



**TOWN OF LOS GATOS
FINANCE COMMISSION REPORT**

MEETING DATE: 07/12/2021

ITEM NO: 9

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

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:

Reserve for Market Fluctuations	Reserve Balance As Reported on FYE CAFR
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.



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ITEM NO: 9

DESK ITEM

DATE: July 12, 2021
TO: Finance Commission
FROM: Laurel Prevetti, Town Manager
SUBJECT: Review of Market Fluctuation Reserve

REMARKS:

Attachment 1 contains public comment received after the July 8, 2021 distribution of the staff report.

Attachment received with this Desk Item:

Attachment 1 – Public Comment

PREPARED BY: Arn Andrews
Assistant Town Manager

Reviewed by: Town Manager

From: Phil Koen [REDACTED]
Sent: Saturday, July 10, 2021 10:27 AM
To: Ron Dickel [REDACTED]; Kyle Park [REDACTED]
stacey.del [REDACTED] loreen [REDACTED] ricktinsley [REDACTED] Rob Rennie
<RRennie@losgatosca.gov>; Matthew Hudes <MHudes@losgatosca.gov>
Cc: Laurel Prevetti <LPrevetti@losgatosca.gov>; Arn Andrews <aandrews@losgatosca.gov>;
jvannada [REDACTED] Lee Fagot [REDACTED]
Subject: Market Fluctuation Reserve - Agenda Item #9

Finance Committee Members,

GASB 72 "Fair Value Measurement and Application" requires the Town's investments to be recorded at fair value. This is disclosed in Note 1 of the CAFR. Accordingly, the change in fair value of investments is recognized as an increase or decrease to investment assets and investment income as of the balance sheet date. Historically the Town's fair value of investments has closely approximated original cost.

For FY 2020, the Town recorded \$1.2m (total investment earnings was \$2.4m) as investment earnings resulting from fair value measurement. The Staff memo discusses the need to segregate these earnings in the Town's General Fund Market Fluctuations Reserve to avoid having these earnings potentially flowing to the Town's Reserve for Capital and Special Projects. This is a reasonable approach.

However, the Staff memo does not disclose that since recording the \$1.2m in unrealized investment gain as of June 30, 2020, the fair value of investments as of March 31, 2021, has decreased by \$576k to \$642k. Assuming no change for the remainder of the current fiscal year, this will result in a \$576 loss in investment income being recorded for FY 2021. This loss will eventually flow to the General Fund Reserve which will reduce the Market Fluctuation Reserve.

The important point is to remember that fair value measurement will create "unrealize" gains and losses at the time of measurement which are then reported in the Statement of Activities as investment earnings. The only way to prevent the "whip saw" impact on investment valuations and earnings is to actually monetize the "unrealized" gain. If the Town had sold the investments which had increased in market value, the gain on the sale would be turned into cash and Town would have realized a true gain of \$1.2m. Barring any other concerns, this would have been a reasonable action to take, rather than to continue to hold the investment until maturity and have the market value gain disappear as the bond values approach par value.

Please let me know if you have any questions.

Phil Koen