

## A-5 Financial Reserves (draft 11.10.21/01.11.22)

### 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 reduce 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 preventing~~, 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, Selectboard and Town Administrator ~~in that capacity~~ and is intended to be advisory to Town Meeting.

### DEFINITIONS

~~Cannabis Impact Fee Stabilization Fund:~~

Colle Undesignated Fund Balance: Due to the requirements of the Federal Grants used to renovate the Colle Opera House, its activities are accounted for in a separate Receipts Reserved for Appropriation special revenue fund. As revenues exceed expenditures, the annual surplus flows into the Undesignated Fund Balance, where it is available for appropriation for additional, generally capital, expenses to maintain the building.

Enterprise Fund: Pursuant to Massachusetts General Law (M.G.L. c. 44, § 53F½), municipalities can establish enterprise funds by vote of Town Meeting to account for a utility, cable television public access, health care, recreational or transportation facility whose services are delivered on a business-type basis. Under enterprise accounting, the service's revenues and expenditures are segregated into a separate fund with its own financial statements, separate from 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 the Finance Committee may from time to time~~ vote transfers from the fund. At the end of each fiscal year, any unused amount of the Reserve Fund is closed to the surplus of the general fund.

**Commented [CTA1]:** JA The Financial Management policies adopted by the Montague Selectboard in 2014 provided the foundation for the draft developed by the Collins Center, but the draft policy that we received in July 2021 identifies several places where we might make adjustments based on current conditions or do a better job of explaining our Town's approach to Reserves. This is closely interwoven with the Annual Budget Process and Capital Planning, and we would like to present an updated Reserves policy to the Selectboard when we offer our proposal for updates to those policies at the end of FY22.

**Commented [CMTA2]:** Your 8/2 email suggested this needed a definition, but the definition for Stabilization Funds covers it.

**Commented [CMTA3]:** I think "in the aggregate" is necessary to avoid thinking that the limit applies only to each town meeting's appropriation.

**Commented [CMTA4]:** I don't see the need to delete this, but don't particularly care.

**Commented [CMTA5]:** You can probably also eliminate "from time to time"

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. The amount of free cash must be certified by the Massachusetts Department of Revenue before it is available for appropriation ~~by Town Meeting~~. Unpaid property taxes and certain deficits reduce the amount of remaining funds that can be certified as free cash. ~~Use of free cash to support appropriations requires a vote of Town Meeting.~~

**Commented [CMTA6]:** I'd also delete this since FC is distinctly different from Undesignated FB, and there's no need to encourage incorrect terminology.

General Fund - The primary fund used by a government entity. This fund is used to record all revenues and expenditures that are not associated with special-purpose funds, e.g., enterprise, capital project, grant, and revolving 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~~ This is the portion of overlay that is determined to be over and above what is needed to cover abatements and exemptions of property taxes in ~~a given~~ specified fiscal years. 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.

Prior Year General Operating Revenue (PYGOR): ~~A formulation~~ calculation used in the annual budget process for a variety of purposes in developing the proposed General Fund operating budget for the upcoming fiscal year. It is a function of General Fund revenues of the prior fiscal year and defined as follows:

- Property tax of the prior fiscal year as billed (Page 1, Item Id. - Tax Rate Recapitulation Sheet of the prior fiscal year) less:
  - Excluded Debt (Form DE-1 - Tax Rate Recapitulation Sheet of the prior fiscal year)
  - Allowance for Abatements and Exemptions (Page 2, Item II.d - Tax Rate Recapitulation Sheet of the prior fiscal year)
- Plus**
- Total Prior Year actual General Fund revenue less:
  - prior year property tax revenue collected (real and personal property taxes and revenue from tax liens and tax possessions)
  - local receipts deemed non-recurring or designated for a particular purpose

Retained Earnings ~~(Applies to enterprise funds.)~~ Any operating surplus (actual revenues in excess of estimates and appropriations in excess of expenses) is retained in the enterprise fund, rather than closed to the General Fund at fiscal year end. ~~Annual surplus of an enterprise is certified by the Massachusetts Department of Revenue, Division of Local Services as available is and becomes part of called "retained earnings". Use of retained earnings requires appropriation by Town Meeting.~~

**Retained Earnings** - any operating surplus (actual revenues in excess of estimates and appropriations in excess of expenses) is retained in the enterprise fund rather than closed to the General Fund at fiscal year-end. Surplus of an enterprise certified by the Massachusetts Department of Revenue, Division of Local Services as available is called "retained earnings". Use of retained earnings requires appropriation by Town Meeting.

**Commented [CMTA7]:** Per vote of FC to keep A4/A10 definition for A5

**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 **but** 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.

**Commented [CMTA8]:** I agree this seems redundant, but think this should remain for accuracy

## POLICY

The following table summarizes elements of the policies and procedures that follow.

Reserve Funds and Target Thresholds			
Name of Fund	Purpose	Funding Target	Primary Source of Funding
<b>General Town Reserves</b>			
Cannabis Impact Fee Stabilization Fund	to finance the mitigation of impacts resulting from the operation of licensed cannabis establishments	No target per se; fund serves as repository for impact fees collected.	Cannabis Impact Fees, <b>which are negotiated as part of each business's host community agreement.</b>
FCTS Stabilization Fund	to mitigate the impact on town's operating budget from spikes in the Town's share of operating and/or capital costs generated by the FCTS	defined by ongoing estimates of projected enrollment as a primary driver of operating costs	Taxation
Finance Committee Reserve Fund	to fund extraordinary or unforeseen expenses	TBD Annually	Estimated General Fund Revenue
Free Cash	to fund emergency expenses, non-recurring operating	3% of PYGOR	Surplus from General Fund operations at each financial year-end

	expenses, or capital expenses		
General Stabilization Fund	to cover projected revenue shortfalls due to economic downturn as a means to maintain services	5% of PYGOR	0.3% of PYGOR from the tax levy if funding is below target plus other sources, e.g., free cash, overlay surplus, and one-time revenues, if available to accelerate progress towards funding target.
GMRSD Stabilization Fund	to mitigate the impact on town's operating budget from spikes in the Town's share of capital and/or costs generated by the GMRSD	the fund is supported by a portion of the Town's Kearsarge lease revenue	Kearsarge lease payments
<b>Overlay Surplus</b>	acts as an additional funding source for appropriation when there is a balance in the account	none	balances of Overlay for Abatements and Exemptions when amounts are no longer needed for the intended purpose.
Town Capital Improvement Stabilization Fund	to finance future capital costs on a pay-as-you-go basis or to underwrite debt service for capital projects	function of spending targets reflected in capital plan	0.2% of estimated annual GF revenue net of revenues targeted for specific purposes plus revenue from cannabis retail sales
<b>Enterprise Funds</b>			
Airport Retained Earnings	to serve as working capital, fund emergency expenses, non-recurring operating expense, or capital	5% of PYEFR	Airport revenues
<b>Airport Capital Stabilization Fund</b>	to finance future capital costs on a pay-as-you-go basis or to underwrite debt service for capital projects	function of spending targets reflected in capital plan	Airport revenues
WPCF Capital Stabilization Fund	to finance future capital costs on a pay-as-you-go basis or to underwrite	function of spending targets reflected in capital plan	Sewer <b>revenues</b>

	debt service for capital projects		
WPCF Retained Earnings	to serve as working capital, fund emergency expenses, non-recurring operating expense, or capital	5% of PYEFR	Sewer <del>rates</del> revenues
Other Reserves			
Colle Undesignated Fund Balance	to finance capital maintenance of the Colle Opera House	function of spending targets reflected in capital plan	Colle rental fees
Sale of Real Estate	<u>Can be used for any purpose for which the town can borrow for 5+ years.</u>	<u>none</u>	<u>Proceeds from sale of town owned real estate (excluding sale of tax possessions)</u>

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 and manage multiple types of reserves, including stabilization funds, free cash, retained earnings, and overlay surplus.
- Maintain overall **General Fund** reserves including the Town's combined stabilization funds (General, Capital, GMRSD, FCTS and Cannabis Impact Fee) and free cash between 5% and 10% of the Town's Prior Year General Operating Revenue.

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 Finance Committee Reserve Fund. Every year, 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 non-recurring operating or capital budget expenditures and 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 avoid the use of free cash to support the operating budget, except under extraordinary or unusual circumstances. Further, to the extent practicable, any amounts of free cash certified in excess of 3% of the Town's Prior Year General Operating Revenue shall be appropriated to one or more of the Town's stabilization funds and/or 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 5% 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% 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.

In fiscal years when no appropriation into the General Stabilization Fund is required because it is at its target, funding sources historically targeted for this purpose but not needed will be re-directed to funding of the Town's OPEB liability. **(FOR DISCUSSION)**

- **Special Purpose Stabilization Fund(s)** – The Town shall maintain one or more specialized Stabilization Funds to finance future needs. Sources of financing appropriations into special purpose stabilization funds shall include each or some combination of taxation; available funds (including but not limited to free cash and overlay surplus; and other term-limited or potentially inconsistent revenue sources. Such Stabilization Funds shall include but not be limited to the following.

- Capital Stabilization Fund(s) - 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. Use of a Capital Stabilization Fund(s) to finance projects on a pay-as-you-go basis can serve to preserve the Town's debt capacity for major capital projects.

The Town will strive to appropriate 0.2% of the Town's Prior Year's General Fund Operating Revenue into a Capital Stabilization fund(s) annually.

- Non-Capital Stabilization Funds:

- Cannabis Impact Fee Stabilization Fund – to finance the mitigation of impacts resulting from the operation of licensed cannabis establishments
- GMRSD Stabilization Fund – to mitigate the impact on the Town's operating budget from spikes in the Town's share of capital and/or costs generated by the GMRSD.
- Franklin County Technical School (FCTS) Stabilization Fund – to mitigate the impact on the Town's operating budget from spikes in the Town's share of operating and/or capital costs generated by the FCTS

- **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 Enterprise Funds, 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 5% of the operating budget. The rationale for this level of retained earnings is as follows: **FOR DISCUSSION**

- 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 cash flow for the fund to preclude the use of the Town's ~~pooled~~ cash to fund sewer operations ~~that~~ would have a negative impact on general fund interest income.
- **To provide a funding source to enable** rate stabilization

In addition, the Town shall consider - consistent with guidance from the Department of Revenue (DLS Departmental Procedure Manual: Enterprise Funds) - adding to Enterprise Fund budgets a line-item ('budget surplus') whose unexpended balance at fiscal year-end 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~~ a capital or other need arises, or could be appropriated annually into a Special Purpose Stabilization Fund created to fund capital projects. FOR DISCUSSION – WHY IS THIS SEPARATE FROM ENTERPRISE CAPITAL STABILIZATION?

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**Commented [CMTA9]:** Retained Earnings is the main source of funding for Enterprise Stabilization Funds, but it is still a separate thing. Some expenses that may require a subsequent appropriation may not be capital in nature, further appropriations from retained earnings only require a simple majority while appropriations from stabilization funds require a 2/3 majority.

## 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 Accountant for initial review, who will then bring those requests to the Finance Committee for review and approval, with input from the Town Accountant and Town Administrator.
- **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 Fund Operating Revenue, the Town Administrator, in consultation with the Selectboard shall develop a plan for transmittal to and consideration by the Finance Committee to bring the balance of the Fund back to its target level.
- **Overlay Surplus** - Pursuant to the policy governing the use of overlay surplus, the Selectboard shall periodically request that the Board of Assessors conduct an analysis of the overlay to determine the amount, if any, that can be declared overlay surplus. The analysis shall consider the following:
  - Current cumulative balance in the overlay accounts of all fiscal years after reconciling with the Town Accountant's records
  - Balance of property tax receivables, which represents the total real and personal property taxes still outstanding for all levy years
  - Estimated amount of potential abatements, including any cases subject to State Appellate Tax Board hearings or other litigation



- ## REFERENCES

M.G.L. c. 40, § 5B

## DLS Best Practices: Free Cash and Special Purpose Stabilization Funds

DLS Informational Guideline Releases 17-20: Stabilization Funds and 17-23: Overlay and Overlay Surplus

**ADOPTED BY:**

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