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Statement of Position Fund Balances for Local Governments (Pre-GASB 54 Version)¹

Background

In governmental funds, a local government should identify fund balance separately between reserved and unreserved fund balance.² The local government may assign and report some or all of the unreserved fund balance as designated and undesignated. This Statement of Position is based on generally accepted accounting principles (GAAP) for government as established by the Governmental Accounting Standards Board.

Reserved Fund Balance

The function of *reserved fund balance* is to separate the portion of fund balance that is *not* appropriable for expenditure or is legally segregated for specific future uses so that the *unreserved fund balance* can serve as a measure of current available financial resources.

Under GAAP, the portion of fund balance that meets the following criteria should be classified as reserved:

- *Resources not available for spending.* Some of the assets reported in governmental funds are not available for spending in the subsequent year's budget. For example, a *long-term* loan receivable, such as an advance to another fund, is not available for *current* spending. Likewise, local governments that report supplies, inventories, and prepaid items in governmental funds typically

¹ GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions* is effective for fiscal periods that begin after June 15, 2010. Until the local government implements the requirements of GASB Statement No. 54, it should follow the guidance in this Statement of Position. If the local government early implements GASB Statement No. 54, it should follow the guidance of Statement of Position Fund Balances for Local Governments (GASB 54 Version); see <http://www.auditor.state.mn.us/default.aspx?page=20110527.018>.

² Governmental fund reporting focuses primarily on the sources, uses, and balances of current financial resources and often has a budgetary orientation. The governmental fund category includes the general fund, special revenue funds, capital projects funds, debt service funds, and permanent funds. (Codification of Governmental Accounting and Financial Reporting Standards §1300.102).

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would report a corresponding amount of *reserved fund balance* to indicate that these amounts are not actually available for spending.

- *Legal restrictions on spending.* Fund balance also is reserved to indicate situations where a portion of fund balance is not available for new spending because of legal restrictions involving parties outside the financial reporting entity. One common example is amounts reserved for encumbrances, which represent contracts for goods or services with outside parties still outstanding at the end of the year. Reservations also are commonly used to report legal restrictions arising from state statutes or grant requirements placed on the use of specific resources.

Unreserved Fund Balance

The part of fund balance not identified as reserved is the *unreserved fund balance*. The unreserved fund balance may, in turn, be subdivided into *designated* and *undesignated* portions.

Designated Fund Balance

Whereas GAAP dictates the criteria for reserved fund balance, fund balance designations represent management's intended use of resources. Fund balance designations may be established to indicate management's tentative plans for financial resource utilization in a future period, such as for general contingencies or for equipment replacement. Such designations reflect tentative managerial plans or intent and should be clearly distinguished from that which is reserved. Designations should be supported by actual plans approved by either the governing body or an appropriate officer. Such plans or intent are subject to change and may never be legally authorized or result in expenditures. Expressed another way, designations are a government's self-imposed limitations on the use of available current financial resources.

Unreserved fund balance is *designated* for a local government's intended use of current available financial resources. The focus on current financial resources is unique to governmental funds. Accordingly, designations are reported on the face of the balance sheet only in connection with governmental funds. Designations should be reported as part of the unreserved fund balance designated for . . . , or disclosed parenthetically or in the notes to the financial statements.³ GAAP does not allow for any equivalent equity designation to be used for government-wide financial reporting or for proprietary fund and fiduciary fund financial reporting.

Undesignated Fund Balance

The unreserved undesignated fund balance consists of current resources available for which there are no government self-imposed limitations or set spending plan. Although

³ Codification of Governmental Accounting and Financial Reporting Standards §1800.144.

there is generally no set spending plan for the undesignated portion, there is a need to maintain a certain funding level. Undesignated fund balance is commonly used for emergency expenditures not previously considered. In addition, the resources classified as undesignated can be used to cover expenditures for revenues not yet received.

The basic financial statements should provide information on the nature and purpose of each major component of reserved fund balance and unreserved fund balance. The notes to the financial statements should disclose this information when it is not discernible on the face of the financial statements.

Recommendations

Adoption of Fund Balance Policy

The Office of the State Auditor (OSA) recommends that each local government establish a formal policy on the level of unreserved fund balance that should be maintained in the general fund and special revenue funds. The policy should be set by the governing body and should provide both a time frame and a specific plan for increasing or decreasing the level of unreserved fund balance. If the fund balance does not match the policy, a plan should be developed by the governing body that will allow for compliance with the policy.

The OSA recommends each local government adopt a policy specifying the types of future expenditures to be designated, how the amounts for such designations are arrived at, and whether the governing body will set the designations annually or will set up a designation process and appoint someone to make the determination based on the guidelines established by the governing body.

The local government's revenue streams should be kept in mind when drafting such a policy. For example, funds that rely heavily on property taxes must maintain sufficient financial resources to provide adequate resources until the next tax revenue collection cycle. Funds that rely on state appropriations and grants should consider the timing of those payments. Also, local governments need to maintain a prudent level of financial resources to protect against a forced service level reduction or having to raise taxes and fees because of temporary revenue shortfalls or unpredicted one-time expenditures.

Other considerations include the predictability of revenues and the volatility of expenditures--higher levels of unreserved fund balance may be needed if significant revenue sources are subject to unpredictable fluctuations or if operating expenditures are highly volatile. The availability of resources in other funds as well as the potential drain on the general fund resources from other funds could affect the level of unreserved fund balance needed. The availability of resources in other funds may reduce the amount of unreserved fund balance needed in the general fund, just as deficits in other funds may require that a higher level of unreserved fund balance be maintained in the general fund.

In some cases, the unreserved fund balance in special revenue funds may not be available for use for general operations of the local government. For example, a park dedication special revenue fund in a city or a ditch special revenue fund in a county would not be available for use for general operations. In these situations, it is important for the local government's fund balance policy to document that these types of funds are not available for future appropriation to the general operations of the local government.

Appropriate Fund Balance Levels

The OSA recommends that, at year-end, local governments maintain an unreserved fund balance in their general fund and special revenue funds of approximately 35 to 50 percent of fund operating revenues or no less than five months of operating expenditures, which should provide the local government with adequate funds until the next property tax revenue collection cycle. The adequacy of unreserved fund balance should be assessed based on an individual local government's own circumstances. If the local government's unreserved fund balance is less than or greater than the 35 to 50 percent recommended above, the local government should be able to explain the reason for the difference.

Local governments should also consider taking a position on the level of unreserved fund balance in other funds that have unrestricted revenues. In setting an appropriate level, the local government should consider any long-term forecasting/planning issues to avoid the risk of placing too much emphasis on the level of unreserved fund balance at any one time.