

**CITY OF NEWPORT BEACH
FINANCE COMMITTEE STAFF REPORT**

August 11, 2011

TO: HONORABLE CHAIR AND MEMBERS OF THE COMMITTEE

FROM: Finance Department
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**SUBJECT: INTERNAL SERVICE FUND RESERVE LEVEL STATUS &
RECOMMENDATIONS FROM THE FINANCE DEPARTMENT**

ABSTRACT:

Council Policy (F-2) provides guidance for the administration and governance of the City's reserves, and establishes accepted/target funding levels for many of the Internal Service Fund reserves.

DISCUSSION:

Prudent long-term financial management requires strategic planning and the ability to recognize that a portion of available funds should be reserved for future liabilities. Because Internal Service Funds such as general liability, workers compensation and compensated absences generally tend to have a long-term measurement focus and include long-term assets and liabilities, establishing accepted/target funding levels for these reserves is vital to ensure long-term financial health of these funds.

For general liability and workers' compensation, the City employs an actuary to estimate the expected liabilities related to those activities. Actuarial estimates are subject to significant uncertainties, and are often performed a couple years in advance using outdated data. Therefore, actuaries recommend establishing a target funding level in excess of the expected liability in order to cover contingencies.

It is the City's policy and practice to fund general liability and workers' compensation obligations at an amount sufficient to establish a seventy-five percent (75%) confidence level. This "Target Funding Level" is also consistent with our actuarial estimate of what is sufficient to set aside for actuarially calculated liabilities. GASB Statement #10 also requires the City to accrue a liability on its financial statements for the ultimate cost of claims and expenses associated with all reported and unreported claims.

The compensated absences minimum cash reserve should not fall below a three-year trailing average of annual cash flows plus a margin, and should not exceed fifty percent (50%) of the long term liability.

Below is a 3-year funding summary of general liability, workers' compensation and compensated absences:

General Liability (Claims & Judgments) Funding Status	2009	2010	2011
Cash Reserve	6,838,561	7,675,407	8,309,290
Long-Term (Expected) Liability	3,918,737	3,820,391	3,958,131
Unfunded Liability	(2,919,824)	(3,855,016)	(4,351,159)
Percentage of Expected Liability Funded	175%	201%	210%
Target Funding Level (75% Confidence Level)	4,385,737	4,273,391	4,444,131
Percentage of Actuarial Target Funded	156%	180%	187%

Workers' Compensation Funding Status	2009	2010	2011
Cash Reserve	14,043,801	14,159,190	14,486,952
Long-Term (Expected) Liability	11,893,000	12,322,000	14,620,000
Unfunded Liability	(2,150,801)	(1,837,190)	133,048
Percentage of Expected Liability Funded	118%	115%	99%
Target Funding Level (75% Confidence Level)	13,213,000	13,825,000	16,404,000
Percentage of Actuarial Target Funded	106%	102%	88%

Compensated Absences Funding Status	2009	2010	2011
Cash Reserve	3,177,746	1,841,034	990,293
Long Term Liability	9,784,085	12,445,316	11,867,350
Unfunded Liability	6,606,339	10,604,282	10,877,057
Percentage of Liability Funded	32%	15%	8%
Minimum Target Funding Level (3 yr Avg of Cash Flows)	1,634,819	1,557,331	2,286,093
Maximum Target Funding Level (50% of Liabilities)	4,892,043	6,222,658	5,933,675

General Liability continues to be overfunded compared to our target funding level of a 75% confidence level; however, Worker's Compensation has just this year fallen below our target level of 75% confidence. The primary reason for the increase in liability for Workers' Compensation is the effects on health care costs due to recent health care legislation and workers' compensation law legislation, which was an assumption used by the actuary when calculating our liability. Other factors attributing to the increase in liability are: the City's average claim costs have risen almost 45% over a ten-year period; our claim loss rate has recently begun to increase; and the annual investment earnings assumption was lowered from 5% to 3%. The immediate action to be taken is for Finance to administratively move cash reserves from the General Liability Reserve, as it continues to be well over funded, to the Workers' Compensation Reserve in the amount of \$1.9 million. This maintains the 75% confidence target funding level in Workers' Compensation and the General Liability reserve will remain in an over funded condition. Longer term we recommend working with Human Resources and an actuary to adjust future rates for both General Liability and Workers' Compensation.

Compensated Absences represent paid time off made available to employees in connection with vacation leave, sick leave and similar benefits. We fell below our minimum funding level for compensated absences in 2011. This drop in funding level is primarily the impact of the Early Retirement Plan (ERIP) offered during FY 2010. ERIP had two impacts to the lower funding levels: 1) The five annual payments of \$950,000 to fund ERIP is paid from the compensated absence reserve balances and, 2) approximately 50 employees retired cashing out accrued leave balances from the compensated absences fund. There have also been significant other retirements and several layoffs experienced during FY 2011 that have caused larger than average payouts from this fund. The short term recommendation from Finance is for the City Manager to consider assigning fund balance in the amount of \$1.2 million from FY 2011 excess General Fund reserves, once the final excess is known. This would then be taken to Council for approval. The longer term solution is for Finance to recalculate the rates once the final phase of City restructuring is closer to complete, this would allow for accurate compensated absence rates to be charged to each newly structured department and should ensure compliance with our minimum funding level per Council Policy F-2.

Finance would appreciate feedback from the committee and the City Manager's Office on these short-term and long-term recommendations to appropriately fund our internal service fund reserves.

Prepared by:

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