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Air Pollution Control Board
800 South Victoria Avenue
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SUBJECT: REAFFIRM OR MODIFY UNRESERVED FUND BALANCE POLICY **(REQUIRES 6/10 VOTES)**

RECOMMENDED ACTION:

Reaffirm the District's Unreserved Fund Balance at a level equal to between four (4) and six (6) months of its annual proposed operating expenses as a guideline.

FISCAL/MANDATES IMPACT:

Mandatory: No

Fiscal Impact: Will promote fiscal stability for the District.

STATEMENT OF MATTER FOR BOARD CONSIDERATION:

Background

On January 12, 1999, the Board adopted a policy to maintain the District's Unreserved Fund Balance between three (3) and four (4) months operating reserves as a guideline, and directed staff to review the policy each year during the budget development process.

On November 8, 2005, the Board adopted a modification to the District's Unreserved Fund Balance Policy of maintaining the District's Unreserved Fund Balance at a level equal to between four (4) and six (6) months of its annual proposed operating expenses as a guideline. In addition, your Board approved to use a five-year revenue and expense projection (excluding pass through grants) to determine if corrective actions are necessary to maintain an adequate unreserved fund balance.

Pursuant to Board direction at its April 11, 2006, board meeting, staff is bringing back the unreserved fund balance policy for your Board's review and consideration, which may result in reaffirmation of the current fund balance policy or direction to change the fund balance level. Prior to the November 2005 modification of the District's Fund Balance Policy by Board's direction, District staff reviewed the District's Fund Balance Policy. Staff consulted with Auditor-Controller staff, the California Special District Association, and other California air districts and they all referred staff to the Government Finance Officers Association (GFOA) Guidance. After reviewing the GFOA, staff has concluded that there are no set rules as to what is considered an adequate fund balance or a maximum level of an unreserved fund balance and GFOA recommends the amount should be based upon a government's own specific circumstances.

Government Finance Officers Association (GFOA) Guidance

There are no set rules as to what is considered an adequate fund balance. The GFOA recommends, at a minimum, general-purpose governments, regardless of size, maintain unreserved fund balance in their general fund of no less than five (5) to fifteen (15) percent of general fund operating revenues, or of no less than one (1) to two (2) months of general fund operating expenditures. The GFOA also recommends the adequacy of unreserved fund balance in the general fund should be assessed based upon a government's own specific circumstances and may require levels of unreserved fund balance in the general fund significantly in excess of these recommended minimum levels.

In addition, according to the *Governmental Accounting, Auditing, and Financial Reporting,* a publication of the GFOA, smaller governments, whose revenue sources lack the diversification of larger governments, are more susceptible to volatility of revenues and expenditures. Therefore, smaller governments usually maintain unreserved fund balance at a higher level (as a percent of revenues/expenditures) than larger governments.

District's Fund Balance Requirements

The District requires an adequate fund balance to mitigate current and future risks. An adequate fund balance is essential to offsetting cyclical variations in revenues and expenditures and to protect against catastrophic events, unforeseen revenue declines and expenditure gaps, unexpected legal obligations and failures in infrastructure or major business systems such as air quality monitoring equipment or computer equipment.

Fund balance size and stability are important factors in avoiding the costs of borrowing. Currently, the District does not have any outstanding loans or interest expenses. An adequate fund balance makes possible a position that is viewed by credit markets as healthy. In addition, it enables the District to respond to unforeseen negative events and to level out the impact of those events on fee-paying facilities. For example, the District was able to meet the ever increasing retirement contribution costs for the last two fiscal years due to its fund balance size and stability.

Internally, an adequate fund balance can provide for cash flow needed until major revenues are received, reducing or eliminating the need for cash flow borrowing. Currently, the District temporarily uses approximately $1.5 million of the unreserved fund balance for payroll and to pay other expenditures while adjusting to cyclical variations in permit revenue, federal grants, state subventions or unexpected increases in expenditures. In the past few years, the District's EPA 105 Grant award has been coming in late (closer to the end of the fiscal year), state subvention funds were decreased, and federal funds were decreased. The fund balance can also be used to leverage state and federal grants.

Recommendation

Although there is no generally accepted formula that defines a completely adequate unreserved fund balance, a conservative fiscal approach on this issue of the unreserved fund balance would enable the District to finance its operations for four (4) to six (6) months without having to incur short-term debt or raise new revenues.

District staff is seeking your Board's reaffirmation of the current Fund Balance Policy. District staff will continue to return each year during the budget development process to review this policy and to make recommendations to establish appropriate Reserves and Designations. We believe the District's Unreserved Fund Balance should stay at the level between four and six months of operating expenditures for financial safety and stability.

This letter has been reviewed by the Auditor-Controller and County Counsel. If you have any questions, please contact me at 645-1440, or Vickie Workman at 645-1416.

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Air Pollution Control Officer