Subject: Comments of CAFR

From: Phil Koen <pkoen@monteropartners.com>
Sent: Monday, December 7, 2020 10:22 AM
To: Laurel Prevetti <LPrevetti@losgatosca.gov>
Cc: Marico Sayoc <MSayoc@losgatosca.gov>; Rob Rennie <RRennie@losgatosca.gov>; Stephen Conway <sconway@losgatosca.gov>; Terry Duryea <[redacted]>; Ron Dickel <[redacted]>; Rick Tinsley [redacted]>; [redacted]
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Hello Laurel,

Due to a conflict I will not attend the Finance Committee meeting tonight, so I am sending you my written comments in advance of the meeting for your review and consideration. I have also copied the Finance Committee members on this email.

Since perhaps not all members of the Committee are equally versed in the reporting requirements outline by GASB 34 for the MD&A section of the CAFR, I have attached a brief background piece that discusses those reporting requirements and the linkage to the transmittal letter. Hopefully, everyone will find this educational and helpful.

In an effort to be constructive I have taken the time to redraft the Financial Highlights section of the MD&A with the goal of providing a balanced discussion of both the positive and negative changes from prior year and to provide more disclosure regarding a) the negative unrestricted net position, b) the Town's net pension liability and the cost of the pension plans, and c) the trend in government-wide revenue and expenses. Please note that I have broken the Highlights into a section that discusses Government-Wide results vs. Fund Level results. The current draft does not make that distinction clear.

I am aware that members of the Finance Committee have already shared their comments with you, many of which I agree with. Not wanting to duplicate those comments, I will focus on my top four concerns.

Unrestricted Net Position
On page 18 of the CAFR an explanation of the $675k decrease in the negative unrestricted net position is provided. I do not agree with the explanation and would ask that the auditors to confirm the explanation. At a high level, the improvement was due to a slightly larger year over year increase in spendable assets and deferred outflows versus the increase in total liabilities and deferred inflows. I am not of the opinion that use of restricted cash to invest in infrastructure is the cause for the slight improvement in unrestricted net position. Additionally, I think it is important to fully disclose that a negative unrestricted net position indicates that the Town does not have sufficient assets to meet its long-term obligations such as the pension and OPEB plans as of the end of the fiscal year. As pointed out in the CAFR, this is not an uncommon occurrence when governments overly rely on a pay-as-you-go model vs funding the accrued liability. Having a negative unrestricted net position is not a positive financial metric and should not be minimized.

Total Net Pension and Deferred Outflows
In the transmittal letter the Town mentions that the net pension liability is $57.2 million and the OPEB net liability is $9.1 million. I would suggest that all comments regarding the pension and OPEB liabilities be moved from the transmittal letter to the Highlights section of the MD&A and further comments provided. For example, there is no discussion in the Highlights section that the ADP of $4.8 million discussed in the transmittal letter is included in the Deferred Outflows

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and accounts for the entire increase in Deferred Outflows from prior year. Additionally, there is no disclosure that total pension and OPEB expense in the government-wide expenses totaled $12.6m and increased 14.6% from prior year. The rate of increase in pension and OPEB expenses relative to the rate of increase in Government-wide total revenues (which grew only 1.1%) has a material impact on the Town's long-term financial health. There needs to be more discussion regarding the recent trends and expected future trends.

Economic Factors, trends affecting the forecasted fund balance and Footnotes 15 and 16
The CAFR discusses the impact of COVID 19 on the Town's financial position in footnote 15. Specifically, it discusses that sale tax and TOT receipts **decreased** in FY 20 from FY 19 **actual levels**. However, the CAFR is confusing in its discussion of the budget for FY 21 and potentially misleads the reader into thinking that the FY 21 budget is conservative in its revenue forecast. Specifically, on page 35 the CAFR discusses that both sales tax and TOT receipts were budgeted to reflect decreases from "**prior year's adopted**" budget, not prior year's actual results. While on the surface that sounds conservative, however, the FY 21 approved budget for both revenue streams represent an **INCREASE** from FY 20 actual levels. In the case of sales tax, the increase is approximately $400k, and for TOT receipts the increase is also approximately $400k. Given the prolonged impact of COVID 19 on the local economy, it is highly unlikely that these budgets are to be achieved and it is more likely than not there will be material shortfall from the adopted budget for both tax receipts.

Footnote 15 goes on to mention that the budget identified "contingences should revenues come in below projected amounts" and that the "Town is carefully monitoring actual revenues and expenditures". While that might indeed be the case, the footnote should disclose what those "contingences" are and should also provide the reader with some insight into the likelihood of such contingences being acted upon. I am not aware of any actual revenues or expenditures for Q1 FY 21 being published, so there is no context for the reader to judge the conditions that are expected to have a significant impact on the current year results from operations and financial position.

My concern is further heightened when footnote 16 is taken into consideration. Footnote 16 warns the reader that there could be an additional $1.2 million negative impact on the FY 21 operating results arising from the claw back of RDA distributions and ERAF distributions. When we combine this with the highly likely shortfall in sales and TOT receipts, the Town could be facing at least $2.0 million in known potential FY 21 revenue shortfalls. Please note that this does not include other COVID sensitive revenue streams such as permits and fees, and business licenses and it also assumes that sale tax and TOT receipts are equal to prior years. How the Town plans to address a potential material shortfall in revenue should be discussed in the CAFR.

General Fund Unassigned Fund Balance
Again, in FY 20, the Staff has classified the entire general fund balance of $29.3 million into restricted, committed and assigned fund balances, choosing not to keep any of the general fund balance as unassigned. I believe this misleads the reader into thinking that the assigned fund balances are truly assigned. History has shown that whenever a budget expenditure adjustment is proposed which needs resources to fund, the Staff has pulled such funding from the Capital/Special Projects assigned fund balance. The Capital/Special Projects fund balance has been used to fund everything from incremental headcount, on-going tree trimming services and engineering consultants in addition to funding the Capital Improvement Fund.

GASB 54 addresses the fund balance distinctions. When funds are "assigned", the government is setting these funds aside for the specific purpose identified. This indicates to the reader that the resources are at a minimum intended to be used for that purpose. In the case of the Capital/Special Projects footnote 8 in the CAFR states, "the Capital/Special Projects assigned fund balance will be used for the acquisition and construction of capital facilities as well as special projects or activities as directed by the Town Council."

Given the history of using this fund balance to routinely provide resources for budget expenditure adjustments, I recommend that some amount of the General Fund balance, perhaps $2 million, remain "unassigned". This will indicate to the reader that these funds are available to the Council to be used as directed and improves the integrity of the

Capital/Special Projects assigned balance. If you look at many cities in Santa Clara county, most have some amount of the General Fund balance as “unassigned”.

There is one other point that should be made while we are discussing fund balances. The resolution passed in June 2020 which approved the fund balance under GASB 54 specifically established a Surplus Property Revenue General Fund Reserve to receive the monies from the sale of surplus property and assigned approximately $1.2 million to the Surplus Property Reserve as of the closing of FY 20. That reserve does not appear in the General Fund balance sheet presented in the CAFR. Instead there is a new assigned fund balance called “Market fluctuations”. There is no explanation in the CAFR about this change nor the intent of the “market fluctuations” assigned fund balance. Furthermore since the Surplus Property Revenue General Fund Reserve was established by a Council Resolution which would indicate that the reserve is a “committed reserve” like the budget stabilization and catastrophic reserves, I am not sure that the Staff has the power to change this fund designation to a “assigned” fund balance. I am under the impression that only a Council resolution can reassign monies from a committed to an assigned fund balance. This point needs to be closely examined.

Thank you for considering the above. I apologize for the length of this email, but getting the CAFR correct is very important.

Phil Koen