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Hot Topic: The New Fund Balance (2011)

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June 20, 2011

THE NEW FUND BALANCE

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INTRODUCTION

The Government Accounting Standards Board issued Statement 54: Fund Balance Reporting and Governmental Fund Type Definitions. The implementation date for this standard is for periods beginning after June 15, 2010, which means FYE 6/30/11.

The statement has raised several issues related to the way cities now define governmental funds, mainly special revenue funds, and the classification of fund balance in financial reports. Fund balance is only used in the governmental fund types:

- General Fund
- Special Revenue Funds
- Debt Service Funds
- Capital Projects Funds
- Permanent Funds

Proprietary funds and internal service funds use the term “net assets” to describe the equity in the funds. That terminology changed with the implementation of GASB 34. Consequently, the changes resulting from GASB 54 do not affect fund types other than governmental fund types listed above.

FUND BALANCE REPORTING

Governmental accounting standards now require the reporting of five classifications of fund balance.

NON-SPENDABLE

This classification of fund balance includes amounts that due to their nature cannot be spent, i.e. inventory. Amounts that legally or contractually cannot be spent also are required to be classified as non-spendable. An example might include the corpus or principal in a permanent fund that is legally required to remain intact.

RESTRICTED

Amounts required to be classified as restricted result from restrictions placed on their use by:

- External enforceable legal restrictions that are imposed by creditors, grantors, contributors, or laws and regulations of other governments.
- Imposed by law through constitutional provisions or enabling legislation.

Examples of restricted fund balance amounts include unspent grant funds, debt covenants and gasoline tax revenue for street purposes.

COMMITTED

Amounts defined as committed arise from self-imposed constraints put on the use of the funds by the government’s highest level of authority, which is the full governing body. The commitment must be made by formal action (resolution or ordinance) and the action must be taken before the end of the fiscal

year. An example might include the passing of a resolution to commit \$20,000 for upgrading the city's computer system.

ASSIGNED

Amounts defined as assigned arise from intentions of the government to use the funds for a specific purpose. This action may be taken by the highest level of authority or a designated body (committee) or an individual (city manager or mayor). Assignment of fund balance is a less formal action than required for committed funds and the action may be taken after the end of the fiscal year.

UNASSIGNED

The amounts in the unassigned fund balance classification represent those funds that are left for spending after funds earmarked for specified purposes have been otherwise classified. The General Fund is the only fund that will record a positive unassigned fund balance. The nature of other fund types automatically makes those resources restricted, committed or assigned. The only situation where other types of funds would report amounts in the unassigned fund balance category is if the balance is negative. This might occur if the fund spends more resources than it has available in restricted, committed or assigned fund balance.

Note: The term "unrestricted fund balance" used in publications refers collectively to the three categories of committed, assigned and unassigned.

FUND BALANCE POLICY

The statement requires that governments report certain policies and procedures in the footnotes to the audited financial statements. Does this mean

cities have to adopt a formal fund balance policy? No, but adopting a fund balance policy is a good idea and is viewed favorably by credit rating agencies. Regardless of whether governments adopt a formal fund balance policy the following information must be included in the June 30, 2011, audited financial statements:

1. For committed fund balance:
 - a. What is the government's highest level of decision-making authority, i.e. full board?
 - b. What is the formal action required to the taken to commit resources, i.e. resolution or an ordinance.
2. For assigned fund balance:
 - a. The body (committee) or individual (mayor, city manager or finance director) authorized to assign resources for a specific purpose.
 - b. The policy established by the governing body that gives that authorization. (See sample policies attached in exhibits A and B).
3. What order will fund balances be utilized?
 - a. The government must state whether restricted or unrestricted resources will be used when expenditures are incurred where either may be used.
 - b. Disclosure must also be made regarding whether committed, assigned and unassigned fund balances are considered to be used when the expenditure incurred is for the specified purpose of those classifications.
4. The purpose of each special revenue fund, identifying each specific revenue stream that is committed or restricted.
5. Detail of the nature of the non-spendable, restricted, committed or assigned fund balance amounts if not presented on the face of the balance sheet.

June 20, 2011
THE NEW FUND BALANCE

When developing a fund balance policy certain elements should be considered. The policy should include the above required disclosures as detailed in items 1-3, the minimum unrestricted fund balance requirement for the general fund and the policy for use and replenishment of stabilization (rainy day) fund resources if the government has one. The Government Finance Officers Association recommends that governments keep at least two months of operating revenues or expenditures in the general fund balance. Maintaining a comfortable cushion is crucial to good financial management because it helps governments compensate for unexpected events.

DEFINING GOVERNMENTAL FUNDS

The definitions of special revenue, capital projects and debt services funds were changed or clarified in the new accounting standard. A special revenue fund can only be used if a significant amount of revenue supporting the activities is restricted or committed for that specific purpose (other than debt service or capital projects). Restrictions must be imposed by an external source such as the state or federal government. A common example is the state street aid fund, which is supported by revenues restricted by state law to be spent on specific street-related expenditures. The restricted source of revenue has to be considered a substantial source of revenue for the fund. A committed revenue source would be one that the full governing board has passed a resolution committing that stream of revenue for a specific purpose and that constitutes a substantial funding source of the fund.

Capital projects funds may include expenditures for general capital purchases. In the past capital

projects funds have been used primarily for major construction projects. Only general fund capital projects should be accounted for in capital project funds, any capital projects done by utilities (proprietary funds) should be accounted for in their respective funds.

Debt service funds are to be used when legally required or when resources are being accumulated to pay for principal and interest on long-term debt. This is simply a clarification from previous standards.

PRACTICAL SUGGESTIONS **FUND TYPES**

Some special revenue funds currently established by governments may not meet the definition of a special revenue fund under GASB 54. Tennessee law currently requires that solid waste operations be accounted for in either a special revenue fund or operating landfill or incinerator in a proprietary fund. Fees charged for solid waste services are not considered restricted and are not committed unless the governing body adopts a resolution committing its use for only solid waste purposes. Any existing special revenue fund that does not meet the new definition must be combined into the general fund at the end of the fiscal year for reporting purposes. In other words, governments should continue to account for solid waste operations in a separate fund during the year. The Comptroller of The Treasury, Division of Municipal Audit has issued the following guidance:

“The activities being accounted for in a proprietary fund are not impacted. However, activities being accounted for in special revenue funds will be affected. Solid waste activities will not meet the criteria for being reported

June 20, 2011
THE NEW FUND BALANCE

in a special revenue fund. To bridge the gap, the accounting records will still account for solid waste activities as they have in the past. However, for financial reporting purposes, the activities will be rolled into the general fund. A supplemental schedule should be created to reflect the activities to demonstrate compliance with T.C.A.”

The complete directive from Municipal can be found in the Internal Control and Compliance Manual for Tennessee Municipalities, www.comptroller1.state.tn.us/ma/citymanual.asp.

CLASSIFYING FUND BALANCES

Classifying fund balances for implementation of the new standard will require governments to assess decisions made throughout the year regarding how resources are intended to be spent. Some of the steps necessary to properly classify fund balances include:

- Determine if the government has non-spendable assets such as inventory, pre-paid expenditures or long-term receivables (due from other funds) that should be classified.
- Locate any resolution or ordinance that earmarks a specific revenue stream or available resources for a specified purpose.
- Identify any restrictions placed on resources by external parties such as debt covenants and state or federal law.
- Document if authority has been given to a committee or individual to assign resources and create a list of assignments made by those parties.

INTERNAL ACCOUNTING AND REPORTING

T.C.A. § 9-2-405, known as the Local Government Modernization Act of 2005, requires that local government accounting and reporting comply with generally accepted accounting principles. Penalties may be assessed at the discretion of the comptroller’s office for non-compliance with the act. What this means for governments is they must follow accounting standards established by the Governmental Accounting Standards Board (GASB). In order to record the new fund balances in the internal accounting system new account numbers must be established. Depending on the type of software used in each government this may have to be done with assistance from software vendors. MTAS recommends that governments consult with their software vendors and independent auditors prior to making any adjustments to fund balance in the accounting system. The best solution for the time being is to create a separate spreadsheet or file to reclassify fund balances and maintain supporting documentation for your classification decisions for the independent auditors.

Contact an MTAS finance consultant if you have specific questions regarding the new fund balance requirements.

June 20, 2011
THE NEW FUND BALANCE

Exhibit A
**GENERAL FUND
FUND BALANCE POLICY**

The Fund Balance Policy is intended to provide guidelines during the preparation and execution of the annual budget to ensure that sufficient reserves are maintained for unanticipated expenditures or revenue shortfalls. It also is intended to preserve flexibility throughout the fiscal year to make adjustments in funding for programs approved in connection with the annual budget. The Fund Balance Policy should be established based upon a long-term perspective recognizing that stated thresholds are considered minimum balances. The main objective of establishing and maintaining a Fund Balance Policy is for the city to be in a strong fiscal position that will allow for better position to weather negative economic trends.

The Fund Balance consists of five categories:

Non-spendable, Restricted, Committed, Assigned, and Unassigned.

- **Non-spendable Fund Balance** consists of funds that cannot be spent due to their form (e.g. inventories and pre-pays) or funds that legally or contractually must be maintained intact.
- **Restricted Fund Balance** consists of funds that are mandated for a specific purpose by external parties, constitutional provisions or enabling legislation.
- **Committed Fund Balance** consists of funds that are set aside for a specific purpose by the city's highest level of decision making authority (council). Formal action must be taken prior to the end of the fiscal year. The same formal action must be taken to remove or change the limitations placed on the funds.
- **Assigned Fund Balance** consists of funds that are set aside with the intent to be used for a specific purpose by the city's highest level of decision making authority or a body or official that has been given the authority to assign funds. Assigned funds cannot cause a deficit in unassigned fund balance.
- **Unassigned Fund Balance** consists of excess funds that have not been classified in the previous four categories. All funds in this category are considered spendable resources. This category also provides the resources necessary to meet unexpected expenditures and revenue shortfalls.

NON-SPENDABLE AND RESTRICTED FUNDS

Non-spendable funds are those funds that cannot be spent because they are either:

- 1) Not in spendable form (e.g. inventories and pre-pays).
- 2) Legally or contractually required to be maintained intact.

June 20, 2011
THE NEW FUND BALANCE

It is the responsibility of the finance director to report all non-spendable funds appropriately in the city's financial statements.

Restricted funds are those funds that have constraints placed on their use either:

- 1) Externally by creditors, grantors, contributors, or laws or regulations or other governments.
- 2) By law through constitutional provisions or enabling legislation.

It is the responsibility of the finance director to report all restricted funds appropriately in the city's financial statements. All restricted funds also must be reported to the city's governing body within two months of the end of the fiscal year.

ORDER OF USE OF RESTRICTED AND UNRESTRICTED FUNDS

When both restricted and unrestricted funds are available for expenditure, restricted funds should be spent first unless legal requirements disallow it.

When committed, assigned and unassigned funds are available for expenditure, committed funds should be spent first, assigned funds second, and unassigned funds last.

AUTHORITY TO COMMIT FUNDS

The city's governing body has the authority to set aside funds for a specific purpose. Any funds set aside as committed fund balance requires the passage of a resolution or ordinance by a simple majority vote. The passage of a resolution or ordinance must take place prior to June 30 of the applicable fiscal year. If the actual amount of the commitment is not available by June 30, the resolution or ordinance must state the process or formula necessary to calculate the actual amount as soon as information is available. In the event the governing body wishes to lift the committed status of funds so that they may be used for general purposes, a formal action equal to that which originally committed the funds must be taken.

STABILIZATION FUNDS

The city's governing body has the authority to establish a financial stabilization account that will be a committed fund balance. A financial stabilization account is established for the purpose of providing funds for an urgent event that affects the safety of the general public (e.g. flood, tornado, etc.). The minimum level for the financial stabilization account is 5 percent of general fund expenditures. The recognition of an urgent event must be established by the governing body or its designee (e.g. chief administrative officer). If established by the governing body's designee, the specific urgent event must be reported to the governing body at its next meeting. A budget amendment must be approved by the city's governing body. In the event that the balance drops below the established minimum level, the city's governing body will develop a plan to replenish the financial stabilization account balance to the established minimum level within four years.

June 20, 2011
THE NEW FUND BALANCE

AUTHORITY TO ASSIGN FUNDS

Upon passage of the fund balance policy, authority is given to the city's finance director to assign funds for specific purposes in an amount not to exceed \$ _____ per purpose or in total not to exceed \$ _____. Any funds set aside as assigned fund balance must be reported to the city's governing body at their next regular meeting and recorded in the minutes. The governing body has the authority to remove or change the assignment of the funds with a simple majority vote.

The city's governing body has the authority to set aside funds for the intended use of a specific purpose. Any funds set aside as assigned fund balance requires a simple majority vote and must be recorded in the minutes. The same action is required to change or remove the assignment.

Upon passage of a budget ordinance where fund balance is used as a source to balance the budget, the finance director shall record the amount as assigned fund balance.

UNASSIGNED FUND BALANCE

Unassigned fund balance is the residual amount of fund balance in the general fund. It represents the resources available for future spending. An appropriate level of unassigned fund balance should be maintained in the general fund in order to cover unexpected expenditures and revenue shortfalls.

Unassigned fund balance may be accessed in the event of unexpected expenditures up to the minimum established level upon approval of a budget amendment by the city's governing body. In the event of projected revenue shortfalls, it is the responsibility of the finance director to report the projections to the city's governing body on a quarterly basis and shall be recorded in the minutes.

Any budget amendment that will result in the unassigned fund balance dropping below the minimum level will require the approval of two-thirds vote of the city's governing body.

The fund balance policy establishes a minimum unassigned fund balance equal to 25 percent of general fund expenditures. In the event that the balance drops below the established minimum level, the city's governing body will develop a plan to replenish the fund balance to the established minimum level within two years.

June 20, 2011
THE NEW FUND BALANCE

Exhibit B
SAMPLE CITY, TENNESSEE
MINIMUM FUND BALANCE POLICY

PURPOSE

The city hereby establishes and will maintain reservations of fund balance as defined herein in accordance with Governmental Accounting Standards Board Statement No. 54 Fund Balance Reporting and Governmental Fund Type Definitions and with regards to guidance from the Government Finance Officers Association (GFOA) GAAFR. This policy shall apply to the city's general fund and general debt service fund. Governmental fund balance may be composed of restricted, committed, assigned, non-spendable and unassigned amounts per GASB Statement 54.

MINIMUM LEVEL OF UNASSIGNED FUND BALANCE — GENERAL FUND

The general fund unassigned fund balance will be maintained at a level sufficient to provide for the required resources to meet operating cost needs, to allow for unforeseen needs of an emergency nature, and to permit orderly adjustment to changes resulting from fluctuations of revenue sources. Given that current property tax collections do not begin until the fourth month of the fiscal year, Sample City will maintain at least 15 percent of the next year's budget in the unassigned fund balance of the general fund.

Any amounts remaining in the fiscal year-end unassigned fund balance in excess of 15 percent of the approved subsequent year's budget will be available for appropriation by the city legislative body to cover such items as revenue shortfalls and unanticipated expenditures, and to ensure stable tax rates. The city legislative body will attempt whenever possible to avoid appropriating such funding for recurring expenses.

MINIMUM LEVEL OF FUND BALANCE — GENERAL DEBT SERVICE FUND

It is the practice of the city to pay the principle and interest requirements on the city's debt obligations from the debt service fund. Each year the budget committee of the city shall determine or estimate the principle and interest requirements of the city and recommend sources of revenues to meet these actual or projected requirements. Additionally, it shall be the policy of the city to begin each fiscal year with a balance of cash or investments in the debt service fund in a conservatively calculated amount adequate to meet (1) cash flow needs, (2) budgeting contingencies, (3) emergency contingencies, (4) variable rate volatility contingencies plus (5) future forecasted needs.

Cash flow requirement component: The majority of local city revenues come from property taxes. Property taxes levied for a specific fiscal year are generally collected in the second half of that fiscal year. For this reason, it is common for the city to expend more than it collects during the first half of the fiscal year. For this reason, it shall be the policy of the city to begin each fiscal year with a sum of cash or investments equal to the debt

June 20, 2011
THE NEW FUND BALANCE

service fund requirements scheduled to be expended during the first six months of the next fiscal year. This amount will typically equal six months of interest expense on the city's total indebtedness unless the city schedules principal payments in the first six months of the fiscal year. Generally, except for short-term capital outlay notes, the city will not schedule principal payments in the first six months of the fiscal year.

ANNUAL REVIEW AND DETERMINATION OF FUND BALANCE RESERVE AMOUNTS

Compliance with the provisions of this policy shall be reviewed as a part of the annual budget adoption process and amounts of the minimum level of unassigned fund balance in the general fund and the minimum level of available fund balance (for debt service payments) in the debt service fund shall be determined during this process.

MUNICIPAL TECHNICAL ADVISORY SERVICE

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