



Office of the City Auditor

**Report to the City Council
City of San José**

**FUND BALANCE AND
RESERVES: SAN JOSÉ
SHOULD AIM TO HAVE
HIGHER SAFETY NET
RESERVES WITHIN THE
GENERAL FUND**

**Report 15-03
March 2015**

March 12, 2015

Honorable Mayor and Members
Of the City Council
200 East Santa Clara Street
San José, CA 95113

Fund Balance and Reserves: San José Should Aim to Have Higher Safety Net Reserves Within the General Fund

For budgeting purposes, the City has two general purpose, safety net reserves within the General Fund: the *Contingency Reserve* and the *Budget Stabilization Reserve*. Together, these reserves are only 4 percent of General Fund operating expenditures, far below the 16.6 percent minimum level recommended by the Government Finance Officers Association (GFOA). Stated differently, the City has less than the equivalent of three weeks of operating expenditures in savings rather than the two months recommended by GFOA. Moreover, San José's policy target for its general purpose, safety net reserves is only 3 percent of operating expenditures. This is the lowest general purpose, safety net reserve policy target of the seven cities against which we benchmarked.

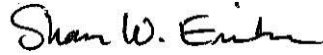
Insufficient reserves limit the City's options and flexibility in the event of economic strain. Although the City does have other reserves in its General Fund, most of these reserves are already intended to be spent for specific purposes in the future, such as purchasing software or hiring additional police officers. Even though such funds would potentially be available in the event of a catastrophic need, they are not designated as general purpose, safety net reserves. We recommend establishing a safety net reserve target in the range of 10 percent (the minimum of benchmarked California cities) to 16.6 percent of expenditures (the GFOA-recommended best practice).

In addition, San José's written reserve policies should be more comprehensive in scope. As a best practice, GFOA recommends reserve policies contain several key elements providing guidance on how to fund, use, and replenish reserves. We recommend the City revise its general purpose, safety net reserve policies to incorporate all essential and important policy elements recommended by GFOA.

We also reviewed the Budget Office and Finance Department's process for reconciling fund balances between the Comprehensive Annual Financial Report (CAFR) and the Budget, which are calculated on different accounting bases. In our opinion, the process in place for this reconciliation is reasonable.

This report includes two recommendations. We will present this report at the March 19, 2015 meeting of the Public Safety, Finance, and Strategic Support Committee. We would like to thank the Budget Office and the Finance Department for their time and insight during the audit process. The Administration has reviewed this report and its response is shown on the yellow pages.

Respectfully submitted,



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Introduction

The mission of the City Auditor's Office is to independently assess and report on City operations and services. The audit function is an essential element of San José's public accountability and our audits provide the City Council, City management, and the general public with independent and objective information regarding the economy, efficiency, and effectiveness of City operations and services.

In accordance with the City Auditor's Fiscal Year (FY) 2014-15 Work Plan, we have completed an audit of fund balances and reserves. 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 objectives. We limited our work to those areas specified in the "Audit Objective, Scope, and Methodology" section of this report.

The Office of the City Auditor thanks the Budget Office and the Finance Department for their time and insight during the audit process.

Background

Oversight of the City's Finances

There are several key City documents relevant to oversight of the City's finances: the Budget,¹ the Annual Report, and the Comprehensive Annual Financial Report (CAFR). The Budget provides an annual spending plan for the City and is approved in advance of each fiscal year by the City Council. The Annual Report is prepared by the Budget Office, issued in September, and provides summaries and analysis of the City's financial performance in the fiscal year. The CAFR is issued in the Fall by the Finance Department after the fiscal year ends. It includes the audited financial statements of the City that explain spending and fund balances. The budget is prospective (prepared in advance of the fiscal year) while the CAFR and Annual Report are retrospective (prepared at the end of the fiscal year, providing information about the state of the City's finances during the prior fiscal year).

Fund balance is a term used both in the CAFR and the Budget. These documents view fund balance from slightly different perspectives. For City of San José budgetary purposes, the fund balance is the difference between total revenue and

¹ The Budget consists of the Operating Budget and the Capital Budgets.

total expenditures in a fund. For purposes of the CAFR, fund balance is an accounting term defined as the difference between assets and liabilities in a governmental fund. This is a broader definition than that used in the Budget and may include non-spendable assets.² Both the Budget and the CAFR are key documents for gaining a broad understanding of the City's spending. They are, however, prepared on different accounting bases and so it is essential to keep this in mind when comparing the documents to each other.

The General Fund is the main operating fund of the City and is the primary source of expenditures for general City services like the Police and Fire departments and libraries. The CAFR classifies the General Fund balance into five categories that include: Nonspendable, Restricted, Committed, Assigned and Unassigned. Fund balance is classified into the various categories based upon how available it is for spending. The subsequent section "Differences in Accounting Basis Between the Budget and the CAFR" as well as Exhibit I show the CAFR categories.

Reserves established against that fund balance may limit the options for spending such funds for other purposes. The word *reserves* typically refers broadly to the portion of fund balance held to provide a buffer against shocks or risks.³ Both the Budget and the CAFR provide information on the level of fund balances and reserves but each is from a slightly different perspective.

In discussing reserves, the General Accounting Standards Board (GASB)⁴ states:

It is common practice for governments to put aside resources to be used in a financial emergency. By turns called rainy-day funds, stabilization funds, emergency funds, contingency funds, and so on, these funds all are intended to provide needed monies should a government find itself facing unexpected financial problems.

² Non-spendable assets are those that cannot be spent such as deposits or inventory, for example.

³ In San José, reserves are defined in this way but the word is also used to describe "earmarks," which refers to funding set aside with the intent to spend it in the future for specific programs or other uses as approved by the City Council.

⁴ The Governmental Accounting Standards Board (GASB) is the independent organization that establishes and improves standards of accounting and financial reporting for U.S. state and local governments. Established in 1984 by agreement of the Financial Accounting Foundation (FAF) and 10 national associations of state and local government officials, the GASB is recognized by governments, the accounting industry, and the capital markets as the official source of generally accepted accounting principles (GAAP) for state and local governments. Accounting and financial reporting standards designed for the government environment are essential because governments are fundamentally different from for-profit businesses. Furthermore, the information needs of the users of government financial statements are different from the needs of the users of private company financial statements. The GASB members and staff understand the unique characteristics of governments and the environment in which they operate.

The GASB is not a government entity; instead, it is an operating component of the FAF, which is a private sector not-for-profit entity. Funding for the GASB comes primarily from an accounting support fee established under the Dodd-Frank Wall Street Reform and Consumer Protection Act as well as the sale of certain publications. Its standards are not federal laws or regulations and the organization does not have enforcement authority. Compliance with GASB's standards, however, is enforced through the laws of some individual states and through the audit process, when auditors render opinions on the fairness of financial statement presentations in conformity with GAAP.

The City has a variety of “reserves” for general government operations. Most of these are part of the General Fund. There are essentially three “levels” of reserves. The differences among the levels relate to the extent to which a given reserve is expected to be used. They include:

- 1) Reserves not expected to be drawn against at all except in cases of extreme difficulty (called the *Contingency Reserve*, which is included within the General Fund)⁵
- 2) A reserve that is expected to be drawn against periodically to stabilize the budget if revenues are lower than expected or expenditures are higher (called the *Budget Stabilization Reserve*, which is included within the General Fund) and
- 3) Reserves that are expected to be spent in the future for a specific purpose. These reserves essentially serve as a budgeting tool to ensure the funding is available when needed (called earmarked reserves).⁶

Differences in Accounting Basis Between the Budget and the CAFR

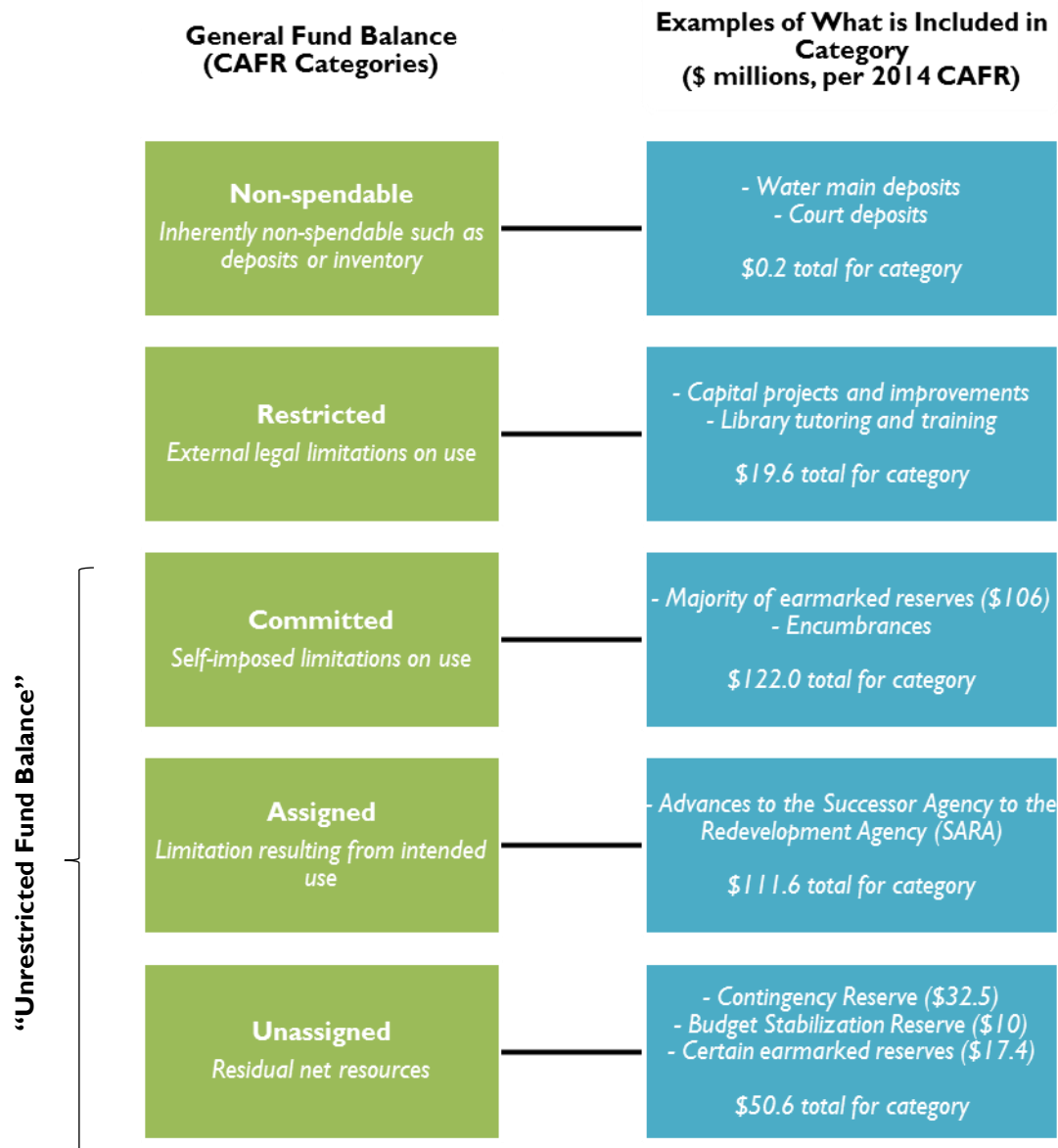
Accounting basis refers to the timing of when revenues and expenditures are recognized. The Budget and the CAFR recognize revenues and expenditures differently. Much like in a checking account when spending is recorded as soon as it occurs (even if the cash is still in the account at that moment), the accrual basis of accounting records spending and revenues as soon as they occur regardless of the timing of the actual flow of the cash. Differences in accounting basis can sometimes account for differences between numbers that appear in the CAFR compared to numbers in the Budget and the Annual Report. The accounting system is designed to assist the City in (1) carrying out the day-to-day transactions of the City and (2) preparation of the annual financial statements that are included in the CAFR. The Budget serves as the annual spending plan for the City. Appendix C provides specific examples of accounting differences between the Budget and the CAFR.

⁵ Another reserve called the *Emergency Reserve Fund* similarly is expected to be drawn against only in cases of “public emergency involving or threatening the lives, property, or welfare of the people of the City or property of the City.” This reserve is its own fund and the Budget Office advises it is used primarily to account for and manage Federal Emergency Management Agency (FEMA) funds. The Emergency Reserve Fund is described later in this section. In addition to the *Emergency Reserve Fund*, the Charter also creates a *Cash Reserve Fund*, the purpose of which is “for the payment of any authorized expenditures of the City for any fiscal year in anticipation of and before the collection of taxes and other revenues of the City for such fiscal year.” A very low balance has historically been maintained in this fund (about \$5,000), and for practical purposes, the *Contingency Reserve* and the *Budget Stabilization Reserve* described previously have instead served the purpose of this fund.

⁶ In the City’s Budget document, the *Budget Stabilization Reserve* is included in the earmarked reserves. However, in the CAFR, it is not included in the earmarked reserves. (See Exhibit I.) In the CAFR, the *Budget Stabilization Reserve* is included in the Unassigned General Fund balance while the other earmarked reserves are included in the Committed General Fund balance.

Fund balance is presented from different perspectives in the Budget versus the CAFR. The CAFR is developed in accordance with the standards issued by the Governmental Accounting Standards Board (GASB). These include specificity about the presentation of fund balance within the CAFR. In the Budget, fund balance associated with a given fund generally represents an amount that is available (although some may be “reserved” through the budget process for a specific future purpose). In the CAFR, portions of fund balance are classified into five categories that represent the availability of such a balance for spending. Exhibit I provides a summary of the General Fund balance as presented in the CAFR.

Exhibit I: Summary of the General Fund Balance as Presented in the CAFR



Source: Auditor summary of data provided by the Finance Department

Annual Audits and Reconciliation Process Provide Oversight

The City issues the CAFR annually after the end of each fiscal year. (The fiscal year ends June 30 and the CAFR is typically published in November.) It includes the City's financial statements that are audited by an external Certified Public Accountant (CPA) to provide "reasonable assurance about whether the financial statements are free of material misstatement."

Prior to the issuance of the CAFR, the Budget Office, per the requirements of Charter Section 701(f), publishes an Annual Report in September. It states:

The Annual Report is established by the City Charter as the City Manager's vehicle for summarizing and analyzing the financial performance of the City for the preceding fiscal year. The mandated elements of the report include the following:

- *A description of revenues received and expenditures incurred in the prior fiscal year, and an explanation concerning material differences between these amounts and the amounts budgeted.*
- *The amount of the financial reserves of the City.*
- *All other information that, in the opinion of the City Manager, is necessary to provide an accurate and complete picture of the fiscal status and condition of the City.*

To prepare the Annual Report, the Budget Office calculates how actual revenues and expenditures compared to the budgeted amounts. The budget "actuals" are then reconciled to the amounts that will be shown in the CAFR by making the appropriate adjustments to account for the differences in the accounting basis (see Appendix C).⁷ This reconciliation process as well as the annual audited financial statements included in the CAFR help to provide oversight and reasonable assurance of the accuracy of fund balances.

In addition to budget policies that require a balanced budget and state that "one-time resources shall not be used for current or new ongoing operating expenses," the Budget Office also develops a Five-Year Forecast that serves as long-term planning to help mitigate the risk of large, unexpected changes in revenues or expenditures.

Fund Accounting – What It Means

The accounts of the City are organized on the basis of funds, each of which is considered a separate accounting entity with a self-balancing set of accounts. This means, for example, that the City's General Fund (which is the broad purpose fund from which many public services are financed) has its own assets,

⁷ In addition to the adjustments to account for the differing account methods, there are adjustments because certain funds are presented as combined with the General Fund in the CAFR but not in the Budget.

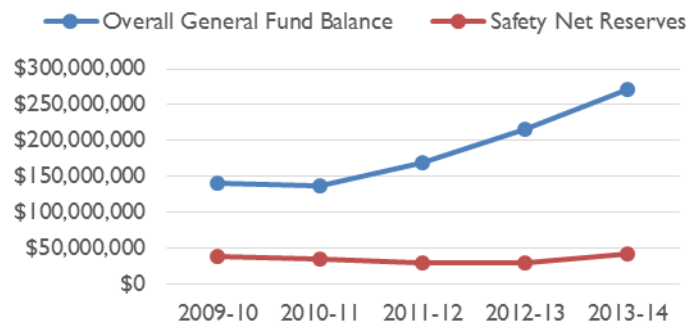
liabilities, and equity or fund balance. Other funds are similarly structured. Information in the CAFR is displayed based on principles of fund accounting. The limitations that derive from the standards established by the GASB drive the accounting practices to which the City adheres. Appendix D provides a detailed description of fund types and fund structures. The fund structure limits the availability of money for a given purpose.

Trends in Fund Balances

General Fund

As shown in Exhibit 2, overall General Fund balances increased 91 percent (from \$141 million to \$271 million) over the last five years. The portion of the General Fund set aside for general purpose, safety net reserves increased 3 percent from \$39.7 million to \$41.0 million during that same time.

Exhibit 2: General Fund Balance Compared to Safety Net Reserves



Source: Budget Office Annual Reports

Earmarked Reserves

A significant portion of the General Fund balance growth shown in Exhibit 2 was in what are called “earmarked reserves.” These are reserves set aside for a specific purpose and essentially serve as a budgeting tool to ensure funding is available for that purpose. Examples of earmarked reserves include funding related to the San José BEST program funding, funding for an upgrade of the Human Resources/Payroll system, and funding for hiring additional police officers.⁸ See Appendix A for a list of the earmarked reserves.

San José’s practice of budgeting “earmarked reserves” for very specific purposes differed from the practices of other jurisdictions against which we benchmarked.

⁸ Earmarked reserves also include the 2015-16 *Future Deficit Reserve*, which is a reserve designated to assist in near future fluctuations in the expected revenues or expenditures. Unlike the *Budget Stabilization Reserve* or the *Contingency Reserve*, this reserve is not established by policy and is liquidated at the end of each fiscal year.

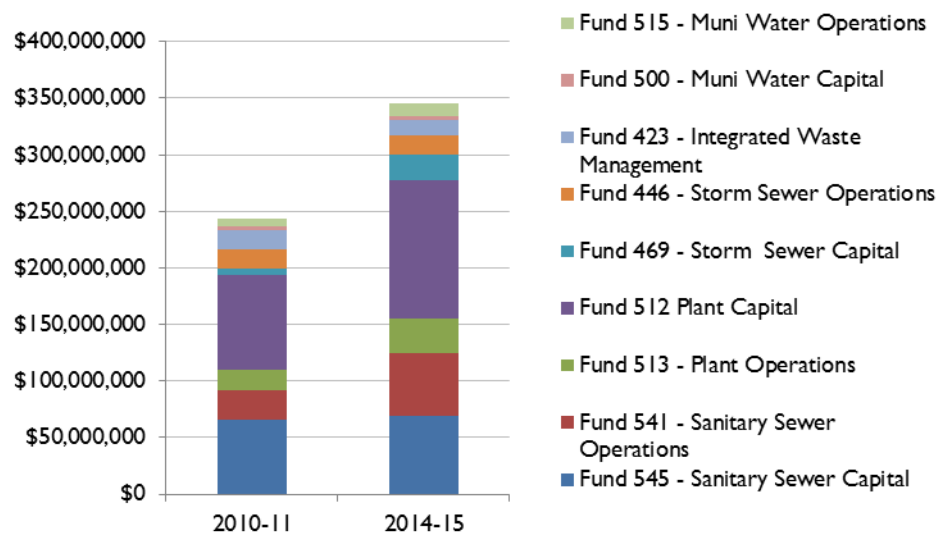
Other cities tend to have broader categories of earmarked reserves, if they have any at all. For example, Long Beach has an “Infrastructure, Systems Replacement and Technology Reserve” whereas San José maintains a variety of separate and specific earmarked reserves for each technology project.

It should be noted that although San José’s practice of budgeting “earmarked reserves” for very specific purposes differed from the practices of other jurisdictions against which we benchmarked, these various reserves have been approved for such purposes by the City Council through the adoptions of the annual Budget in a public meeting.

Concern About Continued Growth in Ratepayer Fund Balances

Certain ratepayer fund balances (on a budgetary basis) have continued to grow despite prior audit recommendations⁹ to develop policies and reserve goals for such funds. As shown in Exhibit 3, these funds grew by 42 percent from the beginning of FY 2010-11 to the beginning of FY 2014-15 (a total of \$102 million from \$243 million at the beginning of FY 2010-11 to \$346 million at the beginning of FY 2014-15).

Exhibit 3: Five-Year Change in ESD Fund Balances



Source: FY 2010-11 and FY 2014-15 Funding Sources Resolution

Other Funds

Excluding the General Fund and the ESD funds described above, fund balances (on a budgetary basis) in all other funds decreased by a total of 4 percent, or by \$32.7 million (from \$833 million to \$800 million) during the five year-period

⁹ See 2012 audit, *Environmental Services: A Department At A Critical Juncture*.

from the start of FY 2010-11 to the start of FY 2014-15. See Appendix B for more detail.

- Of those other funds, Airport funds decreased 33 percent by about \$157 million (from about \$471 million to \$313 million). The overall decrease was largely due to a 75 percent decrease in the Airport Revenue Bond Improvement Fund as a result of the expenditure of these funds on Airport capital projects and the use of remaining bond proceeds for debt service.
- Non-ESD capital funds increased by a net of about \$19.2 million (\$77 million in increases offset by \$57 million in decreases) with the Construction Excise Tax Fund representing the largest increase at \$55 million or 293 percent.
- Special Revenue funds had a net increase of almost \$94 million including large increases in the: Multi-Source Housing Fund (\$22.8 million)¹⁰; Convention Center Facilities District Revenue Fund (\$21.1 million); Building and Structure Construction Tax Fund (\$20.4 million) and the Low and Moderate Income Housing Asset Fund (\$10.8 million).¹¹

Audit Objective, Scope, and Methodology

The objective of our audit was to review and assess the adequacy and appropriateness of ending fund balances and reserves compared to established targets and industry standards. Another objective was to review the annual accounting to budgetary basis reconciliations of the City's operating and capital funds to ensure budgetary fund balances are accounted for properly. The focus of this report is the General Fund reserves. We reviewed trend data related to other funds but did not conduct detailed testing of such funds' balances. To accomplish these objectives, we:

- Reviewed and compiled financial and trend data related to the City's General Fund and other reserves. We obtained an understanding of existing policies regarding General Fund reserves.

¹⁰ The Multi-Source Housing Fund accounts for federal, state, and local funds used to support a variety of housing and community development activities such as: (1) On-going federal entitlement awards to support affordable housing and homeless activities; (2) Inclusionary fees to support the production of affordable housing; (3) One-time grant awards used to support housing including acquisition; rehabilitation development; addressing homelessness; and/or neighborhood revitalization activities; and (4) Rental dispute mediation fees to support the Rental Rights and Referral Program.

¹¹ This Special Revenue Fund accounts for housing assets and functions related to the Low and Moderate Income Housing Program retained by the City. This fund was established on February 1, 2012 with the dissolution of the former Redevelopment Agency through recognition of loan repayments and other sources to provide funding for the administrative costs associated with managing the Successor Housing Agency assets and the continuation of affordable housing programs in the future. This fund was previously named Affordable Housing Investment Fund, but the name was changed, on October 16, 2012, to the Low and Moderate Income Housing Asset Fund.

- Contacted other cities and the Government Finance Officers Association (GFOA) to benchmark San José's General Fund reserve practices to those of other cities and recommended best practices.
- Worked with the Budget Office and Finance Department to obtain an understanding of the process of reconciling fund balances between the accounting bases that appear in the Comprehensive Annual Financial Report (CAFR) and the Budget. We did not conduct extensive detailed testing but, in our opinion, the processes in place for reconciliation are reasonable.
- Updated the data on the balances of various ESD funds that were included in our 2012 Environmental Services audit.

This report focuses primarily on the CAFR General Fund balance categories "Committed" and "Unassigned."

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Finding I **San José Should Aim to Have Higher Safety Net Reserves Within the General Fund**

Summary

For budgeting purposes, the City has two general purpose, safety net reserves within the General Fund: the *Contingency Reserve* and the *Budget Stabilization Reserve*. Together, these reserves are only 4 percent of General Fund operating expenditures, far below the 16.6 percent minimum level recommended by the Government Finance Officers Association (GFOA). Moreover, San José sets a target for its general purpose, safety net reserves that is only 3 percent of operating expenditures. This is the lowest general purpose, safety net reserve policy target of the seven cities against which we benchmarked.

Insufficient reserves limit the City's options and flexibility in the event of economic strain. We recommend establishing a safety net reserve target in the range of 10 percent (the minimum of benchmarked California cities) to 16.6 percent of expenditures (the GFOA-recommended best practice).

For Budgeting Purposes, the City Has Two Safety Net Reserves

The City's general purpose, safety net reserves include the *Contingency Reserve* and the *Budget Stabilization Reserve*. A "general purpose, safety net reserve" is funding set aside in a reserve that is specifically designated to help buffer against general financial shocks and other forms of risk.¹²

Contingency Reserve

The *Contingency Reserve*, included within the General Fund, is considered by the Budget Office to be the City's ultimate "safety net" or "last resort" reserve.

City Council Policy I-18 specifies:

For the General Fund, a contingency reserve, which is a minimum of 3% of the operating budget, is established. The purpose of this reserve is to meet unexpected circumstances arising from financial and/or public emergencies that require immediate funding that cannot be met by any other means. Any use of the General Fund Contingency Reserve shall require two-thirds vote of approval by the City Council.

¹² See Appendix F for a list of factors influencing the setting of reserve policy targets.

As of the beginning of the FY 2014-15, the balance of the *Contingency Reserve* was \$32.5 million.

Budget Stabilization Reserve

The *Budget Stabilization Reserve* is expected to be drawn against periodically to stabilize the budget if revenues are lower than expected or expenditures are higher.

City Council Policy 1-18 describes the *Budget Stabilization Reserve's* purpose as:

For the General Fund, a Budget Stabilization Reserve may be maintained at an adequate level...to provide budget stability when there are fluctuations that result in lower than projected revenues and/or higher than projected expenditures that cannot be re-balanced within existing budget resources in any given year. This reserve would provide a buffer, or bridge funding, to protect against reducing service levels when these fluctuations occur.

As of the beginning of FY 2014-15, the balance of the *Budget Stabilization Reserve* was \$10 million.

Other Reserves

It should be noted that the City does have other reserves within its General Fund, namely, the earmarked reserves described in the Background. However, these earmarked reserves are already intended to be spent for specific purposes in the future, such as purchasing software or hiring additional police officers.¹³ Even though such funds would potentially be available in the event of a catastrophic need, they are not designated as general purpose, safety net reserves.¹⁴ Thus, in our opinion, earmarked reserves should not be thought of in the same way as the *Contingency Reserve* and *Budget Stabilization Reserve*, which are the only reserves that the City has specifically set aside for general, safety net purposes.¹⁵

¹³ See Appendix A for a list of earmarked reserves in FY 2014-15.

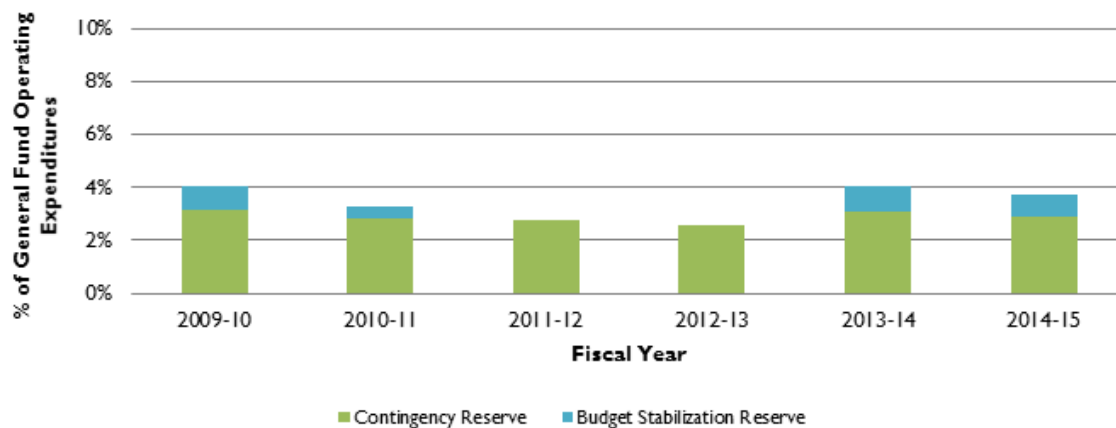
¹⁴ Restrictions on certain earmarked reserves may limit whether they could be liquidated to help supplement the City's general purpose, safety net reserves. For FY 2014-15, the amount of earmarked reserves that could *not* be liquidated represent 43 percent of total earmarked reserves.

¹⁵ The City Charter, as well as Council Policy 1-18, also stipulates that there are two other reserve funds, the *Cash Reserve Fund* and the *Emergency Reserve Fund*. These funds are separate from the General Fund. The *Emergency Reserve Fund* is to meet "any public emergency involving or threatening the lives, property, or welfare of the people of the City or property of the City." The Budget Office advises that this fund is typically used to account for and manage Federal Emergency Management Agency (FEMA) funds. The *Cash Reserve Fund* is "for the payment of any authorized expenditures of the City for any fiscal year in anticipation of and before the collection of taxes and other revenues of the City for such fiscal year." A very low balance has historically been maintained in this fund (about \$5,000), and for practical purposes, the *Contingency Reserve* and the *Budget Stabilization Reserve* described previously have instead served the purpose of this fund. Because the *Emergency Reserve Fund* is used primarily to account for FEMA funds and the *Contingency Reserve* and *Budget Stabilization Reserve* serve the purpose of the *Cash Reserve Fund*, we do not consider these "Charter reserves" as general purpose, safety net reserves.

The City's General Purpose, Safety Net Reserves Are Only 4 Percent of General Fund Operating Expenditures

Although general purpose, safety net reserves have increased 3 percent from \$39.7 million to \$41.0 million over the last five years (FY 2009-10 to FY 2013-14), these reserves currently represent only 4 percent of General Fund operating expenditures (as shown in Exhibit 4).¹⁶ This is much lower than best practices recommend, as will be explained further in the next section. Exhibit 4 also shows that the *Budget Stabilization Reserve* was depleted in FY 2011-12 and FY 2012-13.

Exhibit 4: General Purpose Safety Net Reserve Levels as a Percentage of General Fund Operating Expenditures



Source: Adopted Operating Budgets; Annual Reports; Appropriation Ordinances (FY 2009-10 to 2014-15). Data for safety net reserves for FY 2009-10 to FY 2013-14 are from the end of the fiscal year. Data for FY 2014-15 are as of December 2014.

The City's General Purpose, Safety Net Reserves Do Not Meet the 16.6 Percent Minimum Target Recommended by GFOA

A reserve target establishes an agreed-upon goal for an acceptable range of savings and financial cushion for a governmental entity. The Government Finance Officers Association (GFOA) recommended best practice advises that a government maintain at least two months (or 16.6 percent) of operating expenditures or revenues in reserves.¹⁷ In other words, governments should set aside enough money to pay for two months of operations in case no other funds are available.¹⁸

¹⁶ Calculations use the ending balances of the Contingency Reserve and Budget Stabilization Reserve. In Exhibit 4, data from FY 2014-15 are also depicted. These data are as of December 2014.

¹⁷ The City uses budgeted expenditures as a base for setting its reserve policy target.

¹⁸ GFOA recommends this as a baseline reserve level. Cities may require more than 16.6 percent in reserves if they experience frequent or significant risks, such as vulnerability to natural disasters, revenue instability, or expenditure volatility. See Appendix F for a list of risks an entity may face. Under GFOA recommended policy, jurisdictions have flexibility regarding which portions of General Fund balance are considered as reserves.

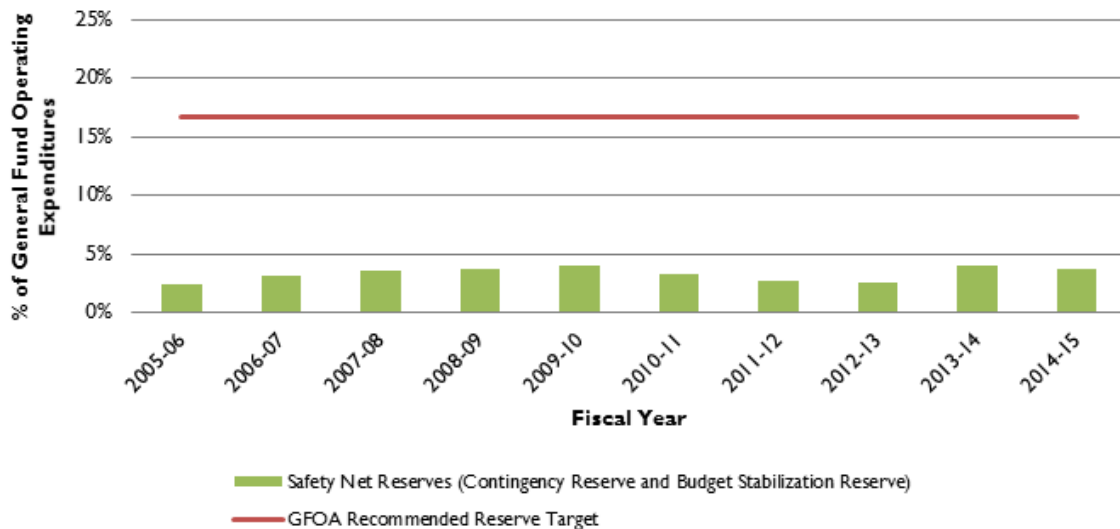
Fund Balance and Reserves

Currently, the City's general purpose, safety net reserves (the *Contingency Reserve* and *Budget Stabilization Reserve*) total about 4 percent of operating expenditures, significantly less than the GFOA-recommended level of 16.6 percent. Stated differently, the City has less than three weeks saved for operating expenditures rather than the two months recommended by GFOA.

Moreover, of the two general purpose, safety net reserves, only the *Contingency Reserve* has a target funding level that is specified in written policy (the policy states that it should be funded at a minimum of 3 percent of operating expenditures). The *Budget Stabilization Reserve* does not have a target specified in policy. Thus, both the *actual* reserve levels and *policy* reserve targets fall below the GFOA-recommended level.

Exhibit 5 shows San José's general purpose, safety net reserve levels over the last ten fiscal years compared to the GFOA-recommended level of 16.6 percent of operating expenditures.

Exhibit 5: San José Historic General Purpose Safety Net Reserve Levels Compared to GFOA Target of 16.6 Percent



Source: Adopted Operating Budgets; Annual Reports; Appropriation Ordinances (FY 2005-06 to 2014-15)

Exhibit 6 provides dollar amounts for both the *Contingency Reserve* and *Budget Stabilization Reserve* over the same time period.

Exhibit 6: San José Historic General Purpose Safety Net Reserve Levels

	Fiscal Year									
	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Contingency Reserve (\$ millions)	\$23.3	\$28.8	\$29.7	\$30.7	\$30.7	\$29.3	\$29.3	\$29.3	\$31.0	\$32.5
Budget Stabilization Reserve (\$ millions)	\$0.0	\$4.0	\$10.0	\$9.5	\$9.0	\$5.0	\$0.0	\$0.0	\$10.0	\$10.0

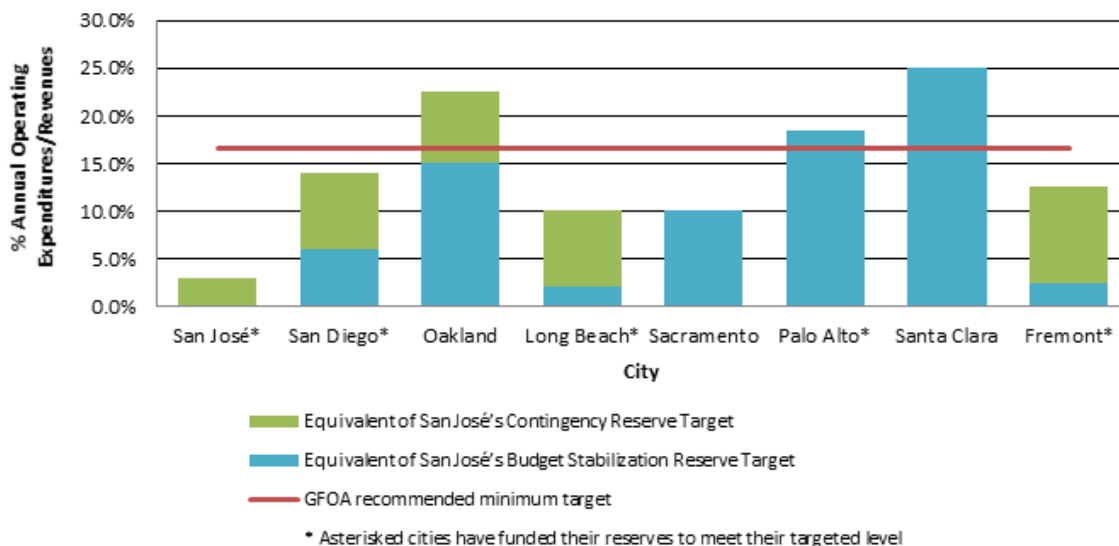
Source: Appropriation Ordinances (FY 2005-06 to 2014-15)

San José Has the Lowest General Purpose, Safety Net Reserve Policy Target of the Seven Cities Against Which We Benchmarked

We also compared the combined levels of the City’s *Contingency Reserve* and the *Budget Stabilization Reserve* to the levels of comparable reserves in other cities.

Other California cities have higher reserve policy targets than San José. Our comparison was based on the reserve categories of other jurisdictions that are comparable to the City’s *Contingency Reserve* and/or *Budget Stabilization Reserve*. Exhibit 7 shows the results of our survey.

Exhibit 7: Minimum Reserve Policy Targets of California Cities



Source: Auditor summary of city reserve policies

Note: This graph shows only policy targets, not actual reserve levels. Because San José’s Budget Stabilization Reserve does not have a targeted level of funding, it is not included in the graph.

While most of the cities we reviewed do not meet the GFOA recommended minimum of 16.6 percent, the average policy target level for these other cities (excluding San José) is about 16.1 percent,¹⁹ and all jurisdictions have policy targets of at least 10 percent.²⁰ These levels are notably higher than the City's policy target for the *Contingency Reserve*, which stands at 3 percent. Moreover, four of the seven cities against which we benchmarked—San Diego, Long Beach, Palo Alto, and Fremont—have funded their reserves to meet the targeted levels.²¹ Appendix E details further the comparisons between San José and the benchmarked cities.

Most of the benchmark cities are smaller than San José, and thus may have a need for higher reserve targets than the GFOA-recommended minimum of 16.6 percent, as smaller governments typically have fewer overall resources to draw upon in an emergency. However, despite the City's size, GFOA still maintains that the baseline minimum reserve level should be set at 16.6 percent. San Diego, a larger jurisdiction than San José, provides an example of a large city that has a higher reserve policy target than San José, and has funded its reserves at that level (although still falling short of the GFOA minimum).

Insufficient Reserves Limit the City's Options and Flexibility in the Event of an Economic Strain

GFOA guidance states that reserves are the cornerstone of financial flexibility by providing governments with options to respond to unexpected issues and provide a buffer against economic shocks and other risks. Balancing revenues with expenditures always presents challenges, especially if cities face lower than expected revenues, unexpected increases in expenditures, or natural disasters. When cities do not have sufficient reserves, they are less equipped to respond to such problems.

San José's low general purpose, safety net reserve policy target of 3 percent and its low *actual* reserve level of around 4 percent left the City ill-prepared to weather the last recession. In FY 2011-12, when the City had forecasted budget shortfall of \$115.2 million, the \$5 million *Budget Stabilization Reserve* (known at that time as the Economic Uncertainty Reserve) was depleted, leaving the \$29 million *Contingency Reserve* as the City's only true general purpose savings for the next two years. The lack of sufficient reserves meant funding for programs and services were cut more quickly than they otherwise might have been, contributing to the severe service reductions experienced by the City and its residents. For

¹⁹ The average policy target level for benchmarked cities excluding Oakland and Santa Clara, which drive up the average, is 13 percent.

²⁰ Long Beach has a reserve policy target range. The minimum of the range has been used for calculations.

²¹ Oakland recently approved the creation of a Vital Services Stabilization Fund (the city's equivalent of San José's *Budget Stabilization Reserve*), and as such it has not been fully funded yet. Its preexisting reserve (the equivalent of San José's *Contingency Reserve*), however, is funded to the target level.

example, from FY 2008-09 to FY 2010-11, branch library hours were reduced significantly (including the elimination of Sunday hours), community centers were closed, and a large number of City employees were let go, leaving the City with fewer employees to provide services to residents, including fire and police services.

Had the City maintained larger reserves, there would have been more of a financial “buffer” to help smooth out the transition into reduced service provision rather than having to make significant personnel and service cuts right away. Essentially, larger reserves would have provided the City Council with more resources to respond to the recession, and more time to determine the severity of the downturn and the best course of action.

Other cities’ reserve policies provide insight as to how a higher reserve level might be funded. The reserve policy of Sacramento states:

Resources to fund [the Economic Uncertainty Reserve] will be identified on an ongoing basis and can include positive year-end results or other one-time resources available to the General Fund which will be presented to Council...through the budget development, midyear review, and year-end processes.

The reserve policy of Oakland provides more specific guidance:

The excess Real Estate Transfer Tax (RETT) revenue is hereby defined as any annual amount collected in excess of the “normal baseline” collection threshold of \$40 million. The excess...collections...shall be used...to replenish General Purpose Funds (GPF) reserves until such reserves reach to 10 percent of current year budgeted GPF appropriations.

City Council Policy 1-18 establishes the 3 percent reserve target for the *Contingency Reserve*. This policy could be developed further to establish a plan for how the City could fund and maintain a reserve level that would provide it with more financial flexibility in the event of an economic downturn.

Recommendation #1: The Budget Office should propose revisions to Council Policy 1-18 (which address the City’s general purpose reserves) that would establish an overall reserve target level range for the *Contingency Reserve* and the *Budget Stabilization Reserve*. Such a range should be approximately 10 percent of expenditures (the minimum of benchmarked California cities) to 16.6 percent (the GFOA-recommended best practice).

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Finding 2 San José’s Written Reserve Policies Should Be More Comprehensive in Scope

Summary

As a best practice, GFOA recommends reserve policies contain several key elements providing guidance on how to fund, use, and replenish reserves. We recommend the City revise its reserve policies to incorporate all essential and important policy elements recommended by GFOA.

GFOA Recommends That Written Reserve Policies Include Certain Key Elements

In addition to stating that reserves must be set at sufficient levels, GFOA guidance states that reserves must be governed by policies that define their acceptable use and describe how they are to be managed. More comprehensive policies provide clearer guidance on the use and management of reserves when a government is faced with an unexpected event that may require reserve funding (e.g., lower than expected revenues, unexpected increases in expenditures, infrastructure collapse, natural disasters).

To this end, GFOA recommends that reserve policies include eight policy elements, as outlined in Exhibit 8. GFOA also ranks these elements in order of importance, from essential to important to discretionary. Essential elements should be included in all policies while important elements are highly recommended. Discretionary elements strengthen a policy, but are not absolutely necessary to include.

Exhibit 8: GFOA-Recommended Reserve Policy Elements

Policy Element	Definition	Essential	Important	Discretionary
Reserve target levels	State reserve targets or target ranges	X		
Conditions for use of reserves	Define the conditions under which a reserve can be used	X		
Authority over reserves	Specify who has authority to use reserves	X		
Definition and purpose of reserves	Define reserves and present reason for maintaining them		X	
Funding the target amount	Establish plan for funding the reserve if it is below the target		X	
Replenishment of reserves	Provide guidance on how reserves will be replenished once used		X	
Excess reserves	Provide guidance on how reserves in excess of their targets can be used			X
Periodic review of targets	Direct staff to periodically review the reserve target level			X

Source: *Financial Policies*, Shayne C. Kavanagh, GFOA

Jurisdictions can further choose to write policy language to allow more flexibility in action (e.g., stating that administration can review reserve targets whenever it deems necessary) or more control over action (e.g., stating that administration must review reserve targets every other year).

The City’s Written Reserve Policies Do Not Include All the GFOA-Recommended Practices

Not all GFOA-recommended policy elements are included in San José’s existing policies that govern the City’s general purpose, safety net reserves. Exhibit 9 details the level of “comprehensiveness” for each policy, based on the GFOA criteria. Only the policy covering the *Contingency Reserve* includes all essential elements. Moreover, each reserve policy is either missing an important element, or contains vague language addressing an important element. Neither of the reserve policies include discretionary elements.

Exhibit 9: General Purpose Safety Net Reserve Policy Consistency with GFOA Best Practices

<i>Policy Element</i>	<i>Importance</i>	Contingency Reserve	Budget Stabilization Reserve
<i>Reserve target levels</i>	<i>Essential</i>	3 percent minimum	None
<i>Conditions for use of reserves</i>	<i>Essential</i>	2/3 Council approval	Not stated
<i>Authority over reserves</i>	<i>Essential</i>	Council	Not stated
<i>Definition and purpose of reserves</i>	<i>Important</i>	Yes	Yes
<i>Funding the target amount</i>	<i>Important</i>	None	Yes ²²
<i>Replenishment of reserves</i>	<i>Important</i>	None	None
<i>Excess reserves</i>	<i>Discretionary</i>	None	None
<i>Periodic review of targets</i>	<i>Discretionary</i>	None	None

Source: Auditor summary of Council Policy I-18

The lack of GFOA-recommended policy elements across the City’s general purpose safety net reserve policies leaves the City with no clear guidance on how, why, and when reserves should be funded, used, and replenished. This lack of detail also leaves the City with a weak reserve strategy to address citywide risks. Moreover, as the Budget Office has noted, reserves are “one-time funds,” meaning that once they are used, there is no guarantee they will be fully replenished by the next year. This characteristic of reserves makes it all the more important for policies to be in place to ensure they are built back up to prepare for future contingencies.

²² Council Policy I-18 states that the “first increment of any General Fund ‘Ending Fund Balance’...shall be split 50% for unmet/deferred infrastructure and maintenance needs...and 50% to offset any projected deficit for the following fiscal year, after necessary appropriation adjustment actions...If the projected deficit is less than the amount allocated for this purpose, the remaining funds shall be allocated for the following uses: 1) Budget Stabilization Reserve. 2) Unmet/deferred infrastructure and maintenance needs. 3) Other one-time urgent funding needs.”

For example, in FY 2011-12 during the most recent economic recession, the City depleted the Budget Stabilization Reserve (at that time called the Economic Uncertainty Reserve) to help stabilize City finances. At that time, the reserve stood at only around \$5 million. Had policies been in place prior to the recession to ensure a higher minimum level of funding for the reserve, the City would have had more flexibility in responding to the downturn.

Recommendation #2: The Budget Office should propose revisions to Council Policy I-18 regarding the City's general purpose reserves (the *Contingency Reserve* and *Budget Stabilization Reserve*) to incorporate all essential and important policy elements recommended by GFOA.

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Conclusion

The City's General Fund "Safety Net" reserves are low compared to recommended best practices and other cities. Insufficient reserves limit the City's options and flexibility in the event of an economic strain.

RECOMMENDATIONS

Recommendation #1: The Budget Office should propose revisions to Council Policy I-18 (which address the City's general purpose reserves) that would establish an overall reserve target level range for the Contingency Reserve and the Budget Stabilization Reserve. Such a range should be approximately 10 percent of expenditures (the minimum of benchmarked California cities) to 16.6 percent (the GFOA-recommended best practice).

Recommendation #2: The Budget Office should propose revisions to Council Policy I-18 regarding the City's general purpose reserves (the *Contingency Reserve* and *Budget Stabilization Reserve*) to incorporate all essential and important policy elements recommended by GFOA.

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APPENDIX A
FY 2014-15 General Fund Earmarked Reserves

Earmarked Reserve	\$
2014-2015 Police Sworn Hire Ahead Program Reserve	3,000,000
2015-2016 Children's Health Initiative Reserve	275,000
2015-2016 Community Action Pride Grants Reserve	100,000
2015-2016 Evergreen Branch Library Saturday Hours Reserve	119,845
2015-2016 Future Deficit Reserve	2,400,000
2015-2016 Homeless Rapid Rehousing Reserve	2,000,000
2015-2016 Homeless Response Team Reserve	1,500,000
2015-2016 San José BEST Program and Safe Summer Initiative Programs Reserve	1,500,000
Airport West Property Sale Reserve	1,000,000
Artificial Turf Capital Replacement Reserve	450,000
<i>Budget Stabilization Reserve (formerly Economic Uncertainty Reserve)</i>	10,000,000
*Building Development Fee Program Reserve (formerly <i>Fee Supported Reserve</i>)	24,093,945
City Annual Required Retirement Contributions Reserve (formerly <i>Retirement Pre-Payment Reserve</i>)	1,000,000
*Development Fee Program Technology Reserve	4,495,000
Employee Compensation Planning Reserve	3,770,000
Employee Market Competitiveness Reserve	500,000
*Fire Development Fee Program Reserve (formerly <i>Fee Supported Reserve</i>)	7,067,781
Fiscal Reform Plan Implementation Reserve	2,680,000
Fuel Usage Reserve	250,000
*General Plan Update Reserve	413,014
Human Resources/Payroll System Reserve	3,437,000
Operating/Capital Budget Systems Replacement Reserve	2,850,000
*Planning Development Fee Program Reserve (formerly <i>Fee Supported Reserve</i>)	1,787,461
Police Department Staffing Reserve	13,002,200
Police Property Facility Relocation Reserve	500,000
*Public Works Development Fee Program Reserve (formerly <i>Fee Supported Reserve</i>)	6,368,297
Retiree Healthcare Solutions Reserve (formerly <i>Retiree Healthcare</i>)	6,195,000
*Salaries and Benefits Reserve	8,877,589
Sick Leave Payments Upon Retirement Reserve	6,000,000
Silicon Valley Regional Communications System Reserve	3,130,000
*Wellness Program Reserve	7,652
Workers Compensation/General Liability Catastrophic Reserve	15,000,000
TOTAL	133,769,784

Source: 2014-2015 Appropriation Ordinance (as of 12/10/2014)

* Restrictions on these earmarked reserves may limit whether they could be liquidated to help supplement the City's general purpose, safety net reserves.

APPENDIX B

Five-Year Fund Summary for Budgeted Funds Other Than the General Fund and Environmental Services Funds

Fund #	Fund Name	2010-11	2014-15	Five-Year	How much more or	Five-Year
		Beginning Fund Balance ¹	Beginning Fund Balance ²	Percent Change	less in FY 2014-15 than in FY 2010-11?	
Capital Project Funds						
465	Construction Excise Tax Fund	\$18,799,145	\$73,874,080	293%	\$55,074,935	
393	**Construction Tax and Property Conveyance Tax Fund: Library Purposes	\$9,475,806	\$13,688,934	44%	\$4,213,128	
391	**Construction Tax and Property Conveyance Tax Fund: City-Wide Parks Purposes	\$6,928,567	\$10,576,306	53%	\$3,647,739	
392	**Construction Tax and Property Conveyance Tax Fund: Fire Protection Purposes	\$1,155,576	\$4,306,443	273%	\$3,150,867	
634	**Contingent Lien District Fund	\$0	\$2,512,508	-	\$2,512,508	
416	**Underground Utility Fund	\$1,814,465	\$3,791,144	109%	\$1,976,679	
390	**Construction Tax and Property Conveyance Tax Fund: Parks Purposes Central Fund	\$3,642,871	\$5,014,762	38%	\$1,371,891	
398	**Construction Tax and Property Conveyance Tax Funds: Park Yards Purposes	\$2,530,224	\$3,496,093	38%	\$965,869	
386	**Construction Tax and Property Conveyance Tax Fund: Parks Purposes Council District #8	\$3,910,409	\$4,801,954	23%	\$891,545	
459	* San Jose Arena Capital Reserve Fund	\$0	\$792,853	-	\$792,853	
381	**Construction Tax and Property Conveyance Tax Fund: Parks Purposes Council District #4	\$4,732,450	\$5,390,086	14%	\$657,636	
420	Residential Construction Tax Contribution Fund	\$958,826	\$1,429,698	49%	\$470,872	
691	Convention Center Facilities District Project Fund	\$0	\$262,259	-	\$262,259	
378	**Construction Tax and Property Conveyance Tax Fund: Parks Purpose Council District #2	\$1,631,743	\$1,856,146	14%	\$224,403	
462	**Lake Cunningham Fund	\$927,553	\$1,132,629	22%	\$205,076	
131	**Emma Prusch Memorial Park Fund	\$299,615	\$388,800	30%	\$89,185	
377	**Construction Tax and Property Conveyance Tax Fund: Parks Purposes Council District #1	\$5,127,321	\$5,152,577	0%	\$25,256	
476	San Jose Municipal Stadium Capital Fund	\$0	\$0	-	\$0	
395	Construction Tax and Property Conveyance Tax Fund: Service Yards Purposes	\$2,686,418	\$2,476,093	-8%	(\$210,325)	
421	**Major Collectors and Arterials Fund	\$1,259,125	\$980,727	-22%	(\$278,398)	
388	**Construction Tax and Property Conveyance Tax Fund: Parks Purposes Council District #9	\$3,543,558	\$3,084,927	-13%	(\$458,631)	
382	**Construction Tax and Property Conveyance Tax Fund: Parks Purposes Council District #5	\$5,549,134	\$4,541,575	-18%	(\$1,007,559)	
384	**Construction Tax and Property Conveyance Tax Fund: Parks Purposes Council District #6	\$4,650,960	\$3,509,948	-25%	(\$1,141,012)	
397	**Construction Tax and Property Conveyance Tax Fund: Communications Purposes	\$4,111,418	\$1,972,418	-52%	(\$2,139,000)	
389	**Construction Tax and Property Conveyance Tax Fund: Parks Purposes Council District #10	\$5,545,205	\$3,356,570	-39%	(\$2,188,635)	
385	**Construction Tax and Property Conveyance Tax Fund: Parks Purposes Council District #7	\$6,033,522	\$3,614,560	-40%	(\$2,418,962)	
380	**Construction Tax and Property Conveyance Tax Fund: Parks Purposes Council District #3	\$5,610,893	\$1,352,328	-76%	(\$4,258,565)	
375	**Subdivision Park Trust Fund	\$77,157,465	\$71,713,270	-7%	(\$5,444,195)	
472	Branch Libraries Bond Projects Fund	\$18,559,795	\$9,979,960	-46%	(\$8,579,835)	
475	Neighborhood Security Act Bond Fund	\$14,322,280	\$664,622	-95%	(\$13,657,658)	
471	Parks and Recreation Bond Projects Fund	\$35,515,994	\$19,979,111	-44%	(\$15,536,883)	
TOTAL - Capital Project Funds		\$246,480,338	\$265,693,381	8%	\$19,213,043	
Enterprise Funds						
521	Airport Revenue Fund	\$35,199,557	\$61,801,467	76%	\$26,601,910	
525	Airport Fiscal Agent Fund	\$60,317,543	\$86,076,988	43%	\$25,759,445	
523	Airport Maintenance and Operation Fund	\$16,958,009	\$30,695,930	81%	\$13,737,921	
519	Airport Customer Facility and Transportation Fee Fund	\$623,559	\$8,591,762	1278%	\$7,968,203	
533	General Purpose Parking Fund	\$7,903,838	\$14,123,190	79%	\$6,219,352	
527	Airport Renewal and Replacement Fund	\$7,817,641	\$11,871,516	52%	\$4,053,875	
524	Airport Surplus Revenue Fund	\$9,265,678	\$12,713,461	37%	\$3,447,783	
502	Major Facilities Fund	\$2,894,218	\$4,258,331	47%	\$1,364,113	
520	Airport Capital Improvement Fund	\$4,436,865	\$4,423,670	0%	(\$13,195)	
529	Airport Passenger Facility Charge Fund	\$46,220,269	\$26,252,424	-43%	(\$19,967,845)	
526	Airport Revenue Bond Improvement Fund	\$289,839,602	\$71,047,149	-75%	(\$218,792,453)	
TOTAL - Enterprise Funds		\$481,476,779	\$331,855,888	-31%	(\$149,620,891)	
Internal Service Funds						
157	Benefit Funds - Unemployment Insurance Fund	\$1,091,011	\$4,475,846	310%	\$3,384,835	
155	Benefit Funds - Dental Insurance Fund	\$3,174,701	\$4,399,345	39%	\$1,224,644	
160	Benefit Funds - Benefit Fund	\$155,468	\$1,073,031	590%	\$917,563	
552	Vehicle Maintenance and Operations Fund	\$1,308,135	\$1,819,060	39%	\$510,925	
156	Benefit Funds - Life Insurance Fund	\$281,081	\$151,977	-46%	(\$129,104)	
150	Public Works Program Support Fund	\$3,959,137	\$2,488,107	-37%	(\$1,471,030)	
TOTAL - Internal Service Funds		\$9,969,533	\$14,407,366	45%	\$4,437,833	
* The San José Capital Reserve Fund (Fund 459) is an agency fund (based on CAFR guidelines) and is included in the City's Operating Budget. It is listed here with Capital funds because it is a capital related fund.						
** These funds are listed in the City's Budget as Capital funds but for CAFR purposes, they are Special Revenue funds. We have listed them here based on the Budget classification because they are related to capital spending.						

(continued)					
Fund #	Fund Name	2010-11	2014-15	Five-Year	How much more or
		Beginning Fund Balance ¹	Beginning Fund Balance ²	Percent Change	less in FY 2014-15 than in FY 2010-11?
					Five-Year Sparkline
Special Revenue Funds					
448	Multi-Source Housing Fund	\$4,977,444	\$27,746,587	457%	\$22,769,143
791	Convention Center Facilities District Revenue Fund	\$3,771,012	\$24,889,696	560%	\$21,118,684
429	Building and Structure Construction Tax Fund	\$10,510,497	\$30,917,493	194%	\$20,406,996
346	* Low and Moderate Income Housing Asset Fund	\$19,040,460	\$29,829,136	57%	\$10,788,676
139	Gift Trust Fund	\$0	\$3,939,053	-	\$3,939,053
599	Improvement District Fund	\$0	\$2,948,239	-	\$2,948,239
418	Library Parcel Tax Fund	\$6,771,127	\$9,557,110	41%	\$2,785,983
461	Transient Occupancy Tax Fund	\$3,366,387	\$5,547,055	65%	\$2,180,668
422	Community Facilities Revenue Fund	\$796,435	\$2,808,162	253%	\$2,011,727
441	Community Development Block Grant Fund	\$7,521,560	\$8,925,267	19%	\$1,403,707
432	Ice Centre Revenue Fund	\$3,704,219	\$4,938,226	33%	\$1,234,007
419	Federal Drug Forfeiture Fund	\$2,295,789	\$3,386,188	47%	\$1,090,399
445	Home Investment Partnership Program Trust Fund	\$570,109	\$1,540,936	170%	\$970,827
369	Community Facilities District No. 2 and No. 3 Fund	\$1,359,821	\$2,195,149	61%	\$835,328
351	Business Improvement District Fund	\$716,775	\$1,466,413	105%	\$749,638
414	Supplemental Law Enforcement Services Fund	\$363,482	\$1,065,931	193%	\$702,449
373	Community Facilities District No. 8 Fund	\$2,960,306	\$3,506,424	18%	\$546,118
376	Community Facilities District No. 12 Fund	\$805,437	\$1,334,553	66%	\$529,116
379	Community Facilities District No. 14 Fund	\$0	\$449,685	-	\$449,685
310	Community Facilities District No. 13 Fund	\$0	\$181,589	-	\$181,589
290	Workforce Investment Act Fund	\$928,134	\$1,076,559	16%	\$148,425
364	Maintenance District No. 11 Fund	\$147,637	\$253,597	72%	\$105,960
302	Downtown Property & Business Improvement District Fund	\$970,816	\$1,040,931	7%	\$70,115
371	Community Facilities District No. 1 Fund	\$448,652	\$508,002	13%	\$59,350
374	Community Facilities District No. 11 Fund	\$215,738	\$274,661	27%	\$58,923
356	Maintenance District No. 21 Fund	\$263,371	\$318,325	21%	\$54,954
366	Maintenance District No. 13 Fund	\$42,612	\$92,102	116%	\$49,490
365	Maintenance District No. 20 Fund	\$334,855	\$381,206	14%	\$46,351
354	Maintenance District No. 2 Fund	\$51,460	\$97,164	89%	\$45,704
361	Maintenance District No. 8 Fund	\$285,886	\$329,473	15%	\$43,587
357	Maintenance District No. 5 Fund	\$339,802	\$365,381	8%	\$25,579
372	Maintenance District No. 18 Fund	\$49,264	\$67,662	37%	\$18,398
301	San Jose Arena Enhancement Fund	\$9,540	\$27,587	189%	\$18,047
410	Gas Tax Maintenance and Construction Fund - 1964	\$0	\$0	-	\$0
370	Community Facilities District No. 15 Fund	\$0	\$0	0%	\$0
409	Gas Tax Maintenance and Construction Fund - 1943	\$0	\$0	0%	\$0
411	Gas Tax Maintenance and Construction Fund - 1990	\$0	\$0	0%	\$0
367	Maintenance District No. 22 Fund	\$268,255	\$239,119	-11%	(\$29,136)
444	Economic Development Administration Loan Fund	\$105,487	\$75,693	-28%	(\$29,794)
362	Maintenance District No. 9 Fund	\$392,938	\$332,676	-15%	(\$60,262)
352	Maintenance District No. 1 Fund	\$792,000	\$726,062	-8%	(\$65,938)
359	Maintenance District No. 19 Fund	\$370,763	\$277,810	-25%	(\$92,953)
368	Maintenance District No. 15 Fund	\$5,270,075	\$4,964,481	-6%	(\$305,594)
536	Convention & Cultural Affairs Fund	\$6,326,613	\$5,992,739	-5%	(\$333,874)
417	State Drug Forfeiture Reserve	\$1,432,947	\$993,470	-31%	(\$439,477)
518	Municipal Golf Course Fund	\$1,073,648	\$542,442	-49%	(\$531,206)
474	Edward Byrne Memorial Justice Assist. Grant Trust Fund	\$1,444,738	\$221,596	-85%	(\$1,223,142)
440	Housing Trust Fund	\$3,170,062	\$1,872,100	-41%	(\$1,297,962)
TOTAL - Special Revenue Funds		\$94,266,153	\$188,243,730	100%	\$93,977,577
210	City Hall Debt Service Fund	\$818,782	\$111,335	-86%	(\$707,447)
Total Five-Year Change - All Fund Types		\$833,011,585	\$800,311,700	-4%	(\$32,699,885)
1- FY 2010-11 Funding Sources Resolution					
2- FY 2014-15 Funding Sources Resolution					
* Effective February 1, 2012, all redevelopment agencies in California were dissolved pursuant to AB XI26, which was signed by the Governor on June 28, 2011. As a result, the Low and Moderate Income Housing Fund (Fund 443) was closed out and the Low and Moderate Income Housing Asset Fund (Fund 346) was established effective February 1, 2012. As allowed under the legislation, the City elected to retain the housing assets and functions of the dissolved San José Redevelopment Agency and the eligible housing assets and liabilities were transferred to this fund.					

APPENDIX C

Examples of Differences in Presentation of Fund Balance in the Budget Versus CAFR (Differences in Accounting Basis)

Unrealized Gains/Losses – These reflect “paper” gains and losses that must be shown in the CAFR in accordance with accounting standards. Since they are not cash transactions, however, they are not reflected in the Budget. For example, an investment such as a bond is listed in the CAFR at its fair market value each year. This may be an increase or decrease from the prior years; however, since such changes in value are not in cash but only on paper, they are not reflected in the Budget.

Year-End Encumbrances – An encumbrance refers to funds that have been committed to pay for a contractual obligation but have not yet been spent. In the CAFR, encumbrances are included as part of restricted or committed fund balance. To calculate the budgetary fund balance, they are subtracted. Encumbrances are considered expenditures (already spent) for purposes of the budgetary fund balance.

Long-Term Assets and Liabilities – These include assets and liabilities expected to be received or owed in a time frame that is more than one year away. Such long-term assets and liabilities are reflected in the CAFR but are not part of the budgetary fund balance since the liability would not be considered “expensed” during the coming year and the asset would not be considered “available” during the coming year. An example might be the long-term portion of a loan that is due more than a year out.

Another factor that may result in differences in the presentation of fund balance between the CAFR and the Budget is that certain funds are combined together with the General Fund in the CAFR presentation in order to comply with Generally Accepted Accounting Principles (GAAP). For example, the Cash Reserve Fund is combined with the General Fund in the CAFR but is not combined with the General Fund in the Budget presentation.

APPENDIX D

Overview of Fund Types

Governmental Funds– track the basic activities of a government. Governmental funds in San José include:

General Fund – accounts for the most basic, tax-supported activities of a local government (technically the resources not required to be in another fund). Funds general purpose activities like police, fire, and library services.

Special Revenue Funds – track revenue sources restricted or committed to specific uses. For example, the Library Parcel Tax Fund accounts for the annual parcel tax revenues to be used for enhancing the City’s library services and facilities.

Capital Projects Funds – follow the resources used to build, acquire, and renovate major general capital assets. For example, the Branch Libraries Bond Projects Fund accounts for general obligation bond proceeds approved by voters. The funds have been used to expand and improve aging branch libraries, add parking, add space for more books and computers, and build new libraries in neighborhoods throughout the City.

Debt Service Funds – for resources used to pay general long-term debt. For example, funds to cover debt service for financing the construction of City Hall and the City Hall off-site employee parking garage.

Proprietary Funds – report activities that are generally financed and operated like private businesses:

Enterprise Funds – may be used to account for any activity that charges a fee to users. Enterprise funds are *required* to be used for any activity that is: (1) financed with debt that is repaid only with the activity’s own user revenues; and/or (2) legally required to cover its costs (including depreciation or debt service) with fees and charges rather than taxes and similar revenues; and/or (3) sets its fees in order to recover all of its operating and capital costs (including depreciation and debt service). For example, there are various Enterprise Funds related to the operations of the Norman Y. Mineta San José International Airport.

Internal Service Funds – report activities that provide goods or services to other funds of the government or to other governments in return for a fee to reimburse costs. The City uses Internal Service Funds to account for the employee benefits, cost for operating a vehicle maintenance facility, and the public works support program.

Fiduciary Funds – report assets that are held for others and that cannot be used to support a government’s own programs:

Pension (and other employee benefit) Trust Funds – account for resources held in trust for employees and beneficiaries of the pension and retiree healthcare plans.

Private Purpose Trust Funds – report various trust arrangements. For example, in San José there is such a trust fund that accounts for the custodial responsibilities that are assigned to the Successor Agency to the Redevelopment Agency of the City of San José (SARA) with the passage of the Redevelopment Dissolution Act.

Agency Funds – contain resources held on a temporary, purely custodial basis. In San José, this accounts for assets held by the City in a custodial capacity of behalf of the SAP Center.

APPENDIX E

Cross-City Comparison of Reserve Structures and Practices

	<i>San José</i>	<i>San Diego</i>	<i>Oakland</i>	<i>Long Beach</i>	<i>Sacramento</i>	<i>Palo Alto</i>	<i>Santa Clara</i>	<i>Fremont</i>
2014 Population (California Department of Finance)	1,000,536	1,345,895	404,355	470,292	475,122	66,861	121,229	223,972
FY 14-15 Adopted General Fund Expenditures	\$1,132,680,837	\$1,202,422,436	\$493,709,824	\$419,084,757	\$382,846,000	\$171,086,000	\$164,777,000	\$156,827,000
Equivalent of San José's Budget Stabilization Reserve	Budget Stabilization Reserve <ul style="list-style-type: none"> Target: none FY 14-15: \$10 million 	Stability Reserve <ul style="list-style-type: none"> Target: 6% of three-year average of annual audited General Fund revenues Meets target?: Yes 	Vital Services Stabilization Fund <ul style="list-style-type: none"> Target: 15% Meets target?: No 	Operating Reserves <ul style="list-style-type: none"> Target: 2-7% of General Fund expenditure Meets target?: Yes 	Economic Uncertainty Reserve (EUR) <ul style="list-style-type: none"> Target: 10% of General Fund revenues Meets target?: No 	Budget Stabilization Reserve (BSR) <ul style="list-style-type: none"> Target: 18.5% of General Fund expenditures Meets target?: Yes 	Working Capital (Emergency) Reserve <ul style="list-style-type: none"> Target: 25% of General Fund operations Meets target?: No 	Economic Volatility Reserve <ul style="list-style-type: none"> Target: 2.5% of General Fund expenditures and transfers out Meets target?: Yes Budget Uncertainty Reserve <ul style="list-style-type: none"> Target: Long-term funding level determined in multi-year forecast Meets target?: Yes

	<i>San José</i>	<i>San Diego</i>	<i>Oakland</i>	<i>Long Beach</i>	<i>Sacramento</i>	<i>Palo Alto</i>	<i>Santa Clara</i>	<i>Fremont</i>
Equivalent of San José's Contingency Reserve	Contingency Reserve <ul style="list-style-type: none"> • Target: 3% • Meets target?: Yes 	Emergency Reserve <ul style="list-style-type: none"> • Target: 8% of three-year average of annual audited General Fund revenues • Meets target?: Yes 	General Purpose Fund Emergency Reserve <ul style="list-style-type: none"> • Target: 7.5% of General Purpose Fund appropriations • Meets target?: Yes 	Emergency Reserve <ul style="list-style-type: none"> • Target: 8-10% of General Fund expenditures • Meets target?: Yes 	<i>No equivalent</i>	<i>No equivalent</i>	<i>No equivalent</i>	Contingency Reserve: <ul style="list-style-type: none"> • Target: 10% of annual GF operating expenditures and transfers out • Meets target?: Yes
Other Reserves within the General Fund	Earmarked Reserves	Excess Equity	<i>No other major reserves within General Fund</i>	Infrastructure, Systems Replacement and Technology Reserve Reserve for Subsequent Years Appropriations Other Reserves and Designation for Purpose	Administrative Contingency Reserve	<i>No other major reserves within General Fund</i>	Capital Projects Reserve Land Sale Reserve Building Inspection Reserve City Manager Contingency Reserve	Program Investment Reserve
Does the city have reserves similar to San José's earmarked reserves that are used for long-term budgeting?	Use of earmarked reserves for long-term budgeting and different purposes	The city does not have reserves similar to San José's earmarked reserves. Excess equity has not been used for long-term budgeting in the past. Since the city's most recent revised policy was adopted, the	Infrequent "reservations of fund balance" at the request of Council or recommended by Budget for Council for a specific purpose. No policy governs this practice. Reservations are funded by unrestricted fund balance and	Reserve for Subsequent Years Appropriations: One-time moneys set aside as reserves for next year expenditures. Few cases where these reserves fund multi-year projects.	Currently none. Used to have smaller reserve "designations" that could be used for specific purposes (e.g., PERS payments down the road; future labor costs; economic development). Depleted during the recession, and will probably not be coming	Began using earmarked reserves in 2014. These are for current year expenditures, and could be carried forward or liquidated if unused. The Human Services Resource Allocation Process reserve is the only more long-term	The city does not have reserves similar to San José's earmarked reserves. The Capital Projects Reserve is used to fund multi-year projects, but funds are only appropriated out of the reserve for one year.	The city does not have reserves similar to San José's earmarked reserves. The Program Investment Reserve seems like a consolidated version of some of San José's earmarked reserves, but has

		possibility of using excess equity for long-term budgeting has not been discussed.	are tracked internally. E.g., \$500 thousand set aside during the '14-'15 mid-cycle budget for libraries.		back since GASB policy changed and having these small designations does not seem in line with the new rules.	earmarked reserve. Reasoning behind earmarking is to clarify what exactly reserve monies are funding, not to be used for long-term budgeting.	Budget plans internally for funding of subsequent years. The Land Sale and Building Inspection reserves are more long term, but are only used for very specific things.	not been used in the last five years.
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	<i>San José</i>	<i>San Diego</i>	<i>Oakland</i>	<i>Long Beach</i>	<i>Sacramento</i>	<i>Palo Alto</i>	<i>Santa Clara</i>	<i>Fremont</i>
Does the city have reserves that could theoretically be liquidated to supplement general purpose reserves?	Some earmarked reserves could be liquidated (see Appendix A), while others have more restrictions. Ending fund balance could also be directed towards stabilization. See Finding 2, Exhibit 9.	Spendable excess equity can be used to supplement reserves.	Unrestricted fund balance could be used. Also, Council could choose to redirect funding from one source to supplement reserves (e.g., the \$500 thousand "reservation of fund balance" for libraries).	The Infrastructure, Systems Replacement and Technology Reserve could be liquidated to supplement the Emergency Reserve. Unassigned fund balance could also be used.	The Administrative Contingency Reserve and fund balance could be used to supplement the Economic Uncertainty Reserve.	As the Budget Stabilization Reserve is already a significant portion of the General Fund fund balance, there are no other reserves that could be liquidated to supplement it. Council could propose a loan transfer from one fund to another to help pay for unforeseen costs.	None	The Program Investment Reserve could be used to supplement the three other general purpose reserves. Unrestricted fund balance could also be used.

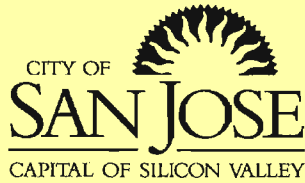
APPENDIX F

List of GFOA “Risks” and “Drivers” Influencing the Setting of Reserve Policy Targets¹

Risks	Explanation	Relationship
Vulnerability to extreme events and public safety concerns	What extreme events (e.g., natural disasters) is a city vulnerable to? What are the public safety programs that must be funded to respond to such events?	↑ vulnerability = ↑ reserve
Revenue source stability	How volatile is a city’s revenue stream? Is a city dependent on revenues from only a few sources of revenue?	↑ stability = ↓ reserve
Expenditure volatility	What are potential spikes in expenditure? How likely are these to happen?	↑ volatility = ↑ reserve
Leverage	How committed is a government to paying for other needs, such as debt or infrastructure maintenance?	↑ leverage = ↑ reserve
Liquidity	How much money does a city have available at certain times in the year? Is there a significant lag between making expenditures and receiving revenues?	↑ liquidity = ↓ reserve
Other funds’ dependency	Does the general fund act as a backstop for other funds?	↑ dependency = ↑ reserve
Growth	How fast is a city growing? Does a city have the necessary funding to support that rate of growth?	↑ growth = ↑ reserve
Capital projects	Do capital projects have a dedicated funding source, or do they rely on reserves and fund balance?	↑ dedicated funding = ↓ reserve

Drivers	Explanation	Relationship
Commitments or assignments	Is a portion of fund balance committed or assigned to another purpose aside from the risks listed above?	↑ commitment = ↑ reserves
Budget practices	Does the city’s budget leave room for contingencies, or is the city’s reserve the only source of funding for contingencies?	↑ built in contingencies = ↓ reserves
Government size	How large is the government and how many overall resources does it have?	↑ size = ↓ reserves
Borrowing capacity	Can a government easily borrow money externally or internally?	↑ capacity = ↓ reserves
Outsider perceptions	Does a city take into consideration rating agencies or the public’s opinion on reserve levels?	
Political support	Do reserve targets have support from elected officials and the public?	

¹ A risk is the probability and magnitude of a loss, disaster, or other undesirable event. A driver is a factor that does not necessarily entail a potential loss (like a risk does), but still influences the appropriate reserve policy target. For a more detailed look on these factors, visit GFOA’s website: <http://www.gfoa.org/financial-policy-examples-general-fund-reserves>.



Memorandum

TO: Sharon W. Erickson
City Auditor

FROM: Jennifer A. Maguire

SUBJECT: SEE BELOW

DATE: March 10, 2015

Approved

Date

SUBJECT: RESPONSE TO THE AUDIT “FUND BALANCE AND RESERVES: SAN JOSE SHOULD AIM TO HAVE HIGHER NET RESERVES”

BACKGROUND

The Administration has reviewed the *Fund Balance and Reserves: San Jose Should Aim to Have Higher Safety Net Reserves* audit report prepared by the City Auditor and agrees with the two recommendations identified in the report. This memorandum provides responses to the individual recommendations.

RECOMMENDATIONS AND ADMINISTRATION’S RESPONSE

The following are the Administration’s response to each recommendation.

Recommendation #1: The Budget Office should propose revisions to Council Policy 1-18 (which address the City’s general purpose reserves) that would establish an overall reserve target level range for the *Contingency Reserve* and the *Budget Stabilization Reserve*. Such a range should be approximately 10 percent of expenditures (the minimum of benchmarked California cities) to 16.6 percent (the GFOA-recommended best practice).

Administration’s Response to Recommendation #1: The Administration agrees with this recommendation and will bring forward a proposed amendment to City Council Policy I-18 (Operating Budget and Capital Improvement Program Policy) as a Manager’s Budget Addendum to the 2015-2016 Proposed Budget for City Council consideration. A proposed overall reserve target level for the Contingency Reserve and the Budget Stabilization Reserve will be brought forward in the range of 10 percent to 16.6 percent of expenditures, consistent with the GFOA-recommended best practice. Given the City’s current General Fund condition, it is important to note that while this policy revision will establish a reserve goal, it will likely take many years to reach that goal without significantly impacting service delivery.

Sharon W. Erickson, City Auditor

March 10, 2015

Subject: Response to the Audit "Fund Balance and Reserves: San Jose Should Aim to Have Higher Safety Net Reserves"

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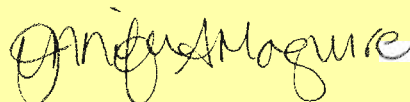
Recommendation #2: The Budget Office should propose revisions to Council Policy I-18 regarding the City's general purpose reserves (the *Contingency Reserve* and *Budget Stabilization Reserve*) to incorporate all essential and important policy elements recommended by GFOA.

Administration's Response to Recommendation #2: The Administration agrees with this recommendation and will bring forward a proposed amendment to City Council Policy I-18 as a Manager's Budget Addendum to the 2015-2016 Proposed Budget for City Council consideration. The description of the general purpose reserves will be revised to incorporate the essential and important policy elements recommended by GFOA. As discussed in the audit, these elements provide clear guidance on the why, how and when reserves should be funded, used, and replenished.

CONCLUSION

The Audit identified issues regarding the funding level of the City's general purpose, safety net reserves and the need to have written reserve policies that are more comprehensive in scope. The Administration will bring forward proposed revisions to the City Council Policy I-18 to implement these recommendations as part of the 2015-2016 Proposed Budget process. By increasing these reserves over time, the City would be better positioned to address economic downturns or other potential revenue or expenditure risk factors without immediately impacting service delivery. This prudent budget practice would also bring the City in line with other comparable jurisdictions and GFOA best practices.

The Administration would like to thank the City Auditor's Office for conducting this audit.



Jennifer A. Maguire
Interim Senior Deputy City Manager/
Budget Director

If you have questions, please contact Margaret McCahan, Assistant Budget Director, at (408) 535-8132.