

Managing Local Reserves Under the Cap

This fiscal alert serves as a reminder to school districts that the conditions required to activate the local reserve cap were met in 2021-22, which means the cap will go into effect beginning with the 2022-23 fiscal year. This alert also makes recommendations about how to manage local reserves under the cap. The local reserve cap is a function of Proposition 2 (2014) and the statute related to state Proposition 98 reserves. Currently, local reserves are strong. Unified districts ended the 2020-21 fiscal year with an average unrestricted reserve of 22.36% of total general fund expenditures and other uses, which was an increase of 3.54% over 2019-20.

The local reserve cap may entail a discussion of where Education Code and Governmental Accounting Standards Board (GASB) Statement No. 54 on fund balance intersect with one another. Small districts (with an average daily attendance of less than 2501), community-funded districts, county offices of education and charter schools are exempt from the local reserve cap specified in Education Code; however, most districts are subject to the GASB pronouncements on fund balance. The related Education Code provisions are directed at budgets, while GASB 54 addresses actual accounting records and financial statements. Keeping this distinction in mind is important to understanding how the two intersect.

Local Reserve Cap Takes Effect in 2022-23

The current year's enacted state budget provided deposits into the Proposition 98 rainy day fund that bring the balance in the fund to \$6.4 billion, triggering the local reserve cap in the following year (2022-23). The governor's proposed budget for 2022-23 makes an additional deposit to the rainy day fund, which ensures that the local reserve cap will remain in place for the foreseeable future. On March 17, 2022, the State Superintendent of Public Instruction issued a "Notification of School District Reserve Cap Requirements 2022-23 Fiscal Year," which affirms that the cap on local reserves is effective with the 2022-23 fiscal year.

The threshold percentages and how they are applied can be confusing. Proposition 2 and its enabling statutes established a 3% threshold in the Proposition 98 Public School System Stabilization Account (PSSSA), or rainy day fund. This metric is measured as 3% of the total Proposition 98 expenditures for TK-12. As noted above, the current year balance is estimated at \$6.6 billion, which exceeds the 3% threshold. When this threshold is met, it triggers a 10% cap on local districts' combined assigned and unassigned reserves (Education Code Section 42127.01(a)).

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The local reserve 10% figure is measured as a percentage of total general fund expenditures, transfers out and other uses. This is the same as the computation used to determine a local district's minimum reserve level, or reserve for economic uncertainties (sometimes also known as designated for economic uncertainties). Assigned and unassigned fund balances in the Special Reserve Fund for Other than Capital Outlay Projects (Fund 17) are added to the general fund to determine total reserves subject to the cap. Excluded from the reserve computation are the nonspendable, restricted and committed components of the fund balance.

Options to Manage the Local Reserve Cap

There are three options for eligible districts with reserves estimated to be higher than the 10% limit.

The first option is to spend down the reserves. This is sensible when it is related to an overall plan that supports students' needs and is not driven by the cap itself. Spending down reserves on one-time high-priority needs such as technology infrastructure, deferred maintenance, etc. may make sense in the context of a district's local control and accountability plan (LCAP).

The second option provided in statute is to seek a temporary waiver from the county superintendent. Each county superintendent will have to evaluate the circumstances of such a request. Education Code Section 42127.01(b) provides that a district may be exempt from the cap for up to two consecutive fiscal years within a three-year period based on documents indicating that extraordinary fiscal circumstances substantiate the need for the excess reserves. The statute requires a district to do all of the following:

1. Provide a statement that substantiates the need for a combined assigned and unassigned ending general fund balance that is more than 10%.
2. Identify the funding amounts in the budget adopted by the district that are associated with extraordinary fiscal circumstances.
3. Provide documentation that no other fiscal resources are available to fund the extraordinary fiscal circumstances.

Keep in mind if extraordinary fiscal circumstances exist, then so does the justification to commit funds. Not every county superintendent will issue a waiver, and not every district within a county will be treated the same, because each district has unique circumstances and risk factors.

FCMAT recommends against seeking a county superintendent waiver unless the county superintendent has expressed a willingness to consider such waivers. Also, a waiver is valid only for up to two consecutive years.

The third, and most viable, option available under statute is to reclassify any unassigned or assigned components of the fund balance to the committed or restricted category of the fund balance. While straightforward, this option shall be governed consistent with GASB 54. Every district should have a board policy on fund balance that references GASB 54 requirements. The model policy published by the California School Boards Association (CSBA) includes this reference in Policy 3100 – Budget and provides the following key provisions:

1. Committed fund balance includes amounts constrained to specific purposes by the Board.
2. For this purpose, all commitments of funds shall be approved by a majority vote of the Board. The constraints shall be imposed no later than the end of the reporting period

(June 30), although the actual amounts may be determined subsequent to that date but prior to the issuance of the financial statements.

The specifics and recommendations about how to reclassify funds to committed fund balance are explored in more detail below.

Excluded from each of the three options to manage the local reserve cap explored here is the reserve for economic uncertainties maintained by school districts pursuant to the criteria and standards for fiscal solvency (minimum reserve requirements) established by the State Board of Education (Education Code 33128). The reserve for economic uncertainties is a stabilization-like arrangement or minimum fund balance policy and does not meet the criteria under GASB 54 to be reported as either restricted or committed, because the circumstances in which the reserve might be spent are by their nature nonspecific and routine. As such, the reserve shall be reported as a component of the unassigned fund balance using the unique object code 9789 established under the Standardized Account Code Structure (SACS). Therefore, the reserve component of the unassigned fund balance is subject to the reserve cap.

The discussion above is not intended to limit more formal stabilization arrangements that may be eligible under GASB 54 to be classified as committed fund balance. In these cases, the circumstances under which the resources may be spent shall be both specific and nonroutine. You are encouraged to consult with your external auditors on the role and requirements for formal stabilization agreements.

Reclassifying a Portion of Local Reserves to Committed Fund Balance

GASB 54 defines *committed fund balance* as:

. . . amounts constrained to specific purposes by a government itself, using its highest level of decision-making authority; to be reported as committed, amounts cannot be used for any other purpose unless the government takes the same highest-level action to remove or change the constraint . . .

The California School Accounting Manual defines *committed fund balance* as:

Committed fund balance (objects 9750-9769) is the portion in which the use is constrained by limitations imposed by the LEA through formal action of its highest level of decision-making authority. It would include amounts set aside pursuant to an economic stabilization arrangement only if the arrangement were more formal than the reserve for economic uncertainties recommend by the Criteria and Standards for Fiscal Solvency.

FCMAT believes the best practice for making the initial commitment or modifying the commitment later is that it be done by governing board resolution and documented in the minutes of the board meeting. This ensures the highest level of transparency of the board's action. As an alternative to a separate resolution, districts can consider including the approval of the commitment in their budget adoption resolution, but districts should ensure each commitment is specifically identified. Districts should not simply include the commitment in the SACS forms without specific board action based on thoughtful justification. Each district has slightly different local preferences for and history of how items of this nature are handled. However, for school districts, formal action is typically limited to actions taken at a public meeting by the governing board, such as a vote, a resolution, or some similar action such as adoption of a budget.

A sample board resolution can be [downloaded here](#).

The list of legitimate short- and long-term needs that justify committing funds to support them is almost endless. But keep in mind that each purpose should be supported by a specific set of facts and justification. The expectations of both GASB 54 and your external auditors are that there will be specific supporting documentation for the purpose and the dollar amount committed. Examples of supporting documents may include existing or new plans (e.g., LCAP, technology plan, deferred maintenance plan, multiyear financial projections). Examples of purposes to support commitments include:

1. Unspent supplemental and concentration grant funding to support LCAP goals
2. Technology refresh and investments
3. Deferred maintenance
4. Declining enrollment mitigation
5. Specific equipment or furnishing replacement
6. Textbook adoption(s)
7. Pension obligations
8. Other post-employment benefit obligations (if the district does not maintain a Fund 20)
9. Specific deficit spending mitigation measures
10. Formal stabilization arrangements (object 9750)

Consult with your external auditors on these and other purposes for commitments, including the justifying documentation that the auditor will be expecting.

If the district has made assignments within the fund balance for specific purposes, those assignments are the first place to go when considering making a commitment. The purpose may be for the same reason, but the authority approving either the assignment or commitment is different: assignments are typically made by administrative staff; commitments are typically made by the board through formal action (as mentioned above).

The purpose of the commitment does not have to be permanent and may be changed. Committed fund balance may be redirected by the district to other purposes if the redirection is done by the same means by which the funds were committed. The original purpose supporting the commitment must be modified using the same method by which it was originally imposed, that is, by the same formal action of the highest level of decision-making authority (i.e., formal action by the board of education via resolution or other means).

Reclassifying a Portion of Local Reserves to Restricted Fund Balance and Other Funds

Making contributions to restricted programs and for purposes typically accounted for in other funds are two other strategies within the reclassifying option. Although best practices would normally avoid contributing from the unrestricted general fund to a restricted program (e.g., Title I or Career Technical Education grant), except in limited circumstances such as for routine restricted maintenance, such an action may be an appropriate strategy to use excess unrestricted reserves. In this case, the contribution, if unspent, will be categorized as restricted fund balance.

Caution is warranted here because school districts do not have the authority to simply reclassify unrestricted funds as restricted funds. Restrictions are stipulated by constitution, external resource providers, or through enabling legislation. As an example, additional contributions to programs such as routine restricted maintenance are sufficient to reclassify funds as restricted. Consult with your external auditors to ensure compliance with GASB and generally accepted accounting principles.

Making contributions of unrestricted general fund resources to another fund for a specific, assigned, committed or restricted purpose is more typical. For example, a transfer to the Special Reserve Fund for Postemployment Benefits (Fund 20), for postemployment benefit liabilities, is routine. Transfers to child development, postemployment benefit reserves, other insurance reserves, capital projects and even food services may all fit in this strategy. Details matter. In some instances, funds that have been contributed to another fund may be lawfully restricted to the purpose of the receiving fund, and reversing this contribution may be prohibited. Further caution should be exercised when a district is subject to local contributions to facility projects funded under hardship conditions. When transfers from the general fund to other governmental funds are made, the district is indicating that it intends to use those resources for the purpose of the fund that receives the monies. At a minimum, this intent meets the requirements for classification as assigned fund balance in the receiving fund. However, the classification of reserves in the other funds (except Fund 17) is immaterial to the local reserve cap calculation because only the general fund and the Special Reserve Fund for Other than Capital Outlay Projects are included in the reserve cap calculation.

Timing can be Confusing

Education Code Section 42127.01(a) requires that:

... a school district *budget* that is adopted or revised pursuant to Section 42127 shall not contain a combined assigned or unassigned *ending* general fund balance that is in excess of 10 percent of those funds [Emphasis added].

First, Section 42127 applies only to the adopted budget (July 1) or the 45-day budget revision. It does not include interim reporting periods; however, the expectation is that what is established at budget adoption is carried forward through the interim reports, unless the board changes the commitment, or the committed funds are appropriated in budgeted expenditures. Second, the prohibition is applicable to the *ending* balance, not the beginning fund balance. The implementation of the reserve cap in 2022-23 means that the adopted budget for 2022-23 (both the July 1 adopted budget and the 45-day revision) must adhere to the Education Code restriction and not contain a combined assigned and unassigned ending general fund (and Fund 17) balance of more than 10%.

As mentioned at the beginning of this alert, GASB 54 is applicable to, and a function of, the accounting process, not the budget process. As such, GASB 54's June 30 deadline pertains to estimated actuals, unaudited actuals and audited financial statements. Whether committing funds for a specific purpose or reclassifying funds to restricted programs or other funds, the timing of the board's action is important. GASB 54 requires that a district's governing board establish the constraints giving rise to a committed fund balance no later than the end of the fiscal year (June 30). The actual amounts attributable to each purpose may be determined after that date, but must occur before a district issues its financial statements. For districts, this means that the list of

purposes for committed funds shall be adopted by the board before June 30, but the amounts designated for each purpose may be determined as part of the year-end closing process typically completed in August and early September. The amounts should be included in unaudited actuals submitted to the county superintendent and the California Department of Education. It is possible that these amounts may be corrected or revised during the audit, in which case final amounts will be reported in the audited financial statements.

Districts that reclassify reserves to committed fund balance would need to show those committed purposes and estimated amounts in the adopted budget as of July 1, 2022. However, they could change the purposes and amounts during the year up to June 30, 2023, which is the applicable deadline under GASB.

Now is the Time to Explore Options and Develop a Plan

The 2022-23 fiscal year is right around the corner. Districts need to finalize their approach to local reserve caps now. If you anticipate having 2022-23 assigned or unassigned reserves that are subject to the limitation, identify your course of action as part of your current budget development process. If you intend to spend down your reserves, those expenditures must be part of your 2022-23 expenditure plan and be included in your draft and final budget documents. If you intend to seek a county superintendent waiver for 2022-23, formally start that process now with an inquiry and follow up with your county office of education. Keep in mind that this option may not be available in every county or for every district; consider it a last resort. If you intend to reclassify reserves to committed or restricted fund balance through formal board action, FCMAT recommends you have that discussion with your board of education ahead of finalizing your budget. You don't want to be surprised at budget adoption if your board does not support reclassification.

Education Code Section 42127.01(a) clearly states, “. . . a school district budget that is adopted or revised pursuant to Section 42127 shall not contain a combined assigned or unassigned ending general fund balance that is in excess of 10 percent of those funds” [Emphasis added]. Districts shall not prepare or adopt a budget with a combined assigned and unassigned general fund balance that is more than 10% (including the Special Reserve Fund for Other Than Capital Outlay Projects, Fund 17).

County superintendents have broad authority in reviewing a district's adopted budget and making a final determination about whether it meets the standards. County superintendents have several options to address a noncompliant condition in a district's adopted budget, including:

1. Disapprove the budget pursuant to Education Code Section 42127(d).
2. Conditionally approve the budget pursuant to Education Code Section 42127(d) and require that the district address the excess fund balance in order to receive approval of its budget.
3. Approve the budget but comment about the excess fund balance in the approval letter, directing the district's governing board to remedy the condition.

County superintendents will follow the basic principles of fiscal oversight in making the appropriate determination about whether a district's budget meets the standards. The county superintendent's approach and message to a district will depend on the unique circumstances and risk factors present.

Most county superintendents have reported that they are proactively communicating and working with their local districts on the requirements related to the local reserve cap and are working to help districts reclassify excess fund balance as part of the budget adoption process.

As noted in this alert, FCMAT recommends districts that project having a combined assigned or unassigned ending general fund balances of more than 10% reclassify portions of their fund balance to committed funds pursuant to the established accounting standards.

Resources

CDE letter to the field, [“Notification of School District Reserve Cap Requirements 2022-23 Fiscal Year,”](#) March 17, 2022

CDE letter to the field, [“New Requirements for Reporting Fund Balance in Governmental Funds,”](#) January 7, 2011

GASB, [“Fact Sheet about Fund Balance Reporting and Governmental Fund Type Definitions”](#)

[California School Accounting Manual, 2019 edition](#)