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TOWN OF CHARLESTOWN

Date: December 9, 2021

To: Honorable Town Council

From: Mark Stankiewicz, Charlestown Town Administrator

Re: Fund Balance Policy

On Friday December 3, 2021, the Charlestown Budget Commission held a regularly scheduled meeting in Council Chambers. The agenda included discussion and possible action regarding a Fund Balance Policy recommendation. At the meeting, the members present voted unanimously to recommend the attached policy to the Town Council.

As background, the Fund Balance Policy was part of a larger risk analysis commissioned through the Government Officers Finance Association (GFOA). The GFOA is the preeminent authority on local government finance offering a variety of educational and standard-setting programs with over 20,000 members across North America. The GFOA report was a review of the adequacy of Charlestown's financial reserves.

The major points of the report included:

- Definition and overview of risk. Including the probability and magnitude of a loss.
- Normal (symmetrical) distributions, cumulative probabilities, and asymmetrical distributions.
- Charlestown's major noted Risks Include:
 - Floods
 - Hurricanes
 - Snowstorms
 - Economic Recessions
 - Sea Level Rise
 - Legal Suits
 - Hazardous Materials Spills
- GFOA's analysis of these risks indicates Charlestown's range of reserves should include:
 - A critical threshold of \$4.3 million in reserves to maintain adequate cash flow throughout the fiscal year.
 - Determination of a 'level of confidence' to be reasonably prepared financially for natural or man-made disaster as:
 - 85% confidence = \$5.5 million in reserves
 - 90% confidence = \$7.8 million in reserves
 - 95% confidence = \$14 million in reserves

It should be noted the GFOA analysis is based upon the Town's current and past historic data and is subject to change over time. The recommended policy includes an acceptable and prudent range of reserves, encourages limitations to use the Undesignated Fund Balance (UFB) to purposes and expenses that are sustainable over time as well as guidance as to how the UFB may be replenished.

Previously the Budget Commission had reviewed the GFOA draft model policy. At the December 3rd meeting the Budget Commission discussed the draft and then voted on a final policy with some language adjustments including:

- Elimination of examples, definitions and other background/explanatory language that is not integral to the policy.
- Adapted a 'target range' for unassigned fund balance between 23% and 33% of the Town's annual operating budget. Using the fiscal year 2021 adopted budget, that range would be approximately \$7 million to \$10 million equating to confidence level just above 90%.
- Provide for budgeted utilization of the UFB above the 23% minimum for purposes consistent with the GFOA report, the adopted policy, and required formal action by the Town Council.
- Establishes formal reporting of UFB to the Budget Commission, and planning for use or replenishment to be included in the budget recommendation to the Town Council.

Attached for the Council's review is the proposed policy. It is anticipated that representatives of the Budget Commission will be available should there be any questions.

The purpose of this policy is to establish the recommended level of unassigned fund balance that are to be maintained in the General Fund for generally accepted accounting principles (GAAP) and budgetary requirements of the Town.

It is essential that Charlestown maintain adequate levels of fund balance to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stability for Town services and tax rates. In most cases, discussions of fund balance will focus on the Town's general fund. The Town shall also consider financial resources available in other funds in assessing the adequacy of unassigned fund balance in the general fund.

In order to comply with the Governmental Accounting Standards Board (GASB) standards and ensure accurate and transparent reporting of the governmental funds received and expended, the Town will adhere to the following:

Classification of revenue: The revenue streams in all governmental funds will be reviewed and appropriately classified and reported in the financial statements as determined by and in accordance with the government accounting standards board (GASB) definitions .

Order of expenditure of funds by classification: Expenditures may be incurred for purposes for which both restricted and unrestricted (committed, assigned, or unassigned) amounts are available. Composition of the ending fund balance will be determined by applying the following: In those instances where both restricted and unrestricted amounts are available, restricted amounts will be considered to have been spent first [as allowed and in compliance with stated and specified terms or requirements], followed by committed amounts, followed by assigned amounts, and then unassigned amounts.

Classification of fund balance amounts: The fund balance amounts in all governmental funds will be reviewed and appropriately classified and reported in the financial statements in accordance with the definitions described in the GFOA report , dated May 2021.

The following outlines the conditions warranting use and replenishment of the fund balance and the amounts to be held in reserve.

Target Levels of Fund Balance:

An adequate level of unassigned fund balance is essential to mitigate current and future risks and to ensure service levels.

The Town will strive to maintain an unassigned fund balance in an amount equal to 23% and 33% of its annual operating expenditures and a cumulative probability of adequacy of 90+%.

The fund balance target is expressed as a range, recognizing that fund balance levels can fluctuate from year to year in the normal course of operations for any local government. The Town shall periodically revisit this range from a risk-based perspective with consideration of the existing economic and environmental conditions. Specifically, amounts are and will be held in unassigned fund balance for:

- Economic uncertainty (i.e., to cushion the Town against fluctuations in revenues and costs due to economic conditions),
- Extreme events (i.e., allows the Town to respond quickly and decisively to events such as natural disasters, catastrophic accidents, unexpected infrastructure repair/replacement, etc.),

- Working capital (i.e., to cushion the Town against revenue shortfalls or expenditure fluctuations associated with routine Town business (e.g., property tax revenues are received quarterly, but the Town delivers all services year-round).

It is anticipated that this is a level sufficient to provide for the required resources to ensure short-term cash availability when revenue is unavailable or unanticipated expenditures (including emergencies) occur.

If, based on the Treasurer's analysis and forecasting, the target balance is not being met or is likely to not be met at some point within a three-year time horizon, then the Town Administrator will develop a plan to meet the target balance. This plan will then be presented to the Budget Commission for consideration during the annual budget process. The Budget Commission will then forward a plan to the Town Council for review and/or adoption.

Use of Unassigned Fund Balance:

Should annual audited general fund revenues exceed expenditures and encumbrances, a year-end operation surplus shall be reported. Any portion of the year-end operating surplus that contributes to the general fund unassigned fund balance in excess of the minimum of the target range will be deemed available for allocation to:

- Replenish any other established assigned, committed, or restricted funds
- Transfer to capital project funds for the capital improvement program and/or deferred maintenance needs.
- Offset one-time shortfalls anticipated in the general fund operating budget

The use of unassigned fund balance in excess of target levels shall not normally be applied to recurring annual operating expenditures. Reserves may, however, be used to allow time for the Town to restructure its operations in a deliberate manner, but such use will only take place in the context of a long-term plan.

Replenishment of Unassigned Fund Balance:

Should annual audited general fund expenditures and encumbrances exceed revenues, a year-end operation deficit shall be reported. Generally, the Town will seek to replenish the unassigned fund balance within one to three years of use. Specifically, factors influencing the replenishment time horizon include:

1. The budgetary reasons behind the fund balance targets;
2. Recovering from an extreme event;
3. Political continuity;
4. Financial planning time horizons;
5. Long-term forecasts and economic conditions;
6. External financing expectations.

Revenue sources that would typically be looked to for replenishment of a fund balance include nonrecurring revenues, budget surpluses, and excess resources in other funds (if legally permissible)

and there is a defensible rationale). Year-end surpluses are an appropriate source for replenishing fund balance.

Authority for Use and Replenishment of Reserves

The Town Treasurer shall provide the Budget Commission with a report of the prior year audited unassigned fund balance along with a projection of the current year unassigned fund balance based on the annual budget operations.

In the event the unassigned fund balance falls outside the Town's target range (equal to 23% and 33% of its current annual operating expenditures), the Budget Commission shall plan for the use and/or replenishment in the budget recommendation to the Town Council.