

Appropriate Level of Operating Reserve and Accumulated Surplus

The original recommended practice was developed by the Government Finance Officers Association (GFOA). Some aspects of the practice have been revised by the Financial Management Capacity Building Committee (FMCBC) for use by Nova Scotia municipal governments. The original GFOA recommended practice is *Appropriate Level of Unreserved Fund Balance in the General Fund*, approved by GFOA Executive Board in 2002.

Recommendation

GFOA recommends that municipal governments create a formal policy to establish the level of unreserved fund balance that should be maintained in the general fund. GFOA also encourages the adoption of similar policies for other types of governmental funds. The “unreserved fund balance” terminology used in GFOA’s recommended practice is replaced by “accumulated surplus” in the FMCBC version because the latter term is more commonly used by municipalities in Nova Scotia.

Purpose

The purpose of maintaining adequate levels of accumulated surplus and operating reserves is to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stable tax rates. Accumulated surplus and operating reserves are a significant consideration in long-term financial planning and management.

Background

The operating fund accumulated surplus and the operating reserve refer to a fund balance that the council has available for contingencies and/or other purposes, defined by the council.

The operating fund accumulated surplus is intended to serve as a measure of the financial resources that have accumulated over a number of years. This surplus might be allocated or unallocated. Allocated accumulated surplus refers to a fund balance that the council has assigned a specific purpose, such as contingencies or appropriations in future years.¹

The fund balance, which includes operating fund accumulated surplus and the operating reserve, can be measured as a percentage of the regular general fund operating revenues, or as a certain number of months’ operating expenditures. The choice of revenues or expenditures as a basis of comparison may be dictated by what is more predictable in a

municipality's particular circumstances. Unusual items that would distort trends (e.g., one-time revenues and expenditures) should be excluded, whereas recurring transfers should be included. Once the decision has been made to compare the operating fund accumulated surplus to either revenues or expenditures, that decision should be followed consistently from period to period.

Unlike a capital reserve, which is required under legislation, the operating fund accumulated surplus and the operating reserve can be established at the discretion of council and are more flexible than a capital reserve. Municipalities are legally required to maintain a capital reserve fund according to the *Municipal Government Act*. Utilization of the capital reserve is also limited to certain areas (see *Appendix I* and *II*). Unallocated operating fund accumulated surplus can be utilized for different kinds of contingencies that may arise (see *Appendix I, Section 4*).

An operating fund accumulated surplus and an operating reserve might generate debate between those who prefer that the municipality use the reserve for temporary tax cuts or increased provision of services and those who prefer a long-term stable tax rate and consistent level of service provision (see Appendix A, section 5). Stability in tax rate and service delivery is important for long term financial planning. Fluctuating tax rates create uncertainty for both citizens and businesses.

There are optimal levels for the operating fund accumulated surplus and the operating reserve. Each municipality has to determine what those levels are, but there has to be a rationale behind the desired levels. Higher levels of operating fund accumulated surplus and operating reserve do not automatically mean better financial management.

Considerations in Policy Development

The following should be considered when municipalities establish a formal policy on the levels of operating fund accumulated surplus and operating reserve (for further information, see *Appendix I*):

- 1) Assessing *adequate levels*
- 2) Plans for *inadequate levels*
- 3) Policies on *utilization*
- 4) *Stakeholders' different interests*
- 5) *Availability* of the formal policy documents
- 6) *Legal and regulatory constraints* (See *Appendix II*)

Appendices

Appendix I: Considerations in Policy Development

Appendix II: Legal and Regulatory Requirements

Appendix I: Considerations in Policy Development

1) Assessing Adequate Levels

The adequate level of operating fund accumulated surplus and operating reserve should be assessed based upon a municipality's own specific circumstances. For instance, the GFOA recommends that the level of operating fund accumulated surplus be kept between 5 and 15 per cent of regular general fund operating revenues or no less than one to two months of regular general fund operating expenditures. The GFOA emphasizes that a municipality's particular situation may require levels of operating fund accumulated surplus significantly in excess of these recommended minimum levels.

As a minimum, the following factors should be considered by municipalities that establish a formal policy on the appropriate levels of operating fund accumulated surplus and operating reserves.

- a) *The availability of other reserves as well as the potential drain upon general fund resources from other reserves.* If a municipality holds a high level of operating reserve, the incentives for also maintaining a high level of operating fund accumulated surplus for contingencies may be low.
- b) *The predictability of its revenues and the volatility of its expenditures.* For example, higher levels of operating fund accumulated surplus or operating reserve may be needed if significant revenue sources are subject to unpredictable fluctuations or if operating expenditures are highly volatile. The predictability of revenues and expenditures can be expressed through forecasting errors or trend analysis. (For a deeper discussion on revenue and expenditure forecasting, please see FMCBC's recommended practice *Financial Forecasting in the Budget Preparation Process*.) Once this analysis is completed, it is up to policy makers to decide to what degree the operating fund accumulated surplus and the operating reserve should protect against this uncertainty.² In practice, levels of accumulated surplus and operating reserves typically are less for larger municipalities than for smaller municipalities because of the magnitude of the amounts involved and because the diversification of the tax base often results in lower degrees of volatility.
- c) *Liquidity.* There is often a disparity when between financial resources required and financial resources available, which can result in timing differences. An accumulated surplus and operating reserve can be used to offset these fluctuations.

If a municipality experiences strong incentives to maintain a high level of accumulated surplus, partial allocation makes the purpose clearer to stakeholders.

2) Plans for Inadequate Levels

Municipalities should develop guidelines and time frames on how to increase and decrease the level of operating fund allocated surplus and operating reserve if the actual level differs from the target level. There are at least two main ways a formal policy can allocate financial resources to the operating fund accumulated surplus³ and the operating reserve:

- Requirement that a portion of any operating surplus be deposited.
- Dedication of revenues from a specific source, such as the real property tax.

3) Policies on Utilization

Municipalities may develop specific policies on the use of the operating fund accumulated surplus and the operating reserve to ensure that the funds are not depleted before an emergency arises. Policies can be tied to an adverse change in economic indicators such as declining tax base and an economic downturn. Other methods for utilization are also available:⁴

- Appropriation of the resources to correct revenue shortfalls or budget deficits.
- Council resolutions requiring the transfer of resources to operating accounts.
- Formula disbursement of resources to various accounts.
- Automatic appropriation of transfer in case of budget shortfalls.

It is also important to include in the policy document information on who should make the decision on utilization.⁵

4) Stakeholder's Different Interests

Those interested in a municipality's financial condition are concerned with the sizes of the operating fund accumulated surplus⁶, the operating reserve, and the trend in their sizes. Opposing pressures for increased services and tax reductions are presented from various groups, which may view high levels of operating fund accumulated surplus and operating reserve as "excessive." In order to improve the communication with taxpayers, it is important to clearly state the rationale for the policy on operating fund accumulated surplus and operating reserves⁷ and make it available for citizens. Allocating portions of the operating fund accumulated surplus for contingencies (and other purposes) is one way of clarifying the purpose of the reserve.

5) Availability of the Formal Policy Documents

The policies on appropriate level of operating fund accumulated surplus and operating reserve should be publicly available and summarized in materials used in budget preparation and identified in other municipal documents, including financial planning and management reports.⁸

Appendix II: Legal and Regulatory Requirements

Any policy addressing desirable levels of operating fund allocated surplus and operating reserve should be in conformity with all applicable legal and regulatory constraints. The *Municipal Government Act* (MGA) requires that municipalities maintain a capital reserve (section 99). There are no legislative requirements for a municipality to maintain operating fund allocated surplus or an operating reserve. When an operating reserve fund is established the investment in the fund must follow section 100 of the MGA.⁹

Capital reserve fund

- 99** (1) A municipality shall maintain a capital reserve fund.
- (2) The capital reserve section of a special reserve fund in existence, on the coming into force of this Act, is a capital reserve fund.
- (3) The capital reserve fund includes
- (a) funds received from the sale of property;
 - (b) the proceeds of insurance resulting from loss or damage of property that is not used for replacement, repair or reconstruction of the property;
 - (c) any surplus remaining from the sale of debentures that is not used for the purpose for which the debentures were issued;
 - (d) the surplus remaining in a sinking fund when the debentures for which it was established are repaid;
 - (e) any capital grant not expended in the year in which it was paid;
 - (f) proceeds received from the winding up of a municipal enterprise as defined in the *Municipal Finance Corporation Act*;
 - (g) the current fiscal year's accrual for landfill closure and post closure costs; and
 - (h) amounts transferred to the fund by the council.
- (4) A withdrawal from the capital reserve fund shall be authorized by a council, by resolution, and may only be used for
- (a) capital expenditures for which the municipality may borrow;
 - (b) repayment of the principal portion of capital debt; and
 - (c) landfill closure and post closure costs.

(5) The council may borrow from a capital reserve fund, by resolution, if the resolution prescribes the terms of repayment, including interest, at a rate not less than the interest rate that the municipality would pay to borrow the funds for a similar term from another source.

(6) A municipality may maintain other reserve funds for such purposes as the council may determine.

Investment of funds

100 (1) Funds in a sinking fund, capital reserve fund, utility depreciation fund or other fund of a municipality shall be

(a) deposited in an interest bearing account at a bank doing business in the Province;

(b) invested pursuant to an investment policy adopted by the council and approved by the Minister; or

(c) invested in investments in which a trustee is permitted to invest pursuant to the *Trustee Act*.

(2) Income arising from the investment of a fund is part of that fund unless the council otherwise provides.

(3) The council may pledge any investments to the credit of the capital reserve fund as collateral security for a borrowing for a capital purpose.ⁱ

ⁱ These excerpts from the MGA can also be found at:
<http://www.gov.ns.ca/snsmr/muns/manuals/pdf/mga/mga04.pdf>.

References

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Notes

¹ Kavanagh, Shayne, and Anderson Williams, Wright. “Fund Balance Policies,” Chapter 5 in *Financial Policies: Design and Implementation*. GFOA Budgeting Series, Volume 7. Chicago: Government Finance Officers Association, 2004.

² Compare to Vasche, Jon D. and Brad Williams. “Optimal Governmental Budgeting Contingency Reserve Funds,” *Public Budgeting and Finance* 7, no 1 (1987): 66-82.

³ Allan, Ian J. *Unreserved Fund Balance and Local Government Finance*. Research Bulletin—Research & Analysis on Current Issues, The Government Finance Officers Association. September 1990.

⁴ Allan, 1990.

⁵ Allan, 1990.

⁶ Compare to Allan, 1990.

⁷ Compare to Tyer, Charlie B. “Local Government Reserve Funds: Policy Alternatives and Political Strategies,” *Public Budgeting and Finance* 13, no 1 (1993): 75-84.

⁸ National Advisory Council on State and Local Budgeting. “Recommended Practice 4.1” in *Recommended Budget Practices: A Framework For Improved State and Local Government Budgeting*, 1998.

⁹ Nova Scotia. *Municipal Government Act*. R.S.N.S. 1998, c. 18. Part 4 – Finance Section 99, “Capital reserve fund.” and Section 100 “Investment of funds“.