From: Ron Dickel <rondickel@gmail.com>
Sent: Saturday, December 7, 2019 3:06 PM
To: Stephen Conway
Cc: Gitta Ungvari; Arn Andrews
Subject: December 9 Finance Committee Meeting

Steve
Before the meeting, please send the committee the engagement letter with the auditor Badawi, as well as any representation letter that you need to sign to complete the audit. Thanks.
Ron

ATTACHMENT 4

From: Terry Duryea <tduryea@aol.com>
Sent: Saturday, December 7, 2019 9:17 PM
To: Laurel Prevetti; Arn Andrews; Stephen Conway
Cc: Gitta Ungvari
Subject: Comments on 2019 Draft CAFR
Attachments: LGFC2019_12FinanceCommDec9_2019RTDThoughts_120619.docx

Hi Laurel, Arn and Steve

I'm in the process of reviewing the draft 2018-2019 CAFR and have made it through all but the Required Supplemental Information and Statistical Section. I wanted to get my questions to you as soon as possible to give you time to respond. The intent of my questions is to understand how Los Gatos accounts for certain types of transactions, understand the story of what happened in 2019 in financial terms and how to interpret it, and get a sense of where the Town is heading and the financial risks it is managing. I also added a section on changes to the CAFR I believe need to be given serious consideration, and a separate section on my observations that are part of the story of where I believe Los Gatos is headed.

I apologize in advance if I asked questions that answered in the footnotes, as I didn't review all of them in the same level of detail.

The full memo is attached as a Word document. Please confirm that you received this email.

Thank you

Terry

December 7, 2019

Hi Laurel
I'm in the process of reviewing the draft 2018-2019 CAFR and have made it through all but the Required Supplemental Information and Statistical Section. I wanted to get my questions to you as soon as possible to give you time to respond. The intent of my questions is to understand how Los Gatos accounts for certain types of transactions, understand the story of what happened in 2019 in financial terms and how to interpret it, and get a sense of where the Town is heading and the financial risks it is managing. I also added a section on changes to the CAFR I believe need to be given serious consideration, and a separate section on my observations that are part of the story of where I believe Los Gatos is headed.

I apologize in advance if I asked questions that answered in the footnotes, as I didn't review all of them in the same level of detail.

Item 2 Staff Report says the CPA firm "prepared the Draft CAFR for the Town of Los Gatos". How can a firm that prepared a financial report audit its own work as it is not independent of the CAFR?

My questions on the CAFR:

1) What is significance of the fact that the Town has a negative unrestricted net position of $4,642K compared to a small positive unrestricted net position last year, and a positive unrestricted net position of $15.1M (with no adjustment for the GASB 84 adoption) in fiscal 2017. This represents a decline of Unrestricted Negative Net Position of $19.7M
   - Does this mean that there are not funds available to meet the restrf
   - Is the negative deficit expected to increase over time?
   - How do rating agencies view this?
   - Please ask Baldawi to be prepared to indicate the approximate percentage of his government clients have a negative unrestricted net position?

2) It's unclear what is happening to Police Department/Public Safety expenses as reported on pages 23 and 27 in the MD&A. The expense increases 21% ($3,334K) on the combined Statement of Activities on page 23 and only 3.6% ($552K) in the Statement Governmental Funds Revenues & Expenses. The explanation for the $3.3M increase in the combined report says that it is "due to negotiated salary increases and increased pension expenses".
   - How much of the $3.3M increase is due to each component?
   - What is the percentage increase in salaries over the prior year if the increase had been in effect as of the beginning of fiscal 2018-19?
   - A 21% year over year increase is alarming if it is indicative of a trend. What do you forecast Police Department spending will be after the next labor negotiations, e.g. fiscal 2021-2022, assuming the next labor negotiations will result in the same increased costs as the most recent negotiations, and using CALPERs forecast for required increases in pension contributions?

3) The $380K and $670K increase in Community Development and Parks and Public Works expenditures, respectively per the MD&A on page 25 represent 6.7% and 8% increases, respectively. The MD&A indicates the increase is due to a combination of negotiated salary increases and pass-through expenditures. What was the percentage increase in salary costs year over year?

4) How much of the $2.5M Library Services costs in the Governmental Funds Revenue & Expenditures on page 27 relates to the historical cost of the building, whether it be lease rental payments under the RDA or depreciation or some other form of original cost recognition.

5) On page 29 of the MD&A the first bullet explaining the Misc. Adjustments & Mid Year Adjustments indicates the $2,390K adjustment includes $1,556K from raises due to the negotiated contracts (2.5%).

- If this is a prorated amount, what would the percentage increase be on an annualized basis?

6) The MD&A on the bottom of page 29 explains the Variance with the Final General Gund budget. The first bullet implies the investment earning from the pension/OPEB Trust flowed through the Town budget on 2019.

- Are you saying it was added to the Town cash rather than used to pay down the Pension obligation?
- Why was this accounting treatment used and who made the decision? This seems inconsistent with setting aside the funds to pay down the unfunded obligations.
- Are there plans to use this gain to pay down the unfunded pension liability?

7) The explanations on pages 30 and 31 of variances between the Final Budget versus Actual results reported on page 46 indicate there are favorable spending variances in a number of departments, e.g. Public Safety, Administrative Services, Parks and Public Works, and Library Services, that are due to unfilled budgeted positons.

- Was this a planned strategy to delay filling positions or are there also other reasons?
- If it was due in part to other reasons, what were they?

8) The explanations on page 30 for the favorable variance in Community Development spending was due in part to $883K of General Plan Update expenditures that were deferred to 2020 as they was not fully executed in 2019.

- Does the 2020 adopted budget reflect this cost deferred into 2020?
- Why wasn't a 2019 mid-year budget adjustment made to reflect some or all of the deferral at the time it was recognized the contract would not be fully executed?

9) The variance in Non-departmental expenditures between budget and actual is partially explained on page 30 by the recognition of a $3.7M benefit from the <u>early</u> implementation of GASB 84

- When was the decision to implement GASB 84 made? And if it wasn't until the end of the year, why did you defer the decision? If the decision was made earlier in the year, why didn't you submit a 2019 budget adjustment?
- See my additional comment under Possible Changes to the CAFR below

10) The Governmental Funds Balance Sheet on page 42 shows Restricted Fund Balances for Vehicle Maintenance & Stores Reserve of $1,040K and Workers' Comp Reserve of $1,232K. My recollection might be faulty, but I thought that when we removed these reserves from the Internal Service Funds they were going to be eliminated in their entirety. It appears all that was done was move them from the IS Funds to the General Fund. Did I miss something?

11) What land was sold to generate proceeds of $1,912K, most of which was an accounting gain?

12) The following table shows the reconciliation of Compensated Absences included in Note 1 compared to the prior year.

	2019	2018
Beginning balance	$2,445	$2,519
Additions	2,140	862
Payments	(1,747)	(936)
Ending balance	$2,837	$2,445

What is the reason for the major increases in Additions and Payments in 2019?

13) The schedule of reserves in Note 8 on page 74 includes $2,579K for "CALPERs/OPEB Reserve". The explanation on the next page speaks only to the CALPERs portion. I had thought the intent was to pay down CALPERs on the assumption of a 20 year amortization. Leaving the money in the Town coffers does nothing to address the accruing interest rate, further increasing the Towns' unfunded pension liability.

- What is the plan for this reserve? Why don't you want to use the money to pay down the CALPERs unfunded pension liability

14) Note 9 (b) under Actuarial Assumptions on page 78 shows a COLA adjustments of 2.0% and 2.5%. The similar numbers in 2018 were 2.75%. Were their changes in the COLA in the last year?

15) Note 13 table on page 90 shows a new fund, the Proprietary Funds with encumbrances of $229K. This fund was not listed in the 2018 CAFR. What is this new fund?

Possible changes to CAFR (Note: I've highlighted in ***bold*** and ***italics*** the most important ones):

- ***MD&A, page 18, 3rd bullet says the negative balance/funds are "considered usable for any legal purpose by the Town". This should be deleted as it makes no sense when there is a deficit***
- MD&A, page 22, first full paragraph, refers to notes 10 and 11, should the reference be to 9 and 10?
- MD&A page 29 first line lists the dollar amounts of approved changes during the year from original budget to final budget. The dollar amounts do not agree to the table.
- ***Note 1 discusses the change in accounting from GASB 84 with no mention of the dollar impact. I didn't find Note 5 until the end of reviewing the financial statements. I'd suggest a reference to Note 15 in Note 1. Furthermore, the change is more significant than the $1,206K impact because without the change, the unrestricted deficit would have been even higher***
- ***The impact of the adoption of GASB 84 on the comparative financial statements on page 23 of the MD&A is even higher. The explanation of the $3.3M decline in General Government expenditures between 2018 and 2019 is explained by the adoption of GASB 84. This is material and comparative information should be presented so the reader can have an apples to apples comparison***

- The discussion of Variance with the Final General Fund Budget on page 29 is referring the financial statement on page 46. You might want to refer the reader to this page so they have some context.
- ***The 2018 CAFR under Economic Factors and Next Year's Budgets and Rates included disclosure of the pension funded percentages for the safety group and the miscellaneous group. Why was this disclosure omitted in the 2019 CAFR.***
    - ***Furthermore, IMHO it is material that the funded percentages declined further as we learned in the recent Pension and OPEB Oversight Committee meetings.***
    - ***Why is there no discussion of the funding percentages in the MD&A***
- Note 1 Internal Service Funds on page 58. I believe Vehicle Maintenance and Workers Comp are no longer included
- Note 5, page 70. Delete the cents ".00" on $38,874.00.
- ***Note 9 under General Information about the Pension Plans, the note refers the reader to the CALPERs website. The Town has publicly recognized that the CALPERs information understates the magnitude of the Pension obligations. It seems it's misleading to the financial statement reader to refer them to information the Town believes is misleading, even though the Town states it relies on CALPERs information in preparing the CAFR. I believe the Note should include a comment along the lines "Historical experience with CALPERs reporting shows that it has consistently understated the cost of pension benefits." The Town has implicitly accepted that the CALPERs discount rate is too high by using a 6.75% discount rate for the Town's OBEB Fund vs CALPERs 7.15% rate and the CALPERs projected salary increase of 2.75% is too low by using 3.0%.***
- Note 9 (a), page 77. Put a "$" on $4,507 PEPRA Required payment of unfunded liability
- Note 9 (b) Net Pension Liability on page 78. The Proposition-June 30, 2017 of .22603% does not agree to the same number in the prior year CAFR
- Note 9 (b) under Actuarial Assumptions on page 78 shows a COLA adjustments of 2.0% and 2.5%. The similar numbers in 2018 were 2.75%.
- Note 11 Risk Management table on page 89 indicates that the Workers Comp and Self Insurance information relates to the IS Fund. I don't think this is the case anymore.

Observations as a result of reading the CAFR:

1) The Towns' unrestricted net position has declined from $15.1M in June 2017, to $171 at June 2018, to a deficit of $4,642K compared. This is a $19.7M change. I recognize approximately $11M of the change was finally recording the OPEB obligation on the Town's books. In the absence of an explanation of this in the CAFR, this seems to imply the Town's financial flexibility is declining. The CAFR should address the implications of what this decline means.

2) The following Table show information from the Statement of Activities on page 39 for 2019 compared to similar information from the two prior year CAFRs.

Total Government Activity	2017	2018	2019
Expenses	Don't have	43,039	44,236 ***
Less Program Revenues, primarily charges for services	Don't have	14,236	13,673
Net Expenses	26,845	28,803	30,563***
General Revenues	29,134	29,539	34,914
Excess Revenue over Net Expenses	2,289	736	4,351 ***

*** 2019 Expenses and Net Expenses would have been $3.7M higher, and Excess of Revenue over Net Expenses would have been only $.651M if GASB 84 was not adopted

It is troubling that Net Expense has increased from $26,845 in 2017 to $34,263 (27.6% increase) before adoption of GASB 84, while General Revenues increased only 20%. Furthermore, the increase in General Revenues is due primarily to increased Property Tax Revenue. It appears the Town is dependent on increasing future property tax revenues to fund the growing costs of government activities. It is unlikely real estate values can continue to increase at the rate they have for the last 3 plus years.

3) The Net Liabilities for Pension and OPEB obligations increased over each of the last 3 years as indicated below in spite of making significant contributions to the OPEB unfunded liability and a strong stock market.

Information on page 43 of the unfunded liability compared to similar disclosures in the prior CAFR's

Year	Combined Unfunded Liability
2019	$63.7M
2018	$61.7M
2017	$45.7M

In spite of all the Town is doing to pay down the liability, it is not making progress, other than to say "it could have been worse". IMHO, the Town needs to begin to consider other options to reduce these obligations.

4) Note 9-Employees' Retirement Plan—The Summary of the Pension accounts you added at the beginning of this footnote is helpful. Thank you. And here are other comments using the information in this footnote:

- The Summary indicates Pension expense is $9,088K. When coupled with the OPEB Expense of $1,883 in Note 10 on page 87, total Pension and Healthcare benefit costs are $10,971K. (This compares to a total cost of $9,829K in 2018, an increase of 11.6%). The $10,971K total cost for 2019 represents 24.8% of the Town's total departmental costs of $44,236K per page 23. Per Note 10 on page 86 it appears that employees pay nothing for the current medical benefits. I find this startling with the rising costs of benefits.
  - The Town's significant cost of benefits consistent is with the conclusions reached in January 2018 report by the League of California Cities, <u>Retirement System Sustainability Study and Findings</u>, that benefits "are at unsustainable levels".
  - IMHO, the agreement of the bargaining units in the last labor negotiations to reduce OPEB benefits for new employees was similar to the employees conceding the "sleeves off their vest" in the negotiations. They gave away the benefits for the people they want the Town to hire to help them to fulfill their job responsibilities. IMHO, it is misleading for the Town to call the recent "concession" a major win. It creates future problems for the next Town Staff and Town Council.
- The table of General Information about Employees' Retire Plan on the Page 77 indicates shows the required payment of unfunded liability for Miscellaneous and Safety plans is $1,998K and $1,197K respectively. These payments increased 17.5% and 27.9% over the 2018 required payment. This is another indication that these type of cost increases are not sustainable.
- The schedule of Employees Covered by pension plans on page 77 shows 666 employees covered between the Miscellaneous and Safety Plan, with only 150 active employees. This compares to

625 employees covered and 151 employees in the equivalent 2018 Table. This reflects an increase of 41 employees covered but with 1 less active employee. Retired employees increased from 287 in 2018 to 315 in 2019, a 28 person increase. This is an example of why CALPER's in their June 30, 2018 Valuation Report classified Los Gatos' Pension Plan a "high risk" plan.

- Note 9 (b) under Actuarial Assumptions on page 78 shows a COLA adjustments of 2.0% and 2.5%. The similar numbers in 2018 were 2.75%. Were their changes in the COLA?

From: Ronald Dickel <rondickel@gmail.com>
Sent: Monday, December 9, 2019 8:57 AM
To: Stephen Conway
Cc: Gitta Ungvari; Arn Andrews; Jak Vannada; Phil Koen
Subject: Tonight's Finance Meeting

Steve

Phil Koen submitted many emails to you for tonight's meeting, but is unable to attend. He summarized his questions/concerns into five points below. Given the effort Phil has put into reviewing the financials, I would like you to discuss these questions tonight at the meeting. I look forward to seeing you at the meeting tonight.

Ron

There are 5 material issues that need to be addressed. They are as follows:

1) Fix the schedule on page 23 to properly reflect the early adoption of FASB 84. The FY 2018 results need to reflect the retrospective implementation. I have sent an email showing the adjustments to be made.

2) Correct the original budget number on page 29 to agree to page 46

3) Conform the explanation of the $4.3m increase in net position on page 21 to the explanation given on page 18. Also correct the $5.6m to $5.1 reported on page 38.

4) Explain why the impact of adopting GASB 84 which reduced the FY 2019 budget by $3.5m is not reflected on the schedule on page 29. This goes to the heart of the question as to when did the Staff decide to adopt GASB 84 and why didn't they inform the Council of the material budget impact. At the mid-year budget review which occurred on February 19, 2019 there was no mention or even hint of GASB 84 and the budget impact. In fact the Staff insisted that the FY net revenues would only exceed operating expenses by $429k. You can see what actually happened. This lack of transparency is materially hurting the Town.

5) Define "balanced budget" as used on page 32. How can this be confirmed. What are the specific one time uses that are being funded by drawing down reserves. How can this be confirmed. I personally find this narrative as potentially misleading for the reader and it needs to be confirmed.

There are more but for the sake of time these are my 5 biggest issues.