BEST PRACTICE

Replenishing Fund Balance in the General Fund (2011) (Budget and CAAFR) (new)

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, the 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. The Government Finance Officers Association (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] Unrestricted fund balance comprises the committed, assigned, and unassigned fund balance categories.

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.

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.

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