

**JUDICIAL COUNCIL OF CALIFORNIA  
ADMINISTRATIVE OFFICE OF THE COURTS**

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**Report**

TO: Members of the Judicial Council

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DATE: April 21, 2009

SUBJECT: Revision of the Trial Court Fund Balance Policy (Action Required)

Issue Statement

The Supplemental Report of the 2006 Budget Act required the Judicial Council to report to the Legislature on the “policy governing trial court reserves”. At its October 20, 2006 business meeting, the Judicial Council adopted a “Fund Balance (Reserve) Policy”. The policy requires courts to do the following:

- Report year-end fund balance according to certain categories and subcategories, and
- Set aside a minimum amount for operating and emergency purposes based on a specified formula.

As a result of the lack of specificity in the policy as it was originally adopted by the council, trial courts have sought guidance from Administrative Office of the Courts (AOC) staff on how to prioritize fund balance categories and subcategories. In addition, audit results and statewide financial analysis have indicated that there is some discrepancy between the manner in which courts are characterizing fund balance, resulting in statewide data and court-by-court financial comparisons that can be misleading.

At the October 3, 2008 Trial Court Budget Working Group (TCBWG) meeting, a motion was passed to establish a subgroup that would review the fund balance policy and consider potential amendments to address these issues. The subgroup, consisting of both presiding judges and court executive officers, met on November 19, 2008 by conference call to discuss reporting issues. The subgroup ultimately agreed on proposed changes and requested that the TCBWG endorse recommendations regarding revisions to the current policy. At its April 16, 2009 meeting, the TCBWG unanimously concurred on revisions to the fund balance policy.

The policy revisions being recommended consist primarily of technical changes, including minor language amendments, the deletion of obsolete language, and the establishment of a prioritization order for identifying and designating year-end fund balance by categories.

The attached policy displays the revisions being recommended: added language is underlined and deleted language is displayed in struck-through format.

### Recommendation

AOC staff and the Trial Court Budget Working Group recommend that the Judicial Council approve the revised trial court fund balance policy.

### Rationale for Recommendation

Minor language revisions and proposed deletion of obsolete language include the following:

- “Fund balance (reserves)” is replaced with “fund balance”. Fund balance is not synonymous with the term "reserves"; fund balance is the appropriate terminology from an accounting standpoint.
- Instructions limited to identifying projected/budgeted fund balances reported in the Schedule 1 budget are deleted. The purpose of the fund balance policy is to address identifying actual year-end fund balance, not projected/budgeted fund balances.
- The term “liabilities” is replaced with “obligations”. Liabilities are not part of fund balance, but are balance sheet items that reduce fund balance.
- Language is added to clarify that the operating and emergency designation is computed using unrestricted general fund expenditures, but excluding material one-time expenditures and using expenditures from the same fiscal year as the ending fund balance.
- Language is added to provide specific instructions on calculating unfunded retiree health care obligations.

While most of the proposed revisions represent technical clean up, as identified above, one substantive revision being recommended is the establishment of a prioritization order for identifying and designating year-end fund balances as follows.

1. Statutorily restricted carryover fund balance.
2. Contractual commitments to be paid in the next fiscal year.

3. The minimum calculated operating and emergency fund balance.
4. Other Judicial Council mandates to be paid in the next fiscal year.
5. Contractual commitments to be paid in subsequent fiscal years.
6. Other Judicial Council mandates to be paid in subsequent fiscal years.
7. Other designated subcategories and/or the undesignated subcategory.

This prioritization incorporates two important principles. The first is the need to clearly state that unspent, receipted revenues whose use is statutorily restricted cannot be used for purposes other than what is specified in law. As such, its identification is mandatory and of the highest priority. The second is that commitments in the next fiscal year should be a higher priority than those in subsequent years. Under the current policy, courts can identify the total value of all multi-year contracts as contractual commitments. Some courts, consistent with this approach, identified multi-year contractual commitments up to five years in advance, leaving no funding to address existing policy requirements such as the minimum operating and emergency fund balance, which is a required minimum level of funding that each court is required to maintain. Contractual commitments are a legal obligation, and therefore courts should identify the fund balance that will be necessary to honor those commitments. From the broadest perspective, courts should be planning on a multi-year basis for future costs. As part of this process, entering into long-term obligations should not, though, result in the commitment of minimum funding levels needed to address other obligations in next fiscal year.

This prioritization would impact only courts that have insufficient funds to meet statutory and council policy requirements and other commitments. The proposed prioritization will ensure that courts identify sufficient funding needed to meet minimum funding requirements, and should also ensure that these requirements are taken into account before multi-year funding commitments are made, prospectively.

#### Alternative Actions Considered

Consideration was given to not modifying the policy at this time, but court requests for more clarity in the policy, especially with regard to fund balance designations, and the need to have consistent statewide reporting for purposes of developing council funding allocations, as well as providing reliable information to the legislative and executive branches, makes it important that the revisions be made in the current fiscal year.

#### Comments From Interested Parties

None

#### Implementation Requirements and Costs

None.

# FUND BALANCE ~~(RESERVE)~~ POLICY

## BACKGROUND

In the Supplemental Report of the 2006 Budget Act, the Legislature specified that the Judicial Council report on court reserves and provide its policy governing trial court reserves. On October 20, 2006, the Judicial Council approved a fund balance policy for trial courts. ~~Minimum~~ Financial accounting and reporting standards and guidelines have been established by the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). The Trial Court Financial Policy and Procedures Manual, in compliance with these standards and guidelines, specifies that the trial courts are responsible for the employment of “sound business, financial and accounting practices” to conduct their fiscal operations. ~~One important policy concerns fund balance or “reserves” that courts manage.~~

~~In 2006, the Legislature in the Supplemental Report of the 2006 Budget Act in Item 0250-101-0932-2(b) specified the following information on fund balance be submitted.~~

~~(i) The Judicial Council shall report all approved allocations to the trial courts . . . by September 30, 2006. The report shall include a statement of the intended purpose for which each allocation was made. The report shall also include the policy governing trial court reserves.~~

~~(ii) The trial courts shall report to the Judicial Council by September 15, 2007, all court revenues, expenditures, and reserves from the prior fiscal year for funding from all fund sources.~~

~~In addition to this specific reporting, Government Code section 77203 specifies that the Judicial Council has the authority to authorize trial courts to carry over unexpended funds from one year to the next. Consistent with this provision, there is a need for a clear this policy provides that ensures courts with specific directions for ~~are able to~~ identifying fund balance resources necessary to ~~that~~ address statutory and contractual obligations on an accurate and consistent basis as well as maintaining a minimum level of operating and ~~contingency~~ emergency funds. ~~In addition, t~~This policy provides the necessary structure to ensure funds are available to maintain service levels for various situations that confront the trial courts including a late state budget.~~

## PURPOSE

Governmental agencies/entities report the difference between their assets and liabilities obligations as fund balance, which is divided into restricted and unrestricted categories components. The function of the restricted fund balance is to isolate the portion of fund balance that represents resources required to address statutory and ~~or~~ contractual obligations and is not available for the following period’s budget. ~~Unrestricted fund balance can serve as a measure of current available, uncommitted financial resources.~~

The purpose of this policy is to establish uniform standards for the reporting of fund balance by trial courts and to maintain accountability over the public resources used to finance trial court operations.

## **POLICY**

As a publicly funded entity, and in accordance with ~~and as~~ good public policy, trial courts must ensure that the funds allocated and received from the state and other sources are used efficiently and accounted for properly and consistently. The trial courts shall account for and report fund balance (“reserves”) in accordance with established standards, utilizing approved categories. Additionally, a fund balance can never be negative.

### **Fund Balance Categories**

When allocating fund balance to the categories and subcategories, allocations are to follow the following prioritization:

1. Statutory fund balance.
2. Contractual commitments to be paid in the next fiscal year.
3. The minimum calculated operating and emergency fund balance.
4. Other Judicial Council mandates to be paid in the next fiscal year.
5. Contractual commitments to be paid in subsequent fiscal years.
6. Other Judicial Council mandates to be paid in subsequent fiscal years.
7. Other designated subcategories and/or the undesignated subcategory.

If there is insufficient fund balance to cover any or all of the first four priorities, the shortfall should be explained in detail in attached footnotes. Also, there are additional reporting requirements when the amount allocated to the operating and emergency fund balance is below the minimum required.

**Restricted Fund Balance.** This is a fund balance category ~~that~~ is not available for purposes other than ~~contractual or statutory or contractual~~ purposes.

**Statutory** - A restricted fund balance that consists of unspent, receipted revenues whose use is statutorily restricted.

**Contractual** - A restricted fund balance set aside for executed contractual commitments beyond the current fiscal year (e.g., multi-year contracts). ~~Contractual obligations expected to be incurred in the current year should be budgeted and encumbered in the current year.~~

~~**Statutory** - A restricted fund balance that is unspent, receipted revenues that have a statutory restriction on their use.~~

**Unrestricted Fund Balance.** This is a fund balance that is comprised of funds that are neither contractually nor statutorily restricted but may, by policy, require minimum amounts be maintained or identified.

**Designated** - The portion of unrestricted fund balance that is subject to tentative management plans ~~beyond the current fiscal year.~~ For each specific plan, trial courts must select a specific designated sub-category that is ~~provided~~ listed and provide a detailed description of the planned use of the fund balance. Specific plans that fall under the same designated sub-category ~~should~~ must be ~~designated~~ listed separately.

**Undesignated** - The portion of fund balance that is neither restricted nor designated.

**Designated Fund Balances**

For designated fund balances that are based on estimates, particularly the operating and emergency (above the minimum required), leave ~~liabilities~~ obligations, and retirement fund balance designated subcategories, explanations of the methodology used to compute or determine the designated amount must be provided. ~~The trial court should fund the operating and emergency fund category prior to any other designated fund balance category being funded. In addition, if there is insufficient fund balance to designate total estimated liabilities, the shortfall should be provided in attached footnotes.~~ Designations or planned uses include but are not limited to:

**1. Operating and Emergency**

Each court shall maintain a minimum operating and emergency fund balance at all times as determined by the following calculation based upon that fiscal year's total actual unrestricted general fund expenditures (excluding special revenue, debt service, permanent, proprietary, and fiduciary funds), less any material one-time expenditures (e.g., large one-time contracts) of the previous fiscal year.

<u>Annual Actual General Fund Expenditures</u>
5 percent of the first \$10,000,000
4 percent of the next \$40,000,000
3 percent of expenditures over \$50,000,000

If a court determines that it is unable to identify ~~in its annual budget~~ the minimum operating and emergency fund balance level as identified above, the court shall immediately notify the Administrative Director of the Courts, or designee, in writing and provide a plan with a specific timeframe to correct the situation.

- 2. One-time facility – Tenant improvements** Examples include carpet and fixture replacements.
- 3. One-time facility – Other** Examples include ~~leases~~ amounts paid by the AOC on behalf of the courts.
- 4. Statewide Administrative Infrastructure Initiatives** Statewide assessment in support of technology initiatives (e.g., California Case Management System and Phoenix) will be identified in this designation.
- 5. Local Infrastructure (Technology and non-technology needs)** Examples include interim case management systems and non-security equipment.
- 6. One-time employee compensation (Leave ~~liability~~ obligation, retirement, etc.)** Amounts included in this category are exclusive of employee compensation amounts already included in the ~~trial~~ court's operating budget and not in a designated fund balance category.

- a. One-time leave payments at separation from employment. If amounts are not already accounted for in a ~~trial~~ court's operating budget, estimated one-time payouts for vacation or annual leave to employees planning to separate from employment within the ~~current~~ next fiscal year should be in this designated fund balance sub-category. This amount could be computed as the average amount paid out with separations or other leave payments during the last three years. Any anticipated non-normal or unusually high payout for an individual or individuals should be added to at the average amount calculated.

In a footnote, the ~~trial~~ court should note the amount of ~~their~~ its employees' currently earned leave balance that is more than the established designated fund balance. The amount would be determined by multiplying the hours of earned vacation or annual leave on the payroll records for each employee times ~~their~~ his or her current salary rate minus the designated fund balance established.

- b. Unfunded pension liability obligation. If documented by an actuarial report, the amount of unfunded pension liability obligation should be included as a designated fund balance. Employer retirement plan contributions for the current fiscal year must be accounted for in the ~~trial~~ court's operating budget.

In a footnote, the ~~trial~~ court should note the amount of the current unfunded pension liability obligation that is in excess of the established designated fund balance.

- c. Unfunded retiree health care liability obligation. If documented by an actuarial report, the amount of unfunded retiree health care liability obligation should be included as a designated fund balance.

The current year's unfunded retiree health care obligation contains: (i) the current year Annual Required Contribution (ARC) based on a 30-year amortization of retiree health costs as of last fiscal year-end and (ii) the prior year retiree health care obligation less (iii) the retiree health care employer contributions and any transfers made to an irrevocable trust set up for this purpose. The current year's unfunded retiree health care obligation is to be added to the prior year's obligation.

Note: The ARC amounts are located in each court's actuarial report, which is entitled "Postretirement Benefit Valuation Report".

In a footnote, the ~~trial~~ court should note the amount of the ~~current~~ cumulative unfunded retiree health care liability obligation that is in excess of the established designated fund balance.

- d. Workers compensation (if managed locally). The amount estimated to be paid out in the ~~current~~ next fiscal year.

**7. Professional and consultant services** Examples include human resources, information technology, and other consultants.

**8. Security** Examples include security equipment, and pending increases for security service contracts.

**9. Other (required to provide detail)**

Any other planned commitments that are not appropriately included in one of the above designated fund balance sub-categories should be listed here with a description in sufficient detail to determine its purpose and requirements.