Item # 46

SEMINOLE COUNTY GOVERNMENT
AGENDA MEMORANDUM

SUBJECT: Administrative Code Amendment Section 22.5 Financial Policies: Fund Balance/Operating Reserve Policy

DEPARTMENT: Fiscal Services **DIVISION:** Resource Management

AUTHORIZED BY: Lisa H. Spriggs **CONTACT:** Lisa H. Spriggs **EXT.** 7172

Agenda Date 09/26/06 **Regular** ☒ **Consent** ☐ **Work Session** ☐ **Briefing** ☐
Public Hearing – 1:30 ☐ **Public Hearing – 7:00** ☐

MOTION/RECOMMENDATION:

Approve resolution amending the County's Administrative Code Section 22.5, Financial Policies to address Fund Balance/Operating Reserves, establishing a target range of unreserved/undesignated fund balance to be maintained for individual County funds whose operating expenditures are for tax-supported services.

BACKGROUND:

Recognizing that it is essential that Seminole County Government maintain adequate levels of fund balances as a crucial component of long-term financial planning, as well as to mitigate current and future financial risks and to ensure stable tax rates; staff has developed a proposed policy for Board consideration. The proposed Fund Balance Policy establishes a target range of unreserved/undesignated fund balance to be maintained for individual County funds whose operating expenditures are for tax-supported services.

Attachments:

- Resolution
- Proposed Amendments to Section 22.5
- Government Finance Officers Association, Recommended Practice: Appropriate Level of Unreserved Fund Balance in the General Fund (2002)
- Fitch Ratings, Public Finance: The Bottom Line, Local General Government Reserves and the Policies that Shape Them

Reviewed by:
Co Atty:
DFS:
Other:
DCM:
CM:
File No. CFSG 40

RESOLUTION NO. 2006-R-_________ **SEMINOLE COUNTY, FLORIDA**

THE FOLLOWING RESOLUTION WAS ADOPTED BY THE BOARD OF COUNTY COMMISSIONERS OF SEMINOLE COUNTY, FLORIDA, AT THEIR REGULARLY SCHEDULED MEETING ON THE ___ DAY OF ____________, 2006

WHEREAS, Seminole County Ordinance No. 89-28 created the Seminole County Administrative Code; and

WHEREAS, Seminole County Resolution Numbers 89-R-438 and 05-R-151 adopted the Seminole County Administrative Code; and

WHEREAS, the Seminole County Administrative Code needs to be amended from time to time to reflect changes in the administration of County government; and

WHEREAS, the Board of County Commissioners desire to establish a target fund balance level for individual operating funds of the County; and

WHEREAS, the Board of County Commissioners desire to maintain an adequate level of fund balance to mitigate current and future risks to ensure stable tax rates, and to respond to emergency situations; and

WHEREAS, adequate reserve levels are a necessary component of the County's overall financial management strategy and a factor in external agencies' measurement of the County's financial strength,

NOW, THEREFORE, BE IT RESOLVED BY THE BOARD OF COUNTY COMMISSIONERS OF SEMINOLE COUNTY, FLORIDA THAT,

1. Section 22.5 A. and E., "Financial Policies", Seminole County Administrative Code, are amended as identified in the attached revised Financial Policies.

2. Section 22.5 J. addressing Fund Balance/Operating Reserve is hereby established and approved.

3. Existing Section 22.5 J. is hereby redesignated as Section 22.5 K.

The attached changes are for inclusion in the Seminole County Administrative Code.

ADOPTED this _________ day of ________________, 2006.

ATTEST:

BOARD OF COUNTY COMMISSIONERS
SEMINOLE COUNTY, FLORIDA

____
MARYANNE MORSE
Clerk to the Board of
County Commissioners of
Seminole County, Florida.

By: ___________________________
CARLTON HENLEY, Chairman

Date: ___________________________

AS/ss
4.27.06
Attachment
Section 22.5 (Financial Policies)

P:\CAO Protected\Admin Samples\Admin Resolutions Drafts\06Resolution 22.5 Financial Policy.doc

SECTION 22. FISCAL SERVICES.

22.5 FINANCIAL POLICIES.

A. PURPOSE. The Financial Policies were established to facilitate management actions on financial decisions, as well as to assist readers in understanding County finances. These policy statements apply to County funds in general. Federal, State and local laws, regulations and standards and specific financial policies may supersede these statements. The benefits derived from consolidated financial policies include:

(1) The availability of a concise reference guide for consideration in decisions associated with County financial matters.

(2) Re-direction of the financial focus to the over-all financial condition of the County rather than to a narrow focus on single issues.

(3) Communication of a commitment to sound financial management and fiscal integrity, and strengthening credibility and confidence aspects for citizens, investors and rating agencies.

(4) Demonstration of compliance with applicable Florida statutory requirements.

The Financial Policies are grouped into the following categories:

- Budget
- Revenue
- Expenditure
- Reserves
- Debt
- Capital Improvement
- Capitalization
- Intradepartmental Transfers
- Fund Balances

B. BUDGET.

(1) Balanced Budget. The County's annual budget shall be balanced; that is, total estimated receipts, including balances brought forward, shall equal total appropriations and reserves (Florida Statutes 129.01(2)(b)).

(2) Budget Adoption. The Board of County Commissioners shall adopt the County's annual budget at a fund level.

(3) Estimates of Receipts. Estimated receipts shall include 95% of all receipts reasonably anticipated from all sources, including taxes to be levied, and 100% of balance to be brought forward at the beginning of the fiscal year (Florida Statutes, 129.01(2)(b) and 200.065(2)(a)).

(4) Contingencies. A reserve for contingencies will be budgeted in operating and capital funds, amounts not to exceed 10% of the total budget, for reallocation by the Board of County Commissioners as needed to fund unforeseen needs during the budget year (Florida Statutes, 129.01(2(c)(1)).

(5) Reserve for Cash Carry Forward. A reserve for cash forward will be budgeted in any fund which requires monies to be carried forward into the budget year to support operations until sufficient current revenues are received. This reserve will not exceed 20% of the budget (Florida Statutes, 129.01(2)(c)(2)).

(6) New Positions. Submission of partial year funding requests for new permanent full time positions is prohibited unless specifically authorized by the Board of County Commissioners as a special or emergency need.

(7) Emergency Budget.

(a) In order to be fiscally prepared for all emergencies (either economic, natural disaster, or act of war), a budgetary procedure shall be in place to deal with emergency situations.

(b) Upon adoption of the annual budget, all Directors, in cooperation with the Fiscal Services Department, shall develop a plan to decrease overall expenditures for that fiscal year by 5% not later than December 1.

(c) The Fiscal Services Department Director shall review items to be decreased for overall operational impact and legal authority.

(d) A summary report identifying emergency budget decreases shall be prepared by Fiscal Services outlining items and financial savings and submitted to the County Manager by January 1.

(e) The County Manager shall monitor economic trends.

(f) The County Manager shall monitor the emergency situation and provide the Board of County Commissioners (BCC) daily, weekly, or monthly updates, depending on the type of emergency, in order to provide the BCC with timely financial information.

(g) The County Manager shall report emergency situations to the BCC as soon as possible and all Department Directors notified as soon thereafter as possible.

(h) If an emergency budget is needed, based on the type or level of emergency, the County Manager shall notify the BCC of the impending emergency and request authorization to implement an emergency budget.

(j) The BCC shall authorize a change from emergency budget status to adopted budget status.

C. REVENUE.

(1) General Revenue.

(a) Generally, the County reviews estimated revenue and fee schedules as part of the budget process. Estimated revenue is conservatively projected (at 95% of estimate) for five (5) years and is updated annually. Proposed rate increases are based upon the following:

(i) Fee policies applicable to each fund or activity;

(ii) The related cost of the service provided;

(iii) The impact of inflation in the provision of services;

(iv) Equity of comparable fees.

(b) The revenue policy of Seminole County includes these informal policies, along with requirements for maintaining a diversified and stable revenue system to shelter the County from short-run fluctuations in any one revenue source.

(2) Revenue Summaries. As part of the annual budget process, a consolidated summary of revenue sources will be prepared and incorporated into the County's budget documents.

(3) Ad Valorem Taxes. The use of ad valorem tax revenues will be generally limited to the following funds:

(a) General

(b) Transportation Trust

(c) Fire

(d) Environmentally Sensitive Lands

(e) Debt Service

(f) Trails Construction Debt Service

(g) Stormwater Management

(4) Gas Taxes. The use of gas tax revenues will be generally limited to the following funds:

(a) Transportation Trust

(b) Mass Transit

(c) Local Option Gas Tax Refunding Bond Series 1993 Debt Service

(d) Road Bonds Series 1992 A Debt Service

(e) Road Bonds Series 1992 B Debt Service

(5) Sales Taxes. The use of state shared sales tax revenues will be generally limited to the following uses:

(a) General

(b) Capital Improvements

(c) Debt Service

(d) Infrastructure Improvement

(6) Impact Fees.

(a) Seminole County shall require development activity to pay fair share fees for new capital equipment and facilities or expansion of existing equipment and facilities. Fees shall not exceed a pro rata share of the reasonably anticipated costs of such improvements.

(b) Impact fees have been implemented for roads, libraries, fire/rescue, and water & sewer.

(7) Utility/Telecommunications Taxes. Utility and telecommunications taxes are levied on purchases of utilities and telecommunications services. It provides additional revenue necessary to maintain adopted levels of service for unincorporated

transportation facilities, Fire/Rescue, Stormwater, and Seminole Government Television.

(8) Tourist Development Tax. Use of tourist development tax revenues will be generally limited to the Tourism Development Fund and Tourist Development Tax Debt Service Fund.

(9) Grants. Only such grants as can reasonably be expected to be received will be considered as revenue sources for budget development purposes. The County shall amend its budget to reflect additional grants received during the budget year.

(10) Restricted Revenues – Bonds. Revenues which have been pledged to bondholders will be restricted and shall conform in every respect to bond covenants.

(11) Countywide Revenues. Revenues collected on a countywide basis will be allocated only to funds which provide Countywide services.

(12) User Fees. User fees, where appropriate, should be established to offset the cost of providing specific services, and will be reviewed annually.

(13) Private Contributions.

(a) The County provides many services to its residents that enhance the "quality of life" in our County.

(b) To the extent possible, efforts should be made to secure private contributions, whether in the form of volunteer services, equipment, or cash contributions. This is particularly important in helping defray the taxpayer burden of providing programs and activities that may be considered primarily "quality of life" in nature, such as various community services, cultural and recreational activities.

D. EXPENDITURES

(1) Community Service Agencies.

(a) As part of its annual budget process, the County sets aside an amount of funding to be granted to various community agencies that provide valuable services to the County's residents.

(b) Because of increasing demands on the County's limited resources, the Board of County Commissioners determines a total maximum to be allocated. In the event that a grant recipient requests additional County funding, such a request will be considered independent of the allocation process.

(2) Grant Supported County Programs.

(a) Seminole County supports a variety of programs that depend on additional grants for partial funding. If reductions occur in such grant funding amounts, program service levels will be streamlined or reduced. Additional County support will not be provided to compensate for the reduction in outside funding.

(b) Full recovery of annual and sick leave for employees working under a grant shall be undertaken.

(3) Performance Measures.

(a) The County will develop "performance measures" for each of its departments in order to assure that maximum productivity is being achieved.

(b) Where performance measures demonstrate that activities could more cost-effectively be provided by outsiders, contracting out of such activities will be considered.

(c) Performance measures will also provide management with criteria to use in evaluating departmental requests for increased funding levels.

(4) Categorization of Services. The County will segregate its budget into two distinct categories in order to set priorities for allocating available money. Categories are as follows:

(a) Basic Services. Services that are best performed at the County level and are associated with protecting the health and safety of citizens. Legally mandated services or commitments are also included in this category. Budgetarily, funding represents maintaining current service levels.

(b) Service Enhancements. An improvement and/or enhancement to the programmatic service level.

E. RESERVES. A formally adopted reserve policy is an important factor in maintaining the fiscal health of Seminole County. There are three primary types of reserves:

- ~~Operating Reserves~~Fund Balances/Operating Reserves
- Capital Reserves
- Debt Reserves

The degree of need for these reserves differs based on type of fund or operation involved. However, one policy statement for each type of reserve can be uniformly applied to most funds (excluding enterprise funds, which are subject to various regulatory requirements). Board approval is required to move funds from reserve accounts into expenditure line items.

~~(1) Operating Reserves. It is the County's goal to maintain adequate undesignated reserves in operating funds to provide a buffer against revenue fluctuations and unforeseen emergencies. Two types of undesignated operating reserves are appropriated in the budget:~~

- ~~Contingency Reserves~~
- ~~Cash Carry Forward Reserves~~

(1) Fund Balances/Operating Reserves. It is the County's policy to establish and maintain target balance ranges for individual operating funds of the County to mitigate current or future financial risks, ensure stable tax rates and to facilitate responses to emergency situations. The County's Fund Balance Policy is detailed separately in Section 22.5 J. hereof.

(2) Capital Reserves. Capital reserves are established primarily to set aside funds to provide for additional future projects, renewal and replacement of fixed assets or additions to existing budgeted projects, which may be deemed appropriate for funding after the annual budget is adopted. Certain capital reserve account balances are established by bond indenture in connection with bond financed enterprise operations and capital financing.

(3) Debt Reserves.

(a) Debt reserves are established to protect bondholders from payment defaults. Adequate debt reserves are essential in maintaining good bond ratings and the marketability of bonds.

(b) The amount of debt reserves and investment requirements are~~is~~ established by bond indenture in association with each bond issuance.

F. DEBT. A formal debt policy is an important factor to insure the most efficient methods of financing are utilized by the county resulting in the lowest total cost of borrowing. It is the County's policy to use competitive bidding, whenever possible, for all debt issued by the County. The complexity of the debt issuance process varies depending on the type of financing requiring the County to employ qualified consultants (bond counsel, financial advisors, independent accountants, etc.) to assist the County in obtaining the most cost effective financing. County staff and consultants should adhere to the following guidelines in structuring each debt issuance.

(1) Method of Financing. The County will use a "pay as you go" policy unless internal funding is not sufficient to meet capital needs or future citizens will realize a significant portion of the benefit of a project.

(2) Financing Parameters (Guidelines).

(a) Projects will not be financed for greater than the useful life of the improvement.

(b) Whenever economically feasible, the County will use revenue, special assessment or other self-supporting bonds instead of general obligation bonds.

(c) The County will use the competitive method of sale unless one or more of the following conditions exists:

(i) Unstable market conditions which require flexibility in pricing or precise timing which would not be expected through a competitive sale.

(ii) Concerns regarding credit quality and availability of credit enhancements.

(iii) Security for repayment is new, unproven or may be perceived as unreliable by the market.

(iv) Innovative or unusual structuring techniques are required.

(v) Changes or anticipated changes in laws or regulations would make prompt sale of bonds desirable.

(d) Credit enhancement will be utilized when necessary to lower total borrowing costs.

(e) The County will competitively bid investment of escrow funds for advance refundings if it is expected that bids will result in lower costs and the required securities are available in the market.

(3) Debt Issuance Plans. The County will include debt issuance plans in its long-term capital plan.

G. CAPITAL IMPROVEMENT.

(1) Five-Year Program.

(a) The County will develop a five-year Capital Improvements Program as part of each year's annual budget process, and will make all capital improvements in accordance with the adopted annual County budget.

(b) The County will identify the estimated costs and potential funding sources for each capital project before it is submitted to the Board of County Commissioners as a component of the five-year program.

(2) Operating Costs. Costs of operating and maintaining all proposed projects will be identified and incorporated in five-year financial projections.

(3) Capital Financing. The County Manager will determine and recommend to the Board of County Commissioners the least costly financing method for all capital projects.

(4) Renewal and Replacement.

(a) The County shall develop and implement a program for identifying, scheduling and budgeting renewal and replacement of capital facilities.

(b) These policy statements apply to County funds in general. Federal, State and local laws, regulations and standards and specific financial policies may supersede these statements.

H. CAPITALIZATION. The reporting model (Government Account Standards Board Statement No. 34 (GASB 34)) is for both capitalization and depreciation of the government's general assets such as buildings, equipment, roads, bridges and traffic systems, etc.

(1) Depreciation Reporting

(a) Record depreciation of capital assets valuing $5,000.00 or more. This will exclude recorded depreciation of assets less than $5,000.00 of value. Items currently not depreciated at all would still be budgeted and accounted for as capital items. All capital equipment will continue to be inventoried even if an item's purchase cost was less than $5,000.00.

(b) Use the "Modified Approach" for certain infrastructure reporting subject to staff evaluation. This approach eliminates the need to record depreciation expenses for certain types of infrastructure such as roads. County must demonstrate that the infrastructures asset has been maintained at or above a condition level established by government. County must disclose estimates of the amount needed to maintain or preserve the asset at the level established as well as the actual expense. Users of the financial statements should assess the government's long-term commitment to maintaining infrastructure assets.

I. INTRADEPARTMENTAL TRANSFERS. Simply provide a more efficient method of making intradepartmental adjustments within the County budget.

(1) Budget Officer Approval Authority.

(a) Authority through the Department of Fiscal Services (DFS) form for all account line budget changes within an approved project and within the same fund and department. Approval requires that their will be no change in total amount approved for the project, no change in scope of project and account lines be within one Capital Improvement Project (CIP) number. (Policy excludes Capital equipment.)

(b) Authority through the DFS form for all account line budget changes up to $50,000.00 within an approved "family" of projects. A family of projects is defined as a like set of sub-projects that have the same first four AS400 CIP numbers and an identifying suffix for the sub-projects. They may have a variety of J. D. Edwards CIP numbers (Policy excludes capital equipment.)

(c) Authority to approve intradepartmental budget transfers up to $25,000.00 each and up to $15,000.00 each when a capital account line is involved. The Director of Fiscal Services is authorized to approve intradepartmental transfers up to $2,500 each, provided that the total department appropriations are not changed.

(i) Department shall mean the department identification as authorized in the State of Florida Uniform Accounting System.

(d) The Budget Officer and the Director of Fiscal Services shall each submit to the BCC, on a regular basis, a report detailing all intradepartmental transfers as authorized.

(2) Board Of County Commissioners. The BCC will approve all intradepartmental transfers from the various reserve accounts appropriated in the County's annual budget in compliance with the applicable provision of State and Federal law.

J. FUND BALANCES.~~AUTHORITY~~

To establish a target unreserved/undesignated fund balance level for individual operating funds of the County. This policy is intended to assist the County in maintaining an adequate level of fund balance to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures), to ensure stable tax rates, and to respond to emergency situations. Adequate reserve levels are a necessary component of the County's overall financial management strategy; as well as a key factor in external agencies' measurement of the County's financial strength.

(1) Definitions.

(a) Fund Balance - fund balance means the difference between fund assets and fund liabilities. Fund balance is also referred to as net assets.

(b) Reserved Fund Balance - reserved fund balance is the portion of fund balance that is legally restricted and is not available for appropriation or expenditure.

(c) Unreserved Fund Balance - unreserved fund balance represents expendable available financial resources.

(d) Designated Fund Balance - designated fund balance is that portion of unreserved fund balance that reflects the County's self-imposed limitations on the use of otherwise available expendable financial resources.

(e) Undesignated Fund Balance - undesignated fund balance is that portion of unreserved fund balance that represents available financial resources which have not been obligated to a specific purpose.

(2) Unreserved/undesignated Fund Balance Level

(a) Unreserved/undesignated fund balance ranges~~levels~~ are established for individual County funds whose operating expenditures are for tax-supported services. The range~~level~~ set for each fund is based on the predictability of revenues, volatility of expenditures, and liquidity requirements. Established levels should be reviewed on an annual basis to ensure sufficiency.

(b) In calculating the ratio of the unreserved/undesignated fund balance to estimated operating revenues, the fund balance from the latest audited financial statements shall be compared with the budgetary operating expenditures for that fund in effect when the financial statements are released. In essence this will mean the current year budgeted operating revenues will be compared with the prior year's unreserved/undesignated fund balance.

(1) General Fund - the unreserved/undesignated fund balance level for the General Fund (inclusive of all budgetary sub-funds) shall ~~not~~ be maintained in the range of 5% to 10%~~less than 5%~~ of general fund operating revenues.

(2) Transportation Trust - the unreserved/undesignated fund balance level for the Transportation Trust Fund shall ~~not~~ be maintained in the range of 5% to 10%~~less than 5%~~ of operating revenues; unless when combined with the County's General Fund, the combined unreserved/undesignated fund balance is not less than 5% of the combined operating revenues.

(3) Fire Protection - the unreserved/undesignated fund balance

level for the Fire Protection Fund shall ~~not~~ be maintained in the range of 5% to 10%~~less than 5%~~ of operating revenues.

(3) Surplus.

(a) If ~~it is determined there is~~ a surplus (an amount in excess of the established minimum level) is determined, it can be designated or appropriated during the next budget amendment for the following purposes:

(1) To fund unforeseen expenditure requirements or offset unanticipated revenue fluctuations.

(2) Reduction or Avoidance of Debt - if financial analysis demonstrates an advantage for the County, the surplus may be applied to reduce or eliminate short-term debt or reduce the principal amount the County needs to obtain from a scheduled borrowing~~there is short-term debt within the fund, the surplus may be applied to reduce or eliminate the debt if financial analysis proves this to be advantageous for the County. If a borrowing is scheduled, the surplus may be used to reduce the principal amount the County needs to obtain if financial analysis proves this to be advantageous~~.

(3) Tax, Fee, or Rate Stabilization - surplus funds may be designated for stabilization in order to avoid raising taxes, fees, or rates related to the fund in subsequent years.

(4) Applied to a Capital Replacement Program - surplus funds may be used to supplement or enhance a capital replacement program such as vehicle, personal computer, or heavy equipment replacement, or any other capital renewal and replacement program initiated by the County.

(5) One-time Capital Needs - since a surplus does not represent a recurring source of revenue it should not be seen as a source to fund recurring expenses; however, if a one-time capital expenditure has been identified, the surplus may be appropriated for this use. The operating impacts associated with the capital expenditure, if any, shall be evaluated simultaneously with the approval of the capital appropriation.

(4) Shortfall

(a) If ~~it is determined there is~~ a shortfall (an amount below the established minimum level) is determined, the unreserved/undesignated fund balance is to be rebuilt through the following mechanism.

(1) An appropriation during the next annual budget process of at least 20% of the established minimum level until it has been reached.

If this is financially infeasible,

(2) A written plan shall be forwarded by the County Manager to the Board of County Commissioners for approval in order to restore the unreserved/undesignated fund balance to the established minimum level within a time frame deemed reasonable and appropriate.

K~~J~~. AUTHORITY.

* Annual Budget Book
* Capitalization Approved by BCC at their meeting of December 11, 2001 Agenda Item 9 for Fiscal Services
* Intradepartmental Transfers Resolution 2002-R-94 adopted May 28, 2002
* Resolution 2006-R___ adopted ______

Appropriate Level of Unreserved Fund Balance in the General Fund (2002)

Background. Accountants employ the term *fund balance* to describe the net assets of governmental funds calculated in accordance with generally accepted accounting principles (GAAP). Budget professionals commonly use this same term to describe the net assets of governmental funds calculated on a government's budgetary basis.[1] In both cases, *fund balance* is intended to serve as a measure of the financial resources available in a governmental fund.

Accountants distinguish *reserved fund balance* from *unreserved fund balance*. Typically, only the latter is available for spending. Accountants also sometimes report a *designated* portion of unreserved fund balance to indicate that the governing body or management have tentative plans concerning the use of all or a portion of unreserved fund balance.

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 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 unreserved fund balance in the general fund.

Credit rating agencies carefully monitor levels of fund balance and unreserved 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 unreserved fund balance for state and local governments.

Those interested primarily in a government's creditworthiness or economic condition (e.g., rating agencies) are likely to favor increased levels of fund balance. Opposing pressures often come from unions, taxpayers and citizens' groups, which may view high levels of fund balance as "excessive."

Recommendation. GFOA recommends that governments establish a formal policy on the level of unreserved fund balance that should be maintained in the general fund.[2] GFOA also encourages the adoption of similar policies for other types of governmental funds. Such a guideline should be set by the appropriate policy body and should provide both a temporal framework and specific plans for increasing or decreasing the level of unreserved fund balance, if it is inconsistent with that policy.[3]

The adequacy of unreserved fund balance in the general fund should be assessed based upon a government's own specific circumstances. Nevertheless, GFOA recommends, *at a minimum*, that general-purpose governments, regardless of size, maintain unreserved fund balance in their general fund of no less than five to 15 percent of regular general fund operating revenues, or of no less than one to two months of regular general fund operating expenditures.[4] A government's particular situation may require levels of unreserved fund balance in the general fund significantly in excess of these recommended minimum levels.[5] Furthermore, such measures should be applied within the context of

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

[3] 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).

[4] 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. 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 unreserved fund balance to either revenues or expenditures, that decision should be followed consistently from period to period.

[5] In practice, levels of fund balance, (expressed as a percentage of revenues/expenditures or as a multiple of monthly expenditures), typically are less for larger governments than for smaller governments because of the magnitude of the amounts involved and because the diversification of their revenues and expenditures often results in lower degrees of volatility.

long-term forecasting, thereby avoiding the risk of placing too much emphasis upon the level of unreserved fund balance in the general fund at any one time.

In establishing a policy governing the level of unreserved fund balance in the general fund, a government should consider a variety of factors, including:

- The predictability of it revenues and the volatility of its expenditures (i.e., higher levels of unreserved fund balance may be needed if significant revenue sources are subject to unpredictable fluctuations or if operating expenditures are highly volatile).
- The availability of resources in other funds as well as the potential drain upon general fund resources from other funds (i.e., the availability of resources in other funds may reduce the amount of unreserved fund balance needed in the general fund, just as deficits in other funds may require that a higher level of unreserved fund balance be maintained in the general fund).
- Liquidity (i.e., a disparity between when financial resources actually become available to make payments and the average maturity of related liabilities may require that a higher level of resources be maintained).
- Designations (i.e., governments may wish to maintain higher levels of unreserved fund balance to compensate for any portion of unreserved fund balance already designated for a specific purpose).

Naturally, any policy addressing desirable levels of unreserved fund balance in the general fund should be in conformity with all applicable legal and regulatory constraints. In this case in particular, it is essential that differences between GAAP fund balance and budgetary fund balance be fully appreciated by all interested parties.

Approved by the Committee on Accounting, Auditing and Financial Reporting and the Committee on Governmental Budgeting and Management, January 30, 2002

Approved by the Executive Board, February 15, 2002.

Tax Supported
Special Report

The Bottom Line

Local General Government Reserves and the Policies that Shape Them

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Related Research
- "Local Government General Obligation Rating Guidelines," dated June 10, 2004.
- "The 12 Habits of Highly Successful Finance Officers," dated Nov. 21, 2002.

This report is the first installment of a series of special reports highlighting key management practices from the tax-supported public finance market sector.

■ Summary

In Fitch Ratings' Nov. 12, 2002 report "The 12 Habits of Highly Successful Finance Officers," which discussed the importance of management practices to credit ratings, Fitch identified the establishment and maintenance of operating reserves as a key element in its analysis of local governments' credit quality. This follow-up report expands on Fitch's view of appropriate reserve levels and the policies that shape them. In an analysis of an issuer's financial flexibility, Fitch reviews the level of reserve funds maintained, typically in the form of fund balance; the level of reserve funds in proportion to tax-supported spending responsibilities including debt service; and the liquidity and availability of such funds. Policies driving reserve levels often are just as important to Fitch as the reserves themselves. Gaining a clear understanding of the reserve policy, how the policy was created, and the longevity over which it is applied and adhered to, or institutionalized, can provide insight into an issuer's ability and willingness to pay debt service. The best reserve policies provide both specificity and flexibility, accomplishing one or more of at least three main criteria: establishing a target level of reserves, or a reserve floor; specifying the appropriate circumstances for drawing down reserves; and directing the replenishment of reserves.

■ Reserve Floor

The appropriate sizing of reserves depends on the potential variability of the issuer's revenues and expenses, as well as its working cash needs to handle seasonality of revenues or expenditures. Fitch does not have a preferred fund balance floor that can be applied to all local governments because the level of fund balance that provides ample financial flexibility is directly related to an issuer's overall credit profile. While Fitch usually refers to fund balance, reserves, stabilization funds, and rainy day funds, all are included in Fitch's analysis of financial cushion. Furthermore, Fitch's analysis typically centers on unreserved general fund balances; however, credit is also given to fund balances that are reserved for budget stabilization or "rainy day" scenarios that may be available.

Generally, issuers with higher degrees of overall credit risk will require a higher level of fund balance or financial flexibility to mitigate such risks. However, it is very important that the target reserve level be both realistic and sustainable. Most commonly, Fitch focuses on the general fund balance as a percentage of general fund expenditures and transfers out, as the general fund is where most local governments account for the bulk of tax-supported services. In the event tax-supported services are accounted for in other funds, such as a separate debt service fund or a special revenue fund for highway, solid waste, or other services, Fitch also examines the cumulative tax-supported fund balance as a percentage of the cumulative tax-supported expenditures.

Establishing a policy to maintain reserves serves as an important financial management tool to help governments address temporary cash flow needs throughout the year, to provide a financial cushion against current revenue shortfalls or unanticipated expenditures, to respond to emergency situations, and to maintain a level of tax rate stabilization in down economic cycles. When crafting the fund balance policy, Fitch believes an issuer should consider what level of reserves is necessary to offset other credit risks and maintain financial stability over the long and short term. A key element of a strong fund balance policy is the requirement to maintain a fund balance floor — not a monetary floor but a minimum level as a percentage of revenues or expenditures. Fitch views percentage-driven fund balance floors as stronger than other types of floors because as the budget grows, so does the level of fund balance maintained. Monetary floors can very quickly become inadequate, declining proportionately as spending increases from year to year.

■ Reserve Drawdowns

After setting the fund balance floor, the strongest fund balance policies detail what situations or expenditures provide for an acceptable use of fund balance reserves. This provides a first defense against deficit spending and helps maintain liquidity when budgeted drawdowns become inevitable.

Fitch favorably views reserve policies that both: limit the use of reserves exceeding the policy floor to nonrecurring expenditures or one-time capital costs; and preserve the policy floor by reducing the fund balance below the minimum only in emergency situations. While unforeseen events may force an issuer to violate the policy and use fund balance for a purpose inconsistent with the policy, the more specific the criteria for use of fund balance, the more likely the issuer will seek alternate budget-balancing solutions before raiding the reserves.

■ Reserve Replenishment

The final element of a strong fund balance policy is the establishment of a mechanism by which to replenish reserves once they have been drawn upon. While setting a reserve replenishment protocol is less common than establishing a policy floor and setting rules for the use of fund balance, its inclusion strengthens the overall policy.

The difficulty in adhering to a reserve replenishment mechanism is that, most often, reserves are drawn upon during times of fiscal stress, thereby limiting the issuer's ability to create surplus to replenish the fund balance. Furthermore, many issuers do not include the reserve replenishment feature in the policy because, during down times, issuers want the utmost flexibility to address fiscal strains and typically do not want to be confined by a replenishment protocol. While Fitch understands the need for flexibility and expects that reserves may be drawn upon in accordance with the policy in times of economic slowdown and resultant fiscal stress, the written replenishment policy is viewed extremely favorably, as it addresses the need for the issuer to balance the discipline of rebuilding fund balance when conditions improve over time with maintenance of financial flexibility. Even if the policy is not strictly adhered to, it can provide some level of comfort to investors that the rebuilding of the fund balance is a priority to the issuer.

■ Institutionalization

The policies driving the maintenance of reserves often are just as important to Fitch as the reserve levels themselves. The adopted reserve policy is stronger than one that is simply practiced. However, Fitch gives the most credit in its rating of local governments to those issuers that institutionalize reserve polices. Institutionalization is the bridge between establishing a policy and actually operating within that policy. Fitch-rated issuers that receive the most credit from Fitch have not only adopted a comprehensive reserve policy, but have adhered to the policy during times of economic and political stress and through changes in leadership. A reserve policy is only as effective and creditworthy as the commitment of the management team to abide by its limits.

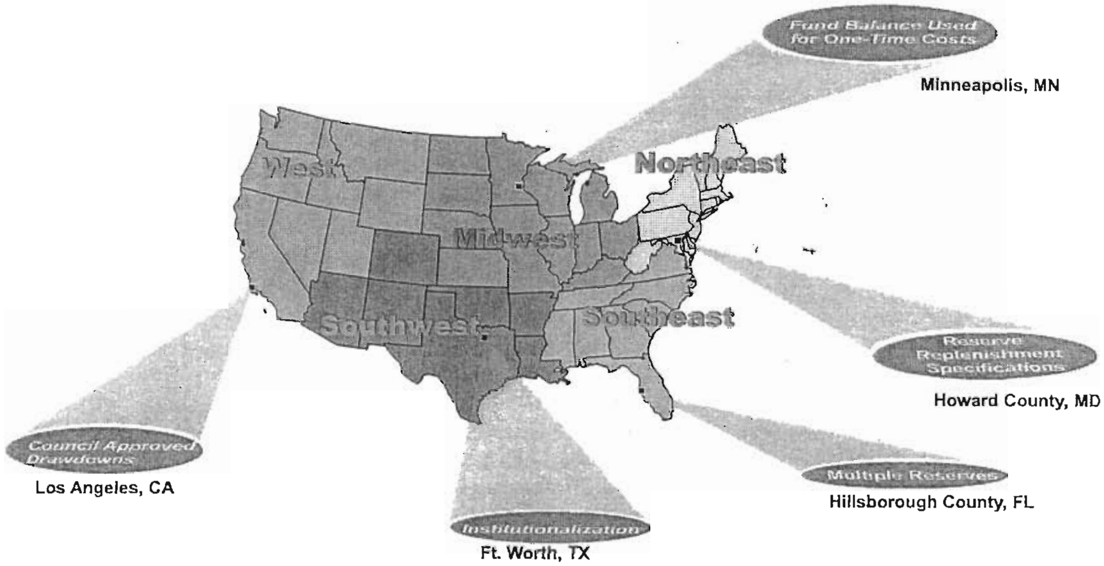
■ Policies in Action

Fitch's perspective on fund balance policies has evolved over time, as issuers shape and refine reserve policies into fluid documents that balance the maintenance of reserves for severe rainy days with the need for ongoing flexibility to address day-to-day budget fluctuations and cash flow cycles. This final section of the report highlights comprehensive reserve policies from five highly rated credits, one in each of Fitch's analytical regions, and spotlights a specific credit strength derived from a unique component of each policy.

Howard County, MD

Fitch General Obligation (GO) Rating: 'AAA'; Stable Rating Outlook.

Spotlight on Reserves: Policies Across the Nation



Fitch Ratings analytical regions.

Spotlight: Reserve replenishment specifications.

Summary: Howard County's policy pertaining to its budget stabilization account is both comprehensive and firmly institutionalized, as it is included in the county charter. Not only does the policy specify requirements in all of the three aforementioned areas, including specifying a floor and parameters for drawdowns, but the unique credit strength is derived from the specifications regarding reserve replenishment. The policy specifically states that if the account falls below the 7% charter-mandated level for two consecutive fiscal years, the county will replenish funds by direct appropriation beginning the following year. In that instance, the county will annually appropriate 25% of the difference between the mandated level and the account balance until the mandated level is met. In the event appropriating 25% is not feasible, the county will appropriate a lesser amount and reaffirm its commitment to fully replenish the reserve funds over a longer period of time.

Contact: Sharon Greisz, Finance Director (sgreisz@co.ho.md.us).

Policy Web Link:
www.co.ho.md.us/DOA/DOAPDFs/Stabilizationfund5.pdf.

Hillsborough County, FL
Fitch GO Rating: 'AA+'; Stable Rating Outlook.

Spotlight: Specified apportionment of general fund surplus exceeding the policy minimum to other county reserves.

Summary: Hillsborough County's general government reserve policies are outlined in sections 15, 35, and 42 of the board of county commissioners' 50 adopted financial policies and procedures. The reserve policies require that the county include in its budget a minimum reserve for cash balance (stabilization funds) of 5% of the most recent available audited expenditures. Additionally, the policies detail criteria for drawdowns of the contingency reserve. Finally, the policy provides unique credit strength from the specificity in which excess fund balance may be used. In the event surplus funds exceed the budgeted 5% fund balance, the county must transfer a set percentage of surplus moneys to various funds for renewal and replacement, self-insurance, and emergency reserves.

Contact: Michael Merrill, Director, Debt Management Department (merrillm@hillsboroughcounty.org).

Policy Web Link:
www.hillsboroughcounty.org/mbd/adopted/fy0405/publications/exsummary.pdf.

Minneapolis, MN
Fitch GO Rating: 'AAA'; Negative Rating Outlook.

Spotlight: Limiting use of reserves for nonrecurring expenditures.

Summary: The City of Minneapolis's reserve policy is one of several financial management policies included in the city's budget document. The policy addresses two of the three main criteria: the reserve floor; and the drawdown of reserves. The policy states that the city shall maintain a minimum unallocated fund balance of 10% of the general fund budget. Furthermore, unique credit strength is derived from the policy's specifications on the use of fund balance stating that available fund balances shall not be used for ongoing operating expenditures unless available balances are in excess of the 10% minimum and plans have been established to address future operating budget shortfalls.

Contact: Patrick P. Born, City Finance Officer (patrick.born@ci.minneapolis.mn.us).

Policy Web Link:
www.ci.minneapolis.mn.us/city-budget/2005recommended/sec4FinPolicies.pdf.

Forth Worth, TX
Fitch GO Rating: 'AA+'; Stable Rating Outlook.

Spotlight: Institutionalization reflected in the policy adopted as a city ordinance.

Summary: The City of Forth Worth's fund balance/retained earnings policy is one of 15 financial management policy statements adopted together as a city ordinance, requiring majority approval of the city council, providing for the unique credit strength of institutionalization. The policy includes a goal of maintaining the general fund undesignated fund balance at 10% of the current year's budget appropriation for operations, which is defined as all general fund expenditures less the transfer out for debt service. Additionally, the policy specifies that the use of fund balance shall only be for emergencies, nonrecurring expenditures, or major capital purposes. Finally, the policy does include some language regarding replenishment but is less specific. The policy states that if the use of fund balance would reduce reserves to a level below that of the 10% minimum, the request to utilize fund balance must be accompanied by restoration recommendations.

Contact: James R. Keyes, Director, Finance Department (keyesj@ci.fort-worth.tx.us).

Policy Web Link:
ci.fort-worth.tx.us/finance/policies/index.htm.

Los Angeles, CA
Fitch GO Rating: 'AA', Stable Rating Outlook.

Spotlight: Use of fund balance requires approval vote of elected officials.

Summary: The City of Los Angeles's reserve fund policy is included in the city's broader debt management policy, which is part of the city's administrative code (Section 11.5.1). The reserve fund policy covers, in great detail, the minimum level of reserves and the mechanism for the usage of fund balance. The policy creates two major reserves: a reserve fund and a liability claims account, which together are budgeted at 4% of the general fund budget. The policy establishes that the reserve fund will represent 2% of the general fund budget and consist of both a contingency reserve (for unanticipated expenses or revenue shortfalls for approved programs) and a emergency reserve account for "urgent economic necessity". The liability claims account reserve also is budgeted at approximately 2% of the general fund budget. While the policy does not discuss replenishment of reserves, the unique credit strength is derived from the strict rules concerning the use of fund balance. Appropriation of the contingency reserve requires a majority vote of the city council and mayoral concurrence, or a super-majority vote of city council in the event of mayoral veto. The removal of moneys from the emergency reserve account requires a finding by the mayor and confirmation by the city council.

Contact: Natalie Brill, Chief Debt Administrator (nbrill@cao.lacity.org).

Policy Web Link:
www.lacity.org/cao/Debt_Mgmt/Reserve%20Fund%20Policy.pdf.