The Importance of a Significant Fund Balance

Periodically clients ask us about the importance of having a significant fund balance. The discussion usually involves the main operating fund(s) and the focus is on unreserved fund equity. Depending upon the accounting method used and the type of governmental entity, a further focus may be on that portion of undesignated fund equity that is actually supported by cash and investments.

This is an on-going and important topic not only because of how it affects budgeting but also due to the significance in bond ratings.

When the economy is very strong, less emphasis is placed on fund balance from a budgeting view as surpluses are usual. With several years of a down economy affecting both local governments in their revenues and the states in their revenues available to support local governments, surpluses have disappeared and fund balances are being drawn down. Annual budgeting of drawdowns continues. From a governance viewpoint, this may be merely a temporary, if necessary, solution. However, rainy day funds can only support so many rainy days.

From a rating viewpoint, occasional draws for capital projects or to reduce an over funded fund balance are acceptable. Continual draws are not. While fund balance levels and policies are only one of many rating considerations, they are significant. And a reduction in fund balance has been cited as a major factor in recent downgrades.

What is the correct target? Unfortunately most printed material from rating agencies merely states that it varies upon need. Factors such as revenue source (property tax, sales tax, state aid) are important in their reliability and timing. However, while the rating services won't give a hard and fast number, they do publish statistics. Nationally, Standard & Poor's reports a mean of some 25% of unreserved fund balance as related to expenditures for "A" rated credits and above. In Illinois, Moody's reports that most "A" and above credits have a median of 30%. Both reports place BBB/Baa credits around 20%.

Our general advice is that, when affordable, aim for a minimum of 25%, equal to three months working cash. To this general target, various factors must be applied to achieve a workable target. For example, a village that is nearly all sales tax supported requires a greater fund balance than a school district with significant property taxes and state aid.

* * * * *

One Benefit of Rising Rates – Escrow Restructuring

In periods of low interest rates, refundings are popular. However, the bond proceeds are often invested in escrows for a number of years until the call date and such investments are frequently earning less than federally allowable rates. As interest rates rise, it is possible to recapture some of these "lost" investment earnings. Not easy, but possible. We are involved in several and would be pleased to discuss this with interested parties.