



City Council Report

City Council Meeting: March 10, 2020
Agenda Item: 3.K

To: Mayor and City Council
From: Gigi Decavalles-Hughes, Director, Finance Department, Financial Operations
Subject: Presentation of Comprehensive Annual Financial Report (CAFR)

Recommended Action

Staff recommends that the City Council receive and file the City's Comprehensive Annual Financial Report (CAFR), the independent auditors' unmodified report for the City's financial statements for the fiscal year ended June 30, 2019, and the Auditors' Letter to Council.

Executive Summary

The Comprehensive Annual Financial Report (CAFR) communicates the City's financial position and activity for the fiscal year ended June 30, 2019. The City's overall financial position continues to be strong, with healthy reserves, including Rainy-Day and Economic Uncertainty funds, a substantial net position, low debt levels, and strategies in place to mitigate retirement-related liabilities. However, we are seeing a moderation in the General Fund brought on by significantly slower revenue growth than we have seen in several years and persistent increases in expenditures such as pension liability, workers' compensation and health care. These changes were exacerbated this year by the transfer of water pollution settlement funds held in the General Fund to the Water Fund to be used for current and future water remediation activities.

The Statement of Net Position, similar to a balance sheet, reports total assets and liabilities of the City. The total net position of the City for all activities was \$1.6 billion at June 30, 2019, compared to \$1.58 billion at June 30, 2018 (as restated), which is an increase of \$21.6 million or 1.4%. While the net position for business-type activities increased \$34.5 million, the net position for governmental activities decreased \$12.9 million.

The General Fund balance decreased by \$95.1 million, to \$340.7 million over the prior year, primarily due to \$78.3 million transfers out, including a \$53.5 million transfer to the Water Fund to fund the Olympic Wellfield restoration project, and increased spending on capital projects such as the City Services Building, City Yards Modernization, and Fire Station 1 using prior year funds and bond proceeds.

The City's three pension plans are approximately 76% funded with a combined unfunded long-term actuarial liability of \$447.8 million. All pension figures presented in the CAFR are based on California Public Employees' Retirement System (CalPERS) GASB 68 valuations that have a measurement date of June 30, 2018. These valuations are used for financial reporting purposes only and are separate from the CalPERS funding valuations that are used to determine the City's annual contribution requirements.

The independent auditors' unmodified report communicates that the CAFR, and audited information within, fairly present the City's financial position for the fiscal year ended June 30, 2019. This audit is performed in compliance with City Charter requirements.

An attached report on the City's internal control over financial reporting and compliance notes no instances of non-compliance (Attachment A). An additional attached submittal letter states that the City's independent auditors encountered no difficulties and had no disagreements with management during the audit (Attachment B). Items that management elected not to adjust in the FY 2018-19 financial statements are noted on the report under Corrected and Uncorrected Misstatements. These immaterial adjustments were made in FY 2019-20. The auditors also noted that working in a new financial system and a temporary Financial Reporting staffing shortage resulted in a higher than normal volume of post-closing journal entries. Staff does not expect the same volume of post-closing journal entries for the FY 2019-20 year-end close process.

The City of Santa Monica has received an unmodified audit report for more than three decades and has been awarded the Certificate of Achievement for Excellence in Financial Reporting by the Government Finance Officers' Association of the United

States and Canada (GFOA) for its CAFR for 35 consecutive years, since it began participating in the program. To make the CAFR more transparent, staff has provided an explanation for key financial performance indicators shown in the report.

Council established an Audit Subcommittee in 2015 to oversee the work of the City's auditors. The Committee has received the last three annual CAFR reports which included details of the audit process and the financial reports, a presentation by the independent auditors, and an opportunity for Subcommittee members to ask questions of the auditors. On February 28, 2017, Council directed staff that future presentations of the CAFR should continue to receive a detailed review by the Audit Subcommittee and come to the Council as a Consent Calendar item.

Background

The CAFR communicates the City's financial condition and activity in a transparent and organized manner and in compliance with accounting and financial reporting standards established by the Governmental Accounting Standards Board (GASB). The report presents historical and comparative information that can be useful to City staff, elected officials, and external users such as debt rating agencies, businesses, other public agencies, and the City's residents. The most recent CAFR and over 10 years of prior year reports are available at the City's libraries, the City's Finance Department, and on the City's Finance website at: <https://finance.smgov.net/budgets-reports/annual#/>.

As required by the City Charter, financial statements are prepared by the City and audited by independent auditors. The City selects its independent auditor through a competitive procurement process that includes members of the Audit Subcommittee as proposal reviewers. The City's current independent auditor, Lance, Soll & Lunghard (LSL) CPAs, is in its fourth year auditing the City.

The quality of the City's financial reporting and the CAFR are measured in two ways: (1) an unmodified audit report by the independent auditors; and (2) the Certificate of Achievement for Excellence in Financial Reporting, awarded by GFOA. The attainment

of the latter is the highest form of recognition in governmental accounting and financial reporting.

Auditors follow audit industry standards established by the American Institute of Certified Public Accountants (AICPA). These standards require auditors to provide an opinion on specific areas of the City's financial statements based on observations, inquiries, testing of transactions, and analysis.

The City's CAFR includes the following major sections and information:

Introductory Section

- Letter of Transmittal – prepared by management and used to communicate information on areas that may have an impact on the City's finances now and in the future. This includes economic factors as well as budget and management factors.

Financial Section (the main body of the CAFR for current year information)

- Independent Auditors' Report – the City's report card on the content of the CAFR
- Management's Discussion and Analysis (MD&A) – provides an analytical overview of the City's financial status and results for the year
- Basic Financial Statements – reports finances at a point in time (assets - liabilities) and throughout the year (revenues - expenditures), and cash flows
 - City-Wide Statements – overview of financial information including all of the City's operations by financial activity
 - Fund Financial Statements – a detailed look at funds, reporting the Balance Sheet and Statement of Revenues, Expenditures and Changes in Fund Balance

- Notes to the Financial Statements (Notes) – a narrative explanation that accompanies the Basic Financial Statements

Required Supplementary and Supplementary Information Sections

- Budget to Actual Comparisons – for all governmental funds with a legally adopted budget
- Notes to Required Supplementary Information
- Pension Information – schedule of changes in the net pension liability and related ratios; schedule of contributions by plan
- OPEB Information – schedule of changes in the net Other Post-Employment Benefits (OPEB) liability and related ratios; schedule of contributions
- A breakout of individual non-major funds – for funds that were presented in a cumulative manner in the Financial Section

Statistical Section (current and historical information – up to 10 years)

- Financial Trends
- Revenue Capacity Information
- Debt Capacity Information
- Demographic and Economic Information
- Operating Information

Discussion

The attached CAFR for FY 2018-19 has received an unmodified opinion by LSL (Attachment C). An unmodified opinion communicates that the financial statements are fairly presented and that the information used in the report is reliable. In their written

communications to Council, the auditors note that they encountered no significant difficulties with management in performing or completing the audit.

Statement on Auditing Standards (SAS) 114 establishes standards for the auditors' communication with those charged with governance. SAS 115 provides guidance on communicating matters related to the City's internal controls over financial reporting that have been identified in an audit of the financial statements. These statements require the auditors to consider and report on internal controls, significant audit findings, and other matters as prescribed in the standards as they relate to the audit of the financial statements. The letters that satisfy the SAS requirements are attached to this report.

The City of Santa Monica has received an unqualified/unmodified audit report and the GFOA Award for 35 years, since the City first participated in the GFOA program in FY 1983-84.

As in past years, LSL conducted a conference call with Subcommittee Chair Greg Morena and Subcommittee member Elizabeth VanDenburgh on February 17, 2020 to discuss the results of the audit without staff present. The CAFR was presented to the Audit Subcommittee of the Council on February 18, 2020 by LSL. Subcommittee members were given the opportunity to review the report and ask questions to the external auditor and staff. The topics discussed included materiality thresholds, fund balances related to capital projects, the decrease of the General Fund balance, upcoming lease accounting requirements, accounting for compensated absences, and the unfunded pension liability. The Audit Subcommittee received and filed the CAFR with a 5-0 vote.

Overall, the City's CAFR shows that City finances are stable. The following is an explanation of some key indicators reported in the CAFR.

General Fund Balance

The most notable measure of a City's financial health is the General Fund balance. As presented in the Basic Financial Statements, the City's General Fund assets exceeded

liabilities by \$340.7 million as of June 30, 2019. This balance is comprised of a number of categories, as follows:

- \$11.6 million nonspendable fund balance includes amounts that are not in spendable form, such as prepaid items and advances to other funds;
- \$70.0 million restricted fund balance is required for specific purposes as stipulated by either external resource providers or enabling legislation, including \$67.0 million for bond funded projects;
- \$1.9 million committed resources represent amounts designated for a specific purpose by formal action from City Council;
- \$182.2 million assigned funds set aside for specific purposes based on budget priorities (i.e., continuing capital improvements projects; future projects; prior year reappropriations; and other projects necessary to advance the City's framework priorities); and
- \$75.0 million in unassigned funds as follows:
 - \$62.0 million rainy day contingency (15% of annual operating and revenue-supported capital expenditure budget);
 - \$9.7 million economic uncertainty reserve to mitigate potential revenue losses;
 - Offset by a \$0.3 million unrealized loss on investments;
 - \$3.0 million other unassigned fund balance.

The General Fund's rainy day and economic uncertainty reserves play a key role in Santa Monica's AAA general obligation bond rating, allowing the City to pursue lower

cost financing structures. However, the General Fund balance has decreased by \$95.1 million during the fiscal year primarily due to a \$53.5 million transfer to the Water Fund of the unspent Gillette Boeing settlement funds and increased spending on several large capital projects using prior year funds and bond proceeds.

Citywide Net Position

The Statement of Net Position, similar to a balance sheet, reports total assets and liabilities of the City as of June 30, 2019. The total net position of the City for all activities was \$1.6 billion. Net position is broken out into three categories: capital, restricted, and unrestricted.

Net Investment in Capital Assets (\$1,183.4 million)

Net Investment in Capital Assets includes land, buildings, improvements, intangibles, infrastructure and utility systems, and construction in progress net of depreciation/amortization and related debt. Intangible assets represent rights of use for items such as software, water rights and payments for Santa Monica's cost of improvements to the City of Los Angeles sewage treatment system. Some notable capital projects that were underway as of June 30, 2019 are:

- City Services Building
- Fire Station 1
- City Yards Modernization
- Sustainable Water Infrastructure Project (SWIP)
- North Beach Trail
- Early Childhood Lab School (City has funded a portion of the Santa Monica College building, which sits on property ground-leased by the City to SMC)
- Bus Replacements
- Civic Center Multipurpose Sports Field

Restricted Net Position (\$246.8 million)

These assets are subject to agreements with creditors, developers, grantors, or laws or regulations of other governments. Approximately 57% of this amount is restricted for

affordable housing and committed to various projects, 20% is restricted per federal, state and other grant regulations, and the remaining amount is restricted for the Cemetery's trust fund, debt service, development agreement terms, and other grant and legislative constraints.

Unrestricted Net Position (\$171.9 million)

This represents the balance of net position that is neither part of capital assets nor restricted. Healthy capital and operating reserves in the business-type activities support rate stabilization and recovery strategies for the City's many activities.

Long-Term Debt

The primary source of long-term debt is in the form of bonds issued by the City. At the end of the current fiscal year, the City's total long-term debt outstanding (excluding issuance premiums) was \$164.3 million, a \$6.8 million decrease from the previous year.

The City did not issue any bonds in FY 2018-19. *More information on Long-Term Debt can be found in Note 9, page 57 of the CAFR.*

Pension Liability

As noted in the Statement of Net Position on page 1 of the CAFR, the City's largest liability is the unfunded actuarial pension liability, which was \$447.8 million as of June 30, 2019, a decrease of \$19.0 million from the \$466.8 million liability at June 30, 2018.

Total net pension liability, or unfunded liability, is based on projected future benefit payments attributed to the current and past employees' service, less the assets accumulated to pay those liabilities. This is the difference between a total pension liability of approximately \$1.87 billion and plan assets of approximately \$1.42 billion, making the City's three pension plans approximately 76% funded. The City's annual payments include a portion to fund currently earned benefits as well as an amount to pay down the unfunded liability. Annual actuarial valuations provide the City with the amount of the contribution that must be paid annually into the plan to ensure that the current unfunded liability is paid off over the following 30 years. However, in 2019

Council adopted the Principles for Pension Funding, as developed by the ad hoc Pension Advisory Committee, that were incorporated into the City's Fiscal Policy. This plan accelerates the pay down of the pension unfunded liability not to exceed 13 years, with an alternative 15-year timeline in case of fiscal emergency. This plan was adopted by Council as part of the FY 2019-21 Biennial Budget process.

The City has had a long history of implementing cost-saving measures related to pensions. The Miscellaneous employee bargaining group approved a second tier of reduced retirement benefits for new employees starting on or after July 1, 2012, and Miscellaneous group employees continue to contribute to a portion of their pension costs, while Public Safety employee bargaining groups have approved annual incremental increases to their employee pension contributions. Over the past eight years, Police and Fire sworn employees have increased their contributions towards pensions to reach up to 28% of the total pension cost for Classic CalPERS members (those joining CalPERS before January 1, 2013), while Classic Miscellaneous employees are contributing over 28% of the pension cost. The passage of the Public Employee Pension Reform Act, or PEPRA, in September 2012 is working to further control cost increases in the future, as new employees entering CalPERS after January 1, 2013 will receive reduced retirement benefits and pay higher contributions when the normal cost increases. To date, approximately 40% of the City's permanent workforce will receive lower cost pension benefits upon retirement.

Since FY 2010-11, the City has made \$88.1 million in payments beyond the actuarially required contribution determined by CalPERS. This has resulted in over \$8.0 million in annual pension contribution savings. In 2014, after a series of pay downs funded from year end savings, Council adopted a policy that, provided that there are sufficient funds, the annual budget would include a minimum set-aside of \$1.0 million in the General Fund, and commensurate set-aside amounts in all other funds, to be used towards pay downs of the CalPERS unfunded liability. Based on the availability of additional funds, staff would annually assess the set-aside of additional CalPERS payments against other unfunded needs and present the Council with a recommendation. This policy has now been replaced by the Principles for Pension Funding policy. Additionally, the City

continues its policy of prepaying the annual employer contributions to CalPERS to the extent allowable under new PERS rules implemented in FY 2017-18. Discounts received from such prepayments are used for pay downs of the net pension liability.

Despite the increases in cost sharing and the additional pay downs of unfunded liability, contribution costs have continued to rise as CalPERS has incorporated several improvements in the way it projects future-year liabilities and calculates annual contribution rates. On December 21, 2016, the CalPERS Board of Administration approved lowering the discount rate for the long-term rate of return from 7.5% to 7.0%, resulting in steep increases in unfunded liability. In the coming year, CalPERS will shorten the period over which future actuarial gains and losses are amortized over 20 years rather than 30 years, and will remove previous methods that phased in changes, gains and losses over time. These changes will apply to new unfunded liability bases and will likely further increase contributions beginning in FY 2021-22.

A detailed explanation of the Employee Benefits Programs including detailed pension information by plan is included in Note 16 (pages 78 through 89) and the Required Supplementary Information (pages 111 through 116).

Other Postemployment Benefits (OPEB)

In fiscal year FY 2017-18, the City adopted GASB Statement No. 75 Accounting and Financial Reporting for Post-Employment Benefits Other Than Pensions. This statement required the City to present the net OPEB liability as the difference between the OPEB plan assets maintained in an IRS Section 115 irrevocable trust and the total OPEB liability as determined by actuarial valuation—the unfunded liability, similar to the presentation for pensions. The City continues the best practice of prefunding its OPEB obligations by making payments into a 115 trust, CERBT, administered by CalPERS.

Employees of the Executive Pay Plan group and management employees of the Rent Control Board are eligible for a City paid medical insurance benefit if their combined retirement age and years of City service equals or exceeds 70. Under the terms of a MOU between the City and a coalition of the various non-sworn bargaining units

(Coalition), all non-sworn permanent retirees are allowed to continue participating in one of the City's health plans at the same rate as active employees. As with other MOU's, this benefit is subject to bargaining between the City and the Coalition. The City also maintains minimum benefits for public safety employees provided by the City's contract with its healthcare provider CalPERS. The annual contribution is based on an actuarially determined contribution. For the fiscal year ended June 30, 2019, the City's cash contributions were \$3,047,011 in payments to a CalPERS CERBT trust. The liability increased to \$27.5 million as compared to \$26.4 million in last year's CAFR. *A detailed explanation of OPEB is included in Note 16 (pages 90 through 96) and the Required Supplementary Information (pages 117 through 118).*

Pollution Remediation

During FY 2017-18, the City revised its estimate of both the Olympic Well Field and Charnock Well Field remediation liability based on the most current information available. The revised figures more accurately portray the City's estimated pollution remediation liability. Cash flow projections discounted at a rate of 5% were used through completion of the remediation work and estimates included contingencies to account for uncertainty in future Federal and State water regulations.

In FY 2018-19, the City moved financial responsibility for the Olympic Well Field restoration project from the General Fund to the Water Fund. This involved the Water Fund assuming a pollution remediation obligation of \$32,337,312 and receiving a \$11,010,000 Boeing settlement receivable from the General Fund. This resulted in a special item in the Water Fund and a transfer from the governmental activities to the business-type activities of \$21,327,312. The \$53.5 million cash already collected from the Gillette and Boeing settlements that had not already been programmed to remediation projects was also transferred to the Water Fund. *More information on Pollution Remediation is found in Note 4, page 35 of the CAFR.*

Cash and Investments

The CAFR also includes detailed information on the City's cash and investments. As of June 30, 2019, the City had \$888.4 million in total cash and investments, all of which

are in the form of investments authorized by the California Government Code and the City's investment policy or in compliance with bond indenture agreements. *More information on cash and investments is found in Note 5, page 37 of the CAFR.*

Financial Impacts and Budget Actions

There is no immediate financial impact or budget action necessary as a result of the recommended action to receive and file this annual report.

Prepared By: Stephanie Manglaras, Accounting Manager

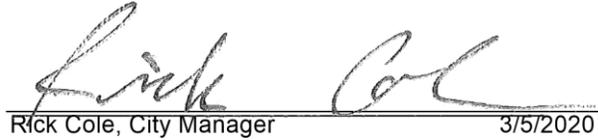
Approved

Forwarded to Council



Gigi Decavalles-Hughes, Director

3/5/2020



Rick Cole, City Manager

3/5/2020

Attachments:

- A. LSL Report on Internal Control
- B. LSL Audit Communication Letter
- C. Comprehensive Annual Financial Report (CAFR)