FUND BALANCE WHITE PAPER

Illinois Association of School Business Officials (Illinois ASBO)

This paper outlines the nuances and complexities in the definition of school district fund balances from an audit perspective and from a policy/practice perspective by individual school districts, the press and public policy makers.

The following points require consideration in any comparison of fund balance across school districts and require an understanding by the reader in how accounting methods of cash, accrual and modified accrual affect fund balance or how tax receipts by any county on any given date affect fund balance.

- A unit of local government, based on its own policies, reserves a fund balance through intentional actions to serve its local interests. No local government maintains a fund balance to loan, underwrite, or otherwise subsidize another governmental body.

- Building and maintaining an adequate Fund Balance is a prudent fiscal policy with increasingly critical benefits for any governmental body. These include the ability of the body to:

    - Stabilize year over year educational performance
    - Minimize educational service disruptions
    - Maintain cash on hand to counter unanticipated cash flow shortfalls
    - Address emergency situations, particularly those that threaten health and life safety
    - Fund educational growth and change opportunities
    - Enhance credit rating strength and increase access to debt markets at lower interest costs
    - Increase long-term fiscal performance
    - Allow the government to manage unforeseen expenditure demands and revenue shortfalls

- The Government Finance Officers Association recommends a <u>minimum</u> fund balance of two months of either revenues or expenditures. It should be stressed that this is a minimum recommendation only and other local factors must be considered, including the timing and dependability of significant revenue sources (i.e. state, federal and county tax distribution and program funding).

- ISBE gives only those districts with three months (25%) fund balance to expenditures its highest Financial Profile sub score. This is a <u>minimum</u> expectation to be qualified to receive a high score and does not take into consideration particular elements of local funding or educational/operational planning.

- ISBE requires any district budgeting a deficit to have three times the deficit in fund balance to avoid filing a deficit reduction plan.

- Fund Balances are an overly simplistic and inconsistent lens through which to measure a district's financial strength. To be useful, a measure should mean the same thing from district to district and year to year. Fund balances are neither, as they are determined by a variety of accounting practices. Cash flow across districts varies due to the timing of liabilities, such as how summer payroll practices are implemented and due to how tax receipts are received and budgeted. The accounting of "early taxes" across school districts varies depending on the accounting practice used and the county resided in, and can have a very big impact on how fund balances are determined at the end of any given fiscal year. Cash on hand does not equate to fund balance in a full accrual accounting methodology.

- Fund Balances are affected by when a county distributes taxes. Counties do not distribute taxes at the same times; therefore fund balances are not comparable from district to district. Should a county be late in distributing taxes, a district's fund balance can be much less than expected, should a county distribute taxes early a district's fund balance can appear inflated and distort cash flow reality.

- Some counties do not distribute taxes at the same time from year to year; therefore fund balance comparisons year to year are inconsistent. Not only can fund balance and cash flow be affected by inconsistent tax distribution, a district may find themselves in a position of having to issue tax anticipation warrants to meet obligations should their fund balances decline based on a requirement to use fund balance in lieu of state contributions.

- Other timing factors, such as receipt of State payments or disbursement schedules, make fund balance comparisons inconsistent from district to district and year to year. Late reimbursements for districts on an accrual or modified accrual basis are impacted differently than districts that use a cash based accounting method. Fund balance calculations can be misleading in such situations.

- Fund balances can be temporarily affected by a district's need to meet its obligations, such as by using interfund loans, abolishment of the Working Cash Fund, or by issuing Tax Anticipation Warrants or Working Cash Bonds. Such legitimate actions cause further inconsistency.

- Fund balances are affected by the method of accounting (i.e. cash, accrual, or modified accrual) for funds on a given date each year.

- Through Local Board of Education control, an appropriate level of Fund Balance is determined based on multi-year analysis of the district's finances and with an expectation of consistent funding by the State. A change as described circumvents a Board of Education's planning process and at the very least deserves both full public hearing and sufficient forewarning to allow a local Board time to review and adjust its determination.

- Using Fund Balance to justify lower State payments to school districts decreases anticipated Fund Balance. Lower Fund Balance decreases interest income earnings and may cost the district more by having to break investments before maturity to meet obligations. Lesser Fund Balance may increase the need to issue more debt, thus increasing the amount of interest paid on that debt. This downward spiral has no impact on the State, but certainly impacts taxpayers and the local district.

Further discussion follows.

Fund Balance Recommendations:

The Government Finance Officers Association of the United States and Canada (GFOA) website clearly recommends the following:

(http://www.gfoa.org/downloads/AppropriateLevelUnrestrictedFundBalanceGeneralFund_BestPractice.pdf)

> "(I)t 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."
>
> "The adequacy of unrestricted 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 unrestricted fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures. 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.' (emphasis added)
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> "Furthermore, a government's particular situation often may require a level of unrestricted fund balance in the general fund significantly in excess of this recommended minimum level." (footnotes deleted)

ISBE Financial Profile Score:

The Illinois State Board of Education, pursuant to the School Code, created a Financial Profile Score for every district. The score takes Fund Balances at face value and gives the highest financial profile sub score only to those districts that have a fund balance equal to or greater than 3 months of expenditures.

An examination of Fund Balances across districts in varied counties and under various accounting methodologies demonstrates that fund balance is an inconsistent and therefore ineffective comparative tool. When considering unintended consequences of well intended comparisons, it is demonstrably wrong for the State to oversimplify Fund Balance as a measure of a district's financial strength. The State is already borrowing from local governments at zero interest by not meeting its obligations; therefore the situation is exacerbated by deflecting the spotlight onto fund balance comparisons.

Several examples of demonstrating the ineffectiveness of using Fund Balance to compare districts follow:

Early Tax Distribution:

In many counties, BUT not all counties, the first tax collection for the fiscal year is distributed before the end of the prior fiscal year. Depending on the timing of that tax distribution, inflated balances occur in counties that distribute in June (e.g. the collar counties), and deflated balances in those who distribute later, including Cook County. The more a district is dependent on local resources, the greater the disparity.

Some counties are inconsistent from year to year in when taxes are distributed, creating an additional "apples to oranges" comparison.

Timing Issues:

Any given year's fund balances may be affected by the timing of revenues and expenditures for many reasons, including capital project funding, delayed State Payments, or repayment of interfund loans.

A district could affect its fund balances by delaying or accelerating its obligations (e.g. cutting all summer checks before June 30).

A district could have created a debt-inflated fund balance by issuing Tax Anticipation Warrants and/or Working Cash Bonds prior to June 30 to provide sufficient cash balance to meet its obligations.

Different auditing firms may interpret auditing standards differently, resulting in inconsistent reporting.

Fund Balance and Other Financial Considerations:

The level of fund balance is established by the local school board and affect both the district's investment interest income and its ability to weather uncertain financial conditions. Both have been extremely important variables in recent years as state and local resources have been undeterminable and interest rates are at all time lows.

A district's credit rating as determined by Moody's or Standard & Poors is impacted by fund balance and can potentially increase both the need for short-term borrowing and the interest paid on that debt. Under the most adverse circumstances, fund balance implications can also impact whether a district can issue debt or not.

At a minimum, a multi-year analysis of fund balances has more validity than a single year analysis and a different reporting date focusing on cash flow shortfalls (i.e. April 30 or May 15) for non-Cook County Districts should be studied.

End Notes:

[1]We made an assumption to review fund balance rather than cash on hand because that is what is reported in the Annual Financial Report.

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