TO: Mayor and Council

DATE: May 18, 2016

THROUGH: James R. O'Connor, City Manager

FROM: Cynthia Lawson, Finance Director

SUBJECT: Resolution Adopting General Fund Fund Balance Policy

BACKGROUND:

Per Council direction during the review and adoption of the FY 15-16 budget, staff developed a General Fund fund balance policy for review and consideration by the City's Finance Commission. The Finance Commission undertook extensive discussion of the proposed policy at meetings on November 4, 2015 and the February 8, 2016. At their May 26, 2016 meeting, the Finance Commission voted unanimously to adopt the General Fund fund balance policy included as Exhibit A to the attached Resolution.

RECOMMENDATION:

City Council adopt the Resolution (Attachment A) establishing a formal General Fund fund balance policy with an effective date of June 21, 2016, which will enable this policy to be applied to the adoption of the FY 16-17 budget.

ANALYSIS:

Strengths: Adoption of a formal fund balance policy is considered a 'best practice' in municipal government finance. The staff analysis of the proposed policy that was originally provided to the Finance Commission is provided in Attachment B for additional information.

Weaknesses: The policy can easily be modified by a future City Council.

Opportunities: As written, the policy will provide a mechanism to appropriate excess fund balances for capital projects and other non-recurring projects or budget needs.

Threats: Once the policy is formally adopted, violations of the policy could be viewed unfavorably by the City's external auditors and bond rating agencies.

ATTACHMENT A

RESOLUTION ADOPTING GENERAL FUND FUND BALANCE POLICY

RESOLUTION NO. 2016-____

A RESOLUTION OF THE CITY COUNCIL OF THE CITY OF VERO BEACH, FLORIDA, ADOPTING A GENERAL FUND FUND BALANCE POLICY; AND PROVIDING FOR AN EFFECTIVE DATE.

WHEREAS, the City Council (hereinafter "Council") of the City of Vero Beach (hereinafter "City") recognizes that it is essential for governments to maintain adequate levels of fund balance to mitigate current and future risks and to ensure stable tax rates; and

WHEREAS, the Council desires to adopt a written policy for the management and preservation of appropriate levels of fund balance within the City's General Fund; and

WHEREAS, the City's Finance Commission has reviewed and unanimously endorsed the General Fund fund balance policy to be adopted by this Resolution; and

WHEREAS, the Council finds that the adoption of this General Fund fund balance policy serves a municipal purpose and is in the best interest of the public.

NOW, THEREFORE, BE IT RESOLVED BY THE CITY COUNCIL OF THE CITY OF VERO BEACH, FLORIDA, AS FOLLOWS:

<u>Section 1 – Adoption of "Whereas" clauses.</u>

The foregoing "Whereas" clauses are hereby adopted and incorporated herein as forming the legislative findings, intent, and purpose of this Resolution.

<u>Section 2. – Adoption of General Fund Fund Balance Policy.</u>

The City Council hereby adopts the General Fund fund balance policy attached as Exhibit A.

<u>Section 3 – Effective Date</u>

This Resolution shall become effective upon adoption by the City Council.

****

This Resolution was heard on the _____ day of __________, 2016 after which hearing it was moved for adoption by Councilmember ____________________, seconded by Councilmember ____________________, and adopted by the following vote of the City Council:

Mayor Jay Kramer	_______
Vice-Mayor Randolph B. Old	_______
Councilmember Pilar E. Turner	_______
Councilmember Richard G. Winger	_______
Councilmember Harry Howle III	_______

ATTEST:

____
Tammy K. Vock
City Clerk

CITY OF VERO BEACH, FLORIDA

____
Jay Kramer
Mayor

Approved as to technical requirements:

____
Cynthia D. Lawson
Finance Director

Approved as to form and legal sufficiency:

____
Wayne R. Coment
City Attorney

Approved as conforming to municipal policy:

____
James R. O'Connor
City Manager

CITY OF VERO BEACH
FUND BALANCE POLICY – GENERAL FUND

1.0 PURPOSE:

The City desires to maintain a prudent level of financial resources in its General Fund to guard against service disruption in the event of unexpected temporary revenues shortfalls or unpredicted one-time expenditures. The City also desires to maintain adequate working cash to support operating expenditures in its General Fund during the first quarter of each fiscal year prior to receipt of seasonal revenues.

2.0 SOURCES OF FUND BALANCE

The General Fund fund balances are accumulated primarily through budget surpluses and/or unanticipated non-recurring revenues.

3.0 FUND BALANCE CATEGORIES

The City will maintain three categories of fund balance reserves in the General Fund in accordance with this policy. These are:

- Emergency (Disaster) Reserves – (Committed Fund Balance)
- Budget Stabilization Reserve – (Unassigned Fund Balance)
- Working Capital – (Unassigned Fund Balance)

4.0 FUND BALANCE CATEGORY DESCRIPTIONS AND TARGET LEVELS

The **Emergency (Disaster) Reserves** category of fund balance is intended to provide funding for expenditures needed in the event, primarily, of tropical storms and hurricane events which require extensive clean up or damage to infrastructure. The **Emergency Disaster Reserve** is hereby established at $2,000,000 in the General Fund as a 'committed' fund balance in accordance with the requirements of GASB Statement No. 54 *"Fund Balance Reporting and Governmental Fund Type Definitions"*.

The City's unassigned General Fund fund balance will be divided into both a **Budget Stabilization Reserve** and a **Working Capital** component.

The **Budget Stabilization Reserve** is intended as a buffer for unexpected budgetary impacts to ensure budget stability and provide service continuity. The targeted level of **Budget Stabilization Reserves** is **10%** of annual budgeted operating expenditures (including transfers out) in the most recently adopted General Fund budget.

The **Working Capital** component of fund balance is intended to serve the City's cash flow needs, including the ability to meet payroll and vendor obligations in the first quarter of the City's fiscal year prior to receipt of significant ad valorem taxes and other seasonal revenues. The targeted level of **Working Capital** is **25%** of annual budgeted operating expenditures (including transfers out) in the most recently adopted General Fund budget.

5.0 DETERMINATION OF EXCESS FUND BALANCE AMOUNTS

After the annual audit and financial statements for each fiscal year ended September 30th have been issued, if the total audited General Fund unassigned fund balance is greater than the sum of the targeted Budget Stabilization and Working Capital reserves (35%) calculated as a percent of the subsequent year's budgeted General Fund operating budget expenditures (including transfers out), the excess may be used for allowable expenditures (as defined in Section 6.0 below) through one or more of the following actions:

1) Appropriated for expenditure in the current fiscal year through a budget amendment.
2) Retained for appropriation in the coming fiscal year as directed during the annual budget adoption process.
3) Left in the General Fund fund balance to earn interest and roll forward for a future use.

6.0 ALLOWABLE USES OF EXCESS FUND BALANCES:

Available fund balances shall not be used for ongoing operating expenditures. Instead, fund balances shall be used for non-recurring items. A non-recurring item is defined as an expenditure that has not occurred in the previous two years and is not expected to occur in the following year. Emphasis shall be placed on one-time uses that achieve future operating cost reductions, fund necessary infrastructure or reduce long term liabilities. Except in unusual circumstances, General Fund fund balance shall be used for general governmental purposes and not transferred in support of enterprise or utility funds.

Unless otherwise prohibited by law, appropriate uses of excess fund balance (as determined under Section 5.0) include one-time capital improvements, funding for capital and construction projects, retirement of General Government debt (not including payment of annual debt service payments which do not meet the definition of a non-recurring item) or funding of pension or OPEB liabilities.

7.0 PROCEDURE FOR USE OF EMERGENCY (DISASTER) RESERVE:

In the event of an emergency, the City Manager may authorize use of the **Emergency (Disaster) Reserve** funds in accordance with the requirements of Section 2-350 of the City's Code of Ordinances.

8.0 MINIMUM RESERVES AND REPLENISHMENT OF FUND BALANCE TARGETS

If the **Emergency Disaster Reserve** is used it shall be replenished to the $2,000,000 level first using any available disaster relief funds or insurance proceeds. If this funding is inadequate to restore the $2,000,000 within one fiscal year, it is the intent of the City Council to restore this committed balance through other funding sources within three fiscal years. Replenishment of the Emergency Disaster Reserve will be the highest priority in restoration of fund balance components to target levels.

If, as a result of unforeseen budgetary needs, the City's audited unassigned fund balance drops below 35% but remains above 25% (as calculated in Section 5.0 above) it is the intent of the City Council that the unassigned fund balance will be replenished to the target level of 35% to restore the **Budget Stabilization Reserve** within four fiscal years.

In no circumstances shall the total General Fund unassigned fund balance be budgeted or otherwise appropriated in such as manner to cause it to fall below the targeted 25% balance for **Working Capital**. If the City's audited unassigned fund balance drops below 25% (as calculated in Section 5.0 above) due to unforeseen circumstances in any fiscal year, it is the intent of the City Council that the unassigned fund balance will be replenished to the target level of 25% to restore **Working Capital** within two fiscal years.

ATTACHMENT B

STAFF ANALYSIS AND RECOMMENDATIONS
RE: GENERAL FUND FUND BALANCE POLICY DATED 11/4/15

TO: Finance Commission
FROM: Cynthia D. Lawson, Finance Director / James R. O'Connor, City Manager
DATE: November 4, 2015
SUBJECT: Analysis and Recommendations – City General Fund Fund Balance Policy

BACKGROUND

There are many reasons that governmental entities require adequate fund balances. As explained by the Government Finance Officers Association (GFOA):

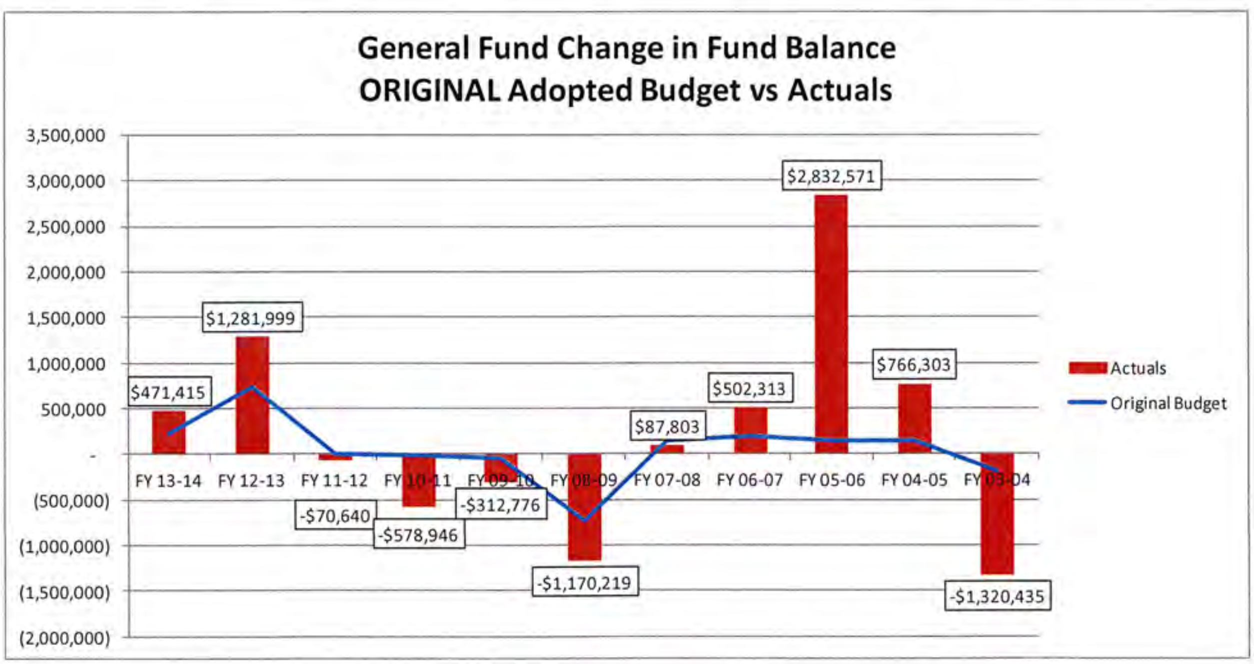
> "It is essential that governments maintain adequate levels of fund balance to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stable tax rates. Fund balance levels are a crucial consideration, too, in long-term financial planning"

In response to discussions during the FY 15-16 budget adoption process regarding appropriate fund balance levels, and the potential uses of excess balances, staff has prepared a proposed fund balance policy (Attachment A) for discussion by the Finance Commission. Once finalized, this policy would be forwarded for formal adoption by the City Council by ordinance.

HOW FUND BALANCE IS CREATED:

General Fund reserves are accumulated primarily through budget surpluses and unanticipated revenues. In some years, the fund balance decreases if the City has experienced unexpected expenditures or revenue downturns. Figure 1 provides a historical perspective on the City's rise and fall in fund balance for the past 11 fiscal years. Please note that the City's General Fund fund balance has actually fallen in 5 of the last 11 years, and the net increase in fund balance across this entire time frame has been $2.5 million. This historical data illustrates the fact that fund balance is not a revenue source that grows indefinitely, but rather a reserve that rises and falls as needed to fund the City's operating and emergency expenditure needs.

Figure 1. Increases and Decreases in General Fund Fund Balance – 11 Fiscal Years



COMPONENTS OF FUND BALANCE – THE ‘LAYERED’ APPROACH:

The proposed fund balance policy, in accordance with the GFOA Best Statement Practice – “Replenishing General Fund Balance” (Attachment A), contains three individual components of target fund balances specifying the purposes for which the various portions of fund balances are intended as follows:

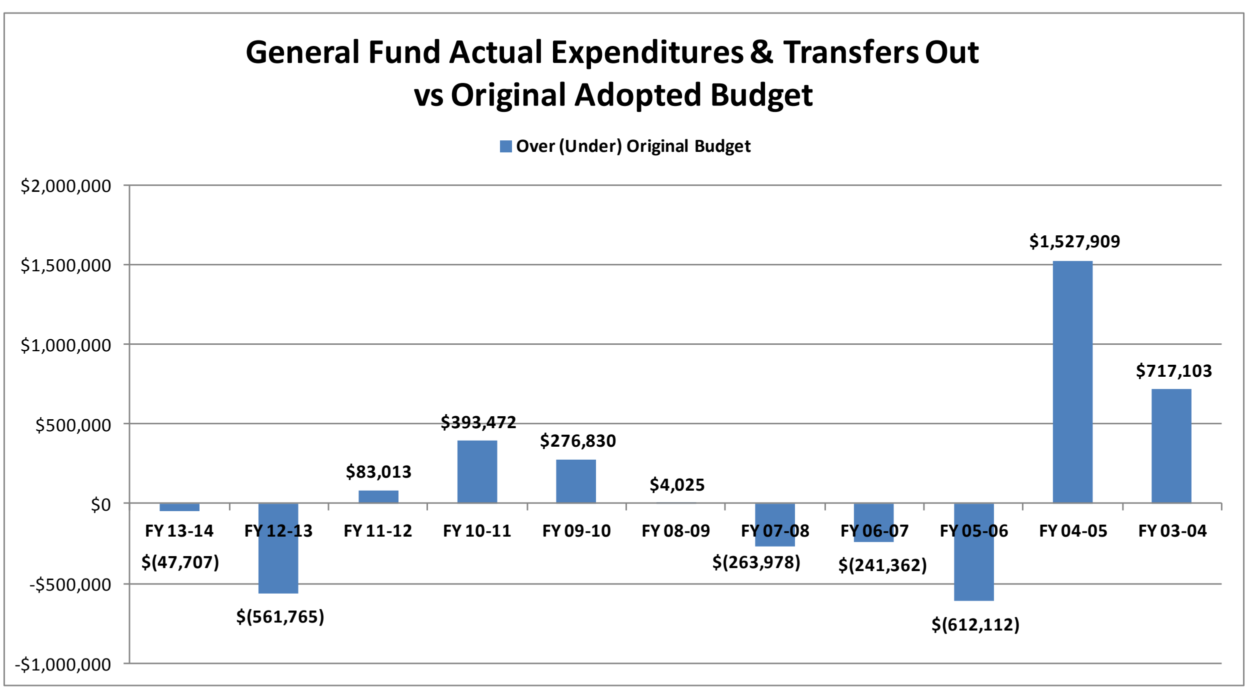
- Emergency Expenditures
- Budget Stabilization
- Working Cash Flow

The **Emergency Expenditures** component of fund balance is intended to provide cash coverage for expenditures needed in the event, primarily, of tropical storms and hurricane events which required extensive clean up or damage to infrastructure. In some cases these events are reimbursed by FEMA coverage. However, this reimbursement from Federal and State is normally 87.5 percent of incurred costs. And in the case of tropical storms or severe weather for which there is no declared emergency (such as a nor’easter which impacts the City’s dunes and boardwalks) there may be no reimbursement, leaving the City to fund the entire amount of expenses plus any associated insurance deductibles. This component of fund balance is also designed to cover deductibles and other expenses in the event of an insured loss not related to a storm.

The **Budget Stabilization** component of the fund balance is intended to provide a buffer against the potential volatility of operating revenues and expenditures. The City’s budget is prepared in July to cover the period that ends almost 14 months later. Events happen that cannot be predicted and the budget stabilization layer is intended to help the City withstand those normal ups and downs in expenditures due to unforeseen circumstances..

Figure 2. shows that amount that the City’s actual expenditures were over/under the original adopted budget for the last 11 years.

Figure 2. General Fund Expenditures Over (Under) Original Budget – 11 Fiscal Years



This time frame includes the hurricanes of September 2004, which caused two years of budget overages in the General Fund totaling approximately $2.2 million.

The **Working Capital** component of the fund balance is intended to support the City's General Fund cash flow needs in the months of October – November, when ad valorem tax revenues and other seasonal revenue sources (such as Recreation revenues) are not yet available, but monthly operating expenditures must be met. In some Cities, this component is covered by the other reserves, but in the case of Vero Beach, the greatest budget volatility and emergency expenditures are likely to occur in the same time frame (Oct-Dec). In my opinion, that makes it prudent to include this as a separate component of fund balance. This will provide a sufficient buffer to meet ongoing operating expenses, even if there is a simultaneous emergency event coupled with the possible downturn of state sharing revenues (for instance a November storm).

APPROPRIATE LEVELS OF FUND BALANCE

There is no 'one size fits all' approach to appropriate fund balance percentages. While best practices provided by GASB, GFOA, and other professional government finance organizations do provide some guidelines, they all conclude that each City's targeted reserves should be based on its individual risks and characteristics.

In addition to percentages, it is important to consider the dollar amount produced by application of those percentages. For instance, if Vero's reserves were at the minimum 17% recommended by GFOA, the dollar amount would be only $3.7 million. In my (admittedly conservative) opinion, this would be a dangerously low dollar amount given the considerations of budget stabilization, emergency expenditures and working cash flow needs outlined above.

The attached policy provides the following recommended percentages as a starting point for our discussion:

Emergency Expenditures = $ 2,000,000 fixed amount as 'committed' fund balance:

This number is consistent with the actual amounts expended in the General Fund during the last major storm as noted in Figure 2 above.

Budget Stabilization at 10%:

As a point of comparison, a 10% stabilization fund would be approximately $ 2 million dollars as a percentage of the FY 15-16 budget. The range of expenditures over (under) budget for the past 11 years (excluding hurricanes) has been $612,000 under to $393,000 over budget.

Working Capital at 25%:

This amount is equal to 3 months expenditures to support negative cash flow in October through December each year.

CALCULATION OF 'EXCESS' FUND BALANCE FOR APPROPRIATION:

The draft policy suggests the following timing for calculation and appropriation of any excess fund balances resulting from the application of the policy:

- In March of each year, the City's Comprehensive Annual Financial Report (CAFR) provides the audited unassigned fund balance for the fiscal year ended the previous September 30th. This unassigned fund balance would be exclusive of the Emergency Expenditures Reserve which would be classified as 'committed' fund balance in accordance with GASB Statement No. 54 *" Fund Balance Reporting and Governmental Fund Type Definitions"*.
- This dollar amount can be compared to the then current year's budgeted operating expenditures (including transfers out) to obtain a percentage.
- This percentage can be compared to the total of 35 % recommended by the fund balance policy for the combination of Budget Stabilization and Working Capital.
- If there is 'excess' fund balance at that point, it can be:
    - Appropriated for expenditure in the current fiscal year through a budget amendment.
    - Left available to be appropriated for expenditures in the coming fiscal year, to be designated by Council during the summer budget cycle.
    - If the fund balance percentage is below the target, then plans can be made to replenish it to acceptable levels as outlined below and in Section 8.0 of the draft policy.

FIGURE 3. Sample Calculation Based on FY 15-16 Adopted Budget

TOTAL FY 15-16 GENERAL FUND OPERATING EXPENDITURES AND TRANSFERS		**$**	**22,040,739**
SEPTEMBER 30, 2015 FUND BALANCE (PROJECTED)		**$**	**9,883,194**
FUND BALANCE COMPONENT			
DESCRIPTION	**%**		**$**
EMERGENCY EXPENDITURE RESERVE	flat	$	2,000,000
BUDGET STABILIZATION	10%	$	2,204,074
WORKING CAPITAL	25%	$	5,510,185
TOTAL RESERVES	**35%**	**$**	**9,714,259**
EXCESS FUND BALANCE AVAILABLE FOR APPROPRIATION		**$**	**168,935**

APPROPRIATE USES OF EXCESS FUND BALANCE:

This is a central part of the fund balance policy and was discussed extensively during the budget workshops. All of the fund balance policies and best practices that are available do seem to agree on one thing….it is not advisable to use a non-recurring revenue source such as fund balance to support a recurring expenditure. This practice simply puts you further behind in the following year, as the availability of fund balance is finite, while the expenditure will re-appear in subsequent years. In practical terms, using fund balance to pay recurring expenses is akin to using your savings account to pay your mortgage; eventually you will have no savings account but you will still need housing.

The best uses of fund balance, as reflected in the draft policy, are one time expenditures, particularly those that may also reduce future operating expenses.

One time expenditures include capital projects. For instance, the City has deferred maintenance expenditures and is currently facing the need for extensive repairs to recreation facilities. A 'one time' use of fund balance to refurbish a recreation facility is not a recurring expense, and may have the added benefit of reducing any ongoing repairs and maintenance paid from operating expenses.

Another potential use of fund balance, as reflected in the draft policy, is a one time infusion of additional cash into the City's frozen defined benefit pension plan. This would reduce the City's unfunded liability, and as a consequence may reduce the City's future annual payments towards that unfunded liability.

During the budget hearing, the option of paying annual debt service with fund balance was discussed. However, annual debt service payments are recurring expenditures in a governmental fund for the life of the loan. The draft policy does includes the use of fund balance to defease debt (i.e. refinance or pay off of a loan) which is a one time expenditure, but not to fund annual debt service expenses.

REPLENISHMENT OF FUND BALANCES THAT FALL BELOW TARGET LEVELS

In accordance with GFOA best practices, the draft policy also includes methods for replenishing fund balances if they fall below acceptable target levels. These include:

- Replenishment of emergency reserves through insurance proceeds and Federal/State disaster relief funding.
- Allowing any budget surpluses created in subsequent fiscal years to accumulate until acceptable levels are reached.
- Budgeting for surplus (through enhanced revenues or expenditure reductions) to accumulate until acceptable levels are reached.

The draft policy also includes targeted time frames for replenishment of fund balances.

ADDITIONAL INFORMATION

The following GFOA 'Best Practice' publications regarding fund balance have been included as Attachment B:

'Determining the Appropriate Level of Unrestricted Fund Balance in the General Fund' (2015)

'Replenishing General Fund Balance' (2011)

ATTACHMENT A – DRAFT FUND BALANCE POLICY PROPOSED FOR ADOPTION

CITY OF VERO BEACH
FUND BALANCE POLICY – GENERAL FUND

1.0 PURPOSE:

The City desires to maintain a prudent level of financial resources in its General Fund to guard against service disruption in the event of unexpected temporary revenues shortfalls or unpredicted one-time expenditures. The City also desires to maintain adequate working cash to support operating expenditures in its General Fund during the first quarter of each fiscal year prior to receipt of seasonal revenues.

2.0 SOURCES OF FUND BALANCE

The General Fund fund balances are accumulated primarily through budget surpluses and/or unanticipated non-recurring revenues.

3.0 FUND BALANCE CATEGORIES

The City will maintain three categories of fund balance reserves in the General Fund in accordance with this policy. These are:

- Emergency (Disaster) Reserves – (Committed Fund Balance)
- Budget Stabilization Reserve – (Unassigned Fund Balance)
- Working Capital – (Unassigned Fund Balance)

4.0 FUND BALANCE CATEGORY DESCRIPTIONS AND TARGET LEVELS

The **Emergency (Disaster) Reserves** category of fund balance is intended to provide funding for expenditures needed in the event, primarily, of tropical storms and hurricane events which require extensive clean up or damage to infrastructure. The **Emergency Disaster Reserve** is hereby established at $2,000,000 in the General Fund as a 'committed' fund balance in accordance with the requirements of GASB Statement No. 54 *"Fund Balance Reporting and Governmental Fund Type Definitions"*.

The City's unassigned General Fund fund balance will be divided into both a **Budget Stabilization Reserve** and a **Working Capital** component.

The **Budget Stabilization Reserve** is intended as a buffer for unexpected budgetary impacts to ensure budget stability and provide service continuity. The targeted level of **Budget Stabilization Reserves** is **10%** of annual budgeted operating expenditures (including transfers out) in the most recently adopted General Fund budget.

The **Working Capital** component of fund balance is intended to serve the City's cash flow needs, including the ability to meet payroll and vendor obligations in the first quarter of the City's fiscal year prior to receipt of significant ad valorem taxes and other seasonal revenues. The targeted level of **Working Capital** is **25%** of annual budgeted operating expenditures (including transfers out) in the most recently adopted General Fund budget.

ATTACHMENT A – DRAFT FUND BALANCE POLICY PROPOSED FOR ADOPTION

5.0 DETERMINATION OF EXCESS FUND BALANCE AMOUNTS

After the annual audit and financial statements for each fiscal year ending September 30th have been issued, if the total audited General Fund unassigned fund balance is greater than the sum of the targeted Budget Stabilization and Working Capital reserves (35%) as a percent of the subsequent year's budgeted General Fund operating budget expenditures (including transfers out), the excess may be used for allowable expenditures (as defined in Section 6.0 below) through one or more of the following actions:

1) Appropriated for expenditure in the current fiscal year through a budget amendment.
2) Retained for appropriation in the coming fiscal year as directed during the annual budget adoption process.
3) Left in the General Fund fund balance to earn interest and roll forward for a future use.

6.0 ALLOWABLE USES OF EXCESS FUND BALANCES:

Available fund balances shall not be used for ongoing operating expenditures. Instead, fund balances shall be used for non-recurring items. A non-recurring item is defined as an expenditure that has not occurred in the previous two years and is not expected to occur in the following year. Emphasis shall be placed on one-time uses that achieve future operating cost reductions, fund necessary infrastructure or reduce long term liabilities. Except in unusual circumstances, General Fund fund balance shall be used for general governmental purposes and not transferred in support of enterprise or utility funds.

Unless otherwise prohibited by law, appropriate uses of excess fund balance include one-time capital improvements, funding for capital projects, retirement of General Government debt (not including payment of annual debt service payments which do not meet the definition of a non-recurring item) or funding of pension or OPEB liabilities.

7.0 PROCEDURE FOR USE OF EMERGENCY (DISASTER) RESERVE:

In the event of an emergency, the City Manager may authorize use of the **Emergency (Disaster) Reserve** funds in accordance with the requirements of Section 2-350 of the City's Code of Ordinances.

8.0 MINIMUM RESERVES AND REPLENISHMENT OF FUND BALANCE TARGETS

If the **Emergency Disaster Reserve** is used it shall be replenished to the $2,000,000 level first using any available disaster relief funds or insurance proceeds. If this funding is inadequate to restore the $2,000,000 within one fiscal year, it is the intent of the City Council to restore this committed balance through other funding sources within three fiscal years.

If the City's audited unassigned fund balance drops below 35% but remains above 25% (as calculated in Section 5.0 above) it is the intent of the City Council that the unassigned fund balance will be replenished to the target level of 35% to restore the **Budget Stabilization Reserve** within four fiscal years.

In no circumstances shall the total General Fund unassigned fund balance be budgeted or otherwise appropriated in such as manner to cause it to fall below the targeted 25% balance for **Working Capital**. If the City's audited unassigned fund balance drops below 25% (as calculated in Section 5.0 above) due to unforeseen circumstances in any fiscal year, it is the intent of the City Council that the unassigned fund balance will be replenished to the target level of 25% to restore **Working Capital** within two fiscal years.

Attachment B

- Determining the Appropriate Level of Unrestricted Fund Balance in the General Fund' (2015)

- 'Replenishing General Fund Balance' (2011)

GFOA Best Practice

Determining the Appropriate Level of Unrestricted Fund Balance in the General Fund (CAAFR, Budget) (2015)

Background. In the context of financial reporting, the term *fund balance* is used to describe the net position of governmental funds calculated in accordance with generally accepted accounting principles (GAAP). Budget professionals commonly use this same term to describe the net position of governmental funds calculated on a government's budgetary basis.[1] While in both cases *fund balance* is intended to serve as a measure of the financial resources available in a governmental fund; it is essential that differences between GAAP *fund balance* and budgetary *fund balance* be fully appreciated.

1. GAAP financial statements report up to five separate categories of fund balance based on the type and source of constraints placed on how resources can be spent (presented in descending order from most constraining to least constraining): *nonspendable fund balance*, *restricted fund balance*, *committed fund balance*, *assigned fund balance*, and *unassigned fund balance*.[2] The total of the amounts in these last three categories (where the only constraint on spending, if any, is imposed by the government itself) is termed *unrestricted fund balance*. In contrast, budgetary fund balance, while it is subject to the same constraints on spending as GAAP fund balance, typically represents simply the total amount accumulated from prior years at a point in time.

2. The calculation of GAAP fund balance and budgetary fund balance sometimes is complicated by the use of sub-funds within the general fund. In such cases, GAAP fund balance includes amounts from all of the subfunds, whereas budgetary fund balance typically does not.

3. Often the timing of the recognition of revenues and expenditures is different for purposes of GAAP financial reporting and budgeting. For example, encumbrances arising from purchase orders often are recognized as expenditures for budgetary purposes, but never for the preparation of GAAP financial statements.

The effect of these and other differences on the amounts reported as *GAAP fund balance* and *budgetary fund balance* in the general fund should be clarified, understood, and documented.

It is essential that governments maintain adequate levels of fund balance to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stable tax rates. In most cases, discussions of fund balance will properly focus on a government's general fund. Nonetheless, financial resources available in other funds should also be considered in assessing the adequacy of unrestricted fund balance in the general fund.

Credit rating agencies monitor levels of fund balance and unrestricted fund balance in a government's general fund to evaluate a government's continued creditworthiness. Likewise, laws and regulations often govern appropriate levels of fund balance and unrestricted fund balance for state and local governments.

Those interested primarily in a government's creditworthiness or liquidity(e.g., rating agencies) are likely to favor higher levels of fund balance. Opposing pressures often come from unions, taxpayers and citizens' groups, who may prefer that fund balance in excess of a government's formal policy requirements, be used for other purposes.

Recommendation. GFOA recommends that governments establish a formal policy on the level of unrestricted fund balance that should be maintained in the general fund for GAAP and budgetary purposes.[3] Such a guideline should be set by the appropriate policy body and articulate a framework and process for how the government would increase or decrease the level of unrestricted fund balance over a specific time period.[4] In particular, governments should provide broad guidance in the policy for how resources will be directed to replenish fund balance should the balance fall below the level prescribed.

Appropriate Level. The adequacy of unrestricted fund balance in the general fund should take into account each government's own unique circumstances. For example, governments that may be vulnerable to natural disasters, more dependent on a volatile revenue source, or potentially subject to cuts in state aid and/or federal grants may need to maintain a higher level in the unrestricted fund balance. Articulating these risks in a fund balance policy makes it easier to explain to stakeholders the rationale for a seemingly higher than normal level of fund balance that protects taxpayers and employees from unexpected changes in financial condition. Nevertheless, GFOA recommends, at a minimum, that general-purpose governments, regardless of size, maintain unrestricted budgetary fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures.[5] The choice of revenues or expenditures as a basis of comparison may be dictated by what is more predictable in a government's particular circumstances.[6] Furthermore, a government's particular situation often may require a level of unrestricted fund balance in the general fund significantly in excess of this recommended minimum level. In any case, such measures should be applied within the context of long-term forecasting, thereby avoiding the risk of placing too much emphasis upon the level of unrestricted fund balance in the general fund at any one time. In establishing a policy governing the level of unrestricted fund balance in the general fund, a government should consider a variety of factors, including:

1. The predictability of its revenues and the volatility of its expenditures (i.e., higher levels of unrestricted fund balance may be needed if significant revenue sources are subject to unpredictable fluctuations or if operating expenditures are highly volatile);
2. Its perceived exposure to significant one-time outlays (e.g., disasters, immediate capital needs, state budget cuts);
3. The potential drain upon general fund resources from other funds, as well as, the availability of resources in other funds;

4. The potential impact on the entity's bond ratings and the corresponding increased cost of borrowed funds;

5. Commitments and assignments (i.e., governments may wish to maintain higher levels of unrestricted fund balance to compensate for any portion of unrestricted fund balance already committed or assigned by the government for a specific purpose). Governments may deem it appropriate to exclude from consideration resources that have been committed or assigned to some other purpose and focus on unassigned fund balance, rather than on unrestricted fund balance.

Use and Replenishment.
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;
3. Describe the time period over which the components of fund balance will be replenished and the means by which they will be replenished.

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

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

Revenue sources that would typically be looked to for replenishment of a fund balance include nonrecurring revenues, budget surpluses, and excess resources in other funds (if legally permissible and there is a defensible rationale). Year-end surpluses are an appropriate source for replenishing fund balance.

Unrestricted Fund Balance Above Formal Policy Requirement. In some cases, governments can find themselves in a position with an amount of unrestricted fund balance in the general fund over their formal policy reserve requirement even after taking into account potential financial risks in the foreseeable future. Amounts over the formal policy may reflect a structural trend, in which case governments should consider a policy as to how this would be addressed. Additionally, an education or communication strategy, or at a minimum, explanation of large changes in fund balance is encouraged. In all cases, use of those funds should be prohibited as a funding source for ongoing recurring expenditures.

Committee: Budget

Notes:

1 For the sake of clarity, this recommended practice uses the terms GAAP fund balance and budgetary fund balance to distinguish these two different uses of the same term.

2 These categories are set forth in Governmental Accounting Standards Board (GASB) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*.

3 Sometimes restricted fund balance includes resources available to finance items that typically would require the use of unrestricted fund balance (e.g., a contingency reserve). In that case, such amounts should be included as part of unrestricted fund balance for purposes of analysis.

4 See Recommended Practice 4.1 of the National Advisory Council on State and Local Budgeting governments on the need to "maintain a prudent level of financial resources to protect against reducing service levels or raising taxes and fees because of temporary revenue shortfalls or unpredicted one-time expenditures" (Recommended Practice 4.1).

5 In practice, a level of unrestricted fund balance significantly lower than the recommended minimum may be appropriate for states and America's largest governments (e.g., cities, counties, and school districts) because they often are in a better position to predict contingencies (for the same reason that an insurance company can more readily predict the number of accidents for a pool of 500,000 drivers than for a pool of fifty), and because their revenues and expenditures often are more diversified and thus potentially less subject to volatility.

6 In either case, unusual items that would distort trends (e.g., one-time revenues and expenditures) should be excluded, whereas recurring transfers should be included. Once the decision has been made to compare unrestricted fund balance to either revenues and/or expenditures, that decision should be followed consistently from period to period.

GFOA Best Practice

Replenishing General Fund Balance

Background. It is essential that governments maintain adequate levels of fund balance to mitigate risks and provide a back-up for revenue shortfalls.

The adequacy of unrestricted fund balance[1] in the general fund should be assessed based upon a government's specific circumstances. Nevertheless, GFOA recommends, at a minimum, that general-purpose governments, regardless of size, incorporate in its financial policies that unrestricted fund balance in their general fund be no less than two months of regular general fund operating revenues or regular general fund operating expenditures.

If fund balance falls below a government's policy level, then it is important to have a solid plan to replenish fund balance levels. Rating agencies consider the government's fund balance policy, history of use of fund balance, and policy and practice of replenishment of fund balance when assigning ratings. Thus, a well developed and transparent strategy to replenish fund balance may reduce the cost of borrowing. However, it can be challenging to build fund balances back up to the recommended levels because of other financial needs and various political considerations.

Recommendation. GFOA recommends that governments adopt a formal fund balance policy that defines the appropriate level of fund balance target levels. Also, management should consider specifying the purposes for which various portions of the fund balances are intended. For example, one portion of the fund balance may be for working capital, one for budgetary stabilization, and one for responding to extreme events. This additional transparency helps decision makers understand the reason for maintaining the target levels described in the fund balance policy.

Governments should also consider providing broad guidance in their financial policies for how resources will be directed to fund balance replenishment. For example, a policy may define the revenue sources that would typically be looked to for replenishment of fund balance. This might include non-recurring revenues, budget surpluses, and excess resources in other funds (if legally permissible and if there is defensible rationale). Year-end surpluses are an especially appropriate source for replenishing fund balance.

Finally, a government should consider including in its financial policy a statement that establishes the broad strategic intent of replenishing fund balances as soon as economic conditions allow. This emphasizes fund balance replenishment as a financial management priority.

Governments are subject to a number of factors that could require the use of fund balances. It is therefore incumbent on jurisdictions to minimize the use of fund balance, except in very specific circumstances. Replenishment should take place in a prompt fashion with amounts that have been used to ensure that the jurisdiction is properly prepared for contingencies. With the foundation of a financial policy in place, governments should use their long-term financial planning and budget processes to develop a more detailed strategy for using and replenishing fund balance. With these criteria in mind, the government should develop a replenishment strategy and timeline for replenishing fund balances as soon as possible, and that is still appropriate to prevailing budgetary and economic conditions and that considers the following:

1. The policy should define the time period within which and contingencies for which fund balances will be used. This gives the public a sense for how fund balance is being used as a "bridge" to ensure stable cash flow and provide service continuity.
2. The policy should describe how the government's expenditure levels will be adjusted to match any new economic realities that are behind the use of fund balance as a financing bridge.
3. The policy should describe the time period over which the components of fund balance will be replenished and the means by which they will be replenished. Frequently, a key part of the replenishment plan will be to control operating expenditures and use budget surpluses to replenish fund balance. The replenishment plan might also specify any particular revenue source that will aid in the replenishment of fund balances. For example, if the government has a volatile sales tax yield, it might specify that yields that are significantly above average would be used to replenish fund balances.

Generally, governments should seek to replenish their fund balances within one to three years of use. However, when developing the specifics of the replenishment plan, governments should consider a number of factors that influence the rate and time period over which fund balances will be replenished. Factors influencing the replenishment time horizon include:

1. The budgetary reasons behind the fund balance targets. The government should consider special conditions that may have caused it to set its fund balance target levels higher than the GFOA-recommended minimum level. For example, if targets are higher because the community has very volatile cash flows, then the government would want to build the fund balances back up more quickly compared to governments with more stable cash flows.
2. Recovering from an extreme event. An extreme event, such as a natural disaster, that has required the government to use a portion of its fund balance, may make

it infeasible to replenish the fund balance as quickly as normal, depending upon the severity of the event.

3. Political continuity. Replenishing fund balance takes political will, and that will is often strengthened by the memory of the financial challenge that caused the use of fund balances in the first place. If the governing board and/or management are already committed to a particular financial policy, the replenishment strategy should be as consistent as possible with that policy in order to maximize political support.
4. Financial planning time horizons. Fund balances should typically be replenished within the time horizon covered by the organization's long-term financial plan. This puts the entire replenishment plan in context and shows the public and decision makers the expected positive outcome of the replenishment strategy.
5. Long-term forecasts and economic conditions. Expectations for poor economic conditions may delay the point at which fund balances can be replenished. However, in its replenishment plan the government should be sure to set a benchmark (e.g., after fund balances have dropped to a certain point below desired target levels) for when use of fund balance is no longer acceptable as a source of funds.
6. Milestones for gradual replenishment. A replenishment plan will likely be more successful if it establishes replenishment milestones at various time intervals. This is especially important if replenishment is expected to take place over multiple years (e.g., if you are starting from 75% of your target, set a goal to reach 80 percent of target in one year, 90 percent in two years, and 100 percent in three years).
7. External financing expectations. A replenishment plan that is not consistent with credit rating agency expectations may increase the government's cost of borrowing. It is important that the logic used by the government to develop the replenishment plan be communicated in an effective fashion to external lenders.

Notes:

1 Unrestricted fund balance comprises the committed, assigned, and unassigned fund balance categories.

References.

GFOA Best Practice, "Appropriate Level of Unrestricted Fund Balance in the General Fund," 2009.

For a fuller explanation of the concept of "bridging" in financial distress, please visit GFOA's financial recovery website at www.gfoa.org/financialrecovery.

Approved by the GFOA's Executive Board, February, 2011.