

ANALYSIS OF ARLINGTON'S FUND BALANCE AND CASH RESERVES

A REVENUE & EXPENDITURES COMMITTEE REPORT

Arlington County Civic Federation

October 3, 2017

Drafted by John Tuohy

REVENUE & EXPENDITURES COMMITTEE

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Preface by Pres. Duke Banks

R&E Fund Balance Report

This past spring the Arlington County Civic Federation (ACCF) passed a resolution prepared by the Revenues & Expenditures Committee calling for no tax-rate increase and asking the County Board to use "surplus balances" to cover any additional spending required in FY2018.

During a County Board work session, Dept. of Management and Finance (DMF) staff and an outside consultant presented an overview of current policies governing the handling of Arlington's General Fund balances and contrasting these policies with alternative policies of other jurisdictions. DMF continues to insist that surplus funds (including fund balances, close-out funds, etc.) should not be used to fund recurring expenditures in the budget.

During budget deliberations, county staff mentioned to the County Board that they would like to better understand R&E's concerns and suggestions.

During the summer, several R&E Committee members met with DMF staff to discuss the county's fund balances, reserves, the application of close-out funds, etc.

The Civic Federation is planning a program on October 3 to cover Arlington's approach to its fund balances, reserves and close-out process as compared to other jurisdictions. The panel is being organized so that members can learn more about the county's cash balances and how these funds are being utilized.

It is important to note that at the end of FY2016 the General Fund's Fund Balance exceeded \$191 million, or approximately 16% of revenues. And the close-out process for FY2017 will be completed in October/November. The County Board will issue directions to the County Manager, guiding the development of a budget for FY2019 very soon. Because the Board may consider additional tax-rate increases for FY2019, our panel discussion will be very timely.

To help delegates and alternates better prepare for the October discussion, R&E is distributing this paper on the county's fund balances, along with comparative information from other jurisdictions. This primer was prepared by John Tuohy, a member of the R&E Committee, who has served as former Deputy Treasurer of Arlington County and Chief Finance Officer of the City of Falls Church.

INTRODUCTION

Public discussions regarding the fiscal year 2018 (FY18) budget have raised a number of questions regarding the County's fund balance and the County's reserves. Reserves and fund balance are not synonymous; rather, the County's reserves are one component of the County's fund balance.

EXECUTIVE SUMMARY

At its simplest, the County's fund balance can be defined as the excess of revenue (income received) less expenditures (income spent), which accumulates over time — a period of many years. Although the fund balance is available for appropriation at the County Board's discretion, there are several valid reasons to maintain an "appropriate" balance. Below are two reasons:

- Funds in the fund balance should be set aside to cover unforeseen costs such as natural disasters or sudden economic events. For example, a blizzard, the closing of a major employer or a government shutdown might require unanticipated spending that the county had not included in its annual General Fund (operating budget).
- Among several criteria that the bond rating agencies (S&P, Moody's and Fitch) use to assess a jurisdiction's creditworthiness and bond rating is the amount of cash that a jurisdiction keeps on hand to repay its outstanding bonds, if necessary. Clearly, the greater the balance available to repay bonds, the more favorably these agencies will rate the jurisdiction's creditworthiness.

Per the County's adopted financial policies, the Board has set aside 5% of annual revenues as an operating reserve. The remainder of the fund balance has been at least nominally assigned or committed to a variety of purposes (spending). However, the County Board is free to reallocate most of these funds if necessary. As of June 30, 2016, the percentage of the fund balance available for appropriation stood at 16% of revenues (\$191,243,859).

This discussion focuses on the fund balance of the County's General Fund and, to a lesser degree, the school system's operating fund. There are numerous other funds within the County, such as funds devoted to affordable housing, transportation, special tax districts, storm water management, etc. These have not been included due to the numerous restrictions placed upon their use.

The data used for this document are available from various public sources. It would be useful, however, if it could be assembled as part of the Management's Discussion and Analysis section in the County's [Comprehensive Annual Financial Report \(CAFR\)](#), thus making it available at the beginning of the budget process.

Below, is an in-depth review of the various aspects of the fund balance: its components (reserves vs. other subdivisions), its unusually complex structure, and the criteria that ratings agencies use to evaluate creditworthiness. This review includes comparative data from several Northern Virginia localities.

BREAKING DOWN THE FUND BALANCE

Definitions

The Arlington County General Fund's fund balance is subdivided into four categories: non-spendable, restricted, committed and assigned. Similarly, the [Governmental Accounting Standards Board \(GASB\) Statement 54](#) defines the categories of fund balance subdivisions as follows:

- ***Non-spendable fund balance***—amounts that are not in a spendable form (such as inventory) or are required to be maintained intact (such as the corpus of an endowment fund)

- **Restricted fund balance**—amounts constrained to specific purposes by their providers (donors, grantors, bondholders, or higher levels of government such as the Commonwealth or the Federal Government), through constitutional provisions, or by enabling legislation.
- **Committed fund balance**—amounts constrained to specific purposes by a government itself, using its highest level of decision-making authority (that is, by a vote of the County Board). To be reported as committed, amounts cannot be used for any other purpose unless the government takes the same highest-level action to remove or change the constraint.
- **Assigned fund balance**—amounts a government *intends* to use for a specific purpose; intent can be expressed by the governing body (**County Board or School Board**) or by an official to which the governing body delegates the authority (the **County Manager or School Superintendent**).
- **Unassigned fund balance**—includes fund balance within the General Fund, which has not been classified within the above-mentioned categories.

See Attachment 1 to review the County’s fund balance categories and dollar amounts for each. (Note: There are \$0 in non-spendable funds and \$1,515,487 in restricted funds.)

Reserves

The County’s financial policies call for operating reserves of 5%. (The County Board calls it the “no- touch” reserve, to be used only in extreme situations.) Arlington’s General Fund operating reserves consist of \$57,997,382 in committed fund balance funds and \$1,887,880 in assigned fund balance funds for a total of \$59,885,262, or approximately 5.16% of budgeted revenues. This 5.16% includes reserves for the County’s annual transfer to Arlington Public Schools (APS).

There is also a \$5 million self-insurance reserve to pay claims and an additional \$3 million economic stabilization reserve.

So how much in cash reserves should a local government keep on hand for operating expenses? The answer: It depends.

The bond ratings agencies require operating reserves equal to 5% of General Fund expenditures. The Government Finance Officers Association offers more flexible recommendations of up to 10%, or enough to cover of 2 months’ worth of expenditures. For a budget of \$1.24 billion (the County’s approved FY18 budget), 2 months of expenditures equals roughly \$200 million.

Remember that in addition to the reserve amounts noted above, Arlington’s fund balance holds \$121,843,110 in unrestricted, spendable cash that the County Board can reallocate to cover expenses in an emergency.

Arlington County also holds individual operating reserves for its “enterprise” funds:

In addition to the County’s reserves, APS holds separate reserves within its own fund balance for the school district’s Operating Fund.

Unlike, for example, the City of Alexandria, it has not been Arlington County’s practice to include the school system’s fund balances in calculating reserves and adherence to financial policies. One explanation for the difference is the fact that the Arlington elects its School Board, which controls how school revenues are managed and spent.

In addition to the reserves in the County’s General Fund, the school system maintains its own fund balance within its operating fund that includes line items for various reserves.

The Arlington School Board has no committed reserves in the school system’s fund balance; however there are \$23,593,920 in assigned reserves (general and operating) out of a fund balance of \$67,376,288 in the school system’s operating fund. See Attachment 2 to review the school system’s fund balance.

The table below shows the General Fund’s fund balances for the major Northern Virginia school systems, including any amounts that are unassigned:

Jurisdiction	Unassigned fund balance for school system	Total fund balance for school system	Percent unassigned
Fairfax County	--	142,03,048	0.00%
City of Alexandria	7,147,198	13,139,006	54.4%
Loudoun County	53	22,079,753	0.00%
Prince William County	16,172,027	87,145,547	18.6%
Arlington County	--	67,376,288	0.00%

It is worth noting that the school system is a component unit of the County and receives the majority of its funding from the County’s General Fund. It is worth considering adopting Alexandria’s approach and combining the school system’s General Fund with the County’s General Fund for purposes of computing the adequacy of fund balances.

Unassigned Fund Balance

The “unassigned” portion of the fund balance refers to funds that are not otherwise classified as non-spendable, restricted, committed or assigned. The unassigned portion of the fund balance can be used only when appropriated via a resolution by the county’s or city’s board or council.

Arlington is unusual in that it has no unassigned funds in its fund balance. The table below shows the unassigned General Fund’s fund balances for the major Northern Virginia jurisdictions:

Jurisdiction	Unassigned fund balance	Total fund balance	Percent unassigned
Fairfax County	38,093,937	341,292,461	11.16%
City of Alexandria	51,978,538	94,525,932	54.99%
Loudoun County	55,710,322	286,330,668	19.46%
Prince William County	76,747,000	203,162,000	37.78%
City of Falls Church	14,415,497	29,455,713	48.94%
Arlington County	--	191,243,859	0.00%

Attachment 1 provides a table of Arlington’s General Fund’s fund balance as of June 30, 2016. Attachment 3 provides the footnote disclosure from the 2016 CAFR describing Arlington County’s fund balance at June 30, 2016—the end of the fiscal year.

For a detailed breakdown of the fund balance, see the attached schedule of fund balance allocations as of November 9, 2016, in Attachment 4. This was prepared by County staff and provided to the Arlington County Board.

In addition to the accounting guidelines contained in GASB 54, the Government Finance Officers’ Association (GFOA) provides best practices related to fund balance. The GFOA defines the “Appropriate Level of Unrestricted Fund Balance in the General Fund” (adopted September 2015) as follows:

GAAP financial statements report up to five separate categories of fund balance based on the type and source of constraints placed on how resources can be spent (presented in descending order from most constraining to least constraining): non-spendable fund balance, restricted fund balance, committed fund balance, assigned fund balance, and unassigned fund balance. The total of the amounts in these last three categories (where the only constraint on spending, if any, is imposed by the government itself) is termed unrestricted fund balance. In contrast, budgetary fund balance, while it is subject to the same constraints on spending as GAAP fund balance, typically represents simply the total amount accumulated from prior years at a point in time.

Using the GFOA definition above, the unrestricted fund balance is not limited to the operating reserves. Instead it recognizes that the entire fund balance with the exception of the restricted funds as being available for redeployment or reallocation if necessary. Using the GFOA definition of adequate fund balance, Arlington County maintained an unrestricted balance of \$189,728,372 or 16.3% of budgeted revenues for FY2016.

As noted above, the GFOA provides guidelines but does not recommend a specific amount or percentage for a government to maintain in fund balance, it recommends factors to consider:

1. The predictability of its revenues and the volatility of its expenditures (i.e., higher levels of unrestricted fund balance may be needed if significant revenue sources are subject to unpredictable fluctuations or if operating expenditures are highly volatile);
2. Its perceived exposure to significant one-time outlays (e.g., disasters, immediate capital needs, state budget cuts);
3. The potential drain upon general fund resources from other funds, as well as, the availability of resources in other funds;
4. The potential impact on the entity’s bond ratings and the corresponding increased cost of borrowed funds;
5. Commitments and assignments (i.e., governments may wish to maintain higher levels of unrestricted fund balance to compensate for any portion of unrestricted fund balance already committed or assigned by the government for a specific purpose). Governments may deem it appropriate to exclude from consideration resources that have been committed or assigned to some other purpose and focus on unassigned fund balance, rather than on unrestricted fund balance.

And as already noted, when the 2007–2008 housing crash occurred, the Arlington County Board appears to have reallocated and leveraged the fund balance (\$89,106,629 at the end of FY07) to help plug a \$72,195,036 budget deficit in FY08. This event is one of the issues that the Revenues and Expenditures Committee (R&E) will ask the Dept. of Management and Finance to clarify. If nearly all of the County’s fund balance is unrestricted and can be reallocated to pay debts in an emergency, why does the county commit or assign every penny? And why do many of the County’s peers instead choose a simpler structure and designate most of their fund balances as unassigned? At the County Board’s work session April 18, 2017, Public Financial Management,

Inc. (PFM) presented a [review of the County's reserve policy](#). PFM noted that the credit/bond rating agencies consider a jurisdiction's fund balance (including committed or assigned reserves) as one element in assessing the jurisdiction's creditworthiness.

CREDIT RATING AGENCIES AND THE FUND BALANCE

For individuals, a bank assesses a borrower's creditworthiness before issuing a credit card and setting an interest rate. Similarly, credit/bond rating agencies evaluate a jurisdiction's creditworthiness to repay what it borrows (by issuing bonds).

The rating agencies focus only on a jurisdiction's ability to pay its debts (not how it spends its money). To do that, they use complex algorithms with inputs based on several weighted measurements to establish a jurisdiction's credit rating.

Attachment 5 displays the factors that Moody's uses to calculate creditworthiness. In brief, 30% of the score is based on the jurisdiction's economy and tax base, 30% on finances (of which the fund balance as a percentage of revenues accounts for 10%), 20% on management, and 20% on debt/ pensions.

Those jurisdictions designating a large percentage of their fund balance as unassigned provides the rating agencies with clear, unambiguous evidence that these funds are available for any purpose, including the repayment of debt.

Arlington's more complicated structure (committing or assigning every penny to be spent on something) offers less clarity, from the rating agencies' perspective. And PFM spends a great deal of time and energy explaining how Arlington County's committed and assigned fund balance subdivisions are essentially unrestricted and should be counted as funds that can be used to repay debts other than to those items to which the County Board has already committed or assigned them.

Arlington has some inherent advantages. Its tax base and the regional economy are among the strongest in the country. Its pension system is sufficiently funded (+/-95%). It has kept its borrowing below its self-imposed cap. And its fund balance is well capitalized. Thus, Arlington has maintained its AAA credit rating, which enables it to borrow at lower rates and reduce its borrowing costs.

IN SUMMARY

The Revenues and Expenditures Committee continues to seek clarification from County staff to better understand subcomponents of the fund balance.

Though the rating agencies' evaluations are important, theirs are not the only measures that should be considered when evaluating the sufficiency, transparency and structure of the County's fund balance. Prudent cash management is an important consideration in keeping borrowing costs down and tax increases to the minimum necessary for efficient and effective operations.

R&E also will continue to press the County Board to integrate CAFR information on the fund balance into the budget guidance it gives the County Manager so that it will be considered in concert with budget discussions for the coming fiscal year.

Drafted by John Tuohy. Other members of the R&E Committee: Burt Bostwick (point of contact), Duke Banks, Frank Emerson, Jerry Auten, Paul Holland, Roger Morton, Cynthia Rheame, Terry Showman, Suzanne Smith Sundburg, Tim Wise.

Attachment 1 — Arlington County General Fund's Fund Balance

Fund Balance, General Fund June 30, 2016 Source: CAFR Exhibit 3		
Non--spendable		0
Restricted		
Seized Assets		1,515,487
Committed		
Self--insurance reserve		5,000,000
Subsequent years' County budget		7,165,939
Capital projects		2,057,099
Operating reserve		57,997,382
Economic stabilization reserve		3,000,000
Incomplete projects		562,321
Affordable Housing Investment Fund		36,834,387
Subsequent years' School budget		25,164,263
Assigned		
Subsequent years' budgets		5,950,000
Budget stabilization		0
Subsequent years' capital projects		17,248,521
Operating reserves		1,887,880
Fresh AIRE program		652,621
Incomplete projects		2,531,501
Affordable Housing Investment Fund		23,676,458
Capital projects		0
Total fund balance		191,243,859

Attachment 2 — Arlington Public Schools Operating Fund's Fund Balance

School Fund Balance -- Operating Fund, June 30, 2016 Source: CAFR Exhibit G--1	
Restricted	
	0
Committed	
Incomplete projects	9,645,592
Next years' School budget	16,689,537
Assigned	
Operating reserve	2,000,000
Unfunded liabilities	2,000,000
Subsequent years' debt service	4,610,000
Health insurance reserve	1,000,000
General reserve	21,593,920
VRS reserve	4,637,239
Compensation Reserve	5,200,000
	67,376,288

Attachment 3 — GASB Statement No. 54, Fund Balance Reporting

CAFR disclosure, FY2016 (page 51)

M. Fund Equity

In accordance with Government Accounting Standards Board Statement No. 54, Fund Balance Reporting and Governmental Fund Type Definitions, the County classifies governmental fund balances as follows:

Non-spendable – includes fund balance amounts that cannot be spent either because it is not in spendable form or because of legal or contractual constraints, such as inventory and prepaid expenses.

Restricted – includes fund balance amounts that are constrained for specific purposes which are externally imposed by providers, such as creditors (such as through debt covenants), grantors, or amounts constrained due to constitutional provisions or enabling legislation.

Committed – includes fund balance amounts that are constrained for specific purposes that are internally imposed by the government through formal action by the County Board and does not lapse at year-end. Committed amounts cannot be used for any other purpose unless the County Board removes or changes the specified use by taking the same type of action it employed to previously commit those amounts.

Assigned – includes fund balance amounts that are intended to be used for specific purposes that are neither considered restricted or committed. Fund Balance may be assigned by the County Manager. The County Board will review the recommendations at the November Board meeting. If approved by a resolution of the County board, the assigned funds become committed. Amendments must follow guidance described in Note 1.I.E. By State law, funds cannot be spent unless appropriated by the County Board.

Unassigned – includes fund balance within the General Fund which has not been classified within the above-mentioned categories and negative fund balances in other governmental funds. The Unassigned Fund Balance can only be appropriated by a resolution of the County Board. The County considers restricted balances to be expended first in cases where both restricted and unrestricted amounts are available. When utilizing unrestricted balances, committed balances are applied first, followed by assigned than unassigned balances.

Attachment 4 — Arlington County Schedule of Fund Balance Allocations (Committed To)

2016 ALLOCATIONS - As of November 9th, 2016

<u>CAFR TITLE</u>	<u>AMOUNT</u>	<u>PROJECT FUNDING</u>	
COMMITTED TO:			
Self insurance reserve	5,000,000		
Subsequent years' County budgets	3,124,000	Housing Grants	<div style="border: 1px solid black; padding: 5px; width: fit-content;"> Actions taken at 15 close-out & 17 adoption by County Board - as of April 1, 2017 most of the funding has been spent </div>
	1,500,000	Economic Development	
	379,448	AED - travel and tourism	
	250,000	Library - pop-up	
	123,077	Library - materials swapped ongoing for one-time	
	175,000	NOND - Compensation & Benefits Study	
	50,000	NOND - Senior and Disabled Tax Relief consultant	
	50,000	NOND - Lee Highway - contingent for Lee Highway Alliance	
	150,000	NOND - Inauguration	
	184,605	NOND - Regionals for NVJDH	
	147,168	FIR - safe staffing equipment	
	73,584	FIR - peak medic unit	
	124,722	POL - patrol officer equipment	
	44,644	SRF - Detention Center Staffing equipment	
	55,000	CCT Clerk Jury Management Technology	
	50,000	CMO - Fair Housing Study	
	50,000	CMO - Streaming Video in community settings	
	50,000	AFAC	
	479,691	Electoral Board - election funding	
	30,000	Arlington Neighborhood Villages	
	50,000	Courthouse Space Reconfiguration Consultant	
	25,000	Marymount Non-Profit Resource Center	
Subtotal	7,165,939		
Capital projects	1,700,000	Maintenance Capital	
	361,300	Land Acquisition	
	(15,960)	E-summons fine revenue to PAYG reconciliation	
	11,759	Field Fund revenue to PAYG reconciliation	
Subtotal	2,057,099		
Operating reserve	57,997,382		
Budget, Economic & Revenue Stabilization reserve	3,000,000		
Incomplete projects	562,321	carryover po's - contractual obligations	
AHIF	27,470,558	balance designated for specific projects	
	9,363,829	amount designated 17 budget adoption	
AHIF	36,834,387		
Subsequent years' Schools budgets	16,549,003	Schools expenditure savings	<div style="border: 1px solid black; padding: 5px; width: fit-content;"> Per Principles of Revenue Sharing </div>
	6,161,858	Schools share of excess tax revenue	
	2,453,402	Schools expenditure savings included at budget adoption	
Subtotal	25,164,263		
SUBTOTAL COMMITTED	137,781,391		

Attachment 4 — Arlington County Schedule of Fund Balance Allocations (Assigned To)

ASSIGNED TO:

Subsequent years' County budget	1,000,000	Operating Contingent
	1,000,000	Budget, Economic & Revenue Stabilization reserve increase
	350,000	Life Safety Items - Body Armor/NOVA Response System
	2,100,000	FY 2018 Housing Grants
	1,500,000	FY 2018 Unallocated Balance
SUBTOTAL	5,950,000	
Subsequent years' capital projects	2,500,000	FY 2018 Land Acquisition
	1,700,000	FY 2018 PAYG
	600,000	FY 2018 Life Safety - Generators
	6,968,417	Master lease carryover
	5,480,104	Funding from bond premium (legally restricted)
	17,248,521	
Operating reserve	1,887,880	True-up to 5% given growth in budget -AC & APS share
FreshAIRE	652,621	
Incomplete projects	50,063	MIPAP carryover
	18,737	Cherrydale Lease Funds
	4,200	Virginia Foundation for the Humanities
	41,500	Fire T&A Fund Carryover from FY 2015
	501,360	AHC revenue from Single Family Loan Program
	122,000	CBO Unspent Auditor Funding
	12,800	Community Facilities Study
	40,000	Single Family Portfolio Transition
	111,208	Parking - Legal Fees & Survey Expenses
	70,505	ART 43
	66,000	ART Light Maintenance Facility - Maintenance
	45,200	County Antibiotics Cache
	10,553	Reid Consulting
	271,540	Facility repair & improvements
	171,335	Public Spaces Master Plan
	50,000	Completion of Barrier Analysis
	20,000	Virginia Hospital Land Swap
	15,000	Outside Legal Services - CHP Ground Lease
	500,000	4-Mile Run / Shirlington Crescent
	250,000	Lee Highway Corridor Study/Civic Engagement
	150,000	Work Order System - Cartegraph
	9,500	Police Staffing Analysis - Northwestern University
	2,531,501	
AHIF	16,679,635	existing balance not allocated to projects (as of June 30, 2016)
	6,996,823	CM recommendation for additional funding from close-out
AHIF	23,676,458	
SUBTOTAL ASSIGNED	51,946,981	
RESTRICTED FOR:	1,515,487	seized assets
TOTAL FUND BALANCE	191,243,859	

GO Scorecard – Factors, Sub-factors and Weights

Factors & Sub-Factors	Weights
Factor 1: Economy/Tax Base	30%
Full Value (market value of taxable property)	10%
Full Value per Capita	10%
Median Family Income	10%
Factor 2: Finances	30%
Fund Balance as % of Operating Revenue	10%
5-Year Dollar Change in Fund Balance as % of Revenues	5%
Cash Balance as % of Revenues	10%
5-Year Dollar Change in Cash Balance as % of Revenues	5%
Factor 3: Management	20%
Institutional Framework	10%
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures	10%
Factor 4: Debt/Pensions	20%
Net Direct Debt / Full Value	5%
Net Direct Debt / Operating Revenue	5%
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value	5%
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues	5%