MASBO Statement on School District Fund Balances
2024

There are a number of reasons for school districts to maintain sufficient reserves, also known as Fund Balances:

- for financial stability and ongoing operations
- for cash flow
- to maintain the district’s credit rating
  - which provides lower cost of borrowing
  - and provides more purchasing power
- it encourages wiser spending (discouraging waste)
- and certain categories of spending have regulations on maintaining a reserve account.

Financial Stability
School districts maintain fund balances for financial stability. It enables them to protect programs that are needed to serve children and to provide consistency at times when they may not have consistency at home. This was critical during the COVID Pandemic.

School districts depend on the receipt of state aid for every part of their operation. In the past, the receipt of state aid has been unstable. State revenues are sensitive to the business cycle, and when the economy is in recession, state aid payments to districts can be cut or metered out at a slower pace.

The majority of a district’s state aid is determined by multiplying the district’s enrollment by the Formula Allowance. While we did see larger than usual increase in the Formula Allowance for Fiscal Year 2024, it did not keep up with inflation (and rarely does).

Enrollment fluctuates and it is not easy to predict. This adds to the volatility of projecting revenues. Enrollment options like open enrollment, PSEO and online programs outside the district make it difficult for school districts to predict enrollment. Family mobility, due to housing and employment changes, also contribute to enrollment fluctuation. This was exacerbated by COVID.

Adequate fund balances offer financial stability on the expenditure side. Unanticipated expenditure increases occur, and maintaining an adequate fund balance protects programs when this happens. For example, a spike in natural gas prices, combined
with an unusually severe winter, will put many school districts over budget on expenditures for operating buildings.

Increases in salaries and benefits beyond the district’s ability to pay for it with current year operational revenue requires districts to use their fund balance accounts to pay the shortfall. Contract settlements impact subsequent years exponentially, meaning what is not covered this year will be added to what is not covered next year, thus doubling the shortfall in the second year. If the district continues to pay salaries and benefits beyond their ability to pay for it with current year operational revenues, without cutting staff or other expenditures, the district will see erosion of their fund balance accounts to critical levels.

Adequate fund balances also cushion the impact of unfunded or underfunded mandates placed on districts by the state and federal legislative branches.

**Cash Flow**
School districts need adequate fund balances for cash flow, which is more acute during economic downturns. Expenditures and revenue receipts are not evenly spread throughout the year, so districts often experience cash flow low points over the course of a year.

Cash flow was acute for school districts as a result of the state’s solutions to its budget problems in 2009. Both the aid payment shift and the property tax recognition shift placed school districts in difficult positions regarding cash flow. In fact, the amount of state aid payments delayed by these two policy changes exceeded the total of all general fund balances maintained by school districts. Many districts had to borrow money in order to meet payroll and other district obligations.

For a number of years investing returns have been dismal. Recent increases in interest income have allowed districts the opportunity to invest cash and receive larger returns, which in turn allows the district to pay for more programming.

**Bond Ratings**
Fund balances clearly have an effect on school districts’ borrowing and bond rating. The Minnesota state credit enhancement program provides a state guarantee of payment of debt obligations by school districts, and school districts receive a higher rating on their bonds as a result. However, many investors are still interested in the “underlying” rating of the school district issuing debt, which is the rating of the district without the state credit enhancement program.

Rating agencies pay close attention to fund balances in determining underlying ratings. They look at a number of other factors as well, and they will not specify a percentage of fund balance that they regard as optimum, but ratings analysts like to see fund balances in the neighborhood of 10% or more of a year’s expenditures. We also know that school districts that fall into statutory operating debt (SOD is defined as a fund balance below -2.5%) suffer a long-term penalty in terms of bond ratings.

Bond ratings are not used solely as an indicator of the quality of a school district’s debt. They also are regarded by taxpayers and other stakeholders as a measure of
how well their school district is managed. Bond ratings also are used by other vendors, such as property/casualty insurers, as a measure of stability and credit quality.

**Encourage Wiser Use of Money**
Allowing school districts to maintain fund balances encourages wiser expenditures. Government entities that are required to “use it or lose it” often make expenditures that are less than optimum. Allowing time for thoughtful spending reduces waste.

**Compliance with State Law**
Fund balances are needed also to comply with state law. State law requires districts to maintain reserve accounts for a variety of revenue sources and programs: operating capital expenditures, staff development, compensatory revenue, area learning centers, and many more. These balances are not available to spend for purposes other than those authorized in statute. Reserved fund balance accounts even exist in districts with negative net fund balances.

**Optimum Fund Balance**
What should the fund balance be for a school district? There is not an exact answer to this question. It is something that local School Boards must determine, keeping some of the following in mind:

- Enrollment trends; is the district’s enrollment falling, stable, or increasing
- Local economy: strength and diversity of employment base
- Operating levy resources, and future plans
- Bond rating, and plans for debt issuance
- Cash flow needs and characteristics
- Need for reserves to cover commitments, e.g. lease purchase agreements, future debt payments
- Need to replace bus fleets
- Replacing 1:1 devices for the student body
- One time spending on cyber security/infrastructure

The Government Finance Officers Association has a “Best Practice” Statement regarding the appropriate level of unrestricted fund balance for governmental units. Their recommendation is that political subdivisions maintain an unrestricted fund balance in the general fund of **no less than two months** of regular general fund revenues or expenditures. Two months, or one-sixth of a year, would be a fund balance of 16.67%. The GFOA recommendation allows for even higher balances if local circumstances warrant this.