

Management's Discussion and Analysis

As management of the City of Hermosa Beach, we offer readers of the City's financial statements this narrative overview and analysis of the financial activities of the City of Hermosa Beach for the fiscal year ended June 30, 2015. We encourage readers to consider the information presented here in conjunction with additional information that we have furnished in our letter of transmittal, which can be found on pages v - x of this report.

Financial Highlights

- Beginning with the fiscal year ended June 30, 2015, the City implemented GASB Statement No. 68, Accounting and Financial Reporting for Pensions which requires the City to include its net pension liability in the government-wide financial statements. Similar to the City's long-term debt, the net pension liability is payable over an extended time horizon and does not represent a claim on current financial resources. For more information on the implementation of GASB Statement No. 68, please refer to the Government-wide Fund Analysis below and the note titled "Accounting Changes" (Note 1.O) in the Notes to the Basic Financial Statements.
- The assets and deferred outflows of resources of the City of Hermosa Beach exceeded its liabilities and deferred inflows of resources at the close of the last fiscal year by \$46,052,668 (net position). Excluding the \$36,303,639 net pension liability, \$11,434,602 represents unrestricted net position and may be used to meet the government's ongoing obligations.
- The City's net position, with the beginning balance restated to reflect the net pension liability as of July 1, 2014, increased by \$8,453,152, prior to the recording of the oil liability settlement, after which, it decreased to (\$5,546,848). See Note 14 on page 87.
- As of June 30, 2015, the City of Hermosa Beach's governmental funds reported combined ending fund balances of \$22,320,452, an increase of \$6,866,615 in comparison with the prior year. This increase due to a 4.9% increase in revenue and \$3 million transfer to the Sewer Fund from the Insurance Fund for the upcoming Sewer Rehabilitation Project.
- At the end of the current fiscal year, the City of Hermosa Beach's governmental fund balances of \$22,320,452 are comprised of nonspendable funds; \$19,444, restricted; \$4,188,404, committed; \$460,616; and assigned; \$17,651,988; to indicate that funds are not available for new spending. Although funds are shown in the committed or assigned category, the City Council still does have discretion over the use of these funds and may change the committed or assigned use. Under that scenario, approximately 79%, or \$17,651,988 of the \$22,320,452 in funds could be redirected at the discretion of the City Council. See Note 11 on page 83.
- After the council approved transfer of \$2,610,442 into the Capital Improvement Fund, the committed and assigned fund balance in the General Fund was \$10,033,940 or 33% of total General Fund expenditures.
- The City of Hermosa Beach had no debt as of the end of fiscal year 2014-15, however the City subsequently issued lease revenue bonds of \$11.6 million in order to fund the balance of the oil settlement agreement with E&B Natural Resources. See Notes 14 and 15 on pages 87-89.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the City of Hermosa Beach's basic financial statements. The basic financial statements are comprised of three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. The report also contains other supplementary information in addition to the basic financial statements themselves.

Government-wide financial statements are designed to provide readers with a broad overview of the City of Hermosa Beach's finances, in a manner similar to a private-sector business.

The **Statement of Net Position** presents information on all of the City of Hermosa Beach's assets and liabilities, with the difference between the two reported as net position. Over time, increases or decreases in net position may serve as a useful indicator of whether the financial position of the City of Hermosa Beach is improving or deteriorating.

The **Statement of Activities** presents information showing how the government's net positions changed during the most recent fiscal year. All changes in net positions are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g., uncollected taxes and earned, but unused, vacation leave).

The governmental activities of the City of Hermosa Beach include legislative and legal, general government, public safety, public works, community development, and culture and recreation.

The government-wide financial statements include not only the City of Hermosa Beach itself, but also the Lighting and Landscaping District, the Lower Pier Avenue Assessment District and the Myrtle Avenue, Loma Drive, Bayview Drive and Beach Drive Utility Underground Districts. Although these entities are legally separate, they function for all practical purposes as part of the City, and therefore have been included as an integral part of the primary government.

The Government-Wide Financial Statements can be found on pages 21- 24 of this report.

Fund financial statements. A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The City of Hermosa Beach, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements. All of the funds can be divided into three categories: governmental funds, proprietary funds, and fiduciary funds.

Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

The City of Hermosa Beach maintains twenty-four individual governmental funds. Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balance for the funds below, which are considered to be a major fund:

General Fund
Sewer Special Revenue Fund
Capital Improvement Capital Projects Fund

Major funds are governmental or enterprise funds whose revenues, expenditures/expenses, assets or liabilities are at least 10% of corresponding totals for all governmental or enterprise funds and at least 5% of the corresponding total for all governmental and enterprise funds combined.

Data from the other twenty-one governmental funds are combined into a single, aggregated presentation. Individual fund data for each of these nonmajor governmental funds is provided in the form of combining statements in the Supplementary Information section in this report.

The City of Hermosa Beach adopts an annual appropriated budget for its General Fund. A budgetary comparison statement has been provided for the General Fund and Sewer Fund in the Required Supplementary Information section to demonstrate compliance with this budget.

The basic governmental fund financial statements can be found on pages 30–33 of this report.

Proprietary funds. The City of Hermosa Beach maintains one type of proprietary fund.

Internal service funds are used to accumulate and allocate costs internally among the City of Hermosa Beach's various functions. The City of Hermosa Beach uses internal service funds to account for its fleet of vehicles, information systems and equipment, and risk management/insurance activities. Because these services predominantly benefit governmental rather than business-type functions, they have been included within **governmental activities** in the government-wide financial statements.

Internal service funds are combined into a single, aggregated presentation in the proprietary fund financial statements. Individual fund data for the internal service funds is provided in the form of combining statements elsewhere in this report.

The basic proprietary fund financial statements can be found on pages 38-40 of this report.

Fiduciary funds are used to account for resources held for the benefit of parties outside the government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of those funds are not available to support the City of Hermosa Beach's own programs. The accounting used for fiduciary funds is much like that used for proprietary funds. Funds of the Lower Pier Avenue, Myrtle Avenue, Loma Drive, Bayview Drive, and Beach Drive Undergrounding Districts are held as fiduciary funds.

The fiduciary fund financial statements can be found on page 43 of this report.

Notes to the basic financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the basic financial statements can be found on pages 45-89 of this report.

Other information. In addition to the basic financial statements and accompanying notes, this report also presents certain required supplementary information concerning the City of Hermosa Beach's major funds. Required supplementary information can be found on pages 92-102 of this report.

The combining statements referred to earlier in connection with nonmajor governmental funds and internal service funds are presented immediately following the required supplementary information on pensions. Combining and individual fund statements and schedules can be found on pages 105-148 of this report.

Government-wide Financial Analysis

As noted earlier, net position may serve over time as a useful indicator of a government's financial position. As of June 30, 2015, total assets and deferred outflows of resources exceeded total liabilities and deferred inflows of resources by \$46,052,668. Without the net pension liability, the net position would be \$82,356,307.

The City implemented GASB 68, Accounting and Financial Reporting for Pensions for the June 30, 2015 financial statements. The beginning balance of the 2014-15 net position was restated to reflect the impact of the implementation.

According to the Governmental Finance Officers Association (GFOA) the underlying factual situation has not changed. Standard and Poor's (the rating agency who rated the City's bonds) indicated that the new standards will lead to more conservative liability estimates and provide some additional disclosure. They will continue to focus on commitment to funding, investment performance, trend analysis, affordability, and maintaining plan sustainability. The Annual Required Contribution (ARC) will continue to be reported as Actuarially Determined Contribution. Standard and Poor's believes this is an easily recognizable and understandable measure for governments. They currently estimate with what frequency governments fully fund their ARC (which Hermosa Beach always does).

The major components of GASB No. 68 that affect the Statement of Net Position for Government-wide are:

- Deferred Outflows of Resources - Represents the deferred pension contribution, which is equal to the total amount of the 2014-15 contributions. The contributions are deferred to 2015-16 because the net pension liability balance is one year in arrears.
- Net Pension Liabilities (recorded in Long-Term Liabilities) - Represents the actuarially valued liabilities for the Police, Fire, and Miscellaneous Plans as of June 30, 2014.
- Deferred Inflows of Resources - Represents the difference between the expected and actual earnings on investments. The new accounting standard requires that differences between projected and actual investment returns be amortized on a straight-line basis over five years.

Net Position		
June 30, 2015		
(dollars in thousands)		
	Governmental Activities	
	2015	2014
Current and Other Assets	\$ 43,074	\$ 44,710
Noncurrent Assets	66,824	64,951
Total Assets	109,898	109,661
Deferred Outflows of Resources	4,480	-
Current Liabilities	18,084	7,163
Noncurrent Liabilities:		
Net Pension Liability	36,304	-
Long-term Liabilities- Other	5,915	10,205
Total Liabilities	60,303	17,368
Deferred Inflows of Resources	8,022	-
Net Position:	46,053	92,293
Investment in Capital Assets	66,733	64,828
Restricted	4,189	4,477
Unrestricted	(24,869)	22,988
Total Net Position	46,053	92,293
Impact of Restatement for GASB 68*	-	(40,693)
Restated Net Position	\$ 46,053	\$ 51,600

*See Note 16 for Prior Period Adjustment. This amount represents the Net Pension Liability of (\$44,066,303) and Deferred Outflow of Resources of \$3,373,029.

The largest portion of the City of Hermosa Beach's net position, \$66,733,301, reflects its investment in capital assets (e.g., land, buildings, machinery, and equipment). The City of Hermosa Beach uses these capital assets to provide services to citizens; consequently, these assets are not available for future spending.

A portion of the City of Hermosa Beach's net position \$4,188,404 represents resources that are subject to external restrictions on how they may be used.

Compliance with GASB 68 and 71 requires that the City's net pension liability be recorded on the Statement of Net Position, which reduces unrestricted net position and created a negative unrestricted net position or deficit of (\$24,869,037). Excluding the \$36,303,639 net pension liability, \$11,434,602 is available to meet the City's ongoing obligations to residents.

At June 30, 2015, the City is able to report positive balances in all categories of net position for the government as a whole except for unrestricted due to the implementation of GASB 68 and the inclusion of the net pension liability, which will likely remain a long-term liability for several decades.

The following is the condensed Statement of Activities and Changes in Net Position for the fiscal years ending June 30, 2015 and June 30, 2014.

Governmental Activities. Governmental activities increased the City of Hermosa Beach's net position by \$8,453,152, prior to the oil liability settlement. After the recording of the liability settlement, the change in net position is (\$5,546,848). Significant elements of this change are as follows:

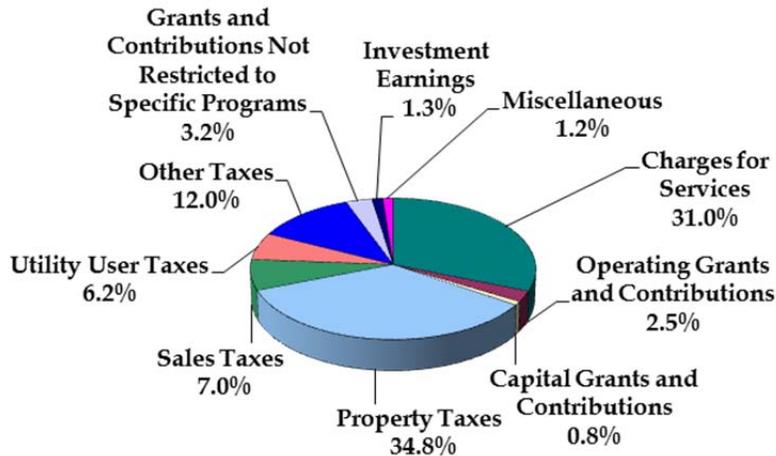
Changes in Net Positions		
June 30, 2015		
(dollars in thousands)		
	Governmental Activities	
	2015	2014
Revenues:		
Program Revenues:		
Charges For Services	\$ 12,268	\$ 11,740
Operating Grants and Contributions	984	1,106
Capital Grants and Contributions	329	261
General Revenues:		
Property Taxes	13,740	12,910
Other Taxes	9,948	9,578
Grants and Contributions Not		
Restricted to Specific Programs	1,246	1,223
Other	1,000	763
Total Revenues	39,515	37,581
Expenses:		
Legislative and Legal	1,293	1,076
General Government	3,078	2,828
Public Safety	16,737	16,856
Community Development	1,711	1,520
Culture and Recreation	1,257	1,068
Public Works	6,986	7,421
Total Expenses	31,062	30,769
Change in Net Position before Special Item	8,453	-
Settlement (Note 14)	(14,000)	-
Increase (Decrease) in Net Position	(5,547)	6,812
Net Position - Beginning, as restated for 7/1/2014	51,600	85,481
Net Position- Ending	46,053	92,293
Impact of Restatement for GASB 68*	-	(40,693)
Adjusted Net Position, Ending	\$ 46,053	\$ 51,600

*See Note 16 for Prior Period Adjustment. This amount represents the Net Pension Liability of (\$44,066,303) and Deferred Outflow of Resources of \$3,373,029.

Revenue for Governmental Activities

- Charges for services increased \$528,669 or 4.5%. An increase in building activities generated more building permits and plan check fees. Demand parking rates were implemented for part of the year as a test program.
- Property taxes revenue increased \$829,222 or 6.4%. Property values at the beach continue to increase at a faster pace than other areas.
- Sales Tax revenue increased \$114,594 or 4.3%.
- Transient Occupancy Tax (TOT) revenue increased \$145,330 or 6.6%. Since reported occupancy rates for 2014-15 were 81% compared to 81.1% for 2013-14, the continued increase in TOT revenue is most likely due to increased room rates, which are not reported to the City.
- Utility User Tax revenue was flat.
- Revenue from other taxes not listed above increased by \$111,123 or approximately 4.9%, primarily due to increases in real property transfer taxes and business licenses.

Revenue by Source - Government Activities



Revenues:	2015	2014
Property Taxes	\$ 13,739,648	\$ 12,910,426
Charges for Services	12,268,168	11,739,499
Other Taxes	4,737,370	4,480,917
Sales Taxes	2,768,225	2,653,631
Utility Users Taxes	2,442,575	2,443,285
Grants & Contributions not Restricted to Specific Programs	1,246,419	1,222,808
Operating Grants & Contributions	983,628	1,106,254
Miscellaneous	489,740	621,480
Capital Grants & Contributions	328,649	260,844
Investment Earnings	510,668	141,794
Total Revenues	\$ 39,515,090	\$ 37,580,938

Expenses for Governmental Activities

Expenses for Governmental Activities increased by \$159,055.

Legislative and Legal expenses increased \$217,003 or 20.2%. The increase is primarily due to interest paid on the oil settlement and the increased need for legal opinions from the City Attorney on matters including E&B Natural Resources and sewer fee.

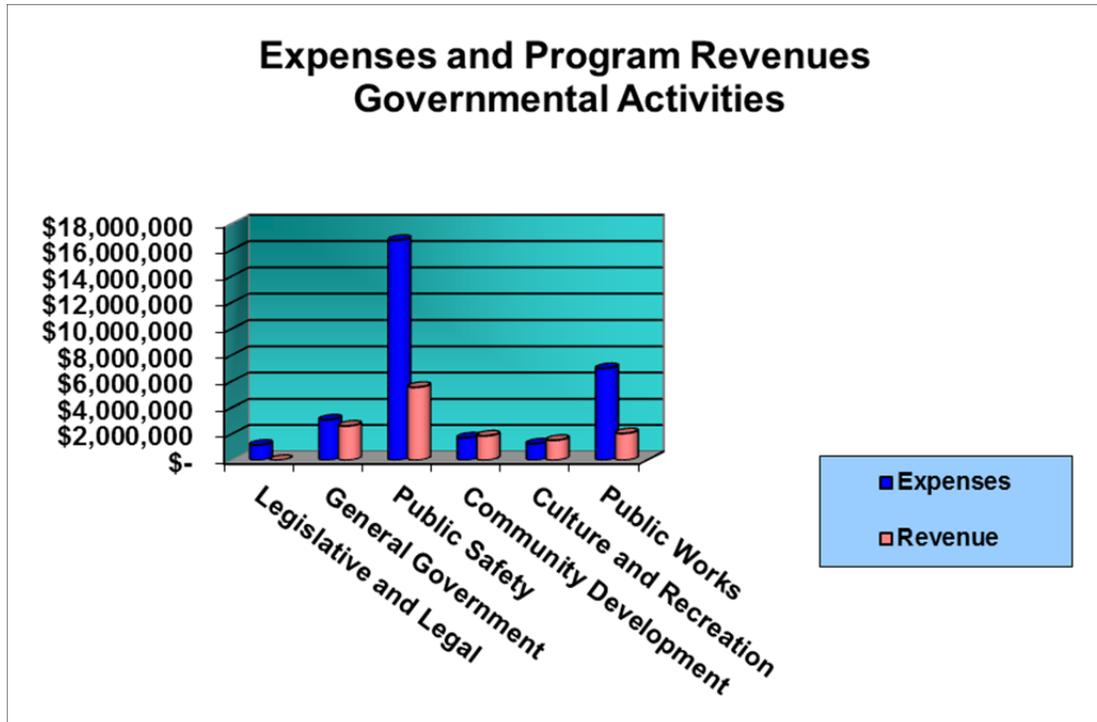
General Government expenses increased by \$250,149 or 8.8%. The increase is primarily due to personnel costs related to the conversion of two Management Analyst positions to full-time permanent (one of which was added at mid-year), the hiring of a full-time/temporary Environmental Coordinator, and additional part-time/temporary staff in the Finance Department. Additionally, there was an increase in contract services related to priority based budgeting and the fiscal health diagnostic tool.

Public Safety expenses decreased by (\$119,122) or 0.7%.

Community Development expenses increased by \$190,931 12.6%. The increase is primarily due to expenses related to the General and Coastal Plan update and an increase in contract services for plan checks.

Culture and Recreation expenses increased by \$188,923 or 17.7%. The increase is primarily due to increased personnel costs over 2013-14 due to position vacancies in the prior year.

Public Works expenses decreased by (\$434,962) or -5.9%. The decrease is primarily from a reduction in depreciation expenses due to several capital assets being fully depreciated in prior year. See Note 6 for allocation of depreciation expense. Without depreciation, expenditures would be up 6.7% primarily due to the addition of a part-time office assistant and increased use of engineering consulting services for technical and staff support.



Financial Analysis of the Government's Funds

As noted earlier, the City of Hermosa Beach uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental funds. The focus of the City of Hermosa Beach's governmental funds is to provide information on near-term inflows, outflows, and balances of spending resources. Such information is useful in assessing the City of Hermosa Beach's financing requirements. These funds are accounted for by using the modified accrual basis of accounting. Types of governmental funds reported by the City include the General Fund, Special Revenue funds, and Capital Projects funds.

As of the end of the current fiscal year, the City of Hermosa Beach's governmental funds reported combined ending fund balances of \$22,320,452, an increase of \$6,866,615, in comparison with the prior fiscal year. See Note 11 for more information. The total fund balances of the governmental funds consist of the following:

- Non-spendable fund balance of \$19,444 represents prepaid items.
- Restricted fund balance of \$4,188,404, which have restrictions imposed by external parties or enabling legislation. Funds in this category include Lighting District Funds, Proposition A and C Transportation Funds, Asset Forfeiture Funds and Supplemental Law Enforcement Funds (COPS).
- Committed fund balance of \$ 460,616 which have reserves for capital outlay and future renovations.
- Assigned fund balance of \$17,651,988 which includes the amounts to be used for specific purposes of the City, but do not meet the criteria to be classified as restricted or committed. Funds in this category include Contingency funds ("rainy day" funds), Retirement Stabilization funds, Compensated Absences funds, Capital Projects, Capital Improvements, and Sewer and Storm drain funds.

The General fund, Sewer Special Revenue Fund, and Capital Improvement Capital Projects Fund qualified as major funds under the GASB Statement No. 34, *Basic Financial Statements – and Management Discussion and Analysis – for State and Local Governments*, reporting criteria.

The General Fund balance increased in fiscal year 2014-15 by \$2,408,686. This increase is a result of the addition of funds to the Contingency balance to meet our goal of 16% of operating appropriations, \$1,000,000 set aside for oil debt service payments, \$500,000 set aside for unspecified contingencies, and due to funds set aside for capital improvement projects not completed in 14-15.

Overall revenue increased by 4.6%. The increase is a result of the following: additional property tax revenue of 6.4%; additional sales tax revenue of 4.3%; increased transient occupancy tax revenue of 6.6%; a decrease in licenses and permits of 5.7%; service charge increases of 9.9%; fines and forfeitures decrease of 5.4%.

General Fund expenditures show an increase of 6.1%. The increase is primarily due to Public Safety and capital projects including: City Facilities Assessment, Community Center General Improvement Plan, Street Improvements, Fire Traffic Signal, and South Park. As previously noted, \$2,610,442 was transferred at year end to the Capital Improvement Fund.

General Fund Budgetary Highlights

The final amended budget for revenue other than transfers is 2% more than the original budget. Actual revenue was higher than the final budget by \$1,079,481 or 3% for the following reasons:

- Tax revenue collections were 1.9% higher than budget primarily due to conservative estimates for property tax, transient occupancy tax, and sales tax.
- Licenses and Permits were 15% higher due to the unpredictability of estimates for building permits.
- Intergovernmental/State revenue was 106% higher due to the repayment by the State of unfunded mandates prior to 2004.
- Current Service Charges were up 7.5% primarily due to increased enrollment for recreation classes and programs and increased meter revenue.

The final amended budget for appropriations other than Transfers Out is more than the original budget by 4%. The increase was primarily due to funds reappropriated from 13-14 for ongoing capital improvement projects.

Actual expenditures other than Transfers Out were less than the final appropriations by 11% due primarily due to salary and benefits savings from personnel vacancies and capital improvement projects not completed in 2014-15.

Capital Asset and Debt Administration

Capital assets. The City of Hermosa Beach's net investment in capital assets for its governmental as of June 30, 2015, amounts to \$66,733,301 (net of accumulated depreciation). This investment in capital assets includes land, buildings and structures, improvements, machinery and equipment, park facilities, roads, highways, and monuments. The total increase in the City of Hermosa Beach's investment in capital assets for the 2014-15 fiscal year was approximately 2.9%.

Major capital asset events during the fiscal year included the following:

Governmental Activities

- Construction in progress on South Park was \$400,531 at the end of the fiscal year.
- Completion of Citywide Street Improvements of \$932,560.
- Construction in progress for PCH Aviation Beautification was \$423,714 at the end of the fiscal year.
- Citywide Energy Conservation upgrades of \$131,494.
- Completion of Municipal Pier Structural Repairs of \$176,428.
- Purchase of 8 vehicles including an Ambulance.

Additional information on the City of Hermosa Beach's capital assets can be found in Note 6 on pages 62-63 of this report.

Insurance Fund

As previously stated, the City had a \$17.5 million oil settlement agreement with E& B Natural Resources, of which \$6 million was paid from previously set aside funds. This resulted in the need to record a liability of \$11.5 million in the Insurance Fund at the end of 2014-15, creating a temporary deficit balance of \$6.9 million. The City issued bonds at the beginning of the 2015-16 fiscal year, which resolved the deficit fund balance. See Notes 14 and 15 for more information. The balance without the \$11.5 million liability is \$4,553,996 due to the decrease in claims liabilities for worker's compensation and liability claims.

Economic Factors and Next Year's Budgets and Rates

- The 2015-16 Budget adds close to \$250,000 to the Contingency in the General Fund, which is 16% of operating expenditures and in line with the Council goal for a "Financially Sound City Government".
- \$2 million is committed in the General Fund as a contingency for potential debt service related to oil drilling issues.
- \$1,250,000 is committed in the General Fund for unspecified contingencies.
- As of October 27, 2015 City has one year agreements with all six employee bargaining units for 2015-16. See Note 15 C.
- Overall retirement costs increase 8% on average for the first three years of the 2016-21 Forecast due to change in actuarial assumptions and then decline by 4% in 2018-19 due to the Fire Side fund payoff, 22% in 2019-20 due to Police Side Fund payoff, and 13% in 2020-21 due to the Miscellaneous Group Side Fund. The side funds were created by CalPERS for any unfunded liability that existed when the city was pooled with other cities in 2003.

Revenue Trends and Assumptions

The 2015-16 Budget demonstrates continuing improvement in the local economy and a balanced budget, with some added personnel, replacement of 12 vehicles, continued funding for upgrading the City's permitting software, high performance organization training that will move the city forward toward the goals set forth in the strategic plan, and funding for \$12.7 million in capital improvement projects. Added personnel include one police officer and one associate planner. Five (5) full time temporary positions, Management Analyst, Environmental Coordinator, Youth Program Coordinator, Code Enforcement Officer and Office Assistant, were converted to full time, permanent positions. Three positions were reclassified, from Senior Recreation Supervisor to Recreation Manager, Assistant City Manager to Human Resources Manager and Senior Planner to Planning Manager.

Hermosa Beach continues to have ongoing revenues exceed ongoing expenses. Revenue growth of 2.8% is anticipated in the 2015-16 Budget. Property tax is estimated to increase by 5% while sales tax and utility user tax is estimated to remain flat.

Significant expenditure reductions were initiated by the City Council and Staff over the last several years. It is difficult to determine the service level impacts of those cuts and that is something that is being studied. The Fiscal Health diagnostic model presented at the budget workshop will assist in achieving long-term fiscal sustainability. The strategy adopted is one where the Council slowly adds services and expenditures that are consistent with their new goals.

Requests for Information

This financial report is designed to provide a general overview of the City of Hermosa Beach's finances for all those with an interest in the government's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Office of the Finance Director, 1315 Valley Drive, Hermosa Beach, CA 90254.