EL DORADO LAFCO

LOCAL AGENCY FORMATION COMMISSION

AGENDA OF MARCH 26, 2014

REGULAR MEETING

TO:	**Don Mette, Chair, and Members of the El Dorado County Local Agency Formation Commission**
FROM:	**José C. Henríquez, Executive Officer**
AGENDA ITEM #9:	**CONSIDER AND ADOPT POLICY ON ESTABLISHING AND MAINTAINING A LAFCO RESERVE**

RECOMMENDATION

Staff recommends that the Commission consider the following information on the establishment of a LAFCO reserve, adopt the enclosed policy and direct staff to implement it.

REASON FOR RECOMMENDED ACTION

This is a continuing discussion the Commission has had for several months. Currently, this agency does not have a reserve; however, some archived records indicate that LAFCO had one in the past. The Commission expressed an interest in reestablishing a reserve at the time it adopted the Fiscal Year 2013-14 budget. The Commission discussed it at length in January and the budget ad hoc committee further refined the concept when it met in February.

BACKGROUND

As indicated in previous discussions, LAFCO does not have a reserve. The Cortese-Knox-Hertzberg Act is silent in the matter on whether reserves can be established. Currently, this LAFCO has two contingency funds built into its budget:

1. The first is an operating contingency, which the Commission's Policies and Guidelines section 2.1.7 calls a "reserve," is defined as 10% of the operating expenses. This has assisted staff when actual expenses have increased beyond the budgeted amounts. For example, the Commission budgeted $905 for membership into the California Special District Association in FY2013-14. The actual cost was $1,005, and the $100 difference was covered by the contingency to compensate. Because operating costs have decreased over the past eight years, there have been very few instances in which the contingency was more than $10,000.

2. The second is called “Accrued Leave” and it was created at the recommendation of LAFCO’s accountant, Terrie Prod’hon. This fund covers the agency’s liability in the instance of paying off an employee’s vested time off if said employee leaves his/her employment at LAFCO. The budget assumes the worst-case (and the least likely, but also not improbable) scenario of all employees leaving within a fiscal year and funds this account accordingly. At no time in the past eight years has this account been funded more than $30,000 annually. Typically, the funding is in the mid $20,000s and all funds are carried over into the following year if they are unused.

As explained in the January memo, the contingencies cover the “known unknowns,” large, unexpected costs in the budgeted items. With these costs, from past experience it is possible to know that they will occur in the future even if the rate of increase of the timing is unknown.

Need

As the Commission is aware, the LAFCO budget is very tight. Costs are calculated to the penny and with no padding. But this budget discipline comes with risk since the budget has no room for flexibility. In a catastrophic event, funds not tied to the “Accrued Leave” contingency would have to be moved from one budget item to another to compensate, with the hope being that no other large bill arrives or that the funds that were moved would not be needed in their original item. Examples of these “unknown unknowns” include:

1. A large unexpected bill – An example of this was last year when LAFCO was faced with the possibility to backfund Social Security.
2. Insufficient cash flow – While the Commission has general liability insurance to cover a lawsuit or a catastrophic event (such as a fire at the LAFCO offices), there is usually a lag time between the event and the insurance payout.
3. Sudden drop in revenues – As part of its annual process, the Commission budgets an estimated amount in fee revenues that it will earn in the coming budget year. While every attempt is made to estimate these amounts as conservatively as feasible, the possibility exists that in any budget year the actual earned revenues fall short of the estimate. In those instances, the budget will have a hole of the same size as the shortfall.
4. A year-over-year increase in the budget – This is the instance where there would be a significant increase year-over-year rise in agency contributions because of decrease in other revenues, an increase in costs or a combination of both. Because two of the four revenue streams are completely out of the Commission’s control (interest revenue and earned fee revenue), any year-over-year increase would have to be substantially covered by agency contributions.

Further, in the event that LAFCO runs out of money in the middle of a budget year, the only recourse granted to it by law is to request a loan from the County Board of Supervisors. Specifically, the pertinent section of Government Code 56381(c) reads, “If, during the fiscal year, the commission is without adequate funds to operate, the board of supervisors may loan the commission funds. The commission shall appropriate sufficient funds in its budget for the subsequent fiscal year to repay the loan.”

There are two considerations regarding the loan option. First, the length of time to repay the loan is vague. The language reads "subsequent fiscal year to repay the loan" implies it must be paid in full in the next fiscal year. It is unknown what would happen if the County and LAFCO were to renegotiate a longer term. Second, as the County Auditor-Controller pointed out to the Executive Officer in a conversation last month, the operative sequence is "*may* loan the commission funds" (emphasis added). The Board is not obligated to loan LAFCO any funds and in the years where the County is also experiencing insufficient cash flow a loan may simply not be feasible.

In the instances listed above, a reserve would help the Commission by:

1. Allowing LAFCO to cover any unexpected expense without compromising the rest of the budget or having the need to move monies within the budget around.
2. Giving LAFCO some cash on hand to bridge the lag time between disaster/legal expenses and insurance payout.
3. Compensating for any shortfall in revenue.
4. Protecting the funding agencies by reducing the amount of a large year-over-year increase.

General Structure of Policy

In discussing the parameters of a reserve, the budget ad hoc committee recommended that the reserve limit would be between 5%-10% of the total LAFCO budget as well as requiring that any use of these funds must obtain the prior approval of the Commission. The Executive Officer would add that an emergency expense from the reserve can be authorized with approval of the Executive Officer and at least the Chair or vice Chair for an amount less than a limit specified by the Commission. Attachment XX contains a draft policy that complies with these parameters.

GASB 54

In 2009, the Governmental Accounting Standards Board (GASB) issued new guidelines (GASB Statement Number 54, *Fund Balance Reporting and Governmental Fund Type Definitions*) that changed the reporting, classification, and terminology associated with reserves. The draft LAFCO policy contained here complies with the provisions in GASB 54 by incorporating these new categories and reporting definitions. LAFCO Counsel and LAFCO's Auditor, Mattson & Isom, have reviewed the draft policy for compliance.

Draft Policy

The draft reserve policy is in two parts. Currently, Section 2.1.7 of the Policies & Guidelines is titled "Reserve" and contains the following statement: "The annual budget will include an operating contingency set at 10% of total operating expense." Staff proposes striking out this language for ease of use and because it only addresses one of the two contingencies in the budget.

Section 2.1.7 would instead direct to a new section 2.10, "Fund Balances." Its first two paragraphs state this agency's intent to comply with GASB 54. The various GASB 54 definitions are contained in the next two sections. Section 2.10.5 has the operative language of the new reserve policy. The first two subsections reference the two contingency funds, the manner in which they will be funded and the instances they may be used. In addition, these subsections classify the two funds within the context of GASB 54. Finally, these two subsections merely codify current practice.

Subsection (c) adds a third fund and the subject of the discussion over the last few months. The new “Emergency Expense” fund is set with a limit of no more than 10% of LAFCO’s budget and uses examples of when it can be used. It specifies Commission authorization is required for the use of these funds or, in the case of an emergency, approval of both the executive officer and either the chair or vice chair with an amount not to exceed $10,000. This amount was used to be consistent with Section 2.9 (“Purchasing Policies and Procedures”), which has that amount as the Chair’s purchase authority limit. Finally, this section also specifies that the method of funding this reserve is solely by any carryover funds in excess of the amount estimated in the Final Budget. The following chart provides examples of the outcomes to illustrate how this funding mechanism works:

Estimated Carryover Amount in Final Budget	**Actual Carryover Amount**	**Total LAFCO Budget**	**Maximum Reserve Amount**	**Emergency Expense Fund Balance**	**Outcome**
$119,000	$121,000	$500,000	$48,300	$5,000	Excess $2,000 of carryover is deposited into Emergency Expense Fund.
$119,000	$121,000	$500,000	$48,300	$47,300	Only $1,000 of the excess carryover is deposited into Emergency Expense Fund in order not to exceed maximum.
$119,000	$121,000	$500,000	$48,300	$48,300	No excess funds are deposited since maximum has been reached.
$119,000	$115,000	$500,000	$48,300	$5,000	No funds are deposited since actual carryover was below estimated amount.

The proposed LAFCO budget for Fiscal Year 2014-2015 is over $483,000, meaning that under the draft policy the maximum Emergency Expense fund would be at a maximum $48,300. Relying on excess carryover funds beyond the budgeted amount (for example, in the FY2014-2015 budget it is estimated that $119,000 will be carried over into that fiscal year from FY2013-2014) means that it will take multiple years to fully fund this reserve assuming no emergency drains whatever amounts are already in this fund. However, in staff’s estimation, this is the best approach since it ensures that it is not funded as a line item in the budget.

Alternatives

The Commission may choose not to establish an “Emergency Expenditures” fund. The Auditor-Controller also suggested entering into an agreement with the County to establish a line of credit that would have to be periodically approved by both boards.

<u>Attachments</u>

Attachment A: Draft Reserve Policy
Attachment B: Summary of GASB Statement 54