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Michigan School Business Officials

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To: **The Honorable Tim Melton, Chair House Education Committee**
From: **David Martell, Executive Director, Michigan School Business Officials**

RE: **Testimony: HB 5963**
The Role of Fund Balance in Michigan's School Districts

Generalizations about fund balances don't work. Although there are some commonalities - circumstances vary from school district to school district. Those circumstances may affect what a fund balance represents and/or how much of a fund balance is necessary for the financial stability of a school district.

Fund balance is commonly mistaken to be 100 percent spendable cash that is sitting in the bank. In fact, this is an accounting term that indicates the difference between total assets and total liabilities.

There are numerous reasons that school districts are compelled to maintain a proper fund balance.

Today, perhaps the most compelling reason to maintain an adequate reserve fund balance is to have sufficient funds to allow a school district to absorb state aid cuts such as has occurred and been threatened in the past four years, and may occur again next year.

Having a financial cushion allows a district to avoid drastic changes in educational programs and/or employee layoffs during the school year. Mid-year cuts can disrupt the educational process for children.

For example, results from a recent MSBO survey show that school districts are planning to spend down 32 percent of their fund balances on average this year and 47 percent of their remaining reserve fund balance in 2010-11.

Other considerations include:

As a general rule, leading accounting and auditing firms recommend school districts have a fund balance of at least 15 percent of their budget. In simple terms - a 15 percent fund balance gives districts the ability to operate for about two months before running completely out of money and not being able to pay their employees.

Fund balance also provides a way to set money aside for repairs (roofs), maintenance (new heating systems, etc.), purchases (buses, textbooks) or catastrophic (or near catastrophic) events.

Another important consideration for a proper fund balance is to counterbalance delayed state funding. The state has created what amounts to a permanent four-month delay in paying state aid to schools. School districts start their fiscal year in July but do not receive their first state payment until mid-October.

School boards, superintendents and business officials have a fiduciary responsibility to be good financial stewards of public funds for the benefit of Michigan's school children. Maintaining a proper fund balance can help a district provide a consistent level of educational services, especially in this time of financial uncertainty.

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Fund Balance and Related Issues

This is to inform you of the Michigan School Business Officials (MSBO) recommendations and position on the establishment and use of what is commonly referred to as a "fund balance" or fund equity. Fund balance is commonly mistaken to be 100 percent spendable cash, when in fact this is an accounting term that indicates the difference between total assets and total liabilities.

One must be careful in generalizing about fund balances because, although there are some commonalities, circumstances vary from district to district that may affect what a fund balance represents and/or how much of a fund balance is necessary for the financial stability of a school district.

A typical fund balance in a school district is composed of three components:

1) Cash on hand – these funds may be in short term, highly liquid investments or in a checking or savings account. These funds are available for district use.

2) Accounts receivable – because of a timing difference between a school district's fiscal year (which ends June 30) and the state's fiscal year (which ends September 30) there are two payments out of the eleven state aid payments that are actually received after the district's fiscal year has ended. Using accrual accounting, the payments are "booked" at the end of the school district's fiscal year and included in calculating fund balance. These funds are not available to the school district until they are actually received in July and August.

3) Inventory and pre-paid assets – includes teaching, custodial and office supplies, and fuel in storage tanks. These are typically modest amounts and are obviously not available to expend.

Other considerations in discussing fund balance include:

A. **The level of non-homestead tax base in the district.** The 18-mill levy is only on non-homestead property. Since the main sources of funding for a district come from local property taxes and state aid, the level of non-homestead property in the district determines the amount received locally. If the district has a low non-homestead tax base, it will result in greater funds received from the state, which means the district will probably have to borrow funds to operate if their fund balance isn't sufficient.

B. **The tax collection practice of the school district.** A 100% summer collection allows a district to receive the local share of its funding up front with the July tax levy. If a 50/50 collection exists they will receive half in the summer and half in the winter collection. A 100% winter collection means the local taxes are collected during the winter only.

C. **The trend of the fund balance level.** Districts spending more than they receive can create a structural deficit, which eventually has to be addressed. The reason for the deficit will determine the level of concern necessary. For example if fund balance is used to purchase a capital asset (buses, technology), that is preferable to spending the fund balance on recurring costs (employee costs).

D. **Future obligations.** Some obligations are large enough to require a greater level of spending such as opening a new building. Districts can build up their fund balance in order to meet the increased obligations of a larger operation.

E. **Declining enrollment presents a myriad of problems for a school district.** The presence of a fund balance allows the district to better manage the decline.

F. **The absence of sufficient fund balance will likely result in borrowing to meet cash flow needs.** If a district borrows money it will pay a related interest cost and closing fees, which is charged to the general operating budget.

G. **Bond practices**. The presence of a reasonable fund balance along with a stable trend in the level of fund balance is viewed favorably by the bond rating agencies. This benefits local taxpayers with lower interest costs on bonds that are issued.

Probably the most important reason in our current climate is that a fund balance provides flexibility in dealing with unanticipated emergencies such as mid-year reductions in state funding.

As a general rule, MSBO recommends that districts have a fund balance of 15 to 20 percent of their total expenditures and operating transfers budget. We selected that amount based on the above listed considerations. In simple terms this level of fund balance is necessary to avoid borrowing during the four-month period between July 1 and October State Aid payment on Oct. 20. Additionally it is important to have a sufficient fund balance to allow a school district to absorb cuts in state funding such as those that have occurred in recent years, and may occur again next year. Having a financial cushion allows a district to avoid drastic changes in educational programs and/or employee layoffs during the school year.