GENERAL FUND RESERVE POLICY

April 2018

William C. Statler

Fiscal Policy ■ Financial Planning ■ Analysis ■ Training ■ Organizational Review

General Fund Reserve Policy

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City of Twentynine Palms
GENERAL FUND RESERVE POLICY

The purpose of this report is to assist the City in developing a General Fund reserve policy for fiscal stability, cash flow and contingencies that will provide a solid foundation for financial decision-making. Provided in Appendix A is the recommended General Fund reserve policy, which covers six key areas:

- Sets the minimum General Fund reserve target using the structured approach developed by the Government Finance Officers Association of the United States and Canada (GFOA) in assessing risk factors (www.gfoa.org/financialpolicies).

  Based on this assessment, the recommended target minimum is 55% of operating and debt service expenditures. (As discussed below, while the City does not currently have any General Fund debt service costs, this could change in the future and thus the policy addresses this possibility.)

- Identifies when it is appropriate to use reserves below the target amount.
- Provides a strategy for restoring the reserve if it falls below the target minimum.
- Presents guidelines for accounting and financial reporting of the reserve.
- Discusses other areas where the Council may decide to set reserve amounts.
- Compares actual versus target.

PROPOSED POLICY OVERVIEW

Minimum Reserve Target

The recommended policy sets the target minimum unassigned General Fund balance at 55% of operating and debt service expenditures. This is largely based on the structured assessment methodology for setting reserve levels developed by the GFOA in considering a city's exposure to the following eight fiscal risk factors, which are discussed in greater detail later in this report:

- Vulnerability to extreme events and public safety concerns
- Revenue source stability
- Expenditure volatility
- Leverage, such as unfunded pensions and asset maintenance
- Liquidity (cash flow)
- Dependence of other funds on the General Fund
- Growth: revenue and expenditure imbalance
- Unfunded high priority capital projects

Depending on the results of this assessment, the GFOA methodology provides recommended targets ranging from a minimum of 16.6% of expenditures (60 days cash flow) to circumstances where more than 35% might be warranted. Based on the City's circumstances, the GFOA's structured methodology recommends a target higher than 35%. Based on the City's need to maintain reserves at 25% just to meet cash flow needs during the year, the recommended policy is 55% to provide appropriate flexibility in addressing economic uncertainties, such as downturns in the economy and external revenue hits (like State takeaways); responding to local disasters; contingencies for unforeseen operating or capital needs; and strategic opportunities.

This compares with the City's most recent audit results for the fiscal year ended June 30, 2017, where the City had an unassigned General Fund balance of $11.3 million (135.8% of actual expenditures); and the 2017-18 Budget, which projects that the ending unassigned General Fund balance will be $11.5 million (130.1% of expenditures).

Uses and Restoration of the Reserve

In addressing future circumstances where the reserve may be less than the target amount, the proposed policy recommends that the City strive to restore reserves to the policy minimum within five years. As revenues versus expenditures improve, the policy recommends that the City allocate at least half to reserve restoration, with the balance available to fund asset replacements, unfunded liabilities, capital improvement projects, service level restorations or new operating programs.

The policy also addresses circumstances where taking reserves below policy levels would be appropriate in responding to the risks that reserves are intended to mitigate, such as:

- Meeting cash flow needs during the fiscal year.
- Closing a projected short-term revenue-expenditure gap.
- Responding to unexpected expenditure requirements or revenue shortfalls.
- Making investments in unfunded liability reductions, economic development and revenue base improvements, productivity improvements and other strategic opportunities that will strengthen City revenues, reduce future costs or achieve high-priority City goals.

- Where a fiscal forecast shows an ongoing structural gap: providing a strategic bridge to the future.

On the other hand, the policy notes that the City should avoid using reserves to fund ongoing costs or projected systemic "gaps." Stated simply, reserves can only be used once, so their use should be restricted to one-time (or short-term) uses.

Accounting for the Reserve

The policy sets the reserve target based on the unassigned General Fund balance: net of non-spendable, restricted, committed or assigned balances. This intuitively makes sense: non-spendable and externally restricted funds are not readily available to meet the risks that the reserve is intended to mitigate. (This is also the recommended approach by the GFOA in its publication *Financial Policies*).

It should also be net of other commitments or assignments, so it is available to meet its intended purposes.

Based on the unassigned fund balance, two things can be readily determined from the audited financial statements after calculating the policy target based on actual operating expenditures:

- Whether the City has achieved its policy goal.
- And the amount (if any) that reserves (unassigned fund balance) exceed or are less than the policy goal.

General Fund Balance Classifications

Under generally accepted accounting principles set by the Government Accounting Standards Board (GASB) in Statement No. 54, General Fund balance is classified into five components:

- ***Non-Spendable.*** Amounts that are not in spendable form, such prepaid items or inventories.
- ***Restricted*.** Amounts subject to *externally* enforceable restrictions imposed by outside third parties.
- ***Committed*.** Amounts whose use is constrained internally by the agency itself for specific purposes set by the governing body.
- ***Assigned*.** Amounts intended for specific purposes as determined by the governing body or others it has formally designated.
- ***Unassigned.*** Residual classification of spendable amounts available for other purposes.

As discussed below, the City's target reserve should be reported as part of the "unassigned" fund balance.

Status Summary: Actual Versus Target

Lastly, the policy provides a status summary of the policy target with the actual reserve amount. If the projected reserve is less than the target minimum, the strategy for achieving policy restoration should discussed. This comparison should be updated at least annually and included with the policy.

It should be noted that comparing policy with actual is a useful approach for all fiscal policies in demonstrating effective steward of City assets. It keeps fiscal policies – and compliance with them – on the City's financial management radar on an ongoing basis.

Include the Reserve Policy in the Budget Document

Key City policies are addressed in the Budget Message. Since having a clearly stated reserve policy has its greatest value during the budget preparation, review and adoption process, this report recommends including the reserve policy in the budget document itself (along with other significant budget and fiscal policies).

DISCUSSION

The Power of Fiscal Policies

As we know from experience over the past 25 years – with the recession and recoveries of 1992-94, 2003-05 and the Great Recession beginning in 2008 – good times come and go. But an organization's values shouldn't. And that's what fiscal policies are all about: articulating the agency's financial management values before they are place under stress.

Stated simply, clearly articulated policies – and being guided by them – are the best way of ensuring long-term fiscal health. While the strength of the local economy and related General Fund revenues are important, no city is immune from economic downturns. In navigating tough fiscal times, effective financial management is the most critical factor for long-term fiscal success; and clearly articulated policies provide an essential framework and foundation for effective decision-making.

Fiscal policies are important in both good times and bad. The roots of fiscal adversity for most governments take hold in the good times, by making commitments that are not sustainable. They rarely surface in the "bad" times, when most agencies act on the "First Rule of Holes" (when you find yourself in one, stop digging).

They are both preventative and curative:

- Clearly articulated policies – and following them – help prevent problems from arising in the good times.

- And provide more effective responses when the inevitable bad times occur.

They are most powerful when it put in place before the need for them arrives, recognizing that not all financial decision-making situations can be reasonably anticipated.

Policies should be set based on the agency wants to be, which may not be where it is today. However, setting the course for where it wants to be significantly enhances its ability to get there. Accordingly, each policy should include a brief "compliance status." And if it is not there yet, the policy should provide the agency's plan for getting there. (As discussed above, the proposed reserve policy includes this component.)

General Fund Reserve Policy

Policies Versus Plans. Planning is essential for success. However, plans change over time as actual results replace assumptions. But fiscal policies are the "north star" guiding the preparation of plans. They help making tough decisions easier by articulating values before they are put placed under stress by adverse circumstances. An organization can reasonably do something else, but policies are a powerful starting point for asking: but for "this" unexpected circumstance, what would we have otherwise done?

Lastly, of all the fiscal policies that cities should set, minimum reserve targets are among the most important.

Prudent Reserves Reflect Ability to Manage Risk, Not Fiscal Strength Per Se

Reserves – whether large or small – do not per se reflect on a city's financial capacity or underlying fiscal strength. There are much better indicators than reserves for this, most notably the ability over time for ongoing revenues to adequately meet day-to-day service needs, capital improvement goals and debt service requirements.

Stated simply, reserves are a risk management tool: how much can things go differently than the organization otherwise thought they would before it must take corrective action? Reserves can also serve as a bridge to the future, providing time to develop and implement thoughtful long-term solutions.

Typical risks that reserves help mitigate include economic uncertainties, such as downturns in the economy and external revenue hits (like State takeaways); responding to local disasters; contingencies for unforeseen operating or capital needs; strategic opportunities; and cash flow.

What's the Right Amount? It depends on each agency's unique fiscal circumstances and its capacity for risk. In answering this question, the GFOA has developed a structured assessment methodology for setting reserve levels in considering an agency's exposure to the following eight fiscal risk factors:

1. **Vulnerability to extreme events and public safety concerns.** Major extreme events the community could reasonably be subject to and the likelihood and potential magnitude of loss for each event.

2. **Revenue source stability.** Volatility of each major revenue source based on factors such as past experience and trends with that revenue, characteristics of the tax or rate payers, state or federal revenue takeaways and economic factors.

3. **Expenditure volatility.** Spikes in expenditures, usually arising from special, non-recurring circumstances such as lawsuits; critical special projects without a funding source; or new state or federal spending requirements and unfunded mandates.

4. **Leverage.** Common examples include unfunded pensions and unfunded asset, as well as outstanding bonded indebtedness and compensated absences. Is the source of leverage very large? Does it have an off-setting funding source or asset?

5. **Liquidity (cash flow).** Intra-period cash imbalances, such as property taxes that are only received at two major points during the year (December and June).

6. **Dependence of other funds.** Are there other funds that have a significant dependence on the General Fund?

7. **Growth.** Is significant growth a realistic possibility in the next three to five years? This includes assessing likely potential marginal costs associated with serving new growth compared with marginal revenues and resulting gaps.

8. **Capital projects.** Are there high priority projects without a funding source, where reserves may be looked to as a funding source?

As discussed in greater detail in Appendix B, the methodology uses a scale of 5 to 1 in assessing how important reserves are in mitigating each risk:

5: Very important
4: Important
3: Neutral
2: Unimportant
1: Very unimportant

Since there are eight mitigation factors, total scores will range from 8 (the least risk) to 40 points (greatest risk). Along with these eight risk factors, the methodology also considers:

- City size (assumes larger cities have more mitigation strategies than smaller ones)
- Other reserve/contingency funds
- Borrowing capacity

Depending on the results of this assessment, the GFOA methodology provides recommended targets ranging from a minimum of 16.6% of expenditures (60 days cash flow) to circumstances where more than 35% might be warranted.

The following summarizes the GFOA's rating scale.

GFOA Reserve Rating Scale

Rating	Target Minimum General Fund Reserve
8 -16	Minimal risk to retain through reserves. Consider target equal to the GFOA minimum recommended reserve of 16.6% (two months cash flow) of revenues/expenditures.
17-24	Low to moderate level of risk to retain through reserves. Consider reserve target of 17% to 25%.
25-31	Moderate to high level of risk to retain through reserves. Consider reserve target of 26% to 35%.

Rating	Target Minimum General Fund Reserve
32-40	High level of risk to retain through reserves. Consider reserve target greater than 35%.

As detailed in Appendix B, the City's rating under this methodology is 32, which indicates that the target minimum should be higher than 35%.

Five of the assessment factors were largely responsible for this rating:

- Revenue stability
- Expenditure volatility
- Cash flow (see sidebar and Appendix C)
- Unfunded liabilities
- Unfunded capital projects

The other three factors (vulnerability to extreme events and public safety concerns; dependence of other funds on the General Fund; and growth) were not significant in this rating.

Mitigating Cash Flow with TRANS

Along with reserves, cash flow needs can be addressed by issuing Tax and Revenue Anticipation Notes (TRANS).

TRANS are short-term borrowings by local government agencies who are not able to meet their cash flow needs during the year. They are typically issued early in the fiscal year and repaid before year-end.

At one time, many TRANS were issued as an investment strategy, since the proceeds could be invested at higher yields than their tax-exempt interest rate. However, this favorable variance between interest costs and yields has not been the case since the Great Recession.

Stated simply, while incurring debt to meet cash flow needs is an option, it is preferable to avoid it if possible. Moreover, TRANS are not free: there are financing and interest costs in issuing them.

Appendix C provides a cash flow analysis for the General Fund, which shows the need for 25% to cover several low points in the fiscal year, most notably in November and May prior to the receipt of property tax revenues (the City's most important General Fund revenue source).

ALTERNATIVES

Setting the Minimum Target Reserve at Lower or Higher Amounts than 55%

Based the GFOA structured assessment methodology, this report recommends a minimum target General Fund balance of 55% of operating and debt service costs.

However, the Council is the ultimate "decider" in balancing risks and reserves. Stated simply, the City's fiscal resources do not exist to amass large fund balances but rather, to deliver important services that help make Twentynine Palms a good place to live, work and play. On the other hand, prudent reserves are essential in helping assure stability in the delivery of services.

Accordingly, the Council could reasonably set reserves at levels that are lower or higher than the recommended target.

Lower Target than 55%. The GFOA assessment methodology recommends a target higher than 35% but does not provide further guidance. A lower target of 40% to 50% would still be with the GFOA recommended range. However, given that 25% is needed for cash flow purposes alone, reserves lower than 55% would provide limited flexibility for fiscal stability and contingencies.

Higher Target than 55%. Based on surveys provided on the California Society of Municipal Finance Officers' web site as well as other studies, there are many cities in California that have minimum target reserve policies of 50% or higher, including:

- La Canada Flintridge: 125%
- Stanton: 75%
- La Palma: 60%
- Carpinteria: 55%
- Brisbane, Camarillo, Laguna Nigel, Lomita, Malibu, Mission Viejo, Moraga, Rancho Palos Verdes and San Ramon: 50%

Given the many uncertainties ahead, a target higher than 55% would also be reasonable.

Using a Different Basis for Determining the Reserve

The proposed policy bases the 55% target on annual operating and debt service costs. However, other options used by California cities include:

- Total expenditures and uses (operating, debt service and capital expenditures, and transfers out)
- Operating expenditures only
- "Normal" annual expenditures (thus including operating costs, less one-time costs such as special studies and plans; debt service; some "normal" capital costs; and transfers out, less any one-time purposes)
- Other combinations of expenditures and uses
- Revenues rather than expenditures

Where the base is narrower (such as just operating expenditures), the same target percentage will result in a smaller reserve; conversely, where the base is broader (including capital, debt service and/or transfers), the same target percentage will result in a larger reserve.

In the case of the City, it makes sense to include both operating and debt service costs in the base:

- ***Operating costs*** are included in the base in virtually all cases, which makes sense: this is the "core" cost base of city services that is most at risk; and while sensitive to economic changes and community needs (up or down), it is relatively stable from year to year. While it is possible that there may be significant one-time costs included in the operating budget, adjusting for this is not recommended: the difference is likely to be immaterial and, more importantly, transparency in calculating the reserve target will be enhanced by "keeping it simple."

- ***Debt service*** costs are also ongoing contractual obligations (until the principal balance is paid-off); accordingly, it makes sense to include this in the target base as well. As noted above, while the City does not currently have any General Fund debt service costs, this could change in the future. Accordingly, to be proactive in accounting for this possibility, it makes sense to include this as part of the base.

On the other hand, capital projects can vary from year-to-year, and the reserve should be relatively stable. And interfund transfers are internally determined by the City: overall City resources are unaffected by them. (And as a practical matter, the City's use of transfers out is minimal. For example, they were $192,000 in 2016-17, just 2% of total expenditures and uses.) Accordingly, the recommended policy *excludes* capital project costs and transfers out, and *includes* operating and debt service costs, as the basis for determining reserve levels.

Showing the Reserve as "Assigned" in Financial Statements

On one hand, it makes intuitive sense to consider the recommended reserve as "assigned" for fiscal stability, cash flow and contingencies. However, these purposes fall into a category that GASB calls "revenue stabilization, working capital needs, contingencies or emergencies;" and unless they are specifically classified as restricted or committed (which would not be appropriate in this case), GASB 54 states that they "… should be reported as unassigned in the general fund."

Defining Reserves as the Unrestricted Fund Balance

As discussed above, GASB defines organizes the unrestricted General Fund balance (net of non-spendable and restricted amounts) into three categories:

- Committed
- Assigned
- Unassigned

As noted above, GASB 54 indicates that "operating reserves" like these should be classified as "unassigned." Also, unless the City formally commits or assigns balances for specific purposes, all of the fund balance will be shown as "unassigned" anyway. Moreover, in its structured assessment methodology, the GFOA recommends that the minimum fund balance target be exclusive of other commitments or assignments.

That said, while this report recommends using the unassigned balance, it is not unusual for cities to define reserves for policy purposes as the potentially larger (depending on the size of the amounts classified as committed or assigned) unrestricted balance.

In the City's case, through June 30, 2017, there is no difference between the unrestricted and unassigned balance: of the $11.3 million in the unrestricted General Fund balance, all of the balance was classified as "unassigned." Accordingly, the distinction will only be important in the future if the City expands its use of fund balance assignments and commitments. (The proposed policy provides for this.)

Segregating the Reserve into Separate Components

The proposed policy sets a unified reserve target of 55% to meet the aggregate of the risks it is intended to meet. Since not all factors are likely to come into play at the same time, this approach makes sense: "pooling" purposes serves to lower the overall reserve amount that might otherwise be needed to meet each of the risk factors individually. Moreover, budgeting and accounting for the reserve is simpler and more straightforward, as is communicating its purpose to the community and organization.

That said, there may be some interest in separating the need for the reserve into specific categories. In that case, the following are recommended:

- Cash Flow: 25%
- Fiscal Stability: 15%
- Contingencies/Strategic Opportunities: 15%

CONCLUSION

Establishing a reserve policy – and being guided by it – is one the City's most important fiscal policies by mitigating financial risks. Based on the results of the GFOA structured assessment methodology, this report recommends that the minimum reserve target be set at 55% of operating and debt service expenditures.

Along with the recommended target, it sets guidelines for when it is appropriate to use reserves below the target amount; restoring the reserve if it falls below the target minimum; accounting and financial reporting of the reserve; and for at least annually comparing actual results versus the target. It also discusses alternatives for the City's consideration for each of the key recommendations.

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APPENDIX

A. Proposed General Fund Reserve Policy
B. General Fund Reserve Risk Factors: GFOA Structured Assessment Methodology
C. Cash Flow Analysis
D. Consultant Background