OFFICE OF THE NEW YORK STATE COMPTROLLER

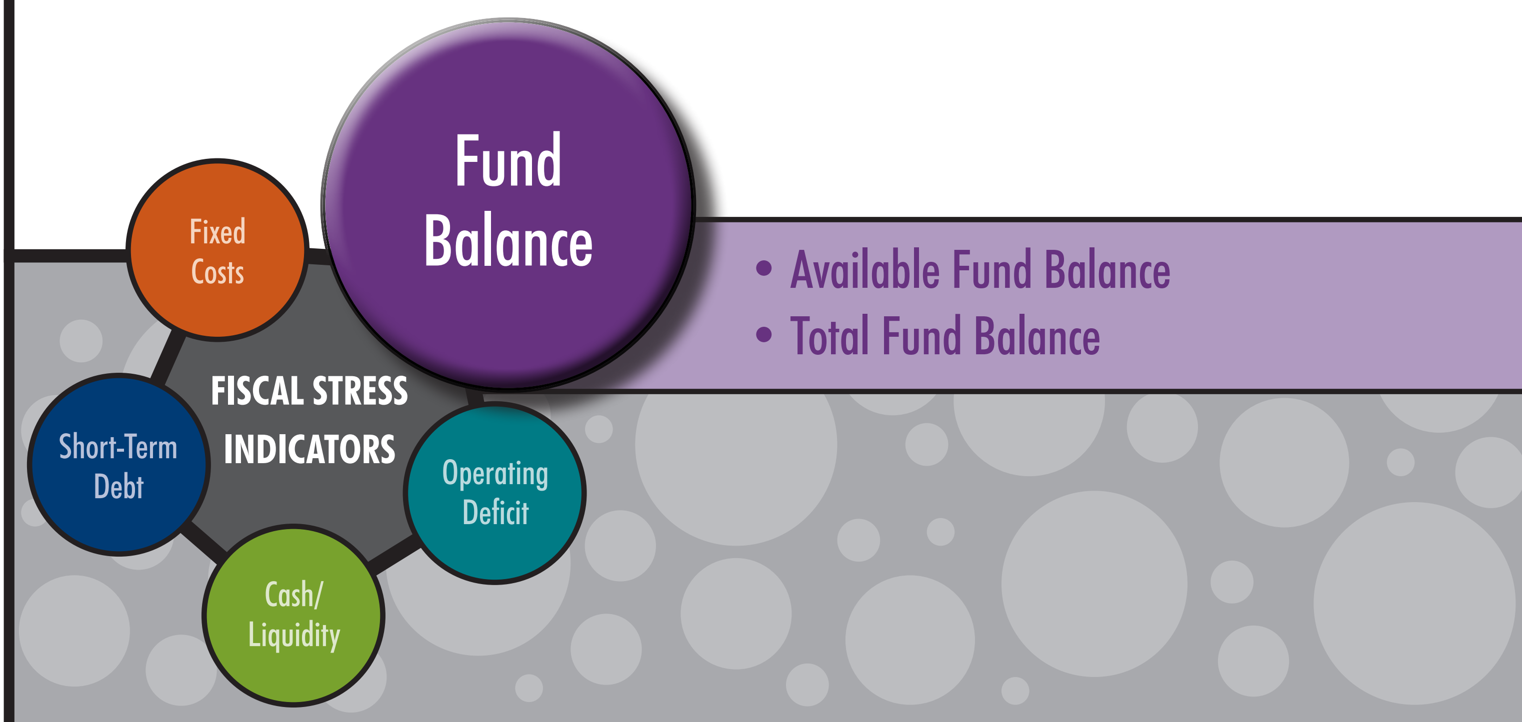
Thomas P. DiNapoli • State Comptroller

Fiscal Stress Close-Up

Fund Balance

Fund balances, often called "rainy day funds" or "budgetary reserves," are a key part of local government finances.[1] A local government can set aside funds for a variety of needs. There are planned uses, such as the periodic repair and replacement of infrastructure like buildings or roads, and unplanned circumstances such as enduring the effects of economic fluctuation. Fund balance also acts as a cushion against normal variations in cash flow. If a local government lacks sufficient fund balance, it may find itself resorting to short-term borrowing, late payments, deferring necessary spending or other undesirable actions.

Technically, fund balance is the cumulative differences between revenues and expenditures for a particular account or fund. When a local government ends a fiscal year with more money than budgeted (more revenues than expenditures), its fund balance increases. Conversely, when the fiscal year ends with less money than budgeted (more expenditures than revenues), fund balance decreases. Since fund balance is the accumulated result of operations over time, it is a strong measure of a local government's long-term financial condition. Low fund balance can be the result of fiscal stress and — since having a low fund balance makes it more difficult for a local government to deal with future problems — it can even potentially cause fiscal stress.



The close relationship between low fund balance and fiscal stress makes fund balance an important measure in the Office of the State Comptroller's (OSC's) Fiscal Stress Monitoring System (FSMS).[2]

The FSMS includes two indicators relating to fund balance:

- Available fund balance (all fund balance that is not in a reserve, or otherwise restricted, committed or appropriated) as a percentage of expenditures,[3] and;
- Total fund balance (all fund balance including that which is reserved for specific future purposes) as a percentage of expenditures.[4]

For counties, cities, towns and villages, the threshold for low available fund balance is defined in the FSMS as less than 10 percent of expenditures, and low total fund balance is defined as less than 20 percent of expenditures. For school districts, the threshold for low available fund balance is defined as less than 3 percent of expenditures, and a low total fund balance is defined as less than 10 percent of expenditures. The school district thresholds are lower because the Real Property Tax Law limits the amount of unexpended "surplus funds" that can be legally retained by district officials to no more than 4 percent of the next fiscal year's budgeted appropriations.[5]

There is no set amount of fund balance that is universally considered to be sufficient for local governments to maintain. Circumstance may dictate the maintenance of higher fund balances for some local governments, such as those having a locale with a particularly volatile revenue base or that has unusual exposure to economic fluctuations.

Local governments sometime report negative available fund balances. This "fund balance deficit" usually does not mean that the local government truly has an operating deficit, but does mean that the government is likely experiencing serious cash flow problems, and must act soon to improve its fiscal position.

Fiscal Stress Monitoring System (FSMS): What Does It Measure?

"Fiscal stress" refers to the difficulties in generating enough revenues to meet expenditures in the long term. OSC's FSMS measures a local government's ability to balance its budget, pay its bills, keep its debt in check and have some funds left over at the end of the fiscal year. It does not measure the quality or quantity of services provided, their cost-efficiency or how hard local officials have worked to achieve this balance given the local economic climate.

FSMS has five categories of indicators: fund balance, liquidity, short-term debt, operating deficits, and fixed costs. These indicators contribute to a local government's final classification of Significant Stress, Moderate Stress, Susceptible to Stress or No Designation. More information on the scoring system for each of the indicators can be found in OSC's "Fiscal Stress Monitoring System" report.

This report, which focuses on the fund balance indicators, is one of a series examining each of the five FSMS indicator categories. These reports will discuss the circumstances under which a high score in any category is cause for concern.

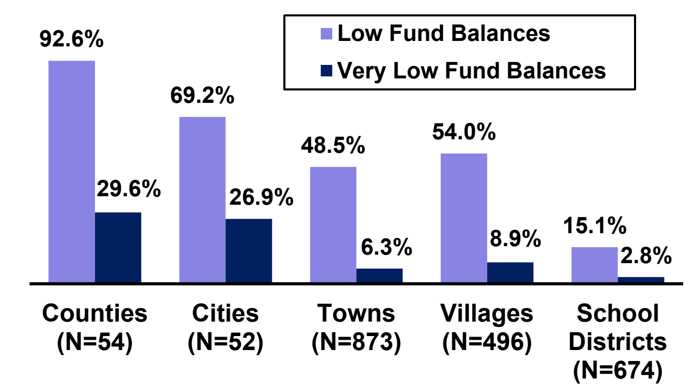
How common is low fund balance?

Almost 93 percent of counties have fund balances that are less than the FSMS threshold, as do 69 percent of cities, 54 percent of villages, and over 48 percent of towns. School districts are much less likely to have low fund balance (only 15 percent), partially because the school district threshold for low fund balance (3 percent available fund balance and 10 percent for total fund balance) is much lower than the threshold for other local governments (10 percent and 20 percent, respectively).

Over one-quarter of counties and cities have very low fund balance, usually meaning that they have little or nothing in either available or total fund balance. Fewer than 10 percent of towns and villages have very low fund balance, while only 2.8 percent of school districts have very low fund balance. Again, the threshold for very low fund balance is lower for school districts (1 percent available and 0 percent total), than for other local governments (3.33 percent available and 10 percent total).

Local governments that were found to be in one of the FSMS stress classifications were much more likely than those with no stress designation to have low levels of fund balance. This is most noticeable in the case of towns, where the 17 towns in a stress category have a median available fund balance of only 0.2 percent of expenditures and a median total fund balance of 2.1 percent, while the 856 towns with no designation have a median available fund balance of 32.1 percent of expenditures and a median total fund balance of 52.3 percent.

Percentage of Local Governments With Low Fund Balances, By Class, Fiscal Year Ending 2013



Source: Office of the State Comptroller (OSC).

Fund Balances by Class and Fiscal Stress Status, Fiscal Year Ending 2013

Class	Number of Local Governments Scored	Median Fund Balance as a Percentage of Expenditures	
		Available	Total
Counties	**54**	**11.8%**	**18.2%**
In Fiscal Stress	10	1.7%	5.5%
No Designation	44	12.6%	20.4%
Cities	**52**	**10.0%**	**20.3%**
In Fiscal Stress	7	0.7%	2.0%
No Designation	45	14.0%	22.2%
Towns	**873**	**31.3%**	**51.8%**
In Fiscal Stress	17	0.2%	2.1%
No Designation	856	32.1%	52.3%
Villages	**496**	**26.6%**	**43.6%**
In Fiscal Stress	16	2.0%	2.6%
No Designation	480	28.7%	45.1%
School Districts	**674**	**4.3%**	**23.6%**
In Fiscal Stress	87	2.1%	9.9%
No Designation	587	4.4%	25.1%

Source: OSC. "In Fiscal Stress" includes all three levels of fiscal stress: significant, moderate and susceptible.

The spread between the fund balance levels of school districts that were in a fiscal stress category and those with no designation was smaller than those for other local governments. The lower fund balance thresholds for school districts in the FSMS contributes to this closer distribution.

Why is low fund balance considered a symptom of fiscal stress?

Low fund balance may be a symptom of ongoing fiscal stress for a local government, and can also lead to future fiscal stress. Since fund balance is the cumulative result of financial performance and decisions over the history of the local government, a low level of fund balance may reflect an ongoing financial challenge. The goal in sound budgeting practice is to come as close as possible to a balanced operating budget (meaning actual expenditures equal actual revenues), or even to err on the side of a small surplus in order to preserve a sufficient fund balance. The reduction in available fund balance to a low level over a number of years reflects a problem with maintaining sufficient operating revenues to cover operating expenditures, also called a structural imbalance. In particular, the consistent use of fund balance to close sizable operating deficits is a troubling practice.[6]

A local government that has insufficient fund balance will have a much more difficult time withstanding future financial emergencies. If it has not established reserves, it may not be able to cover needed capital purchases without resorting to borrowing. The government will face cash flow and liquidity problems, and may have to rely on short-term borrowing to alleviate these, with associated interest costs.

The presence of sufficient fund balance reflects good financial performance in prior years, and constitutes some protection against adverse events that may occur in the future. Low fund balance, on the other hand, may be a sign of poor financial practices.

Audit Findings: School Districts

A financial condition audit released by OSC in 2014 found that a school district had been using fund balance to finance its budget for several years, overestimating expenditures and underestimating revenues and then using the unspent money to fund the ensuing year's budget. This caused a $2.5 million fund balance surplus to be reduced to a $1.4 million fund balance deficit over four years. The district reduced appropriations by $2 million, but still faced possibly significant structural budget gaps.

A 2013 OSC financial condition audit of another school district found that it had depended on using fund balance to stabilize it's budgets, and had ended the 2011-12 fiscal year with a $1.2 million fund balance deficit. While the district was able to end the 2012-13 fiscal year with a $1.1 million fund balance surplus, this amount was still only 0.8 percent of the next year's planned spending. This shortage of fund balance created cash flow problems and necessitated short-term borrowing that added $150,000 annually in interest costs.

Is a low fund balance ever justifiable?

Generally, local governments should try to keep a healthy fund balance for all of the reasons given above. However, the exact level of fund balance desirable may differ from place to place. Even for the same local government, fund balance may be higher in good times and lower in economic bad times without necessarily reflecting on its long-term fiscal condition. The situation is also different for school districts in New York State, since they are limited to retaining 4 percent of the next year's appropriations in fund balance, after some adjustments. This means that school districts cannot build up as much available fund balance as other local governments.

Excessive fund balance, however, can also be a problem. A high fund balance can indicate that the level of taxation is too high and should probably be reduced. A very large excess fund balance may also be an invitation to, and could obscure, financial mismanagement or even misappropriation and fraud.

Local governments may use some fund balance (in the form of planned operating deficits) in order to keep tax rates low and/or maintain services in the face of short-term economic fluctuations, or just to reduce an unnecessarily large fund balance. Even though this results in lower fund balances, spending down of fund balance can be an acceptable practice as long as it is done in conjunction with long-term financial planning and does not reduce fund balance below the critical point.

Audit Findings: Municipalities

A 2013 OSC audit of a city found that, due to lack of financial control, its fund balance in the general fund had declined by $12.8 million over four years, resulting in a fund balance deficit of $11.4 million. Meanwhile its debt service costs increased by 45 percent. This has caused fiscal stress that could affect the level of services that the City can provide.

A 2013 OSC financial condition audit of a county found that it had been consistently appropriating fund balance over five years. In that time, its fund balance had declined from a surplus of $11 million to a deficit of $1.7 million. This had deprived the County of its financial cushion for unforeseen events, and had led to cash-flow problems and the issuance of short-term debt that will cost the County $261,000 in interest payments.

A 2014 OSC financial condition audit of a village found that it had not balanced budgets in either the general fund or the sewer fund. This lead to a decline in fund balance in the general fund over six years, from a surplus of $219,000 to a deficit of $19,000, and a decline in fund balance in the sewer fund from $94,000 to $18,000.

Notes

[1] Counties, cities, towns, villages and school districts are all referred to as "local governments" in this report. Excludes New York City.

[2] The FSMS financial indicators are calculated using data that is filed by local governments in annual update documents (AUDs) and by school districts in annual financial reports (ST-3s). All data in this report relates to each local government's fiscal year ending in 2013. FSMS points are assigned based on the resulting percentage for each indicator; high scores signify fiscal stress. The fund balance indicators carry a weight of 50 percent in the calculation of a local government's fiscal stress score.
For more detail on the FSMS indicators, see Office of the State Comptroller, *Fiscal Stress Monitoring System*, **http://www.osc.state.ny.us/localgov/pubs/fiscalmonitoring/pdf/fiscalstressmonitoring.pdf.**

[3] For counties, cities, towns and villages, "available fund balance" is the assigned fund balance, except for assigned appropriated fund balance, plus unassigned fund balance. For school districts, "available fund balance" is unassigned fund balance, except for any reserve for tax reduction. An additional FSMS point is awarded if the available fund balance in the general fund divided by general fund expenditures is greater than the available fund balance in the combined funds divided by combined fund expenditures.
For more detail on the FSMS indicators, see Office of the State Comptroller, *Fiscal Stress Monitoring System,* **http://www.osc.state.ny.us/localgov/pubs/fiscalmonitoring/pdf/fiscalstressmonitoring.pdf.**

[4] An FSMS point is also awarded if the total fund balance in the general fund divided by general fund expenditures is greater than the total fund balance in the combined funds divided by combined fund expenditures. See Office of the State Comptroller, *Fiscal Stress Monitoring System.*

[5] Real Property Tax Law, Section 1318.

[6] The audit findings discussed in this report are from the following OSC audits: *Lackawanna City School District* (2014M-119), *Utica City School District* (2013M-341), *City of Poughkeepsie* (2013M-30), *St. Lawrence County* (2013M-46), and *Village of Port Dickinson* (2014M-154). OSC audits of local governments are available online at: **http://www.osc.state.ny.us/localgov/audits/index.htm.**

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