The FISCAL REPORT an informational update

Volume 36 For Publication Date: May 06, 2016 No. 9

How Do We Locally Determine an Adequate Reserve Level? [Part 2 of 2]

[Editor's Note: As we emerge from the Great Recession, one of the lessons we learned was that strong leadership, teamwork, planning ahead for contingencies, taking early actions to avoid a fiscal calamity, and having an adequate reserve got everyone through. Given Governor Jerry Brown's concerns about a coming recession and the potential cap on local school district reserves, we continue to receive a lot of questions about what constitutes an adequate reserve level. This series is divided into two parts: (1) a primer on what reserves are and how they are defined, and (2) what constitutes an adequate reserve level. Part 1 of the series can be found here. What follows is Part 2 of the series.]

What Is the Purpose of a Reserve?

A reserve is an identified amount of cash that is available to handle contingencies as they arise. In other words, the reserve is a safety net that allows a local educational agency (LEA) to meet its obligations as unplanned changes in revenues and expenditures occur.

LEAs in California have very little control over revenues, as those are mainly controlled by the state government, and to some extent the federal government and other agencies. We have learned that we cannot depend upon a stable source of revenues in either the good times or the bad. During the good times, the state provides budget proposals and out-year forecasts that, by the time the budget year arrives, can significantly change what LEAs are able to count on for discretionary purposes. During the bad times, LEAs not only can lose the most meager of cost-of-living adjustments but can also have their current funding levels cut.

And, while LEAs have much more control over expenditures, we live in an environment of uncontrollable cost increases. Some of these increases can be planned for and budgeted, but others cannot be anticipated. A reserve fund allows an LEA to continue to meet its obligations even when hit with unexpected expenses.

The important thing to remember if reserves have to be used is that they are *one-time funds*—once used, they are not replenished except by purposeful action of the LEA. However, most financial turbulence that LEAs encounter tends to be ongoing in nature. This means that reserves can help carry the LEA through a year of financial problems—long enough for the LEA to make budget cuts to solve its ongoing financial issues. If budget cuts are not made, reserves would continue to be used by default, and eventually the reserves will be depleted.

While the most immediate purpose of a reserve is to cushion against unforeseen financial issues, remember that credit rating agencies look at LEA reserves when determining credit worthiness. An LEA's credit rating impacts the cost of issuing debt—the stronger the reserves position, the better the credit rating and the lower the cost of debt for the LEA and/or its taxpayers.

What Should Be Considered in Setting a Level of Reserves?

As stated earlier, LEAs in California have very little control over revenues but much greater control over expenditures. Greater control can also be exercised over reserves—LEAs have authority to determine what constitutes an adequate reserve—notwithstanding the potential cap on reserves discussed later in this article.

The state's Standards and Criteria discussed in Part 1 of this series include a *minimum* reserve level for LEAs. This approach assumes that LEAs of similar size face similar risks, but we believe that this is no longer as applicable under the Local Control Funding Formula (LCFF). This most significant part of LEA revenues is not so much related to LEA size—rather, it is related to the unique demographics of each LEA, and the level of risk differs on this basis.

There are many more reasons why an LEA, especially in California, should have a level of reserves that is much greater than the state's minimum. Some of these reasons apply to all LEAs and some do not, which is why each LEA should make its own decision as to an adequate reserve.

Here are some of the risk factors that would indicate a need for higher LEA reserves:

- Declining enrollment, which reduces revenues and requires purposeful action each year to cut expenditures
- Delays in cash receipts, such as: the timing of property tax receipts for LEAs more dependent upon property taxes than state aid for their operating cash; apportionment deferrals, which the state has used in the past to balance its budget; and Education Protection Account revenues, which are doled out at the end of each quarter
- Relatively high expected revenue increases under the LCFF, as we have in the past seen the state's projections for gap funding significantly change before the State Budget is enacted
- Restricted programs requiring unrestricted cash to operate, as many LEAs operate food services, adult education, special education, or other programs that require a contribution of cash from the unrestricted General Fund
- Deficit spending—either in the LEA's recent history, current budget, and/or multiyear projections, as this directly depletes reserves and requires specific action to mitigate
- Relatively small LEA size, as these LEAs do not have the economies of scale or budget capacity to absorb unexpected financial events
- Uncapped health and welfare benefits, as the increased costs are less predicable
- Unstable labor relations, which can directly impact personnel costs—the most significant portion of an LEA's expenditure budget
- Use of one-time sources to pay ongoing costs, which requires specific action to find another source next year or to cut costs
- Lack of sources to pay for technology replacement, preventative and deferred facilities maintenance, or other costs of maintaining and replacing assets
- Debt service, which may not have a dedicated funding source or for which the funding source can be unstable (developer fees dedicated to paying off certificates of participation, for example)
- Exposure to significant one-time expenditures, such as inadequate resources for a facilities project or a large uninsured claim against the LEA
- Other circumstances unique to the LEA, such as exposure to significant natural disasters, unfunded retiree benefit liabilities, etc.

What is an Adequate Reserve Level?

There are several sources for an LEA governance team to consider when setting its level of reserves. We have already discussed the minimum Reserve for Economic Uncertainties (REU) as established by the state's Criteria and Standards, which is a bare minimum. There is also some additional guidance available from other sources:

- The national Government Finance Officers Association (GFOA) published a "Best Practice" report in September 2015, which includes the following:
    - A formal policy should be established by the LEA that specifies the level of reserves, how reserves will be increased or decreased during a set time frame, and then how reserves will be replenished if used below the level prescribed

  - At a minimum, regardless of an LEA's size, no less than two months of General Fund expenditures be set aside for reserves, which is 17%
- The California Department of Education (CDE) issued correspondence in January 2011 regarding the reporting of the fund balance for LEAs, which includes the following:
  - An LEA's fund balance policy should not be limited to the REU recommended by the Criteria and Standards
  - The fund balance policy should specify how the LEA will replenish its reserves—by either dedicating new revenues or reducing expenditures—in the event that some of its reserves are spent
  - Attachment D includes sample language for a minimum fund balance policy, which for local school districts states, "The district is committed to maintaining a prudent level of financial resources to protect against the need to reduce service levels because of temporary revenue shortfalls or unpredicted expenditures. The district's Minimum Fund Balance Policy requires a REU, consisting of unassigned amounts, equal to no less than two months of general fund operating expenditures, or 17 percent of General Fund expenditures and other financing uses."

Most of the local school agencies in California are of the size where the minimum REU under the state's Criteria and Standards is 3% of total General Fund expenditures and other financing uses, which translates to just more than one week of payroll and other expenses. LEAs should consider the guidance provided by the GFOA and the CDE, which is a minimum reserve level of 17%. In addition, we listed in the previous section the many risk factors that may apply to your LEA, each of which should be considered as a potential reason for increasing your reserve level.

Potential Cap on Reserves

The State Budget Act of 2014 (Senate Bill 858, Chapter 32/2014) included language that could impose a cap on local school district reserves of twice the minimum REU if a certain set of circumstances occur. Given that the minimum REU for most school districts is 3%, then this proposal would set 6% as a statutory maximum, which is only about three weeks' expenditures. This new law was politically motivated and is poor public policy. We continue to opine that this sets local school districts up for financial failure, as three weeks is not enough time to even start the process of correcting an unforeseen fiscal issue. We also continue to recommend that school districts ignore this potential cap and maintain their authority to set minimum reserves at a level that is needed for their own local circumstances.

Meanwhile, the fight to reduce or ameliorate this cap continues. Senate Bill 799 (Calderon, D-Montebello), sponsored by the California School Boards Association, would, among other things, set a hard cap of 17% for reserves. Basic aid school districts and districts with fewer than 2,501 in average daily attendance would be exempt from this reserve cap. We believe that replacing the current cap in law with this language would be better public policy. We also believe that this bill should not be a starting point for negotiating something less—public education would be best served by eliminating the cap altogether. Nationwide industry research and many decades of experience have proven this.

Conclusion

In setting a reserve level, the goal for an LEA is to have the resources necessary to meet both planned and unplanned financial challenges, while spending as much of the current year's resources as possible on the current year's programs and students. This is a balancing act that will be unique to each LEA, and we recommend that each LEA examine the guidance provided above and the risk factors that apply in order to determine how much is needed for local reserves.

—Sheila G. Vickers

posted 05/06/2016