Understanding Fund Balance

Financial Policies Certificate Series

Fund Balance

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Estimated General Fund, Unrestricted Fund Balance

Description	Amount
Beginning Fund Balance, July 1, 2012	$21,454,831
Revenues less Expenses	-$600,000
Fund Balance Contribution	$0
Projected Fund Balance, June 30, 2013	$20,854,831
Fund Balance% of Budgeted Expenditures	30.7%
Fund Balance at 15% of Budgeted Exp.	$10,200,000
Fund Balance at 5% of Budgeted Exp.	$3,400,000
Deferrals	$9,800,000

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Agenda

What Is Fund Balance?

- What are the Components of Fund Balance?
- Benefits of a Fund Balance Policy
- What Is a "Reasonable Amount" of Fund Balance?
- Keeping Fund Balance at Desired Levels

Fund Balance "Reserves" vs. Reserve Funds

FUND BALANCE RESERVES

- **GAAP accounting and reporting entities**, fund balance describes the net position of local government funds.

RESERVE FUNDS

- Future outlays for capital projects/equipment
- Capital Reserve Funds
- Expendable Trusts

THREE TYPES OF BALANCES

CASH BALANCE

- Cash balances show the amount of cash you have on hand.
- Cash balances reflect what remains after the transactions have gone through the payment process.

BUDGET BALANCE

- The amount that remains of budgeted funds (approved appropriations) for a set period of time.
- Balance only reflects revenues and expenses.
- Budget balances are the best measure of the current balance of the current budget.

FUND BALANCE

- The life-to-date net worth of a fund, measured by total assets minus total liabilities.
- Fund balance will only measure transactions that have been posted based on General Ledger actuals.

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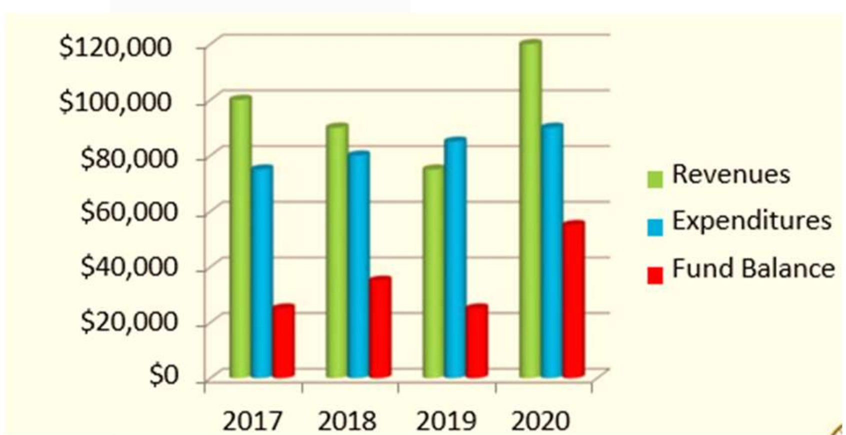
Fund Balance is the total accumulation of operating surpluses and deficits since the beginning of a local government's existence.



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The Fund Balance Formula:

Fund Balance = Assets – Liabilities

Operating Surplus / Deficit

- The difference between a unit's revenues and expenditures for a fiscal year.

Revenues

– Expenditures

Operating Surplus / (Deficit)

GASB Statement 54

Five Components of Fund Balance

- Nonspendable
- Restricted
- Committed
- Assigned
- Unassigned

Nonspendable

Includes the amounts that are **not** in a spendable form or are required to be maintained intact.

- Not in spendable form
  - Inventories
  - Prepaid Expenses
  - Tax Deeded Property
- Legally/contractually required to remain intact
  - Principal portion of a Permanent Fund

Restricted

Includes amounts that can only be spent for the specific purposes stipulated by external resource providers (such as grantors) or the enabling legislation (federal or state law). Restrictions may be changed or lifted only with the consent of the resource providers or the enabling legislation.

- Income portion of a Permanent Fund
- Prepaid grant funds
- Prepaid Bond Funds

Committed

Includes amounts that can be used only for specific purposes determined by a formal action of the Town's highest level of decision-making authority (Legislative Body). Commitments may be changed or lifted through legislative body action taking the same formal action that imposed the constraint originally.

- Fund balance usage voted on at the current year annual meeting being recorded on the prior year's books
- Capital Reserve Funds
- Expendable Trust Funds
- Non-lapsing appropriations
- Possibly:
  - Library
  - Town Forest
  - Conservation Commission

Assigned

Includes amounts the Town intends to use for a specific purpose. Imposed by the Governing Body.

For all governmental funds other than the General Fund, any remaining positive balances are to be classified as "assigned".

- Encumbrances
- Contractual commitments
- Possibly:
  - Library

Unassigned

Includes amounts that are not obligated or specifically designated and is available for any purpose. The residual classification of any General Fund balance is to be reported here.

Any deficit fund balance of another fund is also classified as Unassigned.

- Residual classification for the General Fund
- Fund balance that has not been assigned to other funds
- Fund balance that has not been restricted, committed, or assigned for particular purposes in the General Fund

Purposes For Fund Balance Reserves

- Cash flow
- Avoid short-term borrowing
- Operating cycle - i.e., taxes collected in July/December
- Reserve for emergencies, unforeseen events, unexpected opportunities
- Increased investment income
- Helps protect credit rating & obtain lower interest rates on borrowings
- May help avoid tax increases or service reductions

The Intersection of Cash Flow and Fund Balance

A local government's cash flow and the fund balance reported on its financial statements reflect two different metrics for a specific period of time.

Cash flow
- the ability of an organization to pay the obligations on time

Fund Balance
- a sign of overall financial stability and health.

Comparison
- managing your current bank balance while paying monthly bills
- Vs
- evaluating your overall net worth

short term view vs long term view

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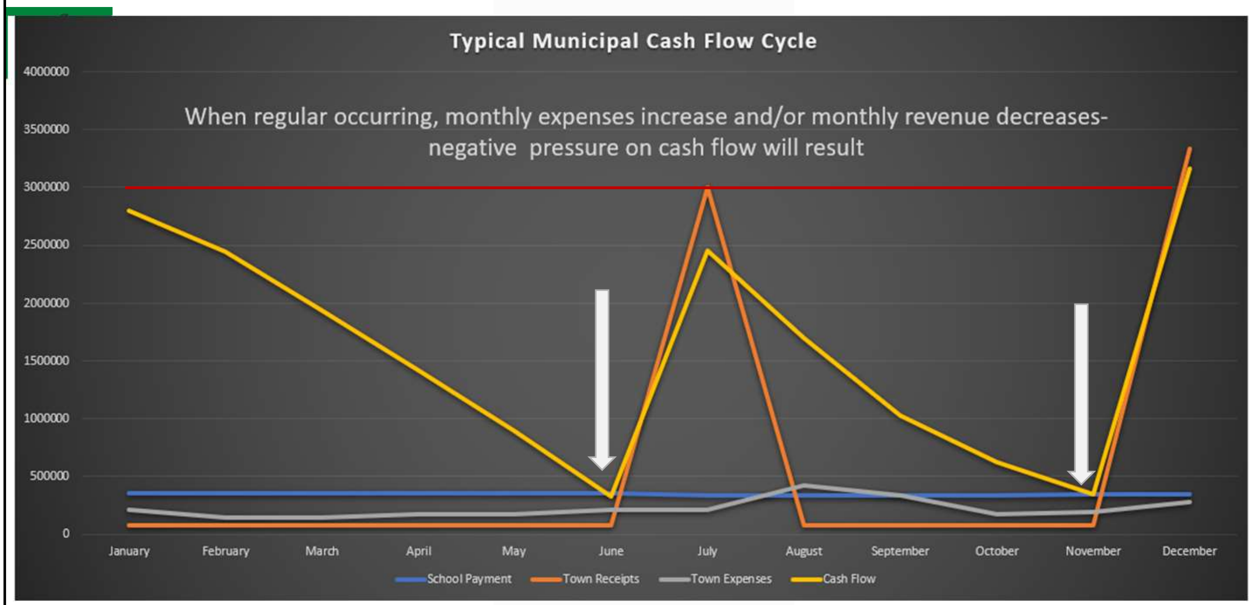
CASH FLOW ANAYLYSIS



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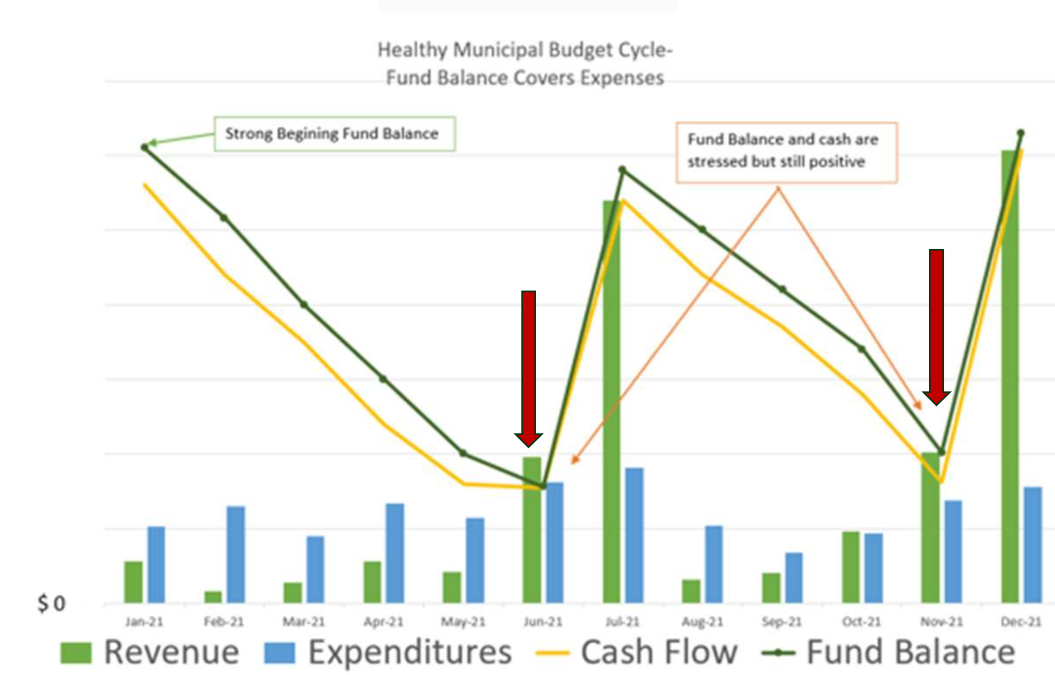
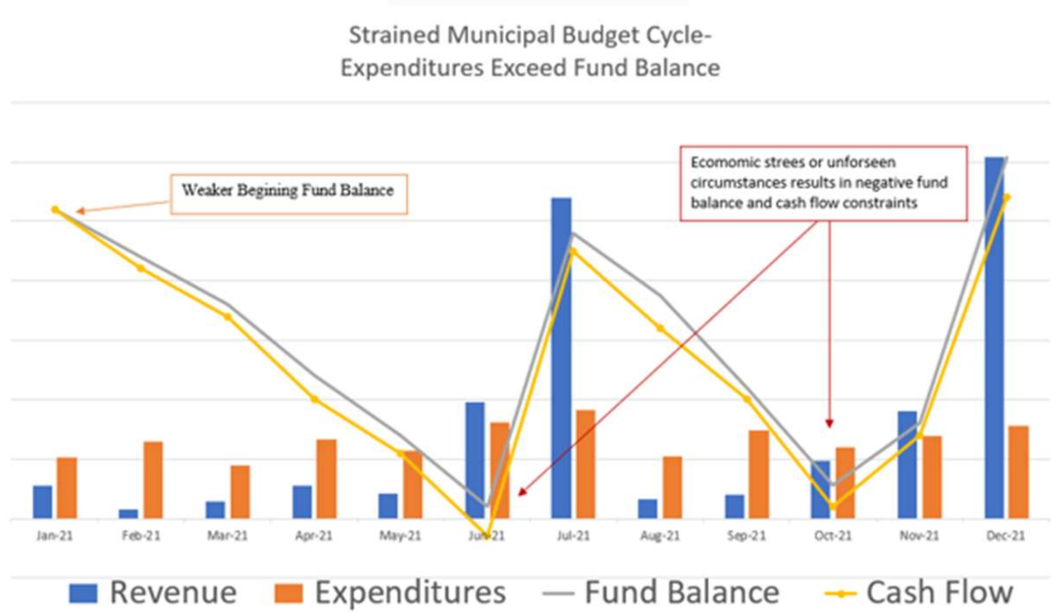
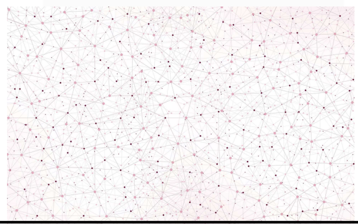

Healthy Municipal Budget Cycle-
Fund Balance Covers Expenses
Strong Begining Fund Balance
Fund Balance and cash are stressed but still positive
$ 0
Jan-21
Feb-21
Mar-21
Apr-21
May-21
Jun-21
Jul-21
Aug-21
Sep-21
Oct-21
Nov-21
Dec-21
Revenue
Expenditures
Cash Flow
Fund Balance


Strained Municipal Budget Cycle-
Expenditures Exceed Fund Balance
Weaker Begining Fund Balance
Ecomomic strees or unforseen circumstances results in negative fund balance and cash flow constraints
Jan-21
Feb-21
Mar-21
Apr-21
May-21
Jun-21
Jul-21
Aug-21
Sep-21
Oct-21
Nov-21
Dec-21
Revenue
Expenditures
Fund Balance
Cash Flow

Fund Balance Statistics

- Smaller governments = larger fund balance percentages in comparison to expenditures in dollars.
- Municipal fund balances have increased over last 25 years due to economic uncertainly.
- Municipalities with utilities saw significant increase in fund balance requirements over the past 2 decades.



Recommended Levels of Fund Balance

The NH Department of Revenue Administration (DRA) and the Government Finance Officers Association (GFOA) both recommend municipalities maintain their unassigned fund balance reserves at a level between 5% and 17% of the total general fund operating budget. CAREFUL - definitions of operating budget differ.

EXAMPLE:

If the Annual Budget Is:	DRA & GFOA Recommended Range 8%	17%
10,000,000	800,000	1,700,000
15,000,000	1,200,000	2,550,000
20,000,000	1,600,000	3,400,000
25,000,000	2,000,000	4,250,000

Target Levels

Desired or target level of unreserved fund balance:
Equal to 2 months of operating expenses.

Annual Budget: Calculation includes the town's general fund operating appropriations (less enterprise funds), the state education tax amount, the local school net tax commitment and the county appropriation in accordance with NH Department of Revenue guidelines.

When establishing a reserve policy, the policy should focus on the following:

– **Scope and Purpose**
  - Need to identify what funds will be included and what purpose are the reserves intended for

– **Appropriate Fund Balance Level**
  - Adequacy of fund balance should take into account each government's unique circumstances including predictability of revenues and volatility of expenditures; exposure to significant one-time outlays; support of other funds outside the General Fund; impact on bond rating; and extent of commitments and assignments of fund balance.
  - GFOA recommends that local government maintain no less than two months of regular General Fund operating revenues or expenditures for unrestricted fund balance.

– **Use and Replenishment of Funds**
  - Policy should define conditions under which fund balance can be utilized, and if fund balance falls below policy level, a plan to replenish it (typically 1–3-year period).

FUND BALANCE POLICY - Example

Introduction

Fund balances and targeted fund balances are the cornerstone of financial flexibility and short-term and long-term financial planning. Adequate fund balances provide the Town/City with options to respond to many issues and afford a buffer against shocks and other forms of financial risk. A fund balance financial policy helps the organization answer these fundamental questions.

The general fund's target fund balance is typically the most important policy a government maintains.

FUND BALANCE POLICY- Objectives Example

Plan for Contingencies

No guarantees exist that governments will always be able to match planned revenues with actual expenditures for any given fiscal year. Reliance on elastic revenue sources - such as registrations and fees - results in a volatile revenue structure. Local events, such as the closure of a major employer, can also negatively affect revenues. Finally, extreme events (major winter storms or floods, for example) can increase operating costs (e.g., public works crews for snow removal) or capital costs (e.g., new infrastructure needed due to storm damage).

Maintain Good Standing with Rating Agencies

Bond rating agencies (such as Standard and Poor's, Moody's, and Fitch Ratings) evaluate several financial indicators to assess a government's fiscal health and the overall economic health of the community at large. An adequate level of fund balance is considered a sign of creditworthiness because it enhances a government's ability to repay debt on time and in full. Fund balances should be maintained at an appropriate level considering the locality's own unique characteristics. Rating agencies generally view sudden, unplanned drops in fund balances unfavorably.

Stabilize the tax rate

Fund balance can be used for this purpose at times when: (A) budgeted non-property tax revenues (i.e., motor vehicle registration fees) are forecasted to fall below what was collected the prior budget year, or; (B) actual non-property tax revenues fall below the amount forecasted

FUND BALANCE POLICY- Objectives Example

Avoid Interest Expenses

There are three main methods for avoiding interest expense through the use of fund balance reserves: 1) fund capital projects using reserves rather than debt . 3) Ensure cash can meet obligations and avoid the issuance of a Tax Anticipation Note.

Generate Investment Income

Fund balance reserves can be a source for investment, thereby diversifying the government's revenue streams and decreasing reliance on taxes. A well-planned investment program that considers Safety, Liquidity and Yield, in that order can generate additional revenue to supplement the annual recurring revenue streams if cash is available to invest.

Ensure Cash Availability When Revenue is Unavailable

Implementation of a fund balance reserve policy allows governments to have funds available during periods of the year when revenue inflows are slow. A common example is property tax revenues that are received primarily at two points during the year, which must then last through the interim. Maintaining adequate reserves can balance intra-period differences in revenue availability and revenue streams.

GFOA Statement of Use of Fund Balance in Policy

The fund balance policy should define conditions warranting its use, and if a fund balance falls below the government's policy level, a solid plan to replenish it. In that context, the fund balance policy should:

1. Define the time period within which and contingencies for which fund balances will be used;

2. Describe how the government's expenditure and/or revenue levels will be adjusted to match any new economic realities that are behind the use of fund balance as a financing bridge.

Replenishment of Fund Balance

Generally, governments should seek to replenish their fund balances within one to three years of use. Specifically, factors influencing the replenishment time horizon include:

- The budgetary reasons behind the fund balance targets;
- Recovering from an extreme event;
- Political continuity;
- Financial planning time horizons;
- Long-term forecasts and economic conditions;
- External financing expectations.

Fund Balance Reserve Level Targets- Example

- **Minimum Balance**: The Town shall maintain a minimum unassigned fund balance of 8% of the town's annual budget as defined by this policy.
- **Target Balance**: The Town shall strive to achieve and maintain an unassigned fund balance of at least 12% of the town's annual budget as defined by this policy.
- **Plan for Target Fund Balance**: The unassigned fund balance target shall be maintained by conservatively estimating revenues and giving consideration when analyzing use of fund balance to mitigating variations related to larger one time revenues anticipated that are related to general operations (such as an unusually high receipts for land use change tax, income from sale of town assets or some other similar source) which is not anticipated to be maintained at the same level in future years. In addition, assets made available by reductions in liabilities related to resolution of legal matters, abatement litigation or other similar circumstances shall be directed toward efforts to reach or maintain the target balance or capital purposes.

Use of Fund Balance- Examples

1. Unassigned fund balance may be appropriated for emergency purposes, as deemed necessary by the Governing Body, even if such use decreases the fund balance below the targeted percentage. Emergency purposes do not include the offsetting of property taxes related to increasing continuing appropriations (operations) of the town, school or county or mismanagement of funds.
2. Use of additional unassigned fund balance may be considered by the Governing Body during the budget setting process, when an annual budget includes an unusually large capital expenditure not financed from other reserves, long term borrowing or leasing, if deemed prudent by the governing body to mitigate the capital expenditures impact on tax rate stability. No more than 2-5% shall be considered for this purpose.
3. Unassigned Fund Balance Uses: The primary acceptable use of unassigned fund balance will be the purchase of goods or services that are: (1) valued at $10,000 or more, (2) "non-recurring" in nature (i.e., has a useful life of at least five years), and (3) not eligible for funding via a municipal capital reserve fund or trust fund.
4. A maximum of 2.0% of the Town's general fund operating expenses may be used from the unassigned fund balance in a given year for the purpose of stabilizing the tax rate.

Bonding and the Fund Balance Reserve Policy

A fund balance policy should establish minimum levels for funds to ensure stable service delivery, meet future needs, and protect against financial instability (revenue shortfalls and unanticipated expenditures).

Fund balance is most important bond/credit rating factor, so ensuring a strong reserve position is critical to maintaining high-grade credit ratings. Source: GFOA

- All three national rating agencies have recently revised their criteria for rating general obligation bonds and have put a greater emphasis on financial policies and long-term planning.
- It is important for local governments to have a good understanding of how their fiscal policies align with rating agency expectations to ensure assignment of the best credit rating.

Questions?

Thank You!

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