

FINANCIAL RESERVES

PURPOSE

The creation and maintenance of financial reserves is a critical component of sound and prudent financial management. Reserves serve multiple functions:

- As a source of funding for selected, planned future capital expenditures to partially or entirely eliminate the need to issue debt thus avoiding interest and borrowing costs.
- As a source of funding for significant and extraordinary, unforeseen expenditures.
- As a source of funding to substitute for lost revenue during a time of economic downturn thus precluding, or minimizing, cuts to municipal and educational services.
- As evidence to credit rating agencies of a municipality's strong financial management in that the maintenance of significant reserves indicate a commitment to comprehensive long-term planning, a positive factor in credit rating determinations.

APPLICABILITY

This policy pertains to short and long-range budget decision making and applies to the Finance Committee, Capital Improvement Committee, Select Board and Town Administrator in that capacity and is intended to be advisory to Town Meeting.

DEFINITIONS

Enterprise Fund – pursuant to Massachusetts General Law (M.G.L. c. 44, § 53F½), municipalities can establish enterprise funds to account for services that are delivered on a business-type basis, e.g. water, sewer, trash disposal, golf courses, etc. A municipality adopts an enterprise by a vote of Town Meeting. The enterprise fund establishes a separate accounting and financial reporting mechanism for a municipal service for which a fee is charged in exchange for goods or services. Under enterprise accounting, the service's revenues and expenditures are segregated into a separate fund with its own financial statements, rather than being commingled with the revenues and expenses of all other governmental activities.

Finance Committee Reserve Fund - pursuant to Massachusetts General Law (M.G.L. c. 40, § 5A), To provide for extraordinary or unforeseen expenditures in each fiscal year, a town may - at an annual or special town meeting - appropriate or transfer a sum or sums not exceeding in the aggregate five percent of the levy of the fiscal year preceding the fiscal year for which the fund, to be known as the reserve fund, is established. No direct drafts against this fund shall be made, but transfers from the fund may from time to time be voted by the Finance Committee. At the end of each fiscal year, any unused amount of the Reserve Fund is closed to the surplus of the general fund.

Free Cash – Also known as Unassigned Fund Balance represents the surplus of the general fund operating budget at the close of a fiscal year resulting from revenues realized in excess of estimates and

expenditures less than appropriations plus unused free cash resulting from the prior fiscal year. Use of free cash to support appropriations requires a vote of Town Meeting. The amount of free cash must be certified by the Massachusetts Department of Revenue before it is available for appropriation. Unpaid property taxes and certain deficits reduce the amount of remaining funds that can be certified as free cash.

General Fund - the primary fund used by a government entity. This fund is used to record all resource revenues and expenditures that are not associated with special-purpose funds. The activities being paid for through the general fund constitute the core administrative and operational tasks of a municipality.

Other Post Employee Benefits (OPEB) - Other post employee benefits are benefits, other than pension distributions, paid to employees during their retirement years. The major post-employment benefit in Massachusetts is health insurance.

Overlay Surplus - Excess overlay that is determined to be over and above what is needed to cover abatements and exemptions of property taxes in a given fiscal year. It is determined, certified, and transferred by vote of the Board of Assessors. The use of overlay surplus as a funding source is subject to appropriation by Town Meeting and can be used for any lawful purpose. Any unused balance of overlay surplus at the end of a fiscal year is closed to general fund balance and becomes part of free cash available for appropriation in the subsequent fiscal year.

Retained Earnings – Similar to free cash, retained earnings is the surplus of an enterprise fund budget at the close of a fiscal year resulting from revenues realized in excess of estimates and expenditures less than appropriations plus unused retained earnings carrying over from the prior fiscal year. The use of retained earnings is subject to appropriation by Town Meeting for expenditures related to the enterprise. The amount of retained earnings available for appropriation must be certified by the Massachusetts Department of Revenue before it can be voted by town meeting.

Stabilization Funds – Pursuant to Massachusetts General Law (M.G.L. c. 40, § 5B), a municipality, through a vote of Town Meeting, may establish one or more stabilization funds and designate the purpose for which each fund is established. The creation of a stabilization fund requires a majority vote of Town Meeting. Appropriation of funds into a stabilization fund is by majority vote. Appropriation of funds out of a stabilization fund requires a two-thirds vote of town meeting. Any interest that is earned from the investment of stabilization fund monies accrues to the stabilization fund. There is no limit on the cumulative balance of all stabilization funds in a municipality.

POLICY

It shall be the general policy of the Town to:

- Maintain reserves to provide the capacity to respond to the costs of unanticipated and extraordinary events, significant reductions in annual revenue streams due to economic disruption, and to provide a source of available funds for future capital expenditures.
- Maintain multiple types of reserves, including free cash, stabilization funds, retained earnings, and overlay surplus.

- Maintain overall general fund reserves including the Town's combined stabilization funds and free cash between 5% and 10% of the Town's Prior Year General Operating Revenue. percent of the annual operating budget.

The following policies shall govern the administration of the following reserves

- **Finance Committee Reserve Fund** - Annually, the annual operating budget recommendation shall include an appropriation into the Reserve Fund in an amount equal to 0.3 percent of the of the Town's Prior Year General Operating Revenue.

Every five years, at a minimum, the Finance Committee shall review the history of Finance Committee transfers to determine if the annual appropriation into the Finance Committee Reserve is adequate.

- **Free Cash** - In the development of the proposed annual general fund operating budget, the Town shall strive to estimate revenue and recommend appropriations at a level that will generate free cash at fiscal year-end equal to approximately 3 % of the Town's Prior Year General Operating Revenue. As a general rule, the use of free cash equal to the 3% threshold will be limited to any or all of the following: non-recurring expenditures such as operating or capital spending for the upcoming fiscal year, snow and ice deficits, or extraordinary or unforeseen costs that cannot be financed from the Finance Committee Reserve Fund or through transfers between line items in the operating budget.

It shall be the policy of the Town to phase out the use of free cash to support the operating budget.

Further, to the extent practicable, any amounts of free cash certified in excess of 3 percent of the Town's Prior Year General Operating Revenue shall be appropriated to any or all of the following: one or more of the Town's stabilization funds and to offset unfunded liabilities, e.g. other post-employment benefits (OPEB).

- **General Stabilization Fund** - The Town shall maintain a general stabilization fund whose primary purpose is to replace declines in general fund revenue due to economic downturn. The target level of the fund shall be five percent of the Prior Year's General Fund Operating Revenue, an amount estimated to support the operating budget through three years of economic downturn. The Town shall strive to annually appropriate to the general stabilization fund 35% of certified free cash in excess of 3 percent of the Prior Year's General Fund Operating Revenue (see above) until the target minimum balance is met. Once the target level of the fund is reached, if any use of the fund reduces the balance below the target level a plan for replenishment of the Fund shall be developed per the procedure described below.
- **Special Purpose Stabilization Fund(s)** – The Town shall maintain one or more specialized stabilization funds as a repository for funds to finance selected future capital needs - as identified through the Town's annual capital planning process - on a pay-as-you-go basis, or to subsidize debt service of large capital projects, (e.g., municipal or school construction), to mitigate the impact on taxpayers. Sources of financing appropriations into special purpose stabilization funds would generally be non-recurring revenues including but not limited to free

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Commented [RA2]: Need concurrence on 5% being adequate to cover three years of downturn.

cash and overlay surplus. Consideration should be given to dedicating a portion of general fund operating revenue to fund this fund(s). Creation and use of this fund preserves the Town's debt capacity for major capital projects.

The Town will strive to appropriate 2% of the Town's Prior Year's General Fund Operating Revenue into this capital stabilization fund(s) annually.

- **Overlay Surplus** - Overlay surplus shall be reserved for non-recurring costs such as direct capital expenditures, contributions to the general stabilization fund or a special purpose stabilization fund, or to finance unfunded liabilities, e.g., OPEB.
- **Retained Earnings** - In the development of the proposed annual budget for its sewer enterprise fund, the Town shall strive to estimate revenue and recommend appropriations at a level that will generate retained earnings at fiscal year-end equal to approximately 20% of the operating budget. The rationale for this level of retained earnings is as follows:
 - To cover potential revenue shortfalls in any given fiscal year
 - To finance unanticipated, extraordinary expenditures not provided for in the adopted annual budget
 - To provide cashflow for the fund to preclude the use of the Town's pooled cash to fund sewer operations which would have a negative impact on general fund interest income.
 - For rate stabilization

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In addition, the Town shall consider - consistent with guidance from the Department of Revenue - adding to the sewer budget a component ("budget surplus") that would accrue to retained earnings and be available to finance selected future capital needs as identified through the Town's annual capital planning process. These amounts could accumulate as unappropriated retained earnings until the capital need arises, or could be appropriated annually into a special purpose stabilization fund created to fund sewer capital projects.

PROCEDURES

The following procedures are adopted pursuant to this policy.

- **Finance Committee Reserve Fund** - requests of the Finance Committee for Reserve Fund transfers shall be based on requests from department heads submitted to the Town Administrator for review and approval, who will then forward to the Committee for action.
- **Free Cash** - Pursuant to the policy to phase out the use of free cash to support the operating budget, upon approval of this policy, the Town Administrator, in consultation with the Select Board shall develop a plan during the next annual budget cycle for transmittal to and consideration by the Finance Committee to end the appropriation of free cash for this purpose over the ensuing five years.
- **General Stabilization Fund** - Pursuant to the policy governing the General Stabilization Fund, if use of the Fund results in a balance that falls below the target of 5% of the Prior Year's General

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Government Finance Officers Association Best Practices: Fund Balance Guidelines for the General Fund and Working Capital Targets for Enterprise Funds

ADOPTED BY:

DATE ADOPTED:

DRAFT

