Office of the City Auditor

ACTION CALENDAR
February 23, 2016

To: Honorable Mayor and Members of the City Council

From: Ann-Marie Hogan, City Auditor

Subject: Audit Report: General Fund Reserve Policy Fails to Convey that Maintaining the Reserve is a Priority

## RECOMMENDATION

We request that City Council agree to implement our recommendation to amend the general fund reserve policy, and that City Council request that the City Manager report back by November 29, 2016, and every six months thereafter, regarding the status of all four of our audit recommendations, until fully implemented.

## CURRENT SITUATION AND ITS EFFECTS

Berkeley's general fund reserve policy lacks all of the core elements recommended by the Government Finance Officers Association (GFOA). The lack of an effective policy for its general fund reserve, sometimes referred to as a "rainy day fund," jeopardizes the City's ability to continue operations and provide much-needed services and programs during a crisis, such as an earthquake or significant economic decline. The City's target reserve level of 8 percent is less than half the reserve level of 16.7 percent recommended by the GFOA. The GFOA further recommends a robust policy that addresses the specific circumstances under which the reserve can be tapped and for what purpose, the authorization required to access the reserve, and the method and timing of the reserve's replenishment when it dips below its target level. The City's current policy, which consists of "building a prudent reserve," contains none of these elements. The City can better prepare itself to weather periods of economic uncertainty and continue to provide much-needed services during catastrophic events by establishing a well-developed general fund reserve policy that incorporates GFOA's recommendations:

- Amend the general fund reserve policy to align it with best practices. This includes increasing the level to at least a minimum of 16.7 percent, designating specific portions of the reserve for contingency and stabilization purposes, and defining the use and replenishment of the funds.
- Perform a risk assessment to determine the appropriate general fund reserve level.
- Use visual aids and definitions in the City's budget reports to improve transparency and clarity of the general fund reserve.

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## FISCAL IMPACTS OF RECOMMENDATION

While the City of Berkeley has successfully navigated prior periods of economic uncertainty, we do not know what challenges the future holds. However, we do know what happens when local governments are not financially prepared to contend with such uncertainty, as evidenced by the municipal bankruptcies that followed in the wake of the Great Recession. We have recommended that the City adopt GFOA best practices with regard to the general fund reserve. Many of these practices have already been adopted by other cities. The extent to which Berkeley embraces these best practices will determine its ability to provide a stable and functioning government during future periods of economic uncertainty.

## BACKGROUND

The general fund reserve, or “rainy day fund,” ensures government’s ability to maintain vital services to the community during times of economic uncertainty, while avoiding the need to increase taxes. The issue of the general fund reserve gained greater immediacy in the aftermath of the Great Recession and the municipal bankruptcies that followed. In response, local governments, including the cities of San Diego, Hayward, and San Jose, as well as the State of California, have sought to strengthen their reserve policies. Berkeley has yet to follow suit.

## ENVIRONMENTAL SUSTAINABILITY

Our office manages and stores audit workpapers and other documents electronically to significantly reduce our use of paper and ink. Although many of the audits we issue do include information about specific environmental impacts, this particular report has no identifiable environmental effects or opportunities associated with it.

## RATIONALE FOR RECOMMENDATION

Implementing our recommendations will assist the City Manager and City Council in maintaining the general fund reserve at sufficient levels to ensure the City’s ability to sustain vital services to the community during periods of economic uncertainty.

## CONTACT PERSON

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Attachment:
1: Audit Report: General Fund Reserve Policy Fails to Convey that Maintaining the Reserve is a Priority

# City of Berkeley
# Office of the City Auditor

## General Fund Reserve Policy Fails to Convey that Maintaining the Reserve is a Priority

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Presented to Council February 23, 2016

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## General Fund Reserve Policy Fails to Convey that Maintaining the Reserve is a Priority

**February 23, 2016**

## Purpose of the Audit

Our audit answers the question: Is the City's general fund reserve policy in line with best practices and what is needed to ensure the general fund reserve will allow the City to mitigate current and future financial risks?

## Executive Summary

**City's general fund reserve policy well below *minimum* recommended level**

Berkeley's general fund reserve policy lacks all of the core elements recommended by the Government Association of Finance Officers. The City's target reserve level of eight percent is less than half the reserve level of 16.7 percent recommended by the Government Finance Officers Association (GFOA). Further, the GFOA cautions that 16.7 percent is the *minimum* reserve level recommended and that this percentage does not take into consideration the existence of extraordinary risks, such as the fact that Berkeley is situated on a major earthquake fault. The GFOA also explains that the reserve should be distinctly separate from set-aside funds, that is, money assigned for planned projects, such as unfunded liabilities and infrastructure and technology investments. The general fund reserve is not meant for such needs.

**General fund reserve is distinctly separate from and in addition to set-side funds**

In addition to setting an appropriate reserve level, the GFOA recommends a robust policy that addresses the specific circumstances under which the reserve can be tapped and for what purpose, the authorization required to access the reserve, and the method and timing of the reserve's replenishment when it dips below its target level. The City's policy, which consists of "building a prudent reserve," contains none of these elements. As a result, the rather minimalist policy does not provide City management the guidance and tools necessary to effectively manage the reserve. This in turn has led to the general fund reserve being used, or targeted for use, for ongoing or new programs, which is not the intent of the reserve.

**General fund reserve has gained immediacy among local governments in the wake of the Great Recession**

The issue of the general fund reserve has gained immediacy among local governments in the wake of the Great Recession and the succession of municipal bankruptcies that followed. In response, local governments have taken steps to strengthen their general fund reserve policies. The time for building the reserve is during "these fleeting good times" commented a California State official recently, in reference to a positive economic report.[1] While the San Francisco Bay Area continues to enjoy the benefits of a booming economy, the prospect of a return to economic uncertainty looms on the horizon.

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[1] Mercury News, November 9, 2015, "Legislative Analyst's Office: California's budget is strong; surpluses are likely": http://www.mercurynews.com/california/ci_29135020/legislative-analysts-office-californias-budget-is-strong-surpluses

**Economic downturn expected to result in deficit spending in 2018 and 2019**

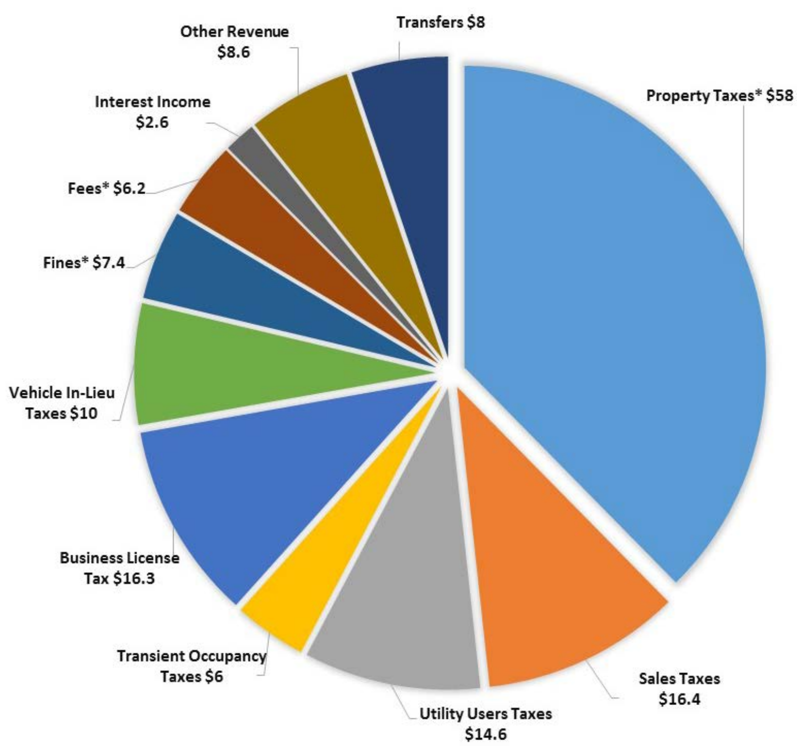
The City projects an economic downturn in 2017 that will result in deficit spending in fiscal years 2018 and 2019. The projection is based mainly on historical patterns; however, there are indicators that the domestic and global economies will be entering a period of recession. These include the slowdown in economic output in emerging markets, China in particular, and the probability that the tech-driven housing bubble in the San Francisco Bay Area is reaching unsustainable levels, and will soon burst. The GFOA warns local governments of the need to manage resources during an era of increasing economic uncertainty. The governments that will fare best will be those that anticipated economic uncertainty by developing adequate resources.

## Recommendations

Our recommendations will provide the City Manager and City Council the impetus to establish a well-developed general fund reserve policy that will enhance the City's ability to weather periods of economic uncertainty and continue to provide much-needed services:

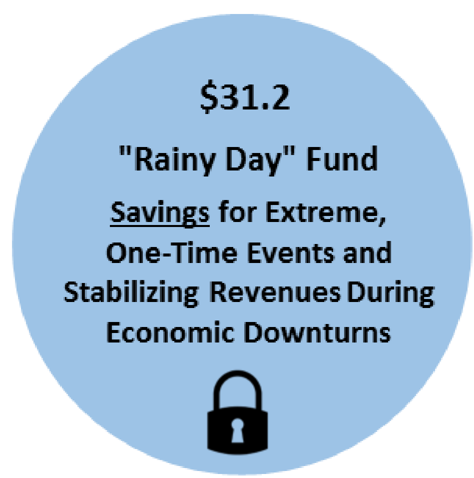
- Amend the general fund reserve policy to align it with best practices. This includes increasing the level to at least a *minimum* of 16.7 percent, designating specific portions of the reserve for contingency and stabilization purposes, and defining the use and replenishment of the funds.
- Perform a risk assessment to determine the appropriate general fund reserve balance.
- Use visual aids and definitions in the City's budget reports to improve transparency and clarity on the general fund reserve.

FY 2015 Adopted Revenue for Planned Expenditures
(In Millions)




*Property taxes include secured, unsecured, supplemental, and transfer taxes; fines include parking and moving violations; fees include ambulance and franchise fees.

Beginning FY 2015 General Fund Reserve
(In Millions)




The general fund reserve is ***separate from the revenue pie***. Pieces should be taken from the reserve pie only when needed to cover sharp revenue declines during economic downturns or to cover unplanned expenditures from extreme, one-time events.

## AUDIT OBJECTIVE

Our audit asks the question: Is the City's general fund reserve policy in line with best practices and what is needed to ensure the general fund reserve will allow the City to mitigate current and future financial risks? We included this audit as part of our fiscal year 2016 Audit Plan[2] because we recognized a need to provide clearer information on why establishing a stronger general fund reserve is crucial to the City's long-term fiscal health and its ability to continue to provide much needed services during economic downturns.

## BACKGROUND

### "Rainy Day" general fund reserve: Preparing for economic winter

The general fund reserve, sometimes referred to as a "rainy day fund," ensures government's ability to maintain vital services to the community during times of economic uncertainty, while avoiding the need to increase taxes. The concept of the "rainy day fund" dates back to antiquity. Nearly 3,000 years ago, the Greek writer, Aesop, penned his cautionary tale of the "Grasshopper and the Ant," wherein the frivolous grasshopper fritters away the summer months at play, while the industrious ant labors to store up enough food for the coming winter. When winter finally arrives, the grasshopper is caught unprepared and starves. More recent cautionary tales are found in the unprecedented string of municipal bankruptcies that followed in the wake of the Great Recession, including Stockton, California (2011), San Bernardino, California (2012) and finally, Detroit, Michigan (2013), the largest municipal bankruptcy in American history. While each was a unique event, they all shared in common the untimely depletion of their general fund reserve, which left them ill-equipped to weather their respective economic winters.

[2] Fiscal Year 2016 Audit Plan: http://www.cityofberkeley.info/uploadedFiles/Auditor/Level_3_-_General/RPT_City%20Auditor%20Fiscal%20Year%202016%20Audit%20Plan_102715(1).pdf

Threat of domestic and global recessions puts California jobs and revenues in jeopardy

While California, and the San Francisco Bay Area in particular, are enjoying the benefits of a booming economy, the prospect of another economic recession looms on the horizon. In its Fiscal Year 2016 and 2017 Budget Proposal, the City projects an economic downturn in 2017 that will result in deficit spending in fiscal years 2018 and 2019. While the projection is based mainly on historical patterns, there are indicators that the domestic and global economies will be entering a period of recession. These include the slowdown in economic output in emerging markets, China in particular, and the probability that the tech-driven housing bubble in the San Francisco Bay Area is reaching unsustainable levels and will soon burst. Exacerbating this eventuality is the expectation of a severe winter driven by an "El Nino" effect projected to be of historic proportions, along with the ever-present probability of a major earthquake along the Hayward-Rodgers Creek Fault.

**GFOA warns local governments to be prepared in an era of increasing economic uncertainty**

The Government Finance Officers Association (GFOA) represents public finance officials throughout the United States and Canada. Founded in 1906, its mission is to enhance and promote the professional management of governmental financial resources, which it accomplishes, in part, by providing best practice guidance. In 1990, the GFOA warned local governments of the need to maintain a sufficient fund balance reserve in an era of increasing economic uncertainty.[3] At the time GFOA issued its research bulletin, there was little guidance available to finance officers on the subject of unrestricted reserves. However, the association foresaw that, as economic conditions worsened, a growing number of local governments would find themselves in an increasingly difficult financial position. The governments that would fare best would be those that anticipated economic uncertainty and developed adequate resources to respond to that uncertainty when it arose.

[3] The GFOA addressed local governments' need for a sufficient reserve in its Research Bulletin, "Unreserved Fund Balance and Local Government Finance, issued November 1990. The general deterioration of state and local governments' fiscal position in the late 1980's was the contextual backdrop for the research bulletin.

Governments strengthened reserve policies in the wake of the Great Recession

The issue of the general fund reserve gained greater immediacy in the aftermath of the Great Recession and the municipal bankruptcies that followed. In response, local governments sought to strengthen their reserve policies. In 2015, the City of Hayward revised its general fund policy to raise its reserve level from 15 to 20 percent of general fund expenditures. The City of San Diego raised its reserve policy level from 8 to 14 percent of general fund revenues in 2014. In March 2015, the San Jose City Auditor issued an audit report on San Jose's general fund reserve and recommended that the City strengthen its reserve policy to bring it in line with GFOA best practices. Finally, in 2014, the voters of California approved Proposition 2, which strengthened the State's "rainy day fund" by setting aside 10 percent of total general fund revenues for the general fund reserve.

California voters supported stronger reserve level for state

The general fund is considered the government's chief operating fund. The City of Berkeley's general fund comprises nearly half of the City's $300 million-plus budget, the majority of which is allocated for public safety. It is the natural home for the fund balance reserve for two reasons: (1) Its funds are unrestricted, that is, the general fund can be used to support all government functions. By contrast, special funds, such as the Zero Waste, Permit Center, Sewer, and Library funds, are restricted in use to supporting only their respective operations; (2) the revenues that support the general fund, for example, sales tax, property tax, business license tax, and hotel tax, are more sensitive to fluctuations in the economy. That is, revenues from these sources are likely to fall during a slowing economy. Ergo, the need for a financial cushion in the general fund to draw upon during times of economic uncertainty.

General fund is the natural home for the reserves

## Berkeley general fund reserve level set at 8 percent of general fund revenues

The City's general fund reserve policy consists of "building a prudent reserve," and is reflected in the Proposed Biennial Budget as one of nine fiscal policies adopted by the City Council. The City currently defines a prudent reserve as eight percent of gross general fund revenues. The purpose of the reserve, as reflected in the Biennial Budget, is to provide "flexibility to address one-time priority programs, smooth out economic swings, buffer the loss of state and federal revenues, and support City operations in the event of a catastrophic event (such as an earthquake)."

Earmarked funds are **not** part of the general fund reserve

Governments will sometimes earmark funds to be set aside over a period of time for a specific purpose. These funds are not part of the general fund reserve. For example, the City of Berkeley is currently setting aside excess property transfer tax for the replacement of its aging financial management system, FUND$. These funds are not included in the City's general fund reserve. The GFOA explains that governments should treat the general fund reserve separately from set-aside funds and that the 16.7 minimum recommended level is in *addition to* any and all set-aside funds.

## FINDING AND RECOMMENDATIONS

### Finding 1: Reserve requirement well below recommended level and policy lacks all the core elements recommended by GFOA

Berkeley's general fund reserve policy lacks the core elements recommended by the Government Association of Finance Officers. Most of these core elements have already been adopted by other cities as best practices, including Hayward, Fremont, Atherton, San Diego, Lompoc, and Irvine, California; and Portland, Oregon. The City's current policy calls for a reserve balance equal to 8 percent of general fund revenues. The Government Association of Finance Officers (GFOA) recommends *minimum* reserve levels equal to two months of general fund operations, or 16.7 percent. The City's policy calls for a reserve balance less than half that *minimum* recommended level. Further, the GFOA recommends a robust policy that addresses not only the target reserve level, but also the specific circumstances under which reserves can be tapped and for what purpose, the authorization required to access those reserves, and the method and timing for replenishing reserves when funds are used. Berkeley's current policy contains none of these elements. As a result, City management lacks the guidance and tools necessary to effectively manage the reserve. Moreover, the message conveyed by this minimalist policy is that the protection of the reserve is not a priority, as evidenced by several recent attempts to use the reserve for other than its intended purpose. Without clear guidance and stronger policies, there is a danger that the reserve will not be available in sufficient strength when it is needed most.

**Berkeley's target reserve level only half of what is recommended**

In 2008, Berkeley raised its general fund reserve level from six percent of general fund revenues to its current level of eight percent, or enough to cover operations for about one month. However, even with this increase, the City's target reserve level remained at less than half the minimum reserve level of 16.7 percent recommended by GFOA. In its Fiscal Year 2010 and 2011 Adopted Biennial Budget, City management recommended to Council that Berkeley maintain a reserve balance of 10 percent. However, the policy remains at eight percent. City Council members have conveyed confidence that Berkeley's relatively reliable tax base will remain so into the future. While the City, historically, has had a reliable revenue stream from a diversified and stable tax base, the GFOA's recommended minimum balance already presumes a low-risk economic environment. Additionally, reliance on past stability is not an acceptable reason to forego preparing for the future. Any number of unknown events could greatly reduce the City's revenue stream. Having a stronger reserve balance and policy will allow the City to continue to maintain operations and provide programs and services in the event of a financial crisis or significant economic downturn.

A sizable reserve is the key to making it through a financial crisis with minimal disruption to services

Further, the entire premise of the general fund reserve is based on the concept of economic uncertainty, that is, what is presumed certain becomes uncertain. For example, the City of Hayward, in addition to being the namesake of the Hayward-Rodgers Creek Fault, suffered the greatest damage in the last big quake that occurred along that fault in 1868. The City of Berkeley also rests upon the Hayward fault. The United States Geological Service monitors this fault system because "the reality is a major quake is expected on the fault any day now." [4] The probability of another big quake along this fault is reflected in Hayward's general fund reserve level, which Hayward recently increased to 20 percent of general fund expenditures.

Berkeley sits on an earthquake fault expected to have a major quake "any day now"

[4] CBS San Francisco News, July 21, 2015, "USGS Scientist: Major Quake on Hayward Fault Expected 'Any Day Now'": http://sanfrancisco.cbslocal.com/2015/07/21/major-quake-on-hayward-fault-expected-any-day-now-fremont-earthquake/

GFOA recommends a risk-based approach to analyzing local risk factors

In determining the appropriate level for the general fund reserve, the GFOA recommends a risk-based approach and provides step-by-step guidance in analyzing those risks using these factors:

- vulnerability to extreme events and public safety concerns
- revenue source stability
- expenditure volatility
- leverage
- liquidity
- dependency of other funds on the general fund
- growth
- capital projects

GFOA provides risk-assessment tools to help determine appropriate reserve levels

The GFOA provides detail for each risk factor, as well as a risk-assessment template to assist governments in performing the analysis (see Appendix D). It would be incumbent upon management to conduct this analysis to determine the appropriate reserve level for Berkeley. The City reported that its fiscal year end 2015 general fund reserve balance was $26.9 million, or 16.9 percent of general fund revenues, which effectively brings the reserve in line with GFOA's recommended minimum balance.[5] However, without a revised policy in place, those funds would be vulnerable to appropriation for purposes for which the general fund reserve is not intended. That is, without a stronger policy, the general fund reserve could be misspent.

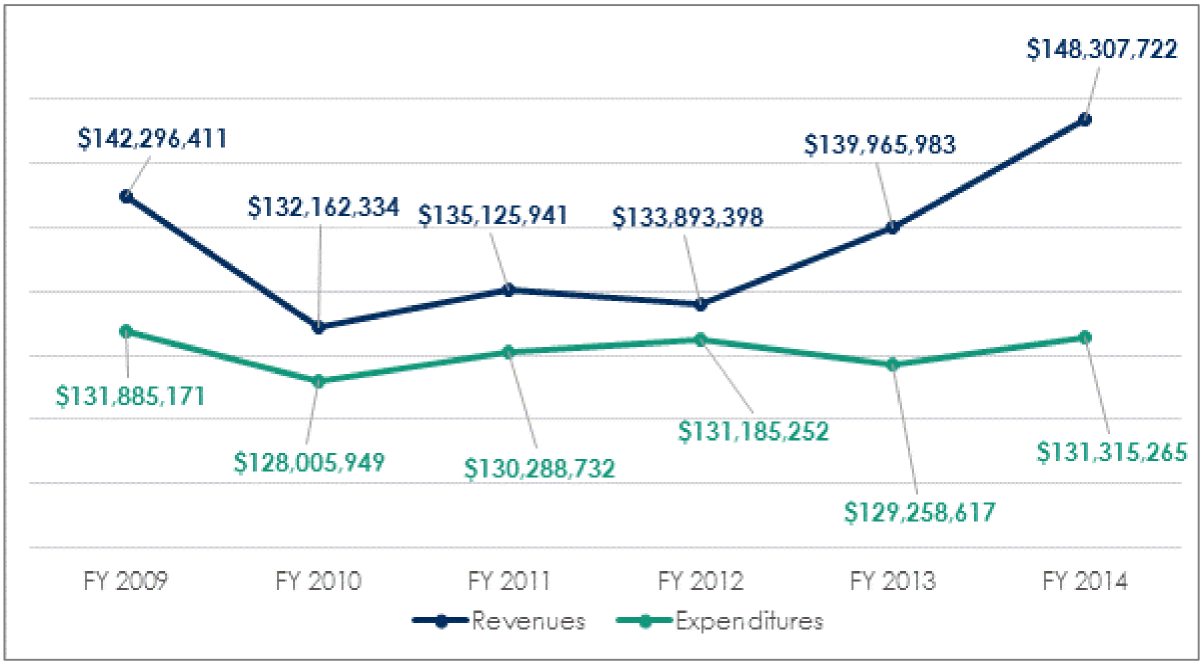
**Reserve should be based on which is more predictable: revenues or expenditures**

General fund reserve levels can be calculated on the basis of either general fund revenues or expenditures. The City of Berkeley determines its reserve level using general fund revenues. The GFOA does not recommend one method over the other, just that the local government choose the one that is the most predictable. We compared Berkeley's practice to seven other cities. We found that five used general fund expenditures and, like Berkeley, two used general fund revenues as the basis for the general fund reserve calculation. We saw no clear indicator as to why one method was preferred over the other.

[5] Fiscal Year 2015 Year-End Results and FY 2016 First Quarter Budget Update: https://www.cityofberkeley.info/Clerk/City_Council/2015/11_Nov/Documents/2015-11-17_Item_29_FY_2015_Year-End_Results.aspx

Our analysis of Berkeley's Comprehensive Annual Financial Report (CAFR) from fiscal years 2009 through 2014 indicates that, for the City of Berkeley, general fund expenditures were slightly more consistent from year to year than general fund revenues.

**City of Berkeley Actual Revenues and Expenditures**
**Fiscal Years 2009 to 2014**




**Source:** Berkeley's Comprehensive Annual Financial Reports Fiscal Years 2009 to 2014

Berkeley expenditures more stable than revenues over the last six years

Over the six-year period, total revenues increased by $6 million, or 4 percent, while total expenditures decreased by about $600,000 or 0.4 percent. Our analysis covers a relatively short timeframe and does not consider other factors that may influence the use of either revenue or expenditures as the basis for the general fund reserve. Further analysis by management is warranted in determining the most appropriate basis for calculating general fund reserves.

## Reporting and tracking of general fund reserve lacks transparency

Management reports on the status of the general fund reserve in the City's budget reports, primarily in the year-end reports. The trend over the past few years has been towards providing more information on reserve levels, which is a positive development. However, the information provided tends to leave the reader with more questions than answers. For example, the Fiscal Year 2013 Year End Review introduced the term "liquid reserve" when referring to the City's 12

Multiple terms used in relation to General Fund Reserves making it difficult to identify the true balance

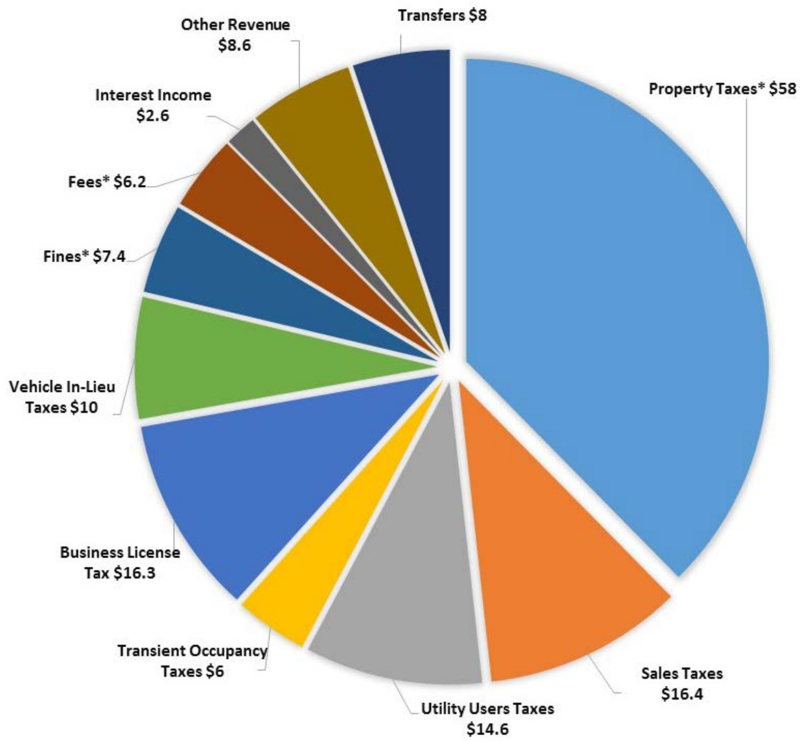
percent year-end reserve balance, which raises several questions: What is the definition of liquid reserve? Is there an illiquid reserve and, if so, what is the definition for it? Were prior fiscal year balances comprised only of liquid reserves for comparative purposes, or both liquid and illiquid reserves? The Fiscal Year 2014 Year End Review discusses both the general fund reserve balance and the general fund balance, and includes an analysis of the impact of operational savings and the carryover process on the general fund balance. Since the analysis touches upon both the reserve balance and the general fund balance, additional information is needed to ensure that the reader is able to distinguish the difference between the two terms. Without clear definitions as to the meaning of terms used, and a clear distinction between funds held in reserve, funds designated for use, and funds available for use, it is difficult to interpret the meaning of the figures provided. By simply providing a glossary of terms in the budget reports, City management could provide more clarity to its reserve balance and other funding designations (see Appendix C).

Budget reports do not include general fund reserve graphics, trend analysis, or forecasts

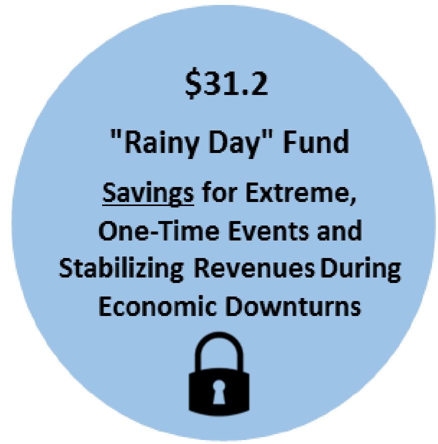
There is also a lack of transparency in the way the general fund reserve is presented. Figures for the general fund reserve are presented in isolation in the year-end reports, separate from any analyses of general fund revenues and expenditures. As a result, it is difficult to see the impact of general fund activity on the general fund reserve. For example, in its five-year forecast of the general fund, the City projects expenditures to outstrip revenues in fiscal years 2018 and 2019 as it bears the impact of the next recessionary period. However, there is no corresponding analysis to show the impact of this deficit on the general fund reserve. The end result is a somewhat opaque reporting practice. By contrast, the City of Hayward provides a detailed analysis of its general fund reserve in its general fund forecasts, including projected balances; target balances, per the general fund reserve policy; and whether the fund is on, above, or below target. Hayward also provides a graphic representation of its general fund reserve. Berkeley could similarly enhance its reporting by including analyses of its general fund reserve in its year-end budget reports and providing graphics that show the general fund reserve as funding that is distinctly separate from available revenue.

**General Fund Reserve: Distinct and Separate from Budgeted Revenue for Planned Expenditures**

Fiscal Year 2015 Adopted Revenue for Planned Expenditures In Millions




Fiscal Year 2015 General Fund Reserve Beginning Balance - In Millions




The general fund reserve is ***separate from the revenue pie***. Pieces should be taken from the reserve pie only when needed to cover sharp revenue declines during economic downturns or to cover unplanned expenditures from extreme, one-time events.

*Property taxes include secured, unsecured, supplemental, and transfer taxes; fines include parking and moving violations; fees include ambulance and franchise fees.

**Source:** Fiscal Year 2015 Year-End Results and Fiscal Year 2016 First Quarter Budget Update[6]

City budget reports do not distinguish between general fund *reserves* and general fund *balance*

The amount shown in the "Rainy Day" graphic above reflects the current reporting practice, which does not distinguish between the general fund reserve and the general fund balance. As a result, the amount includes not only reserve funds, but also unspent appropriations carried over from the prior fiscal year, as well as funds available over and above the reserve target level. Ideally, this number would reflect only available funds held in reserve for the reserve's stated purpose.

[6] FY15/FY16 Budget Update: https://www.cityofberkeley.info/Clerk/City_Council/2015/11_Nov/Documents/2015-11-17_Item_29_FY_2015_Year-End_Results.aspx

**Berkeley does not separate its reserves between emergency and stabilization needs**

In addition to minimum reserve levels, GFOA recommends defining the specific purposes for the reserve fund, describing the circumstances under which funds could be used, and assigning a portion of the reserve balance to those respective purposes. At a minimum, this should include a contingency (emergency) reserve and a stabilization reserve:

- *Contingency (Emergency) Reserve:* This reserve is for responding to extreme, one-time events, such as earthquakes, fires, floods, civil unrest, and terrorist attacks. The City of Portland reserves one half of its general fund reserve for its contingency reserve. The Town of Atherton's policy offers a range of 15 to 20 percent.
- *Stabilization Reserve:* Sometimes referred to as "bridge funding," the stabilization reserve is normally used to offset reduced revenues during a slower growth or recessionary period. The City of Portland reserves half of its general fund reserve for its stabilization reserve. The policy defines slower growth as below three percent for two consecutive quarters. It also requires one or more of the following conditions be met before triggering the use of the stabilization reserve: (1) local unemployment rate above 6.5 percent for two consecutive quarters, (2) property tax delinquency rate exceeds 8 percent, or (3) business license year-to-year revenue growth falls below 5.5 percent for two consecutive quarters.

Berkeley's Proposed Budget briefly discusses that the various purposes of the reserve are "to address one-time priority programs, smooth out economic swings, buffer the loss of state and federal revenues, and to support City operations in the event of a catastrophic event, such as an earthquake." However, there is no formal policy establishing a contingency or stabilization reserve, apportioning funds to the respective reserves, or defining the specific circumstances under which the respective reserves can be used.

**City has used the general fund for other than its intended purpose**

The City's lax policy has led to its use of reserve funds for purposes other than those considered appropriate under GFOA guidelines. For instance, in October 2013, the City used $2.4 million from the general fund reserve to write-off deficits in special revenue funds. In May 2015, the City used the general fund reserve to "forward fund"

Berkeley Unified School District programs to be funded by the City's newly implemented Sweetened Beverage Tax, aka Sugar Tax. Neither of these instances are considered an appropriate use of general fund reserves. While it may be acceptable to use the general fund balance for these purposes, using the general fund reserve is not, given that it is intended for stabilization and emergency needs. More recently, a number of proposals have been floated for using the reserves to fund new or ongoing programs. Incidents such as these Illustrate the need for the City to strengthen its reserve policy to ensure that the funds are only used for their intended purpose.

### Reserve policy does not define the authorization required to access reserve funds

The City's general fund reserve policy provides no guidance on authorization required to access reserve funds. GFOA recommends that the general fund reserve policy establish such authorization. The Town of Atherton, for example, requires a majority vote of Council, while the City of San Diego requires a two-thirds vote of Council. The City of Portland is stricter, requiring that the Council must declare an emergency by ordinance before drawing on its contingency reserve. Similarly, the State of California requires that the Governor declare a budget emergency before the State can dip into its "rainy day" fund.

### Reserve policy should address replenishment requirements

Once reserve funds have been depleted, it is important to have a plan in place to replenish those funds to ensure that funds will be available for future periods. Rebuilding reserves can be a long proposition. The City of New Orleans, in 2011, six years after Hurricane Katrina, was still faced with depleted reserves. The GFOA recommends that governments incorporate into their general fund reserve policy the intent to replenish fund balances as soon as economic conditions allow. Methods typically include the designation of one-time-revenues or budget surpluses toward replenishing the reserve. GFOA does not endorse one method over the other, but does recommend that funds be replenished within three years. The City of Fremont has adopted this best practice.

## Budget Office proactive in its use of best practice to replenish general fund reserves

Berkeley's general fund reserve policy does not address fund replenishment. Despite this fact, the Budget Office recently demonstrated an example of a best practice policy in its handling of the previously mentioned use of the general fund reserve to forward fund programs at the Berkeley Unified School District. The Consent Calendar item, dated May 12, 2015, stipulated the terms of replenishment, stating that proceeds from the Sugar Tax would be allocated to repayment until the general fund reserve was repaid.[7]

## Recommendations

Increase general fund reserves level and align policy with best practices

**The City Council should:**

1.1 Amend the general fund reserve policy, specifically, to increase the minimum level and align the policy with best practices:

- Raise the minimum level to 16.7 percent or higher, as warranted by risk analysis. See recommendation 1.2.
- Identify and clearly state the purposes for which the funds are intended.
- Identify and clearly state the purposes for which the funds are not allowed to be used, for example, to fund ongoing operations or to start new programs.
- Establish the method and timing for fund replenishment when funds dip below a certain, identified level.
- Establish the authorization required to access the funds, for example, two-thirds vote.
- Define the basis for establishing the reserve balance as either general fund revenues or general fund expenditures, depending on which is considered more appropriate for use in the calculation. See recommendation 1.3.
- Establish separate contingency (emergency) and stabilization reserves within the general fund reserve balance, and assign a portion of the general fund reserve for each.
- Clarify that the general fund reserve is distinctly separate from the general fund balance.

[7] May 12, 2015 Consent Item to forward fund Berkeley Unified School District programs and replenish use of the general fund reserve: https://www.cityofberkeley.info/Clerk/City_Council/2015/05_May/Documents/2015-05-12_Item_17_Allocate_$500,000.aspx

- Provide for transparency in the reporting of the general fund balance reserve. See recommendation 1.4.

**The City Manager should:**

Perform risk assessment to determine the appropriate reserve level

1.2 Perform a risk assessment to determine the appropriate general fund reserve level for Berkeley. Use the step-by-step guidance and risk-assessment template made available by the Government Association of Finance Officers to complete the analysis. Conduct this assessment regularly, for example, every five years, to determine if the reserve level should be increased or lowered (to no less than the minimum level). Report the results of the analysis to City Council for adoption of an amended general fund reserve policy, if necessary, to align it with current needs. See recommendation 1.1 and Appendix D.

Assess use of expenditures as basis for reserve

1.3 Assess whether the City should use general fund expenditures instead of general fund revenues as the basis for the general fund reserve calculation and, if so, amend the general fund reserve policy accordingly. See recommendation 1.1.

Make general fund reserve reporting more transparent

1.4 Improve the transparency of the City's general fund reserve reporting by:

- providing tables and charts that clearly depict the reserve balance;
- including trend analysis and forecasts, i.e., target projections; and
- explaining the different terms often used in the discussion of fund balances and reserves, for example, liquid, illiquid, and unreserved. See Appendix C.

## *City Manager's Response*

The City Manager agreed with the recommendations. The full response is at Appendix B.

## FISCAL IMPACT

**Failure to adopt stronger reserve policies could greatly compromise City services during periods of economic uncertainty**

Economic uncertainty is, by definition, uncertain. While the City of Berkeley has successfully navigated prior periods of economic uncertainty, we do not know what challenges the future holds. However, we do know the results when local governments are not financially prepared when faced with such uncertainty, as evidenced by the municipal bankruptcies that followed in the wake of the Great Recession. The Government Finance Officers Association has recommended prudent best practices with regard to the general fund reserve, many of which have been adopted by other cities. The extent to which the City embraces these best practices will determine its ability to provide a stable and functioning government during future periods of economic uncertainty.

## CONCLUSION

**General fund reserve policy falls far short of best practices**

The City of Berkeley's general fund reserve policy lacks the core elements recommended by the Government Finance Officers Association. The City's current target reserve level is less than half the minimum level recommended by Government Finance Officers Association (GFOA), which calls for a reserve large enough to cover general fund operations for two months. In addition, the policy does not fully address the specific circumstances under which the reserve can be tapped and for what purpose, the authorization required to access the reserve, and the method and timing for replenishing the reserve when funds are used, all core elements recommended by GFOA. Without these core elements, City management lacks the guidance and tools necessary to effectively manage the reserve. Moreover, the message conveyed by this minimalist policy is that the protection of the reserve is not a priority, as evidenced by several recent attempts to use the reserve for other than its intended purpose. To better prepare the City and its residents for future periods of economic uncertainty, the City Council and City management should work to develop a

City has not made establishing strong general fund reserve policies a priority general fund reserve policy that fully embraces GFOA recommended best practices. Doing so will allow Berkeley to maintain operations and provide programs and services in the event of a financial crisis or significant economic downturn.

**We appreciate the Budget Office's commitment to preserving the City's fiscal health**

We would like to thank the Budget Manager for her cooperation and assistance during this audit, and for requesting that we identify methods to improve the City's reserve policy. We appreciate her commitment to strengthening City policy and providing more transparency in budget reporting. We hope that this audit will lead to a stronger general fund reserve policy that will better protect Berkeley during a financial hardship and help provide clearer information to City Council and public about the need for sustaining a strong general fund reserve.

# APPENDIX A

## Scope and Methodology

We audited the City of Berkeley's general fund reserve policy and activities related to the general fund reserve during fiscal years 2010 through 2015. Specifically, we looked at reserve levels reported in the City's Year-End Review budget reports, which we compared to the City's reserve policy and Government Finance Officers Association's recommended best practices. We also identified instances in which the City had drawn from its fund reserve. We assessed the purpose for the use of those funds and what steps, if any, were taken to replenish the reserve. Additionally, we reviewed the general fund reserve policies of other cities to determine the extent to which they had adopted the Government Finance Officers Association's recommended best practices.

We met with the Budget Manager to gain an understanding of the City's general fund reserve policy and process for determining, monitoring, and reporting on the general fund reserve. We performed a risk assessment of internal controls in relation to the general fund reserve, and identified potential weaknesses should the City have an insufficient general fund reserve policy, fail to maintain a sufficient reserve balance, or use the funds for other than the intended purpose. We also reviewed:

- City of Berkeley Proposed Biennial Budget for Fiscal Years 2016 and 2017
- City of Berkeley Fiscal Year 2014 Comprehensive Annual Financial Report
- Government Finance Officers Association research and analysis article on the general fund reserve and the local government
- Articles and studies pertaining to municipal bankruptcies and the general fund reserve
- Articles and studies related to economic and other factors affecting the local economy

We obtained budgetary and financial statement data from budget reports and financial statement audit reports downloaded from the City of Berkeley website. We used the data to provide context and background information in our audit. We did not use the data to support our findings, conclusions, or recommendations; therefore, we did not perform data-reliability assessments.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

# APPENDIX B

## Audit Finding, Recommendations, and Management Response Summary

| Audit Title: General Fund Reserve Policy Fails to Convey that Maintaining the Reserve is a Priority | | | | | |
|---|---|---|---|---|---|
| **Finding and Recommendations** | | **Lead Dept.** | **Agree, Partially Agree, or Do Not Agree and Corrective Action Plan** | **Expected or Actual Implementation Date** | **Status of Outstanding Audit Recommendations and Implementation Progress Summary** |
| **Finding 1: Reserve Requirement Well Below Recommended Level and Policy Lacks all the Core Elements Recommended by GFOA** | | | | | |
| 1.1 | Amend the general fund reserve policy, specifically, to increase the minimum level and align the policy with best practices:<br>▪ Raise the minimum level to 16.7 percent or higher, as warranted by risk analysis. See recommendation 1.2.<br>▪ Identify and clearly state the purposes for which the funds are intended.<br>▪ Identify and clearly state the purposes for which the funds are <u>not</u> allowed to be used, for example, to fund ongoing operations or to start new programs.<br>▪ Establish the method and timing for fund replenishment when funds dip below a certain, identified level. | City Council | The City Manager's Office agrees with this recommendation. | Will report back on implementation status by November 29, 2016 | |

| Audit Title: General Fund Reserve Policy Fails to Convey that Maintaining the Reserve is a Priority | | | | | |
|---|---|---|---|---|---|
| | **Finding and Recommendations** | **Lead Dept.** | **Agree, Partially Agree, or Do Not Agree and Corrective Action Plan** | **Expected or Actual Implementation Date** | **Status of Outstanding Audit Recommendations and Implementation Progress Summary** |
| | ▪ Establish the authorization required to access the funds, for example, two-thirds vote.<br>▪ Define the basis for establishing the reserve balance as either general fund revenues or general fund expenditures, depending on which is considered more appropriate for use in the calculation. See recommendation 1.3.<br>▪ Establish separate contingency (emergency) and stabilization reserves within the general fund reserve balance, and assign a portion of the general fund reserve for each.<br>▪ Clarify that the general fund reserve is distinctly separate from the general fund balance.<br>▪ Provide for transparency in the reporting of the general fund balance reserve. See recommendation 1.4. | | | | |

| **Audit Title: General Fund Reserve Policy Fails to Convey that Maintaining the Reserve is a Priority** | | | | | |
|---|---|---|---|---|---|
| **Finding and Recommendations** | | **Lead Dept.** | **Agree, Partially Agree, or Do Not Agree and Corrective Action Plan** | **Expected or Actual Implementation Date** | **Status of Outstanding Audit Recommendations and Implementation Progress Summary** |
| 1.2 | Perform a risk assessment to determine the appropriate general fund reserve level for Berkeley. Use the step-by-step guidance and risk-assessment template made available by the Government Association of Finance Officers to complete the analysis. Conduct this assessment regularly, for example, every five years, to determine if the reserve level should be increased or lowered (to no less than the minimum level). Report the results of the analysis to City Council for adoption of an amended general fund reserve policy, if necessary, to align it with current needs. See recommendation 1.1 and Appendix D. | City Manager | The City Manager's Office agrees with this recommendation | Expected completion by September 30, 2016 | |
| 1.3 | Assess whether the City should use general fund expenditures instead of general fund revenues as the basis for the general fund reserve calculation and, if so, amend the general fund reserve policy accordingly. See recommendation 1.1. | City Manager | The City Manager's Office agrees with this recommendation | Expected completion by September 30, 2016 | |

| Audit Title: General Fund Reserve Policy Fails to Convey that Maintaining the Reserve is a Priority | | | | | |
|---|---|---|---|---|---|
| **Finding and Recommendations** | | **Lead Dept.** | **Agree, Partially Agree, or Do Not Agree and Corrective Action Plan** | **Expected or Actual Implementation Date** | **Status of Outstanding Audit Recommendations and Implementation Progress Summary** |
| 1.4 | Improve the transparency of the City's general fund reserve reporting by:<br>▪ providing tables and charts that clearly depict the reserve balance;<br>▪ including trend analysis and forecasts, i.e., target projections; and<br>▪ explaining the different terms often used in the discussion of fund balances and reserves, for example, liquid, illiquid, and unreserved. See Appendix C. | City Manager | The City Manager's Office agrees with this recommendation | Expected completion by November 29, 2016 | |

# APPENDIX C

## Glossary of Terms

The following terms are often used in relation to the general fund reserve. Although some, such as "designated," are no longer applicable by GASB[8] standards, they may be used during discussions of the general fund balance and reserve by those familiar with their historical use.

**Designated**: Prior to GASB 54, funds that were unreserved were classified as either designated or undesignated to indicate their degree of availability for use. Under GASB 54, unreserved funds are redefined as "unrestricted," and the levels of local government's self-imposed restrictions on these funds are, in descending order "Committed," "Assigned," and "Unassigned."

**Earmark/Set-aside**: Refers to the process of setting aside funds for a specific purpose, such as unfunded liabilities and infrastructure and technology investments. Often, this will include the use of one-time revenue or excess revenue.

**General Fund Reserve**: Refers to the portion of the general fund balance that is not restricted in use either by internal policy or by external sources, for example, federal law. The general fund reserve provides relief funding to respond to extreme, one-time events, such as an earthquake, or to continue to maintain services to the community during times of economic uncertainty.

**Illiquid Reserve**: Refers to the portion of the reserve that represents amounts due to the general fund. For example, grant program expenditures fronted by the general fund represent grants receivable. When departments request reimbursement for their program expenditures, the grant revenues will be used to reimburse the general fund.

**Liquid Reserve**: Refers to the portion of the general fund reserve that is available for use.

**Reserved**: Prior to GASB 54, funds that were restricted in use were classified as reserved.

**Restricted Fund Balance:** Refers to funds with legal restrictions that are externally enforceable. In the context of GASB 54, these are funds that can be spent for only specific purposes stipulated by constitution, creditors, or laws and regulations of non-local governments.

**Undesignated**: Prior to GASB 54, funds that were classified as unreserved were identified as either designated or undesignated to indicate their degree of availability for use. Undesignated funds would be the equivalent of "Unassigned" funds under GASB 54.

[8] The GASB is the independent organization that establishes and improves standards of accounting and financial reporting for U.S. state and local government: www.gasb.org

**Unreserved**: Prior to GASB 54, unrestricted funds were referred to as unreserved. Within that category, funds were classified as either designated or undesignated to indicate their degree of availability for use.

**Unrestricted Fund Balance:** Unrestricted funds, in the context of GASB 54, refer to all funds other than those classified as "Non-spendable" or "Restricted." The term unrestricted is somewhat of misnomer in that means that there are no external restrictions placed on funds, such as grant conditions or legislation that legally restrict the use of funds. Unrestricted refers to the fact that the government has discretionary use of the funds. Within this overall designation there are varying levels of restriction that local governments may place on the use of these funds. This includes funds that may be classified as "Committed," "Assigned," or "Unassigned." Committed refers to restrictions placed on funds at the highest level within the government, usually in the form a resolution or ordinance. Assigned refers to restrictions placed at the management level. Unassigned refers to all unrestricted funds that are neither Committed nor Assigned.

# APPENDIX D

# Government Finance Officers Association Guidance: Analyzing the General Fund Reserve Risk Factors[9]

**Vulnerability to Extreme Events and Public Safety Concerns**

*Identify Risks.* List out the major extreme events to which the community could reasonably be subjected. This could include both natural and man-made events. Public safety professionals may have a community disaster preparedness plan that could help identify these risks; linking the reserve analysis to such a plan would increase the credibility of the resulting policy.

*Assess Risks.* Consider the potential magnitude of loss for each event. The magnitude of loss should be based on past experiences with similar extreme events or reasonable estimates based on the disaster preparedness plan (note that the estimate is not necessarily a worst-case scenario).

*Identify Other Risk Mitigation Approaches.* If extreme events are a serious risk for the community, also consider risk transfer options. Might more comprehensive insurance coverage be a better option than very high levels of fund balance? If the source of risk is man-made, such as the potential for an accident at a hazardous chemical plant, might the chemical company be able to take greater responsibility for the risk they pose to the community? Also consider how quickly federal assistance can be accessed and the speed with which funds spent responding to a disaster might be reimbursed.

*Assess Necessity of Risk Retention.* Assign a score for the importance of risk retention through the use of reserves, when it comes to extreme events.

**Revenue Source Stability**

*Identify Risks.* Start by listing out major revenue sources.

*Assess Risks.* Consider the volatility of each source, based on factors such as past experience and trends with that revenue, characteristics of the tax or rate payers, and economic factors.

*Identify Other Risk Mitigation Approaches.* Think about other approaches that the government has to deal with declining revenues. This might include means to easily reduce variable costs or the ability to access other sources of funding.

[9] http://www.gfoa.org/sites/default/files/u63/GFOAFinancialPoliciesDoc4BGFReserveTargetCalcInstructions.pdf

*Assess Necessity of Risk Retention.* Assign a score for the importance of risk retention through the use of reserves, when it comes to revenue stability.

**Expenditure Volatility**

*Identify Risks.* Start by listing sources of potential spikes in expenditure (usually arising from special, non-recurring circumstances) that could be expected to occur within the next three to five years. Examples might include lawsuits against the government or critical special projects without a funding source. Typically, recurring sources of expenditure volatility, such as health care benefit costs, would not be included because they should be dealt with in the context of an annual budget process. An exception to this might be highly variable and difficult-to-predict costs, such as energy or fuel (in the case of a fleet).

*Assess Risks.* Enumerate a reasonable estimate of the potential cost of each source (i.e., the magnitude of the risk), taking into account the probability of it occurring (i.e., an unlikely event is less of a risk than a more likely event of similar potential loss).

*Identify Other Risk Mitigation Approaches.* Think about other approaches to dealing with these expenditure spikes. For example, the finance officer may find that some events (like an essential special project) have a very high chance of occurring, but will not occur for a number of years into the future. In this case, the finance officer could suggest a "sinking fund" where the project would be gradually funded over time. This could be made a commitment or assignment within the fund balance to help differentiate it from funds used to manage more uncertain risks. A similar approach could be used for known lawsuits.

*Assess Necessity of Risk Retention.* Assign a score for the importance of risk retention through the use of reserves, when it comes to expenditure spikes.

**Leverage**

*Identify Risks.* Start by listing major sources of leverage. Common examples include pensions, unfunded asset maintenance, and debt.

*Assess Risks.* Then assess each source's implications for the organization's future financial flexibility by consider the size of the obligation. Is the source of leverage very large? Does it have an off-setting funding source or asset?

*Identify Other Risk Mitigation Approaches.* It is often better to use other approaches to risk management on these sources of leverage, rather than retaining the risk through reserves. For example, if unfunded asset maintenance is a problem, then the finance officer might use an asset maintenance plan (or other suitable estimate) to demonstrate the magnitude of the risk and encourage the governing board to create a special set-aside to begin funding this liability – and avoid managing this risk with general fund reserves. In another example, if unfunded pension liabilities are an issue, the organization should develop a strategy to pay down those liabilities. In this situation, the finance officer could point out how pension liability constrains the financial flexibility of the organization, thereby decreasing the reserve's ability to manage other types of risk.

*Assess Necessity of Risk Retention.* Assign a score for the importance of risk retention through the use of reserves, when it comes to leverage.

**Liquidity**

*Identify Risks.* List major sources of intra-period cash imbalances. A good example is property taxes that are only received at one or two points during the year.

*Assess Risks.* Describe the size of the problem created by these sources of imbalance. Does it have the potential to significantly interfere with operations?

*Identify Other Risk Mitigation Approaches.* To what extent can tools like internal borrowing or tax anticipation notes provide a cost-effective alternative to keeping a reserve?

*Assess Necessity of Risk Retention.* Assign a score for the importance of risk retention through the use of reserves, when it comes to liquidity.

**Other Funds' Dependency**

*Identify Risks.* Start by listing other funds that have significant dependence on the general fund. Dependence will usually be indicated by regular operating transfers that are an unusually high percentage of the receiving fund's expenditure budget.

*Assess Risks.* Assess the level of reserves in these other funds. Are reserves low? If so, is this fund subject to potential risks that could require a substantial draw on reserves? If so, is the general fund expected to backstop this fund?

*Identify Other Risk Mitigation Approaches.* A major point for the finance officer to explore is whether the general fund should be "back stopping" these other funds in the first place. For example, an under-performing enterprise fund may be receiving operating transfers not because it is good public policy, but because the political will has not been mobilized to make the enterprise self-sufficient or to divest of it.

*Assess Necessity of Risk Retention.* Assign a score for the importance of risk retention through the use of reserves, when it comes to other funds.

**Growth**

*Identify Risks.* This factor is only relevant if significant growth is a realistic possibility in the next three to five years. Start by identifying major potential sources of growth.

*Assess Risks.* Estimate the potential marginal costs associated with serving new growth and compare it to marginal revenues (this information should be available from long-term financial plans and forecasts). If there is a gap due to significant timing differences between when revenue is received from growth and when expenditures are made on services for that growth, then reserve targets could be adjusted to account for that gap.

*Identify Other Risk Mitigation Approaches.* Special growth or impact fees could be assessed at the time of construction to avoid this risk. For example, if a new development is expected to generate $10M annually in new taxes starting three years in the future (but nothing before then), but costs $7M to service starting in two years, then a reserve (or impact fees) may be needed. If the gap between revenue growth and service expenditures is due to a structural mismatch between costs and revenues (i.e., the growth does not pay for itself), then the government should re-examine its tax-fee structures, service provision methods, and/or land use plans to correct this imbalance.

*Assess Necessity of Risk Retention.* Assign a score for the importance of risk retention through the use of reserves, when it comes to growth.

**Capital Projects**

*Identify Risks.* Use a capital improvement plan to determine if there are high priority projects without a funding source.

*Assess Risks.* Assess whether decision-makers might consider pay-as-you-go financing, using general fund reserves as at least part of the source.

*Identify Other Risk Mitigation Approaches.* If pay-as-you-go financing is something decision-makers might consider, then the finance officer may wish to broach the possibility of a commitment or assignment for the project so that pay-as-you-go financing does not detract from the general reserve's ability to manage other risks.

*Assess Necessity of Risk Retention.* Assign a score for the importance of risk retention through the use of reserves, when it comes to capital projects.

More about the Government Finance Officer Association's recommended analysis and risk-assessment template can be found at [http://www.gfoa.org/financial-policy-examples-general-fund-reserves](http://www.gfoa.org/financial-policy-examples-general-fund-reserves).