

As a first step, the government should identify key items related to structural balance. These

include: *recurring and non-recurring revenues, recurring and non-recurring expenditures, and reserves.*

Recurring revenues are the portion of a government's revenues that can reasonably be expected to continue year to year, with some degree of predictability. Property taxes are an example of recurring revenue. A settlement from a lawsuit is a good example of non-recurring revenue.

Some revenue sources may have both non-recurring and recurring components. These sources require finance officials to exercise judgment in determining how much of the source is truly recurring. For instance, a government may regularly receive sales tax revenues, but a large part of its base may be made up of retailers with highly volatile sales. In this case, it may be prudent to regard unusually high revenue yields as a non-recurring revenue under the assumption that such revenues are unlikely to continue, making it imprudent to use them for recurring expenditures. Another example might be building permit revenues in a period of high growth in the community. Governments should review their revenue portfolio to identify non-recurring revenues and revenues with potentially volatile components, such as the examples above.

Recurring expenditures appear in the budget each year. Salaries, benefits, materials and services, and asset maintenance costs are common examples of recurring expenditures. Capital asset acquisitions are typically not thought of as recurring because although some capital assets may be acquired every year, they are not the same assets year after year. In general, recurring expenditures should be those that you expect to fund every year in order to maintain current/status quo service levels. In general, a government has a greater degree of flexibility to defer non-recurring expenditures than recurring ones.

Reserves are the portion of fund balance that is set aside as hedge against risk. The government should define a minimum amount of funds it will hold in reserve.² This serves as a "bottom line measure" to help determine the extent to which structural balance goals are being achieved. If reserves are maintained at their desired levels, it is an indication that the organization is maintaining a structurally balanced budget. If reserves are declining, it may indicate an imbalance in the budget (e.g., if reserves are being used to fund on-going expenditures). It should be noted that reserves levels are not a perfect measure of structural balance, but are a good and readily available measure.

With the forgoing terms defined, a government should adopt a formal policy calling for structural balance of the budget. The policy should call for the budget to be structurally balanced, where recurring revenues equal or exceed recurring expenditures. The policy should also call for the budget presentation to identify how recurring revenues are aligned with or not aligned with recurring expenditures.³

For a variety of reasons, true structural balance may not be possible for a government at a given time. In such a case, using reserves to balance the budget may be considered but only in the context of a plan to return to structural balance, replenish fund balance, and ultimately remediate the negative impacts of any other short-term balancing actions that may be taken. Further, the plan should be clear about the time period over which returning to structural balance, replenishing reserves, and remediating the negative impacts of balancing actions are to occur.⁴

Notes:

- Note that this Best Practice excludes non-operating funds like capital and debt funds. While governments should ensure that these funds are financially sustainable as well, the specific recommendations found in this Best Practice may not always be a match to the circumstances of non-operating funds.
- Please note that the best practice is not advocating that recurring revenues be formally allocated or "earmarked" to recurring expenditures, but rather is advocating that the budget presentation provide transparency as to whether recurring revenues and recurring expenditures are balanced.

Board approval date: Tuesday, February 28, 2012

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