NIPOMO COMMUNITY SERVICES DISTRICT

MONDAY, NOVEMBER 19, 2012

2:00 P.M.

SPECIAL MEETING NOTICE & AGENDA

FINANCE AND AUDIT COMMITTEE

COMMITTEE MEMBERS
LARRY VIERHEILIG, CHAIRMAN
DAN GADDIS, MEMBER

PRINCIPAL STAFF
MICHAEL S. LEBRUN, **GENERAL MANAGER**
LISA BOGNUDA, **ASST GM/FINANCE DIRECTOR**
JON SEITZ, **GENERAL COUNSEL**

MEETING LOCATION - District Board Room
148 S. Wilson Street, Nipomo, California

1. **CALL TO ORDER, FLAG SALUTE AND ROLL CALL**

2. **REVIEW DRAFT CASH RESERVE POLICY**

   ACTION RECOMMENDED: Provide direction to Staff

3. **REVIEW AUDITING SERVICES**

   ACTION RECOMMENDED: None – information only

4. **ADJOURN**

TO: MICHAEL S. LEBRUN
GENERAL MANAGER

FROM: LISA BOGNUDA
FINANCE DIRECTOR LSB

DATE: NOVEMBER 15, 2012

AGENDA ITEM

2

NOVEMBER 19, 2012

REVIEW DRAFT CASH RESERVE POLICY

ITEM
Review draft Cash Reserve Policy

BACKGROUND

A reserve policy is an integral part of the overall District financial plan to ensure that sufficient funding is available for current operating, capital, and debt service needs as well as providing for unanticipated or unforeseen events. It is the District's responsibility to prudently accumulate, manage and maintain its reserves.

At the recommendation of the rate consultant in 1996, the District informally adopted cash reserve goals for the Water and Sewer Funds. The consultant recommended the cash reserve for the water fund be set at six months (180 days) of operating costs (not including funded replacement) and the cash reserve for the sewer funds be set at three months (90 days) of operating costs (not including funded replacement). The District continues to follow these reserve goals for the Water and Sewer Funds and are meeting and/or exceeding them today.

Bond Counsel for the Southland WWTF Upgrade 2012 Certificate of Participation (COP) issuance requested the District adopt a Debt Management Policy prior to the issuance. This was completed in February 2012. In addition, Bond Counsel suggested the District consider a Reserve Policy.

California Special Districts Association (CSDA) prepared Special District Reserve Guidelines (Attachment A) that address the principles for a reserve policy. In addition, Staff has reviewed various reserve policies from special districts and water districts throughout the State. What can be concluded from the review of these policies is that no two policies are alike and each district's policy is tailored to fit their needs. As stated in the City of San Luis Obispo Setting Reserves Levels article (Attachment B), *"In comparing reserve levels between government agencies, it is important to recognize that "one size does not fit all." In short, other than having a reserve at all, there is no "right" level: it depends on the circumstances in each agency."*

Staff met with the Finance and Audit Committee on October 2, 2012 and reviewed the first draft of the Cash Reserve Policy. Staff received Committee recommendations and incorporated them into the current draft (Attachment C).

Staff has updated the summary of the Operating Funds (Attachment D) which provides the status of each Fund based on the proposed Reserve Policy.

In addition, Staff has included a flow chart of the Fund Structure and Cash Flows (Attachment E) to provide a visual to aid in the discussions.

RECOMMENDATION

It is recommended that your Committee review the draft Cash Reserve Policy and direct Staff to present it to the Board of Directors for consideration.

ATTACHMENT

A. Special District Reserve Guidelines
B. City of San Luis Obispo Setting Reserve Levels
C. Draft Cash Reserve Policy
D. Summary of Operating Funds
E. Fund Structure and Cash Flows

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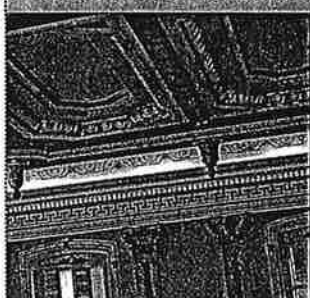
NOVEMBER 19, 2012

ITEM 2

ATTACHMENT A

Special District Reserve Guidelines



CSDA
Providing value for
special districts.

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Acknowledgements

In preparing the *Special District Reserve Guidelines*, the California Special Districts Association (CSDA) greatly benefited from individuals who were very generous with their time and insightful with their views. Our task force consisted of finance staff and general managers from independent special districts and professional financial consultants.

CSDA extends its appreciation to its district task force members:

- Dewey Ausmus of North County Cemetery District
- Ward Winchell of Southgate Recreation & Park District
- Rainy Selamat of Olivenhain Municipal Water District
- Ray Waletzko of Contra Costa Mosquito & Vector Control District
- Janice Simcoe of Sacramento Metropolitan Fire District
- John Martin of Bear Valley Community Services District
- Jeff Ramos of Elk Grove Community Services District

To the finance professionals on our task force, who significantly contributed to the development of the treatises, in addition to the drafting of the principles and guidelines, CSDA extends its sincere gratitude. The contributions of the following were invaluable:

- Jim Marta, CPA, of James Marta & Company
- Tim Schaefer of the public financial advisory firm, Fieldman, Rolapp & Associates
- Saul Rosenbaum of the investment banking firm, Prager, McCarthy & Sealy
- Steven Northcote, CPA, of Leaf & Cole

The Formation of Special District Reserve Guidelines

Answering a Call, Fulfilling a Need

The genesis for CSDA's *Special District Reserve Guidelines* was a 2000 Little Hoover Commission report entitled, "Special Districts: Relics of the Past or Resources for the Future?" The report includes a section on special district reserves with an introductory finding that states: *"Hundreds of independent special districts have banked multi-million dollar reserves that are not well publicized and often not considered in regional or statewide infrastructure planning."*

The section raises a number of issues relating to special district reserves including:

- Lack of guidelines and consistency
- Lack of visibility, and publication of, district financial information
- Lack of understanding among constituents and policymakers of district finances
- Lack of districts incorporating reserve information into infrastructure planning

The Commission's report claimed that, statewide, independent special districts have over $19.4 billion in reserves and many special districts have excess retained earnings (reserves). The report recommends that guidelines for prudent reserves be established, and that investment policies and practices be reviewed to determine if additional oversight is warranted.

The Little Hoover Commission report generated significant media coverage with banner headlines claiming that "obscure" public agencies have "hoarded" billions in reserves. Legislative hearings on special district finances were held and interest was spiked among grand juries, leading them to investigate how special districts within their counties handle reserves. The Sacramento Grand Jury report of 2000-2001 states: *"Few of the enterprise districts have an easily understood, board-approved and documented plan describing the development and use of undesignated retained earnings."*

CSDA Forms Task Force

Although special district advocacy organizations have concerns with some of the report's findings and data interpretation, CSDA believes that the establishment of reserve guidelines will assist special district governing officials and administrators in fulfilling their fiduciary responsibilities. To accomplish this, CSDA formed a task force in 2001 to identify both the essential elements of a reserve policy and the issues to be discussed during policy development.

The *Special District Reserve Guidelines* were developed by the task force as a tool for special district governing officials and administrators to assist them in fulfilling their commitment to provide cost-effective and efficient public services for the communities they serve. The guidelines may be used to evaluate an existing reserve policy, develop a new reserve policy, and/or promote comprehensive and easily understood policies within a special district. CSDA encourages district officials to incorporate guideline elements into their policies that are applicable to their district based on its size and the services it offers.

These guidelines are general in nature and should not be reviewed as legal or financial opinions. Prior to a district's adoption of any policy, the agency should seek review by its legal counsel, accountant and/or auditor to ensure compliance with all applicable rules and regulations.

In developing the guidelines, the task force recognized that many independent special districts already have established reserve policies and most, if not all, special districts officials recognize their fiduciary responsibilities and take them very seriously. What may have generated the concern regarding special district reserves is not lack of policy, but lack of outreach to constituents and others regarding district operations. It is essential that special districts increase the level of understanding outside their boardroom and initiate an outreach program on district financial management to increase the level of understanding among the public, media and legislators.

To assist special districts in their effort to either launch or enhance their community outreach efforts, CSDA introduced a new member benefit – "Public Outreach Assistance Service". CSDA's outreach assistance program is a fee-based copy editing/writing and graphic design service developed to encourage districts to increase their visibility and the level of understanding among constituents, the media and other decision-makers. Additional information on this program can be obtained by calling CSDA at (877) 924-CSDA.

Prudent Accumulation and Management of Reserves

The principles and guidelines that follow reflect the common belief among special districts that there should be clear and well-articulated rationale for the accumulation and management of reserve funds. Individual districts should formulate and adopt a reserve policy, as it is an integral part of the prudent accumulation and management of reserves. The public has a general lack of understanding regarding the purpose of special district reserves and appropriate reserve levels. Districts can make great strides in dispelling misperceptions related to reserve levels--while building stronger bonds with the communities they represent--through the adoption of a well-developed reserve policy and efforts to educate and inform the public of reserve particulars.

While it is essential that districts adopt reserve policies, it is critical to understand that a reserve policy must be developed in a manner consistent with other financial policies, budgetary practices, district programs, and legal requirements. Three foundational elements are essential prerequisites to the development of any reserve policy:

1. A clear, organizational philosophy/mission
2. A well-developed capital improvement plan, as a critical element of regular strategic-planning efforts
3. Use of a standardized method of financial reporting, such as GASB 34

Principles and Guidelines

1. Identify the uniqueness of the district.
    a) Consider district goals, needs, and constraints.
    b) Utilize life-cycle analysis if district is capital intensive. Regularly measure condition of assets.

2. Have a complete understanding of the district's core business.

3. Develop and maintain a strategic plan, including a well-developed capital improvement plan.

4. Make communicating with customers and constituents a priority.
    a) Seek input through customer surveys, community meetings, and other means.
    b) Inform customers and constituents of output and seek their input in evaluating policies.

5. Recognize that a good reserve policy must be consistent with other financial policies, such as balanced operating budget or investment policies.*

*An excellent resource on this point is "Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting," available from the Government Finance Officers Association. For more information, log onto www.gfoa.org.

6. Clearly identify reserves, both categories and purposes. Set target level for reserves that are consistent with district's mission, the district's uniqueness, and the philosophy of the district's board and community.

7. A broad reserve policy may include many elements or sub-policies. Some areas that may need sub-policies include:
    a) rate-stabilization funds
    b) fees and charges
    c) debt issuance and management
    d) deferred maintenance
    e) contingency funds

8. Engage in strategic planning.
    a) By developing, regularly evaluating and, when necessary, modifying strategic plans, districts can more efficiently plan and shape their futures. Strategic planning can help district boards anticipate and adapt to changing environmental, regulatory and demographic conditions. This assists districts in establishing appropriate reserve funds and adopting adequate target levels.
    b) Seek community input in the strategic planning process, i.e., ratepayers, business groups, community organizations, etc.
    c) While a district might invite some community members to participate in a formal strategic planning meeting with the board, a more likely scenario is for the district to engage various stakeholders through surveys, focus groups, or a series of neighborhood meetings.

9. Make communicating with customers and constituents an integral part of the district's financial practices. Whether through a quarterly newsletter or a condensed annual report, it is critical for districts to explain their financial position to their customers in layman's terms. If a district needs assistance or new ideas on how to effectively communicate with its constituents or customers, CSDA is available to assist through its Public Outreach Assistance Service or other means.

Specific Considerations for Budgeting and Allocating Fund Balance or Retained Earnings

1. <u>Define organization's objectives:</u>
    - Short-term
    - Long-term
    - Operating
    - Capital

2. Identify where funds are used:
   - Operating revenues
     These are the general-purpose funds through which ongoing activities are funded.
   - Special-purpose revenues
     Most often these are legally restricted for a particular use. For example, a special assessment for infrastructure must be separately accounted for and spent on the designated infrastructure costs.
   - Debt proceeds
     These should be used to fund costs that provide a benefit across fiscal years. The issuance of debt allows the district to allocate these costs by spreading the debt service to these periods. Debt proceeds should never be used for short-term operating costs because this would entail allocating current operating costs to future periods.
   - Other one-time revenues
     One-time revenues should be used for one-time expenses. If a special district gets one-time revenues and uses it to provide additional full-time positions or to fund on-going operating costs, there may be a budget crisis when the one-time funding runs out.

Capital Planning

A Capital Improvement Program (CIP) exists to identify and prioritize a district's need for capital goods. A CIP should prioritize the importance and timing of the various assets to be acquired. In addition, a CIP should contemplate how those goods will be paid for – cash (equity) or debt. A capital plan is a strategic or comprehensive plan for the acquisition and implementation of the district's capital assets as a group, or over time. In that sense, it is different from a finance plan, which focuses on individual acquisitions and how to pay for them.

To fulfill its mission, the district must make capital investments. Debt -- especially tax-exempt debt -- is recognized as an important and continuing source of a district's capital to fund improvements necessary to achieve its mission and strategic objectives. A CIP provides the framework by which decisions will be made regarding the use of cash and debt to finance capital projects. Debt is defined to include all short- and long-term obligations, guarantees and instruments that have the effect of committing the district to future payments. The assumption of debt, both direct and indirect, will be subject to the district's approval. Any debt issued by subsidiary entities is subject to these policies. In satisfying their fiduciary responsibilities, it is critical that the district's board and management know the extent of debt obligations.

CIP Objectives

1. To provide guidelines to management on the use of reserves and debt to support the district's capital needs while achieving the lowest overall cost of capital.
2. To provide selected financial measures, with specific targets, to ensure that the district continues to operate within appropriate financial parameters while allowing the agency to maintain financial stability and the highest acceptable credit rating that permits it to issue debt at favorable rates.
3. To bridge the cash flow gap between the district's available funds and its capital needs when the assumption of debt is deemed prudent.

Debt Allocation

Given that a district has limited debt capacity, management must prioritize debt resources among all uses, including capital projects, equipment financing, real estate investment, financial opportunities, and other projects. In allocating debt, the following guidelines may be used:

- **Core mission:** Only projects which relate to the core mission of the district will be considered for tax-exempt debt financing.
- **New revenue stream or budgetary savings:** A project that has a related revenue stream or can create budgetary savings will receive priority consideration. However, this is not meant to exclude other projects that are key to the district's mission. For these projects, the use of debt must be supported by an achievable financial plan that includes servicing the debt and meeting any new or increased operating costs. These costs could include the funding of a replacement and renovation reserve. For projects that can create budgetary savings, the budget may be reduced to fund the debt service and any additional savings may be invested into other critical capital projects.
- **Length of useful life:** The useful life of a project needs to be taken into account when considering long-term debt for capital investment.
- **Capacity to attract outside funds:** Project-generating revenues, federal and state grants, expendable reserves, and other sources are expected to finance a portion of the cost of a project. Debt is to be used conservatively and strategically.
- **Other considerations:** The above factors are not intended to be all-inclusive. Management's judgment ultimately will determine the use and amount of debt.

Debt Portfolio

No undue restriction should be imposed on the nature of a debt instrument as long as it can be appropriate and advantageous for the purpose of limiting interest-rate exposure and reducing debt-service costs. Fixed-rate debt provides more long-term interest rate stability than variable-rate debt, however, variable-rate debt can be a desirable component of the debt portfolio because it is typically issued at lower interest rates. Because the use of variable debt exposes the debt portfolio to interest rate fluctuations, the district should limit the use of variable-rate debt, and use it only when it is clearly advantageous.

Credit-rating Maintenance

Maintaining the highest acceptable credit rating is a primary objective of a CIP. This permits the district to continue to issue debt and to finance capital projects at favorable interest rates, while meeting its strategic objectives. The district should limit its overall debt to a level that maintains an acceptable credit rating with the bond-rating agencies.

Creating a Capital Plan

Creating a capital plan takes six basic steps:

1. Establish goals
2. Assess needs
3. Develop strategic cash vs. borrow approach
4. Identify methods available for funding
5. Design the loan or secure financing
6. Organize approach

Establish Goals

The key elements in setting clear capital plan goals include:

1. Understanding the role of the planning horizon.
2. Integrating the use (or lack thereof) of reserves.
3. Understanding the repetitive nature of implementing the CIP.

Planning horizons are important considerations in well-developed capital plans. For example, it makes little sense to try to plan for a 10- or 20-year horizon if innovation, technology, demographics or legislative threats to the plan occur often or on short notice. Conversely, agencies that are in low-technology businesses and stable demographic circumstances can afford to (and probably should) plan for long periods.

The extent to which a particular district has accumulated reserves will dramatically impact the capital plan. The development of, and adherence to, strong reserve policies can greatly simplify funding choices for the capital plan. But, blind adherence to arbitrary reserve levels can be just as inhibiting as no reserves at all. The key is to make the reserve accumulation, or depletion, work in harmony with the capital plan, the operating budget and the risk management of the district.

The last point is worth emphasizing. The capital plan is by its nature repetitive. For that reason, many districts choose to review and update it annually, usually as an adjunct to deliberation of the operating budget. This keeps the capital plan current and tempered by current information on the financial and political priorities of the district.

Assess Needs

Every capital plan starts with a needs assessment. The assessment should rely on a comprehensive inventory of capital assets already owned, an estimate of their remaining useful lives, and a good understanding of future requirements. While a detailed review of the steps necessary for an effective needs assessment are beyond the scope of the *Special District Reserve Guidelines*, the needs assessment is the foundation for virtually all of the decisions that will arise in the capital planning process. As a result, it pays big dividends to emphasize this element of the plan.

Useful tools in the operation of the needs assessment may include: community focus groups or commissions, local and regional planning agency studies, staff input, and reviews by engineering, accounting and legal experts.

A Strategic Decision – Pay-as-you-go or Borrow?

Once major acquisition needs are identified and service goals established, the district faces the decision of whether to pay cash or borrow to acquire capital assets. There are two theories as to which is the best approach to take. Those who believe that paying cash is the most desirable way of funding capital assets point to the inherent fiscal conservatism of such an approach. This approach is often referred to as "pay-as-you-go" or "pay-as-you-acquire." Use of this approach produces cash equity in capital assets and is often promoted because a dollar not borrowed is a dollar on which interest need not be paid.

On the other side of the spectrum are the "pay-as-you-use" proponents, who usually argue that accumulation or creation of major amounts of equity in capital assets is economically inefficient, particularly for those districts that are capital intense and whose capital goods are "used up" over long periods of time. The rationale behind this approach is that the district's stakeholders should "pay" for the assets required to deliver the goods or services of the agency over a time period that more closely mirrors the useful life of those assets.

Most districts use a blended approach. Often, a district's approach is dictated as much by affordability as by philosophy, as few public bodies can afford (either in a political sense or economic one) to pay cash for all capital assets. Similarly, financing of smaller capital goods, or those with short or uncertain useful lives, is also inefficient.

Identify Methods Available for Financing

Once the goals have been set, the needs assessed and the decision whether to pay cash or finance the asset has been made, some thought must be given to the method of financing. For example, even if an asset is to be procured for cash, and the cash is on hand in a reserve set aside for that purpose, a decision still must be made on whether to replenish or restore that reserve, and over what time period and from what source it will be replenished.

Choosing to issue debt means that the following choices must be made: form of debt, mode (fixed or variable rate), repayment terms, and method of sale. These are the tactical decisions that often blur the understanding of the strategic elements of the capital plan.

Designing the Loan – The Tactical Plan

If a decision is made to borrow, there is a dizzying array of choices to be made. Some districts choose to borrow from banks or private lenders; others choose public offerings of debt. Lease financing may be considered as an alternate to bond financing. Some districts pool their needs with other similarly situated districts in order to reduce costs through efficiencies of scale.

Regardless of the choice of lenders or approach, important considerations of this element include matching the useful life of the financed asset to the borrowing term. Common sense tells us that we should hesitate to finance automobiles with 30-year bonds. By the same token, a water treatment plant with a design life of 50 years can be safely and prudently financed over long periods of time.

This element of the capital plan should also carefully consider other needs within the strategic plan when pledging assets or revenues to lenders. A generous package to a lender on today's asset may make tomorrow's asset financing problematic or impossible. The key is to ensure that each tactical financing plan within the capital plan works harmoniously with other elements of the plan and is flexible enough to allow for the inherently changing nature of the capital plan.

Organizing the Approach

The successful capital planning process looks a great deal like the successful budgeting process. The end-result articulates the goals and objectives of the organization to all stakeholders and relies on accurate and unbiased assessment of needs. It provides for an evaluation of the desired assets to distinguish between "wants" and "needs." It is written and shared with the district's stakeholders.

The capital plan is revisited often and provisions for changing or amending it are straightforward. Finally, it incorporates periodic analysis of results and achievements for management and governing bodies.

Summary

A capital plan need not be elaborate or weighty to be effective. Many effective capital plans consist of a single spreadsheet and several paragraphs of supporting text. The development of the plan is vital to the efficient use of capital. It is a key ingredient in a lender's assessment of management's effectiveness and control. It is among the most important tools an elected official possesses to discharge the duties of office.

Readers who are interested in additional information about the development of capital plans should consider a variety of books, and other information sources, on the topic. Some suggested examples are shown in the attached resource listing at the back of this document.

Fund Equity and Retained Earnings

In a public entity, the board and management have to decide how much money is enough for the district's needs and how much is too much. Public entities such as utility districts collect fees from users to provide day-to-day services, as well as to maintain the corporate facilities. A water district has operating expenses such as water purchase and delivery costs, maintenance and operations and infrastructure costs. Fees collected by districts need to provide for day-to-day operations, as well as the anticipated repair and replacement of the infrastructure. The excess of the amount collected in fees and other revenues during the fiscal year over the amount expended during the same period go into the fund equity or retained earnings. Fund equity and retained earnings is the net excess of assets over liabilities.

Governmental-fund types use the terminology "fund balance" to describe the net excess of assets over liabilities. Enterprise-fund types (governmental organizations that are operated and account like a commercial enterprise) use the term "retained earnings" to describe the net excess of assets over liabilities.

To further understand the fund balance or retained earnings and how much is enough, review the following financial statement (*Exhibit 1).* Under the enterprise statement, the total assets are $3.5 million dollars and the retained earnings are in excess of $2.5 million dollars. Is this enough?

Exhibit 1

XYZ GOVERNMENT BALANCE SHEET

	General	Enterprise
Assets:		
Total Assets	423,450	3,502,459
Liabilities and Fund Equity:		
Total Liabilites	136,000	935,000
Total fund balance/retained earnings	287,450	2,567,459
Total liabilites and fund equity	423,450	3,502,459

In Exhibit 2, more detail shows that the assets are primarily invested in buildings and improvements. Analysis of the components of the retained earnings shows that over $2.1 million of the $2.5 million in retained earnings is a result of net investment in fixed (not spendable) assets.

Exhibit 2

XYZ GOVERNMENT BALANCE SHEET

	General	Enterprise
Assets:		
Cash	65,000	113,559
Cash with fiscal agent	25,000	-
Investments	258,000	1,178,400
Receivables	48,000	29,000
Inventory	7,200	24,000
Prepaid expenses	250	1,500
Restricted investments	20,000	-
Building and improvements		3,580,125
Accumulated depreciation		(1,424,125)
Total Assets	423,450	3,502,459
Liabilities and Fund Equity:		
Accounts payable	118,000	135,000
Deferred revenue	18,000	-
Bonds Payable		800,000
Total Liabilites	136,000	935,000
Fund Equity:		
Investment in fixed assets	-	2,156,000
Retained earnings:		
unreserved		7,459
Reserved for:		
inventory	7,200	24,000
Designated for:		
debt service	-	200,000
capital improvements	-	150,000
contigencies	100,000	30,000
Undesignated	180,250	
Total fund balance/retained earnings	287,450	2,567,459
Total liabilites and fund equity	423,450	3,502,459

Is this organization in good financial shape? That depends on the condition of the current assets and the short- and long-term needs of the organization as they relate to its resources. If there exists $2 million dollars in current infrastructure needs, then financing may be required. Is enough set aside for contingencies? If water costs increase by 10 percent, how will that affect total retained earnings? If the federal government mandates high water-quality standards, then what will be the equipment costs related to meeting this new standard?

Governmental entities collect, hold and expend resources in public trust. If not enough is collected, they risk not being able to meet mandated needs. If too much is collected, then the government overburdens the public and ties up resources that taxpayers could use in the economy. Governments have not always done a good job budgeting and making long-term plans for capital needs and for contingencies. Historically, governments spend most of their resources each year. Governmental entities need to examine their operations and make long-term plans and budgets to ensure that expenses are anticipated and resources set aside.

Some governments, either through good fortune or good planning, have set aside retained earnings for future plans and needs. What most governments have failed to do, as emphasized in the Little Hoover Commission's report, is to effectively communicate their plans for the retained earnings and explain why the balance is appropriate.

Each district needs to:

1. Examine its financial position.
2. Examine its current and long-term needs.
3. Determine the need for a long-term capital plan.
4. Establish target fund balance or retained earnings.
5. Communicate its goals and needs through policy, budgets and enhanced financial statements note disclosures.
6. Anticipate public scrutiny of financial statements and disclose how finances are being used.

Summary

CSDA facilitated the Reserve Guidelines Task Force in response to the concerns outlined in the Little Hoover Commission's report "Special Districts: Relics of the Past or Resources for the Future?" Our goal was to prepare a document that could be used by all independent special districts as a map in the preparation or review of the district's reserve policy. We encourage you to have your financial and legal professionals review the final policy prior to adoption to ensure you are in compliance with all current laws and regulations. Districts should schedule a regular review of their reserve policy as the financial environment within which it operates may be dynamic as well as there may be applicable legislative or regulatory changes.

The report concluded that there is a disconnect between special districts and their constituents and other local government entities. Districts should consider preparation of a public outreach program to communicate financial and program information on a regular basis to affected or interested populations. How involved each respective public outreach program is for a district is typically determined by the size and complexity of the district. It may be as simple as adding the information to an agency's website or the development of an annual report. In response to the demand for help in effectively communicating this information, CSDA launched its Public Outreach Assistance Service. This program is a member service of CSDA and can be tailored to meet the various communication needs of both small and large districts. It is important that each agency not only develop a reserve policy, but ensure that your constituents and fellow local governments understand your financial position and decision-making tools.

We hope you find these guidelines helpful and if you have any comments or suggestions on how we can improve this document, please contact us at (877) 924-CSDA.

Glossary

Net assets: The amount of assets in excess of liabilities
For governmental-fund types, this excess is referred to as "fund balance."
For enterprise-fund types, this excess is referred to as "retained earnings."

The GASB has made a distinction between reserved equity and designated equity in accordance with NCGA-1 (Governmental Accounting and Financial Reporting Principles).

<u>Designations v. Reservations</u>
While cash set asides are popularly referred to as "reserves," it is important and more accurate to identify them as designations or reservations. The two are distinctly different.

Designations: Net funds that are set aside based on board policy or tentative plans. Discretionary.

Examples:

- Designated for cash-flow (to help cover operating expenses during shortfalls)
- Designated for capital improvements
- Designated for contingency
- Designated for rate stabilization

Fund-balance designations may be established to indicate tentative plans for financial resource utilization in a future period, such as for general contingencies or for equipment replacement. Such designations reflect tentative managerial plans, or intent, and should be clearly distinguished from reserves. Such plans, or intent, are subject to change and may never be legally authorized or result in expenditures. Designated portions of fund balance represent financial resources available to finance expenditures other than those tentatively planned. Designations should be reported as part of the unreserved fund balance, i.e., "Designated for ..." or disclosed parenthetically or in the notes to the financial statements.
(National Council on Governmental Accounting Statement: NCGAS-1, paragraph 120)

Reservations: Net funds that are not appropriable. Assets that cannot be spent or are limited by legal or contractual requirements.

The following are examples of reservations that may be made because the funds are not appropriable:

- Reserved for inventory
- Reserved for restricted cash or investments
- Reserved for investment in net fixed assets

Often debt covenants require that certain reserve balances be maintained to secure payment of the debt service. **Debt-service reserves** is an example of a contractual requirement to set-aside funds.

Many governments and their accountants have referred to the excess of assets over liabilities as "reserves," however, preparers and users need to be careful with the terminology used in conjunction with financial information.

Reserves should be reported in the "Fund Balance" section of governmental fund balance sheets, not as liabilities or between liabilities and fund balance. The "Fund Balance" section may be subdivided between or among its reserved and unreserved components, or separate "Reserved Fund Balance" and "Unreserved Fund Balance" sections may be used. (NCGAS-1, paragraph 121)

Use of the term "reserve" in proprietary fund accounting should parallel commercial accounting and reporting. Thus, it should be limited to indicating "Reserved Retained Earnings." (NCGAS-1, paragraphs 121)

Restricted Funds: Equivalent to reserved funds.

Some governments often need special funds for building projects or special funding. Resources restricted for expenditure for specific purposes may be accounted in the general fund, provided that any applicable legal requirements can be met and the use of a separate fund is not legally mandated. If this type of funding is accounted along with other general funding, any excess balances should be recorded as restricted funds in the "Fund Balance" section of the financial statements.

Fund Balance Reserves (Reservations) and Designations

In governmental-fund accounting and reporting, use of the term "reserve" should be limited to indicating that a portion of the fund balance is not appropriable for expenditure or is legally segregated for a specific future use.

An example of a portion of a fund balance that is not appropriable for expenditure is the Reserve for Inventories, which indicates that the portion of fund balance represented by inventories is not available for appropriation and expenditure at a balance sheet date.

An example of a reserve indicating that a portion of the fund balance is legally segregated is the Reserve for Encumbrances, which indicates that a portion of the fund balance has been segregated for expenditure on vendor performance.

In instances where part of the fund balance is reserved, the remainder should be reported as Unreserved Fund Balance. (NCGAS-1, paragraph 118)

GASB 34 Note:
Under GASB 34, the formal presentation of the report should not include use of the terms reservations, reserves, or designations. Funds are broadly classified as either restricted funds (equivalent to reserved funds) or unrestricted funds (designated or undesignated surpluses). In the footnotes to the financial report, however, these additional terms can be effectively employed to provide greater detail and full disclosure of plans for the district's fund balance/retained earnings, the importance of which cannot be overstated.

Resources

The Government Finance Officers Association (GFOA) is a great source for more information regarding various government financial matters, including fund balance and financial reporting. GFOA has an extensive publications department. View a list of their full offerings by logging onto their website at www.gfoa.org. The following publications may be useful:

- "Recommended Budget Practices: A Framework for Improved State and Local Government Budgeting"
- "An Elected Official's Guide to Fund Balance"
- "An Elected Official's Guide to Financial Reporting"
- "Governmental Accounting, Auditing, and Financial Reporting"

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ITEM 2

ATTACHMENT B

city of
san luis obispo

SETTING RESERVE LEVELS

What's the Right Amount?

In comparing reserve levels between government agencies, it is important to recognize that "one size does not fit all." In short, other than having a reserve at all, there is no "right" level: it depends on the circumstances in each agency.

Strong Reserves Reflect Ability to Manage Risk, Not Fiscal Strength

Reserves (defined here as unreserved, undesignated fund balance) – whether large or small – do not *per se* reflect on an agency's financial capacity or underlying fiscal strength. There are much better indicators than fund balance for this, most notably the ability over time for ongoing revenues to adequately meet day-to-day service needs, capital improvements and debt service requirements.

Then what does retaining a prudent level of fund balance reflect?

It measures an agency's ability to manage risk. How much can things adversely turn-out differently than "usual," and how much fiscal capacity (measured in time) does the organization think is prudent in developing and implementing plans to respond to unexpected circumstances?

First Step: Assess Risk in Determining Reserve Policy

Based on this, the first step in assessing an appropriate reserve level is to assess fiscal risks, which fall into six categories:

1. ***Economic.*** How dependent are the agency's key revenues on local economic performance? And how dependent is it on the fortunes of a few key taxpayers – or are revenue sources broadly distributed? In short, are all of the agency's revenue "eggs in one basket?" And if so, how large and strong is the basket?

   For example, property taxes are usually viewed as stable, dependable revenue sources. As such, if this is a large part of a city's revenue base (as it is in most states, other than California), then its fiscal risks are lower, and accordingly, its reserve levels can be lower. However, sales tax is the most important revenue source for most California cities, including San Luis Obispo, and it can be highly volatile. So, where sales tax is a key revenue source, this argues for higher reserves.

   And within any one revenue source, agencies also need to assess their vulnerability (the "eggs" thing). For example, if one or two key property owners account for a large part of property tax revenues, then any adverse circumstances for them will adversely affect the agency.

   How likely is this to happen? And what's the consequence if it does? The same is true for sales taxes: already a variable revenue source, it's even worse if one or two outlets (like a single car dealership or major retailer) account for a large part of an agency's sales tax revenues.

2. ***Cash Flow.*** What cash resources does an agency need in balancing when it receives key revenues, and when it incurs expenses? Again, this requires each agency to review their own unique circumstances in evaluating "lumpy" receipts and disbursements. In short, every agency has a different cash flow story to tell.

3. ***Expenditure Flexibility.*** How much of an agency's costs are relatively "fixed" or ongoing, like debt service and regular staffing; versus more flexible costs, like capital projects or other "one-time" costs? The more "flexible" an agency's costs, the more flexibility it will have in not disrupting day-to-day services in responding to adverse circumstances while it figures out a longer-term strategy.

4. ***General Contingencies.*** What is the likelihood of a major, unanticipated cost?

5. ***Disasters.*** What is the likelihood (and frequency) of natural or human disasters like floods, fires or earthquakes in increasing response and recovery costs, or reducing revenues?

6. ***Stability of State-Local Government Relationships.*** How likely is it that the federal or state government will structurally change revenue sources, such as no longer providing a key subvention that it routinely provided to an agency in the past? Or no longer allowing an agency to set a key fee or a tax that it has relied upon for many years? Or assessing agencies for services that the state or federal agency has traditionally provided at no cost?

   Placed in context, the past twenty years, until the passage of Proposition 1A in November 2004, State budget takeaways have consistently been the largest single fiscal threat to local government in California.

Summary

Reserves act as an insurance policy, a risk management tool. So, in setting appropriate reserve policies, an agency should ask itself:

- How much risk is it exposed to?
- And how much risk is it willing to take in the event that adverse circumstances emerge?

When adverse circumstances do arise, appropriate reserves provide agencies with the ability to:

- Absorb "one-time" problems without disrupting day-to-day operations and services.
- Or if the problems are more systemic and ongoing, then they provides the fiscal capacity to take the time needed to fully identify how big the problem is, and then develop and implement a thoughtful longer-term strategy tailored to the problem, without resorting to extreme crisis actions.

SETTING RESERVE LEVELS

Knowing how other agencies answer these questions can be helpful; but ultimately, each agency needs to be guided by its own circumstances. Eighteen years ago the City adopted the policy of maintaining a minimum unreserved, undesignated General Fund balance that is 20% of operating expenditures; and we were one of the first cities nation-wide to formally adopt this type of policy.

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ITEM 2

ATTACHMENT C

NIPOMO COMMUNITY SERVICES DISTRICT
DRAFT CASH RESERVE POLICY

PURPOSE

A key element of prudent financial planning is to ensure that sufficient funding is available for current operating, capital and debt service needs. Additionally, fiscal responsibility requires anticipating the likelihood of, and preparing for, unforeseen events. Nipomo Community Services District (District) will strive at all times to have sufficient funding available to meet its operating, capital and debt service obligations as well as to protect its creditworthiness. The District is committed to maintaining a financial structure that provides adequate and predictable revenues at the lowest possible cost to meet forecasted needs and operational objectives.

It should be noted that the District has a Debt Management Policy that establishes parameters for evaluating, issuing and managing the District's debt. The District's Debt Management Policy should be considered prior to committing to any new financial obligations.

The adequacy of the targeted cash reserve year-end balance ranges and/or annual contributions to each fund will be reviewed annually during the budgeting process or when a major change in conditions threatens the reserve levels established within this policy.

OPERATING FUNDS

WATER FUND (FUND #125)

Purpose: To ensure sufficient cash resources are available to fund daily administration, operations and maintenance of providing water services. (Funded from rates and charges)

Target Criteria: To meet the District's cash flow needs and unbudgeted expenses, the Water Fund cash reserves should be equal to or greater than six months (180 days) of annual budgeted operating expenses (not including Funded Replacement).

After adoption of the budget and within 90 days after the end of the fiscal year, the Board of Directors shall review the cash reserves, and if there is excess above the reserve requirement based on the cash reserve balance as of the fiscal year just completed, the Director's may approve a transfer of the excess to the Funded Replacement Water Fund #805.

TOWN SEWER FUND (FUND #130)

Purpose: To ensure sufficient cash resources are available to fund daily administration, operations and maintenance of providing water services. (Funded from rates and charges)

Target Criteria: To meet the District's cash flow needs and unbudgeted expenses, the Town Sewer Fund cash reserves should be equal to or greater than six months (180 days) of annual budgeted operating expenses (not including Funded Replacement).

After adoption of the budget and within 90 days after the end of the fiscal year, the Board of Directors shall review the cash reserves, and if there is excess above the reserve requirement based on the cash reserve balance as of the fiscal year just completed, the Director's may approve a transfer of the excess to the Funded Replacement Town Sewer Fund #810.

BLACKLAKE SEWER FUND (FUND #150)

Purpose: To ensure sufficient cash resources are available to fund daily administration, operations and maintenance of providing water services. (Funded from rates and charges)

Target Criteria: To meet the District's cash flow needs and unbudgeted expenses, the Blacklake Sewer Fund cash reserves should be equal to or greater than six months (180 days) of annual budgeted operating expenses (not including Funded Replacement).

After adoption of the budget and within 90 days after the end of the fiscal year, the Board of Directors shall review the cash reserves, and if there is excess above the reserve requirement based on the cash reserve balance as of the fiscal year just completed, the Director's may approve a transfer of the excess to the Funded Replacement Blacklake Sewer Fund #830.

WATER RATE STABILIZATION FUND (PROPOSED)

Purpose: To serve as a buffer to water rates during any period where there are unexpected increases in operating costs or decreases in revenues. In addition, in a severe drought or extremely wet conditions, it is reasonable to expect that water sales could fluctuate significantly. As such, this fund will absorb these types of fluctuations in operations and help stabilize rates and enable smooth or level increases to rates despite uneven increases in underlying costs or variations in annual revenues received. This fund should not be used to artificially suppress rates (i.e. to sustain rates at levels below the costs of service). (Funded by rates and charges)

Target Criteria: Minimum reserve requirement of $400,000.

TOWN SEWER RATE STABILIZATION FUND (FUND #135)

Purpose: To serve as a buffer to sewer rates during any period where there are unexpected increases in operating costs or decreases in revenues. This fund should be used to enable smooth or level increases to rates despite uneven increases in underlying costs or variations in annual revenues received. This fund should not be used to artificially suppress rates (i.e. to sustain rates at levels below the costs of service). (Funded by rates and charges)

Target Criteria: Minimum reserve requirement of $300,000 set by Bond Indenture Agreement for the Revenue of Certificates of Participation Series 2012.

BLACKLAKE SEWER RATE STABILIZATION FUND (PROPOSED)

Purpose: To serve as a buffer to sewer rates during any period where there are unexpected increases in operating costs or decreases in revenues. This fund should be used to enable smooth or level increases to rates despite uneven increases in underlying costs or variations in annual revenues received. This fund should not be used to artificially suppress rates (i.e. to sustain rates at levels below the costs of service). (Funded by rates and charges)

Target Criteria: Minimum reserve requirement of $50,000.

BLACKLAKE STREET LIGHTING (FUND #200)

Purpose: To ensure sufficient cash resources are available to fund administration, operations and maintenance of providing street lighting services for Blacklake Village. (Funded by annual assessment to property owners in Blacklake Village)

Target Criteria: Minimum reserve requirement of $30,000.

LANDSCAPE MAINTENANCE DISTRICT (FUND #250)

Purpose: To ensure sufficient cash resources are available to fund administration, operations and maintenance of providing landscape maintenance to the property owners of Tract 2409. (Funded by annual assessment to property owners in Tract 2409 aka Vista Verde Estates)

Target Criteria: Minimum reserve requirement of $20,000.

SOLID WASTE (FUND #300)

Purpose: To ensure sufficient cash resources are available to fund solid waste programs, rate stabilization and to cover operating costs in the event that the District may find itself operating solid waste collection, disposal and recycling functions should its business partner now franchised to do these functions be unable to continue to provide these services due to an unforeseen event. This reserve provides assurance that solid waste services remain uninterrupted during an extended disruption to service provider. (Funded by Franchise Fees)

Target Criteria: Minimum reserve requirement of $115,000.

DRAINAGE (FUND #400)

Purpose: To ensure sufficient cash resources are available to operate and maintain the Nipomo Drainage Maintenance District 76-02 (one basin located on Juniper Street). (Funded by a 1% ad valorem property tax rate)

Target Criteria: Minimum reserve requirement of $50,000.

FUNDED REPLACEMENT – WATER (FUND #805)

Purpose: The reserves can be used for both short-term and long-term purposes. The objective of the Funded Replacement Fund is to provide monies for the current and future replacement of existing capital assets as they reach the end of their useful lives. The District recognizes that the Funded Replacement fund may only be sufficient to pay a portion of the full cost of future capital asset replacements and other sources of replacement funding may be needed, such as a bond issuance. This fund will also help normalize the impact of the capital asset replacements on future water rates. (Funded by water rates and charges and interest earnings)

Target Criteria: $12,800,000 based on 2007 Replacement Study.

FUNDED REPLACEMENT – TOWN SEWER (FUND #810)

Purpose: The reserves can be used for both short-term and long-term purposes. The objective of the Funded Replacement Fund is to provide monies for the current and future replacement of existing capital assets as they reach the end of their useful lives. The District recognizes that the Funded Replacement fund may only be sufficient to pay a portion of the full cost of future capital asset replacements and other sources of replacement funding may be needed, such as a bond issuance. This fund will also help normalize the impact of the capital asset replacements on future town sewer rates. (Funded by Town sewer rates and charges and interest earnings)

Target Criteria: $3,500,000 based on 2007 Replacement Study.

FUNDED REPLACEMENT – BLACKLAKE SEWER (FUND #830)

Purpose: The reserves can be used for both short-term and long-term purposes. The objective of the Funded Replacement Fund is to provide monies for the current and future replacement of existing capital assets as they reach the end of their useful lives. The District recognizes that the Funded Replacement fund may only be sufficient to pay a portion of the full cost of future capital asset replacements and other sources of replacement funding may be needed, such as a bond issuance. This fund will also help normalize the impact of the capital asset replacements on future Blacklake sewer rates. (Funded by Blacklake sewer rates and charges and interest earnings)

Target Criteria: $968,000 based on 2007 Replacement Study.

NON-OPERATING FUNDS

SUPPLEMENTAL WATER (FUND #500)

Purpose: The revenue generated from the Supplemental Water Capacity Charge accumulates in this fund and its use is restricted to projects, programs and expenditures that reduce the District's reliance on groundwater as its sole water supply. (Funded by development capacity charges and interest earnings)

Target Criteria: No minimum target is maintained.

PROPERTY TAX (FUND #600)

Purpose: District's share of the 1% ad valorem tax on real property collected by the County of San Luis Obispo and distributed to the District pursuant to Article XIIIA of the California Constitution. (Funded by property taxes and interest earnings)

Target Criteria: No minimum target is maintained, however, a portion of the annual property tax revenue stream is pledged to pay the annual debt service for the 2003 Certificates of Participation Revenue Bond.

WATER CAPACITY CHARGES (FUND #700)

Purpose: The revenue generated from the Water Capacity Charge accumulates in this fund and is used to offset new development related capital improvements as outlined by the District's Capital Improvement Plan. (Funded by development capacity charges and interest)

Target Criteria: No minimum target is maintained.

TOWN SEWER CAPACITY CHARGES (FUND #710)

Purpose: The revenue generated from the Town Capacity Charge accumulates in this fund and is used to offset new development related capital improvements as outlined by the District's Capital Improvement Plan. (Funded by development capacity charges and interest earnings)

Target Criteria: No minimum target is maintained.

SINKING FUND – TOWN SEWER (FUND #880)

Purpose: The reserves may be used to pay annual debt service payments for the Revenue Certificates of Participation (Southland Wastewater Project) Series 2012. (Funded by Town sewer rates and charges in years 2008 – 2012 in anticipation of the Southland Wastewater Treatment Facility Upgrade)

Target Criteria: No minimum target is maintained. Once the reserves in this fund are depleted, the fund will be terminated.

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ATTACHMENT D

NIPOMO COMMUNITY SERVICES DISTRICT

OPERATING FUNDS

(A) FUND NAME	(B) FUND NUMBER	(C) PROPOSED CASH RESERVE FORMULA	(D) ADOPTED OPERATING BUDGET 2012-2013 (to determine cash reserve requirement)	(E) PROPOSED CASH RESERVE REQUIREMENT (based on 2012-2013 Operating Budget)	(F) ACTUAL CASH BALANCE AS OF 6/30/12	(G) PROPOSED POLICY MET OR WILL BE MET?
Water Fund	125	180 days (6 months) of operating expenses	$2,860,269 ($3,426,269 less Funded Replacement of $566,000)	$1,430,135 ($2,860,269 x 50%)	$2,103,089	Yes
Town Sewer Fund	130	180 days (6 months) of operating expenses	$897,042 ($1,292,042 less Funded Replacement of $395,000)	$448,521 ($897,042 x 50%)	$563,738	Yes
Blacklake Sewer Fund	150	180 days (6 months) of operating expenses	$293,699 ($461,699 less Funded Replacement of $168,000)	$146,850 ($293,699 x 50%)	$266,573	Yes
Water Rate Stabilization Fund	Proposed	$400,000	N/A	$400,000	N/A	Yes (upon transfer from Fund #125)
Town Sewer Rate Stabilization Fund	135	$300,000	N/A	$300,000	$300,000	Yes
Blacklake Sewer Rate Stabilization Fund	Proposed	$50,000	N/A	$50,000	N/A	Yes (upon transfer from Fund #150)
Blacklake Street Lighting Fund	200	$30,000	N/A	$30,000	$27,209	No
Landscape Maintenance District Fund	250	$20,000	N/A	$20,000	$20,941	Yes
Solid Waste Fund	300	$115,000	N/A	$115,000	$259,396	Yes
Drainage Fund	400	$50,000	N/A	$50,000	$5,000	No
Funded Replacement-Water	805	$12,800,000 Based on 2007 Replacement Study	N/A	$12,800,000	$4,573,183	No
Funded Replacement-Town Sewer	810	$3,500,000 Based on 2007 Replacement Study	N/A	$3,500,000	$4,081,449	Yes
Funded Replacement – Blacklake Sewer	830	$968,000 Based on 2007 Replacement Study	N/A	$968,000	$226,913	No

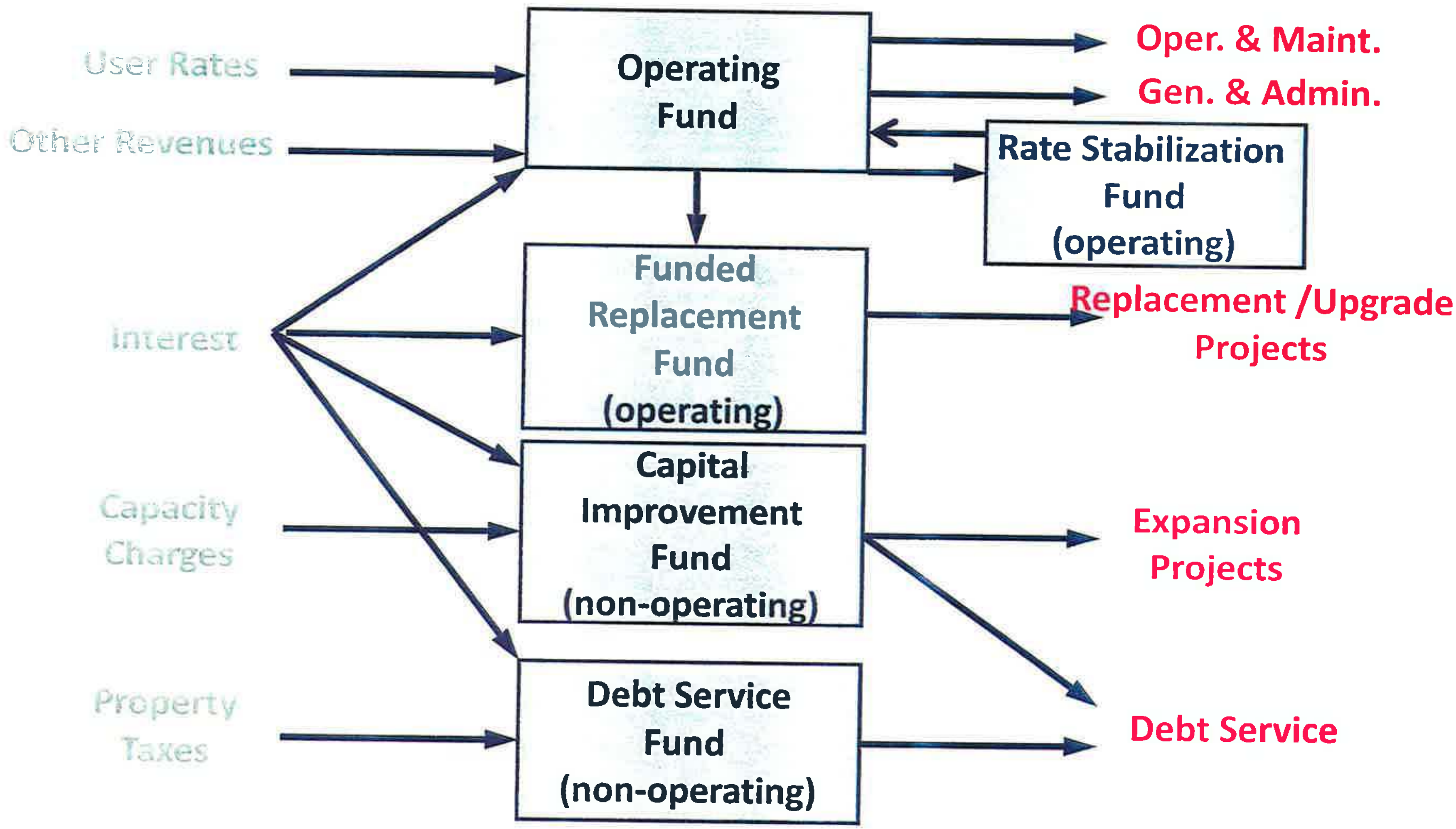
N/A = not applicable

NOVEMBER 19, 2012

ITEM 2

ATTACHMENT E

Fund Structure and Cash Flows



TO: MICHAEL S. LEBRUN
GENERAL MANAGER

FROM: LISA BOGNUDA LSB
FINANCE DIRECTOR

DATE: NOVEMBER 15, 2012

AGENDA ITEM

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NOVEMBER 19, 2012

REVIEW AUDIT SERVICES

ITEM

Review audit services

BACKGROUND

Pursuant to Special District Law, the Board of Directors shall provide for regular audits of the District's accounts and records. An audit is performed on the accounts and records of Nipomo Community Services District every year by an independent Certified Public Accountant (CPA).

The District contracts for auditing services under a three year contract. With the completion of the June 30, 2012 audit, the three year contract with The Crosby Company is complete. It is District practice to seek proposals every three years for auditing services.

Staff will circulate a Request for Proposal for auditing services for fiscal years ending June 30, 2013, 2014 and 2015 and request responses by January 11, 2013. The proposals will be presented to the Board of Directors at the January 23, 2013 for consideration.

RECOMMENDATION

Information item – no action required.

ATTACHMENT

None