MONEY MATTERS

COUNTY FINANCES
HOW IT ALL ADDS UP

Introduction

In fulfilling its mandate under California Penal Code Section 925 to examine the budget, operations, accounts and performance of county departments and functions, the Civil Grand Jury selected four areas to highlight. This report will include comments on:

- The Santa Barbara County budget, including the effect of state budget impacts on County finances
- The County's 2003-2004 Comprehensive Annual Financial Report (CAFR) and the external auditor's Report and Management Letter on those financial statements
- An analysis of the County's retirement system
- The time and cost of the fiscal study prepared for the Mission County Formation Review Commission

Objective

The 2004-2005 Civil Grand Jury chose to examine some of the complexities and challenges currently facing County government and the legal requirements under which it must function. These complexities and challenges include managing a $650.8 million budget, the impacts of the State fiscal environment on that budget, the costs involved in maintaining the current retirement system, and this year's unique exercise in sorting out the fiscal issues involved in a possible County split.

Investigation

The Grand Jury interviewed the:

- County Executive Officer
- County Auditor-Controller

- County's Independent Auditors
- Retirement System Administrator
- Retirement System Independent Auditors
- Retirement System Actuary
- County Supervisors

The Jury reviewed and analyzed the following documents:

- The 2004-2005 County Operating Plan, Proposed Budget and Five-Year Capital Improvement Plan
- The 2003-2004 Comprehensive Annual Financial Report
- The Management Letter from the County's independent auditor
- The 2003-2004 County Employee's Retirement System Comprehensive Annual Financial Report and related documents
- The Mission County Fiscal Study, Distribution of Indebtedness Determination Report and Summary Report

Finally, the Jury observed Board of Supervisors meetings with respect to fiscal issues.

The County Budget

A Hard Read

"Paths to Performance" is the title of the Operating Plan and Proposed Budget for the County for fiscal year 2004-2005. It is a massive document, weighing about 5 pounds, with over 550 pages in eight separate sections. The accompanying Executive Summary is more than 100 pages long.

The document shows recommended expenditures for countywide functions of $630.8 million, with $617.3 of that amount for the Operating Budget and $13.5 million for the Capital Budget. An additional $20 million is designated for future uses. Expenditures are grouped into seven categories. The largest amounts are for Health & Public Assistance at 39% and Public Safety at 23% of the total budget. Revenues and other financing sources total $651.2 million. The largest revenue sources are federal and state support for a variety of programs, vehicle license fee payments, fees for County services, and taxes.

For the past seven years, the County has received the Government Finance Officers Association's Distinguished Budget Presentation Award. Despite this proof of budget excellence, the County Budget document is so large and complex that the average taxpayer would not ordinarily be expected to spend the hours necessary to understand it and discern problems or priorities. Partially in response to this fact, the First and Third District Supervisors are proposing a Blue Ribbon Budget Task Force which was considered by the Board at its May 3, 2005 meeting. At this meeting, the Board voted to reduce the task force from the originally proposed nine members to five and to not place any restrictions on membership but to recruit the best candidates available. The goals of the task force are to:

- Identify budgeting best practices in both public and private sectors that could be applied to County budget processes

- Make the County budget process more transparent to the average citizen

- Promote more participation from the public

It is anticipated that the Task Force recommendations could be incorporated into the process as early as the 2006-2007 fiscal year budget document.

Shift, Swap and Flip

When the County adopted its 2004-2005 budget, the State's budget had not been finalized. Therefore, any impacts to the County from the State's ongoing budget difficulties were not yet known. The State budget, as adopted, resulted in a negative net impact on the County budget of $4.129 million. This occurred after a complex "shift" of property tax revenues from the County General Fund to the Educational Revenue Augmentation Fund (ERAF), a "swap" of Vehicle License Fee (VLF) revenue with a return of some property tax revenues in the form of additional ERAF funds, and the "triple flip" of local sales tax revenues to the State in return for ERAF funding backfilled from the State General Fund. The goal of the shift, swap and flip is to reduce the State's Proposition 98 obligation to school districts. Fortunately, the current fiscal year's $4.129 million negative net impact has been offset with higher property tax revenues and the County's 2004-2005 budget has remained balanced.

In fiscal year 2005-2006, beginning July 1, 2005, discretionary General Fund revenues are expected to increase by approximately $9.9 million. This increase has, however, already been committed to negotiated employee cost of living increases and program and budget changes approved by the Board of Supervisors. Potential State budget impacts are estimated at $6.3 million, which includes the second and final year of the County/State shift, swap and flip. Without any additional State impacts, revenues should cover expenditures. Any new spending will most likely have to be accompanied by reductions in other areas.

Finding 1
Despite fiscal impacts resulting from State budget issues, County revenues can be expected to cover expenditures both this fiscal year and next.

Financial Report Card

How Did We Do?

The County's Comprehensive Annual Financial Report (CAFR) for the fiscal year 2003-2004 was presented to the Board of Supervisors on November 2, 2004. The report is 140 pages long and contains detailed information and management comments on the financial health of Santa Barbara County. It also contains general information on the County, the services offered, and factors affecting financial condition. It was noted that the County received a number of important awards last year from the Government Finance Officers Association, including Certificate of Achievement for Excellence in Financial Reporting.

Key numbers indicating changes in the County's financial well being as of June 30, 2004 are:

- County assets exceeded liabilities by over $557 million, an increase of more than $26 million during the year.
- Total revenues for governmental activities were more than $560 million, a 4% increase from the prior year. The property taxes item showed the largest increase.
- Total expenses for governmental activities exceeded $537 million, an almost $17 million increase from the prior year. The health and public assistance item showed the largest increase.
- Employee salaries and benefits accounted for approximately 52% of the County's total budget.
- The average full time equivalent (FTE)[1] employee count decreased from 4,274 in 2003 to 4,209 in 2004. Despite fewer employees, expenditures for salaries and benefits increased by over $20 million from the prior year. This was due to cost of living salary increases and increases in contributions to the employees' retirement plan.

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[1] A full-time equivalent (FTE) is defined as the actual hours budgeted to fund a position. A position funded for 12 months is equivalent to 1 FTE and a half-time position funded for 6 months is equivalent to .5 FTE. FTEs include all regular, extra-help and contract employees.

As required by law, the County retained an independent firm, KPMG, to audit its financial statements. The audit was conducted in accordance with generally accepted auditing standards and concluded the financial statements present fairly the financial position of the County in all material respects. An accompanying Management Letter identified three minor internal control weaknesses which are being addressed.

In the meeting with the Jury, the KPMG auditor praised the County Auditor-Controller's office for its practice of requiring an early "soft" closing of the books in March each year. This greatly expedites the June 30 fiscal year end process. The auditor also praised the County's in-house accounting system and the quality of the staff.

Finding 2
The Auditor-Controller's office designed, implemented and continues to improve its in-house accounting system, possibly saving the County millions of dollars in development and maintenance costs. The high quality of the Auditor-Controller's staff is the result of vigorous recruiting at local universities.

Retirement System

A Real Employee Benefit

The Santa Barbara County Employees' Retirement System (SBCERS or the System) was established in 1944 and is administered by the Board of Retirement to provide service retirement, disability, death, and survivor benefits for County employees and contracting districts[2]. Members include permanent full and part-time employees and retirees. SBCERS is a legally separate entity from the County of Santa Barbara. At the end of the last fiscal year, the System had $1.347 billion in assets and 7,660 members, including 2,440 benefit recipients who received an average annual allowance of $21,421.

As of June 30, 2004, the System had paid out $61.1 million in benefits, an increase of over $6.9 million from the previous year. All categories of expenses show increases, with the major dollar increases in operating expenses and legal costs. The independent audit concluded that the financial statements prepared by the System are free of material misstatements and present fairly the plan net assets.

The primary sources of System funds are the return on investments and the collection of employee and employer contributions. Investment performance is a

[2] Contracting districts are the Air Pollution Control, Carpinteria Cemetery, Carpinteria-Summerland Fire Protection, Goleta Cemetery, Oak Hill Cemetery, Santa Barbara Coastal Vector Control, Santa Maria Cemetery, Summerland Sanitary Districts, and Santa Barbara County Association of Governments.

function of the financial markets and asset allocation. Over the last year, the investment portfolio produced an overall return of 16.1%, about average for similar pension funds but 1.1% less than the policy benchmark. Over the past five years, the SBCERS investment portfolio produced an average annual return of 3.5%. The employer contribution for 2003-2004 amounted to over $39 million, and was 100% of the Annual Required Contribution as has been the case for every year shown in the report.

The level of the System's unfunded liability is a concern, both for pension fund members and for County taxpayers. On June 30, 2004, the actuarial present value[3] of plan assets was $1.379 billion and the actuarial accrued liability[4] was $1.579 billion. This indicates that SBCERS had an unfunded actuarial accrued liability of almost $200 million. The funded ratio as of that date was 87.4%. The funded ratio is an indication of the financial health of the system; a decrease in the funded ratio does not necessarily indicate a plan is in financial decline as actuarial assumptions can impact the ratio. However, this ratio is the lowest shown for the past seven years and has been declining for each of the past four years.

Finding 3
SBCERS' funded ratio of accrued assets to accrued liability has been declining for four years and is currently the lowest shown for the past seven years.

Recommendation 1
SBCERS should provide members and taxpayers with an explanation for the decline in the funded ratio of accrued assets to accrued liability including what, if anything, can or should be done to reverse it.

Defined Benefit vs. Defined Contribution Plan—A Defining Moment

A significant portion of County employees' compensation is the retirement benefit. As a form of deferred compensation, it is both a very valuable benefit and a bargaining issue during negotiations with employee unions. At this time, the County's contribution rate is approximately 15% of covered payroll. It will increase to 18% on July 1, 2005. Pension benefits for public sector employees are taking an increasing share of government spending, and taxpayers are at risk for the long-term cost of benefits already awarded.

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[3] Actuarial present value is the value, as of a specified date, of an amount payable in the future, where the amount has been adjusted to reflect both the time value of money and the likelihood that the payment is actually made.

[4] Actuarial accrued liability is the portion of the total present value of benefits attributable to past service credit.

Public employee retirement systems are a controversial subject, both in California and elsewhere. One solution to the problem is to change public employee retirement plans from the traditional defined benefit to a defined contribution plan.

A **Defined Benefit Plan** like Santa Barbara County's guarantees workers a certain income when they retire. The amount of this income is determined by a formula based on how much the employee earned and years of employment. The account is usually managed by the employer. If the invested funds do not earn enough to pay the benefit, the taxpayer must make up the difference. Conversely, when the invested funds do well, the taxpayer's obligation is reduced.

A **Defined Contribution Plan**, which is becoming more common in the private sector, guarantees that the employer will match an employee's contribution to his or her retirement account up to a certain amount. The money is invested at the direction of the employee, who, after vesting, can take the account with him or her when changing jobs. In this plan, the employee, not the taxpayer, takes the risk. If the invested funds do well, the individual will earn more; if the funds do poorly, the individual will earn less.

Neither the Board of Supervisors nor the Board of SBCERS can make unilateral substantive changes in the County's retirement plan. Retirement benefits are subject to contractual provisions of collective bargaining with employee groups. Also, legislation at the state level to amend the California Government Code is necessary for a significant change such as replacing a defined benefit with a defined contribution plan. SBCERS has undertaken a study on how various modifications and possible options would affect its members and the taxpayers. Members and taxpayers need to be aware of the positives and negatives of possible changes and understand the implications.

For the foreseeable future, governmental entities, including Santa Barbara County, will likely continue to experience pressure to change from a Defined Benefit to a Defined Contribution retirement plan. For both taxpayers and employees, there are advantages and disadvantages to each system. The Retirement Board has commissioned a complete analysis of the issues. This analysis needs to be thoroughly debated by all involved before the County considers any change to its retirement system.

Forming a New County

On May 10, 2004, after the certification by the County Clerk of a petition advocating the formation of a new county, the Governor appointed a five-member commission to study the viability of the proposed county which would occupy the northern section of the current Santa Barbara County. The county split petition will be voted upon in a countywide election in June 2006.

The commission was charged with making eleven "determinations," generally classified as fiscal, geographical or administrative. The four fiscal determinations were to:

- Allocate the County's existing debt between the proposed Mission County and the remaining Santa Barbara County
- Determine the economic viability of the proposed Mission County
- Determine the fiscal impact of a new county formation on the remaining Santa Barbara County
- Compute a statutory spending limit for the proposed county

The commission has released the "Mission County Fiscal Study, Distribution of Indebtedness Determination Report" and "Summary Report." Costs to date of this exercise include the staff time of three full time employees from the Auditor-Controller's office working full time for the committee for nine months, a high-level manager who did extensive work on the Fiscal and Indebtedness Study, and the time of the Auditor-Controller himself. The exercise has had an enormous impact on the normal workload of the Auditor-Controller's office. The County may or may not be reimbursed for these costs.

Conclusion

This year, the County was faced with more State impacts to its budget, continued financial pressure related to the funding of the County's retirement system, and the requirements of the Mission County Formation Committee. Other issues not discussed in this report include the costs of litigation which might be borne in the current year from the County's General Fund and a costly high profile trial in the North County. The Jury finds that the County Executive Officer, the Auditor-Controller and the Board of Supervisors are doing a good job in facing and solving these challenges.

Affected Agencies

County Board of Supervisors
Finding 1

County Auditor-Controller
Finding 2

Santa Barbara County Employees' Retirement System

Finding	3
Recommendation	1