The COMMUNITY COLLEGE UPDATE

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How Do We Locally Determine an Adequate Reserve Level? [Part 2 of 2]

[Editor's Note: As we emerge from the Great Recession, one of the lessons we learned was that strong leadership, teamwork, planning ahead for contingencies, taking early actions to avoid a fiscal calamity, and having an adequate reserve got everyone through. Given the upcoming increases in pension contributions, the minimum wage, and other cost pressures with limited revenues, we continue to receive a lot of questions about what constitutes an adequate reserve level. This series is divided into two parts: (1) a primer on what reserves are and how they are defined, and (2) what constitutes an adequate reserve level. Part 1 of the series can be found here. What follows is Part 2 of the series.]

What Is the Purpose of a Reserve?

A reserve is an identified amount of cash that is available to handle contingencies as they arise. In other words, the reserve is a safety net that allows a community college district to meet its obligations as unplanned changes in revenues and expenditures occur.

Community colleges in California have very little control over revenues, as those are mainly controlled by the state government, and to some extent the federal government and other agencies. We have learned that we cannot depend upon a stable source of revenues in either the good times or the bad. During the good times, the state provides budget proposals and out-year forecasts that, by the time the budget year arrives, can significantly change what districts are able to count on for discretionary purposes. During the bad times, districts not only can lose the most meager of cost-of-living adjustments, but can also have their current funding levels cut.

And, while districts have much more control over expenditures, we live in an environment of uncontrollable cost increases. Some of these increases can be planned for and budgeted, but others cannot be anticipated. A reserve fund allows a district to continue to meet its obligations even when hit with unexpected expenses.

The important thing to remember if reserves have to be used is that they are *one-time funds*—once used, they are not replenished except by purposeful action of the district. However, most financial turbulence that districts encounter tends to be ongoing in nature. This means that reserves can help carry the district through a year of financial problems—long enough for the district to make budget cuts to solve its ongoing financial issues. If budget cuts are not made, reserves would continue to be used by default, and eventually the reserves will be depleted.

While the most immediate purpose of a reserve is to cushion against unforeseen financial issues, remember that credit rating agencies look at district reserves when determining credit worthiness. A district's credit rating impacts the cost of issuing debt—the stronger the reserves position, the better the credit rating and the lower the cost of debt for the district and/or its taxpayers.

What Should Be Considered in Setting a Level of Reserves?

As stated earlier, community colleges in California have very little control over revenues but much greater control over expenditures. Greater control can also be exercised over reserves—districts have the authority to determine what constitutes an adequate reserve at the local level.

The Board of Governors' (BOG) criteria and standards discussed in Part 1 of this series include a *minimum* prudent reserve level of 5% for community college districts. There are many reasons why a district, especially in California, should have a level of reserves that is much greater than the minimum prudent level. Some of these reasons apply to all districts and some do not, which is why each district should make its own decision as to an adequate reserve.

Here are some of the risk factors that would indicate a need for higher local district reserves:

- Declining enrollment, which reduces revenues and requires purposeful action each year to cut expenditures, or any significant fluctuations, either up or down, in the student population
- Delays in cash receipts, such as: the timing of property tax receipts for districts more dependent upon property taxes than state aid for their operating cash; apportionment deferrals, which the state has used in the past to balance its budget; and Education Protection Account revenues, which are doled out at the end of each quarter
- Restricted programs requiring unrestricted cash to operate, as some programs require a district match, and many districts operate other programs that require a contribution of cash from the unrestricted General Fund
- Deficit spending—either in the district's recent history, current budget, and/or multiyear projections, as this directly depletes reserves and requires specific action to mitigate
- Relatively small district size, as these districts do not have the economies of scale or budget capacity to absorb unexpected financial events
- Uncapped health and welfare benefits, as the increased costs are less predicable
- Unstable labor relations, which can directly impact personnel costs—the most significant portion of a district's expenditure budget
- Use of one-time sources to pay ongoing costs, which requires specific action to find another source next year or to cut costs
- Lack of sources to pay for technology replacement, preventative and deferred facilities maintenance, or other costs of maintaining and replacing assets
- Debt service, which may not have a dedicated funding source or for which the funding source can be unstable
- Exposure to significant one-time expenditures, such as inadequate resources for a facilities project or a large uninsured claim against the district
- Other circumstances unique to the district, such as exposure to significant natural disasters, unfunded retiree benefit liabilities, etc.

What is an Adequate Reserve Level?

There are some references for a district governance team to consider when setting its level of reserves. We have already discussed the minimum prudent level of 5% as established by the BOG, which is a bare minimum—it translates to less than two weeks of payroll and other expenses.

There is some additional guidance available from the national Government Finance Officers Association (GFOA). The GFOA published a "Best Practice" report in January 2015, which includes the following:

- A formal policy should be established by the community college that specifies the level of unrestricted reserves that should be maintained in the General Fund, how reserves may be spent, who can authorize the use of reserves, and then how reserves will be replenished if used below the level prescribed
- At a minimum, regardless of a district’s size, no less than 10% of regular General Fund expenditures and transfers out should be set aside for reserves
- The various risk factors listed above should be considered when determining how much greater than the 10% minimum a local district’s reserves should be

Conclusion

In setting a reserve level, the goal for a community college is to have the resources necessary to meet both planned and unplanned financial challenges, while spending as much of the current year’s resources as possible on the current year’s programs and students. This is a balancing act that will be unique to each district, and we recommend that each district examine the guidance provided above and the risk factors that apply in order to determine how much is needed for local reserves.

—Sheila G. Vickers

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