

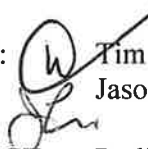


TOWN OF NORTHBOROUGH

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MEMORANDUM

TO: Select Board
Appropriations Committee
Financial Planning Committee

FROM:  Tim McInerney, Town Administrator
Jason Little, Finance Director

SUBJECT: Preliminary FY2025 Free Cash Plan

DATE: February 27, 2024

CC: Greg Martineau, School Superintendent
Financial Team
Department Heads/Agency Directors

The Town of Northborough adopted its very first set of [Comprehensive Financial Policies](#) in 2009, followed by the adoption of the Free Cash Policy in November 2010. These policies were formally approved by the Select Board with the unanimous support of the Appropriations Committee and the Financial Planning Committee. So, in accordance with the adopted Free Cash Policy, the Town's Administration has developed a Preliminary FY2025 Free Cash Plan for consideration during the upcoming budget process.

Please note that the Town's Free Cash was certified at \$3,572,920 following the close of FY2023, higher than the \$2,440,073 from FY2022. In its most basic form Free Cash is the balance of unspent Free Cash from the prior year, plus balances of appropriations not spent and revenues realized in excess of the budget.

- Unspent Free Cash from FY2022 was \$460,073 which means the Town "generated" \$3,112,847 during FY2023 resulting in certified Free Cash of \$3,572,920.¹

¹ It is important to note that although revenues exceeded the budget by \$1,869,649 and unexpended appropriations returned \$1,380,905, the combined total of "generated" Free Cash is adjusted down by \$30,584 to account for changes in overlay balances (provision for property tax abatements/exemptions) and other minor adjustments.



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- Revenues and transfers-in exceeded the FY2023 budget by \$1,869,649 or 2.76% with local receipts such as motor vehicle excise taxes and building permits performing better than anticipated due to the improving economy.
- Expenditures returned were \$1,380,905 or 1.98% of the FY2023 budget. The return included positive results in the Employee Benefit lines due to favorable health insurance experience. Staff turnover in public safety also resulted in returned appropriations as new hires were brought on at a lower salary cost.

The Administration's goal of using projections where revenues and appropriations come within *1-3% of the amounts budgeted was maintained*. With this level of Free Cash, the Town will be able to maintain an appropriation to the Reserve Account, continue to contribute the policy-targeted amount into the FY2025 Operating Budget, and once again pay cash for a significant portion of upcoming capital articles.

In addition, the preliminary Free Cash Plan maintains the Town's financial reserves within the policy limits of 5-10% of the operating budget. The Town's "reserves" are defined as being available Free Cash combined with the Stabilization Fund, which current has a balance of *approximately \$5.7 million*. Therefore, reserves currently are at about 12.5% when compared to the FY2024 budget of \$74 million. Prior to the close of FY2023, the Town's reserves were at 8%, or \$5.9 million. After the close of FY2023, the reserves increased to approximately 11%. The preliminary Free Cash Plan below provides an *initial proposal* on how these one-time funds can be used in the upcoming budget cycle. While there will be more discussion regarding the exact amounts to be used in the various categories, the plan as proposed would provide for the maintenance of financial reserves at approximately 8%, within the policy target area.

PRELIMINARY FY2025 FREE CASH PLAN	
Free Cash Certification	3,572,920
FY2025 Appropriation Reserve Fund	(175,000)
FY2025 Operating Budget	(500,000)
FY2025 Stabilization Fund	(200,000)
FY2025 Capital Projects	(2,197,920)
Total Proposed Use	(3,072,920)
Remaining after plan	500,000



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The preliminary Free Cash plan contains the annual appropriation to the Reserve Account in the amount of \$175,000, which is the same as in FY2024. Also included in the plan is a contribution of \$500,000 to the FY2025 Operating Budget, which is the goal specified in the policy. Finally, the Town has the option to contribute additional funds to the Stabilization Fund and/or use the funds to pay for capital projects, thereby forgoing debt costs. As currently drafted, the plan calls for contributing \$200,000 to the Stabilization Fund in an effort to maintain current reserve levels, as well as using \$2,197,920 to pay for various capital projects being developed during the annual capital planning process with the Financial Planning Committee. Lastly, the plan contemplates leaving approximately \$500,000 in unappropriated Free Cash, which would remain available if needed. This is a financially conservative approach, since it ensures that the Town will have at least the same level of Free Cash for use in the subsequent operating budget. The Town opted for a similar approach in each of the past ten fiscal years, leaving at least \$500,000 remaining in uncommitted Free Cash following the approval of all operating and capital appropriations.

It is important to note that the Town's bond rating, which was upgraded to [AA1](#) during FY2016, increased partially due to the Town's healthy financial reserves and disciplined implementation of the [Free Cash Policy](#). Maintenance of reserves will be critical as we contemplate moving forward with significant capital projects such as the new fire station.

As with most aspects of capital and operating budgets, the final use of Free Cash remains subject to Town Meeting approval and appropriation. The point of this exercise is to generate a planning tool based upon available resources and the Town's policy guidelines. The Financial Planning Committee and Appropriations Committee have begun meeting to discuss the various projects and funding plans for recommendation at Town Meeting. [See tentative calendar.](#)

For your reference, attached to this memo is an updated version of the previously distributed *Introduction to the Free Cash Policy* document, which is presented in the format of frequently asked questions. In addition, a copy of the appropriate section of the Financial Policies contained in Appendix A of the Annual Budget document is included for your information.

We look forward to discussing this information in more detail at your upcoming meetings.

Tim McInerney
Town Administrator

Jason Little
Finance Director



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Introduction to Northborough's Free Cash Policy

1. What is Free Cash?

In its most basic definition, Free Cash is the fiscal year-end combination of revenues that come in higher than estimated and expenditures that come in lower than budgeted. Free Cash is an available fund that is composed of the remaining, unrestricted funds from operations of the previous fiscal year including unexpended free cash from the previous year, actual receipts in excess of revenue estimates and unspent amounts in appropriated budget line-items. After the June 30th close of the fiscal year, the Town's Free Cash is certified by the State Department of Revenue and only then is it available for appropriation.

2. Why is Free Cash identified as "one-time" revenue and what are the budgetary considerations associated with this type of revenue source?

In the past, the Town of Northborough relied upon significant amounts of Free Cash to balance the operating budget and we continued this practice for many years. However, the dependency upon "one-time" available funds to supply a portion of the foundation for the operating budget essentially created a rolling *Structural Deficit*. Further, while we realize that a significant portion of the operating budget has traditionally been based on this financing source, it proved impossible during a previous economic downturn to continue using the same level of Free Cash to fund the operating budget. By necessity, use of Free Cash in the operating budget was systematically phased down over the years from \$700,000 in FY2010, to \$600,000 in FY2011, and ultimately, \$500,000 in FY2012. The Free Cash Policy target of \$500,000 was maintained from FY2012 to FY2020.

During FY2021 the economic impacts of the COVID-19 pandemic required \$878,000 in one-time revenues to balance the operating budget. The use of additional one-time funds was done in accordance with the Free Cash Policy *to allow for fiscal flexibility* during the declared state of emergency. During FY2022 the use of Free Cash returned to the policy target of \$500,000 where it has basically remained in following years.

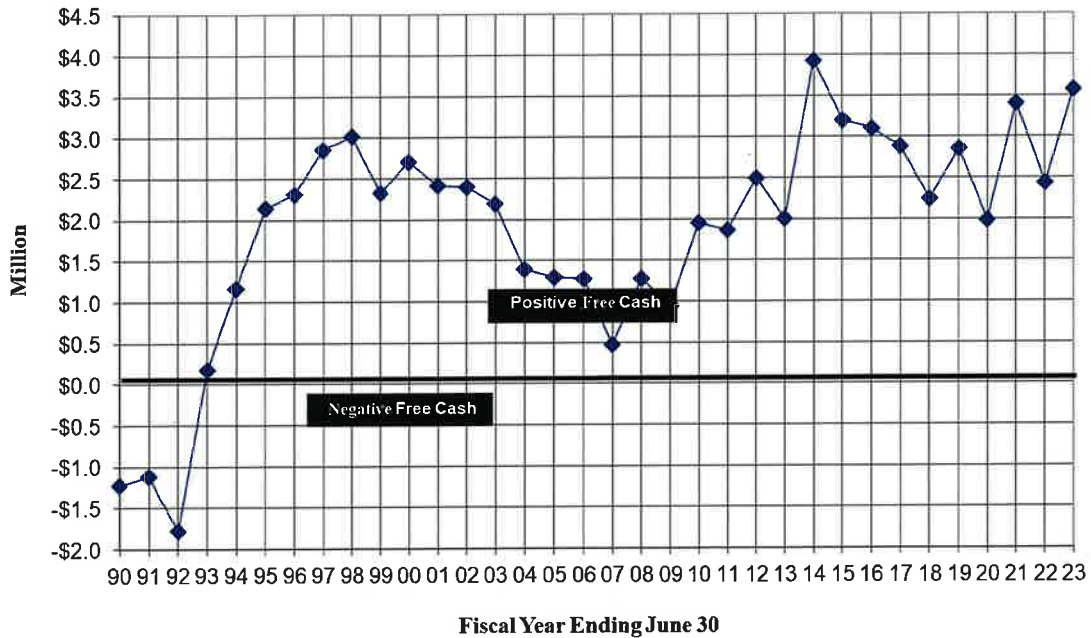


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Throughout the most recent budgets cycles a combination of positive economic activity and conservative financial management has kept the Town of Northborough in a good financial position. Certified Free Cash has varied over the last 34 years from negative \$1.78 million to \$3.93 million in the positive, as Free Cash levels tend to loosely mirror the general economic cycles. However, certified Free Cash over the last ten years has averaged \$2.96 million.

Certified Free Cash FY1990-2023



*Source: Massachusetts Department of Revenue

The chart above illustrates the unpredictability of Free Cash as a budgeted revenue source since it is heavily influenced by economic activity and political decision-making in the State Legislature. Any level of Free Cash used in the operating budget must be reasonably expected to recur in subsequent years. If the Town fails to generate sufficient Free Cash to replenish what was used, a structural deficit will materialize that could result in significant service reductions. More importantly, that structural shortfall would carry forward into subsequent fiscal years.



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3. What is the difference between a Free Cash Policy and a Free Cash Plan?

The Free Cash Policy represents the Town's agreed upon and principled approach to how this unpredictable revenue source will be used. The policy guides our decision-making process based upon sound financial planning practices and sets realistic and sustainable goals. The Free Cash Plan is the annual implementation of how actual Free Cash will be used during the budget process in the context of our policy guidelines. Any use of Free Cash is subject to Town Meeting approval and appropriation.

4. What are the acceptable uses of Free Cash under the policy?

The Free Cash Policy attempts to line up one-time revenues with appropriate one-time expenditures. A goal of the policy is to minimize the level at which recurring expenses, such as personnel, are dependent upon this revenue source. To that end, the following are explicitly authorized uses of Free Cash under the adopted policy:

- **Appropriation Committee's Reserve Fund** – Authorized by state statute, the Reserve Fund provides the Town operations with an option for the funding of extraordinary or unforeseen expenditures during the year, such as snow and ice overdrafts. Transfers from this account require the approval of the Appropriations Committee. Historically, the fund has contained approximately \$118,500 at the start of the budget year. During a following recessionary period the fund was significantly and in FY2011 the Reserve Fund was budgeted at only \$80,000. Under the 2010 Free Cash Policy this fund was raised to \$150,000 in FY2012 and later increased to \$175,000 in FY2016 where it has remained. During FY2021 the Reserve Fund was increased to \$375,000 due to the uncertainty of potential COVID-19 impacts. However, in FY2022 the Reserve Account returned to \$175,000 where it is anticipated to remain in FY2025. Any unused amount of the Reserve Fund returns to Free Cash at year-end. The Reserve Fund is designed to deal with one-time extraordinary expenditures and is therefore an appropriate use of Free Cash.
- **Limited Subsidy of the Operating Budget** – Over recent years the Town pursued a gradual transition away from using Free Cash to fund recurring operational expenses. This was accomplished by annually reducing the appropriation by \$100,000 until such time as the appropriation from Free Cash into the operating budget was lowered to \$500,000. This goal was fully realized in FY2012. Based



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upon trend analysis and historical data, it is anticipated that \$500,000, or approximately 1% of the operating budget, is a sustainable level. Given the need for conservative revenue estimates, the Town strives to generate 2-3% more in revenues than budgeted. Given the necessity of the practice, it is reasonable to return a portion of the Free Cash generated from conservative estimates back into subsequent budgets. The key is to use an amount that will realistically be available in subsequent years. It is anticipated that the level of Free Cash used in the FY2025 operating Budget will be at the target amount of \$500,000.

- **Stabilization Fund** – The Stabilization Fund can be thought of as the Town’s emergency savings account. It is designed to accumulate amounts for unforeseen circumstances, capital and other future spending purposes, although it may be appropriated for any lawful purpose in accordance with MGL Ch. 40 §5B. Communities may establish one or more stabilization funds for different purposes and may appropriate into them in any year an amount not to exceed ten percent of the prior year’s tax levy. The total of all stabilization fund balances shall not exceed ten percent of the community’s equalized value, and any interest shall be added to and become a part of the funds. A two-thirds vote of Town Meeting is required to establish, amend the purpose of, or appropriate money from the Stabilization Fund. However, it only requires a simple majority to appropriate money into one.

Historically, the Town’s budget provided for an annual appropriation of \$100,000 to add to the Stabilization Fund from the tax levy. However, from FY2008 through FY2015 no appropriations were proposed due to financial constraints. In any given year ending with healthy Free Cash levels, an appropriation to the Stabilization Fund would be among the appropriate uses for the funds and a practice that would add to the Town’s overall financial stability. Such an appropriation in the amount of \$200,000 was made in FY2020 but deferred in FY2021 and FY2022 due to the pandemic. In FY2023 and FY2024 the \$200,000 transfer to the Stabilization Fund was included in the budget. It is again recommended that \$200,000 be appropriated into the Stabilization Fund in FY2025 to maintain reserve levels.

- **Capital Improvement Program** – Another good use of Free Cash is to fund capital projects that would otherwise incur borrowing costs associated with the issuance of debt. The financing of small capital projects or equipment is not considered a best practice for a community this size. Although perfectly legal, the Town has moved away from incurring debt for vehicles and other small equipment purchases. Bond rating agencies prefer to see Towns using a pay-as-you-go approach for smaller capital projects. The one-time nature of Free Cash makes it an excellent match for



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one-time capital expenditures. If for some reason sufficient Free Cash does not materialize in a given year, the Town can make the decision to borrow for capital projects, or delay them, without causing immediate impact to the operating budget and related services. Recently, the Town chose to exercise the option of postponing some capital projects in FY2021 in order to temporarily free up financial resources during the pandemic emergency.

- **Extraordinary Deficits & Emergency Appropriations** – Lastly, Free Cash could be used to fund any potential deficits that would otherwise be carried over to the following fiscal year, such as snow and ice deficits, or emergency appropriations.

5. Why did the Town adopt a Free Cash Policy?

During the “Great Recession,” the Town was forced to deal with the operational impacts of reduced Free Cash for several budget cycles. To manage the decline of Free Cash and the impact on the operating budget, all departments had to constrain spending. When the economy improved, the Town did not want to simply return to undisciplined past practices that would leave finances vulnerable again. A goal of the Free Cash Policy is to hold the use of Free Cash in the operating budget to a sustainable level (less than 1%) and use it in a manner that adds to our long-term financial stability, such as funding capital projects.

6. What are the key benefits of the adopted Free Cash Policy and related Free Cash Plan?

- Creates a principle-based decision-making process that establishes clear, agreed upon priorities and expectations regarding the use of Free Cash.
- Provides for a planned, sustainable level of Free Cash to be used in the operating budget; thereby, preventing wild swings in available revenues.
- Links one-time revenues to one-time expenses and provides an appropriate funding source for capital projects, especially small pay-as-you-go equipment purchases.
- It strengthens the Town’s overall financial position by lowering our reliance on one-time revenues in the operating budget, provides for adequate financial



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reserves, eliminates financing costs for small projects, and increases flexibility and lead time to address significant changes in economic conditions.

- Lastly, it strengthens our bond rating; thereby lowering interest costs on future debt.



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**Excerpted from Town of Northborough's Adopted Financial Management Policies
contained in Appendix A of the FY2024 Budget document**

TOWN OF NORTHBOROUGH FINANCIAL MANAGEMENT POLICIES

III GENERAL FUND

- D. Reserves reflect a community's ability to react to unforeseen circumstances and to minimize or avoid borrowing for capital expenditures. Reserves should normally range between 5% and 10% of the Town's General Fund (operating budget) Expenditures. The Town will endeavor to continue its policy of maintaining reserves at 10% of General Fund Expenditures. Reserves are defined to include the Town's Stabilization Fund and Free Cash.

The Stabilization Fund is the Town's main reserve fund designed to provide financial stability for the Town while improving the Town's credit worthiness and flexibility. The provisions of this fund are dictated by [Massachusetts General Law, Chapter 40, Section 5B](#). The Stabilization Fund may be appropriated for any lawful purpose. However, at no time can an appropriation placed into the fund exceed 10% of the previous year's real property tax levy, nor can the fund itself exceed 10% of the equalized value of the Town.

Free Cash reserves are the remaining, unrestricted funds from operations of the previous fiscal year; these include unexpended Free Cash from the previous year, actual receipts in excess of revenue estimates and unspent amounts in budget line-items. Once certified, monies held in this reserve may be appropriated during the current budget year and may also be used as a source of revenues for the ensuing budget year.

The Town has historically used some portion of its Free Cash to subsidize the ensuing year's annual operating budget. However, it is the Town's goal to limit the amount of Free Cash used in the operating budget to a sustainable level and to use these available funds for non-recurring one-time expenses, such as capital items.



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For purposes of this policy, the following are deemed to be appropriate uses of Free Cash:

- Appropriated Reserve – an amount to provide for extraordinary or unforeseen expenditures as authorized by [MGL Chapter 40, Section 6](#).
- Operating Budget – in order to pursue a gradual transition from using Free Cash to fund recurring operational expenses, the Town will reduce its annual appropriation by \$100,000 each year until such time as the annual appropriation from Free Cash for the operating budget is lowered to \$500,000.
- Stabilization Fund – to fund or replenish the Stabilization Fund.
- Capital Improvement Program – to fund capital projects that would otherwise incur borrowing costs associated with the issuance of debt.
- Special Use – to augment the trust funds related to fringe benefits and unfunded liabilities related to employee fringe benefits.
- Extraordinary Deficits – to fund any potential deficits that would otherwise be carried over to the following fiscal year.
- Emergency Appropriations – to allow for fiscal flexibility.

The overall level of Financial Reserves is critical to maintaining the Town's Bond Rating and ensuring sufficient funds to manage unanticipated needs. Funds shall be allocated from Reserves only after an analysis has been prepared by the Town Administrator and presented to the Board of Selectmen. The analysis shall provide sufficient evidence to establish that the remaining balance is adequate to offset potential downturns in revenue sources and provide sufficient cash balance for daily financial needs.