

Explanation of Fund Balance

Governmental funds report the difference between their assets and liabilities as *fund balance*. Under Generally Accepted Accounting Principles (GAAP) fund balance is divided into reserved and unreserved portions. The *reserved fund balance* isolates the portion of fund balance that is not available for appropriation to the next budget. Under GAAP the *unreserved fund balance* can be further divided into designated and undesignated portions with the *designated fund balance* representing intended uses of fund balance. Designating the use of fund balance is a powerful tool in prudent fiscal planning, allowing governments to manage their future fiscal health. *Unreserved/undesignated fund balance* is fully available for appropriation and, under the Code of Public Local Laws of Carroll County Article 7, 3-62(19), must be appropriated to the next budget following the completion of an independent financial audit of those funds.

The reservation of fund balance is necessary for two reasons:

- *Resource 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 is not available for current 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. A common example is funds reserved for encumbrances.

The designation of funds is a fiscal tool used to ensure the County's fiscal stability. Some examples of designations include:

- *Stabilization Fund.* The County maintains a stabilization fund of 3% of budget to provide a reserve against certain specified conditions including a natural disaster or a sudden and unexpected drop in revenues.
- *Medical Claims Reserve.* The County is self-insured for medical and hospitalization costs and maintains a reserve against a short-term rise in claims experience.

Projected Fund Balance

Projected for 6/30/06
as of 6/27/06

Beginning Fund Balance	\$77,439,731
Revenues ¹	264,324,840
Expenditures	<u>(276,522,740)</u>
Projected Ending Fund Balance	\$65,241,831
 Reserved Funds	
Loans to Carroll County General Hospital	\$80,529
Loans to Volunteer Fire Companies	12,791,188
Encumbrances	900,000
Inventory	933,320
Loans to Municipalities	305,872
Loans for Economic Development	5,082,184
Advances to Industrial Development Authority	1,790,000
Agricultural Preservation IPA Payables	3,856,864
Total Funds Reserved	\$25,739,957
 Unreserved/Designated Funds	
Stabilization Fund	\$9,500,000
Subsequent Years' Expenditure of Undesignated/Unreserved Fund Balance	12,891,533
Lien Certificates	15,000
Workers Compensation Claims Reserve	400,000
Vehicle Replacement Reserve	500,000
Agricultural Center Loan	20,000
Short-Term Reserve	5,250,000
Medical Claims Reserve	1,400,000
Loan to Lineboro Fire Company	120,880
Loan to Warfield Development	315,387
Total Funds Unreserved But Designated	\$30,412,800
 Projected Ending Fund Balance	 \$65,241,831
Less Reserved Fund Balance	25,739,957
Less Unreserved/Designated Fund Balance	<u>30,412,800</u>
Unreserved/Undesignated Fund Balance	\$9,089,074

THE USER'S PERSPECTIVE

MAY 2006

Fund Balance: It May Not Be What You Think It Is

The annual financial reports of state and local governments are many things to many people. They are designed to provide information that helps a wide variety of people—bond analysts and attorneys, government researchers, legislative staff, and so on—make disparate decisions and answer myriad questions. Although different types of financial statement users try to address varying concerns, certain pieces of information appear to be nearly universally valuable. Foremost among that information may be fund balance.

If fund balance is broadly useful, it is equally broadly misunderstood. Research by the GASB has found that even the most sophisticated and experienced users of governmental financial information may not agree on what fund balance actually communicates. The confusion is exacerbated by inconsistencies in how governments report fund balance. The result is that the fund balance you see in the financial statements may not mean what you think it means.

Fund Balance Basics

Most simply, fund balance is the difference between assets and liabilities in a governmental fund. The governmental funds account for the bread-and-butter, typically tax-supported activities of a government (as opposed to the proprietary funds, which account for self-financing, business-like activities), and include:

- The general fund, where a government accounts for everything not reported in another fund
- Special revenue funds, for reporting specific revenue sources that are limited to being used for a particular purpose
- Debt service funds, which account for the repayment of debt
- Capital project funds, which track the accumulation and use of resources for constructing, acquiring, and rehabilitating capital assets, such as buildings and roads
- Permanent funds, where a government reports principal amounts that are restricted to being invested to produce income but cannot be spent.

Resources in a fund other than the general fund are either (1) required to be used for the purpose of the fund or (2) intended by the government to be used for that purpose.

The governmental funds report information on a modified accrual basis of accounting and current financial resources measurement focus. In other words, with a few exceptions the governmental funds balance sheet reports cash and other financial resources (such as receivables) as assets and amounts owed that are expected to be paid off within a short period of time as liabilities. The fund balance in any given fund is essentially what is left over after the fund's assets have been used to meet its liabilities.

Fund balance is required to be reported in two components—reserved and unreserved. When fund balance is *reserved*, it either means that the resources are in a form that cannot be appropriated and spent (such as inventory) or that the resources are legally limited to being used for a particular purpose. For instance, grant monies from the federal government that may be used only for building

Fund Balance: It May Not Be What You Think It Is

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schools would be reported as reserved fund balance in the general fund or a broad capital projects fund. Governments also tend to report the nonexpendable portion of their permanent funds—the resources that can be invested but not spent—as reserved fund balance.

The portion of fund balance that is not reserved is fittingly called *unreserved* fund balance. It represents resources that can be used for any purpose of the fund they are reported in. Unreserved fund balance in a debt service fund can be used to repay any outstanding debt. Unreserved fund balance in the general fund can be used for any purpose at all.

Governments may report *designations* of their unreserved fund balance. Although unreserved fund balance is not legally limited to any specific purpose, a government may designate some unreserved fund balance to express its *intention* to use available resources in a particular manner. A designation is not legally binding but does convey a government's plans for using its available resources. Reporting designations is optional and only about half of governments studied by the GASB did so.

The fund balance section of a government's balance sheet might look like this:

Figure 1. Sample Fund Balance Section of a Governmental Funds Balance Sheet

Fund balances:	General Fund	Major Special Revenue Funds		Major Debt Service Fund	Major Capital Projects Fund	Other Funds	Total
		Transportation Fund	School Aid Fund				
Reserved for:							
Encumbrances	\$ 86,319	\$ 42,815	\$ —	\$ —	\$ —	\$ 2,254	\$ 114,288
Long-term receivables	37,000	—	—	—	—	—	37,000
Inventory	104,500	50,763	1,096	—	—	2,042	156,400
Pothole repair	—	102,770	—	—	—	—	102,770
Social services	241,563	—	—	—	—	—	241,563
Law enforcement	—	—	—	—	—	36,426	36,426
Parks and recreation	78,950	—	—	—	—	—	78,950
Education	54,125	—	—	—	—	—	54,125
School construction	—	—	—	—	313,654	—	313,654
Capital projects	—	—	—	—	140,135	—	140,135
Other purposes	61,582	—	—	—	—	—	61,582
Unreserved:							
Designated, reported in:							
General fund	597,932	—	—	—	—	—	597,932
Special revenue funds	—	193,976	—	—	—	109,025	302,000
Capital projects funds	—	—	—	—	123,456	—	123,456
Undesignated, reported in:							
General fund	829,709	—	—	—	—	—	829,709
Special revenue funds	—	160,051	119,185	—	—	224,839	508,645
Debt service funds	—	—	—	364,163	—	12,345	378,498
Capital projects funds	—	—	—	—	754,201	—	754,201
Total fund balances	\$1,974,389	\$ 663,174	\$ 120,280	\$ 364,163	\$1,334,440	\$ 384,831	\$4,731,643

The Relationship of Fund Balance to Its Fund

Fund balance information should be interpreted in the context of the particular fund it is reported in, rather than from the perspective of all funds or of the entire government. Any legal limitation imposed on how resources in the general fund may be used would be reported as reserved fund balance, because resources in the general fund are available for any purpose. However, because resources in another governmental fund are already limited to or intended for the purpose of that fund, reserved fund balance communicates *an additional limitation* on how resources can be used that is *more specific* than the purpose for which the fund was created. This subtlety, which has a significant impact on how fund balance is interpreted, is not well understood by many users, preparers, and auditors of financial statements.

Consider a special revenue fund created to account for a motor vehicle fee that is legally restricted to being used only for transportation purposes. A point of contention is how unreserved fund balance in that fund should be understood. Based on the current standards, it can be asserted that the intent of the unreserved account is to report the amount available to be used for any *transportation* purpose, rather than an amount available for *any* purpose the government chooses. If fund balance is reserved in that fund, it means that a legally-binding limitation has been placed on some of the fund's resources for a specific transportation activity, program, or project. The reservation conveys that, although all resources in the fund can only be used for transportation purposes, the reserved resources can legally be used only for *certain* transportation purposes.

Figure 2. Examples of How Reservations Relate to the Purpose of the Fund

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How Resources Would Be Reported in:			
	General Fund	Broad Capital Projects Fund	School Construction Fund
State government grant to a locality for school construction	Reserved for school construction	Reserved for school construction	Unreserved

How Resources Would Be Reported in:			
	General Fund	Broad Debt Service Fund	Highway Debt Service Fund
Federal grant to pay for debt service on highway projects	Reserved for highway-related debt	Reserved for highway-related debt	Unreserved

How Resources Would Be Reported in:			
	General Fund	Public Safety Special Revenue Fund	Police Special Revenue Fund
Property tax surcharge restricted to financing police protection	Reserved for police	Reserved for police	Unreserved

Most respondents to a GASB survey of financial statement users did not understand that fund balance was intended to be interpreted within its fund. Only three out of ten respondents correctly answered that a limitation consistent with the purpose of the fund, but not more specific, *does not* lead to reserved fund balance. But they were not alone. When asked to describe the criteria they use to decide when fund balance should be reported as reserved, very few of the government finance officers surveyed recognized the distinction either.

The consequences of this misunderstanding can be seen in financial statements. A review by the GASB of nearly 200 financial reports found that more than half of the governments reserved the *entire* fund balance of at least one fund and more than one-third did so for two or more funds. To appropriately reserve all of a fund's fund balance, the fund would have to be broadly defined and all of the resources it contains would have to be legally limited to more specific purposes. For instance, if a government has a single capital projects fund to report all of its capital construction activity and all of the resources in the fund are legally limited to being used for particular individual capital projects (a specific bridge project or the purchase of a fire truck) or types of capital projects (bridge reconstruction projects or firefighting equipment), then it would reserve all of that fund's fund balance. However, such circumstances are more the exception than the norm. Therefore, it is likely that most of those governments that reserved all of a fund's fund balance were not aware that the broader level of use limitation should be inferred from the fund itself. Of course, this misunderstanding could be traced to a lack of clarity in the current standards.

Figure 3. The Meaning of Unreserved Fund Balance

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

Fund Balance: It May Not Be What You Think It Is

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Unreserved fund balance represents resources that can be used for...	Any purpose at all	Any purpose consistent with the restriction placed on the fund	Repaying any outstanding debt	Financing any capital project	Any purpose stipulated by the provider of the non-expendable corpus
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Although this issue may seem esoteric, it can have a significant impact on the user of the financial statements. If the accounting standards are applied based on the intent described above, a financial statement user should not conclude that unreserved fund balance in any fund other than the general fund can be used for any purpose. One should realize that those resources are available only for the purpose of the fund they are reported in. If a government reserves all of a fund's fund balance, the reader of the balance sheet may come away believing there is no flexibility in how those resources can be used, when in fact there is.

So, could the GASB solve these problems simply by clarifying this point? While doing that might be helpful, it would be a partial solution. The users of financial statements look to the fund balances of governmental funds because they know from experience that they can find generally available resources there. It is popularly believed that some governments transfer resources from the general fund to another governmental fund although they do not intend to use the resources for the purpose of that fund. This may be done in order to minimize the size of the fund balance in the general fund.

It is very difficult to identify when this has happened by looking at the financial statements; even if such resources are reported as unreserved, you cannot distinguish between the available resources that belong in the fund and those that reside there temporarily. The public may be helped by a provision of GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, requiring governments to provide information about the resources they transfer between funds. The standards require governments to describe the general reasons why they made transfers between funds and to present the actual amounts transferred between each of the fund columns in the governmental and proprietary funds financial statements. Governments should also specify the amounts and intended purposes of significant transfers that do not occur routinely or are inconsistent with the activities of the fund making the transfer, such as a transfer from a capital projects fund to the general fund.

Other Fund Balance Issues

Many of the respondents to the GASB's survey of users commented that they were unsatisfied with the level of detail with which governments report reserved and designated fund balance. This is borne out in both the GASB's survey of finance officers and its financial statement review. A sizeable percentage of reserved fund balance is reported with nondescript labels such as "subsequent year's expenditures," "other," "specified programs," and "continuing appropriations." It is also common for large portions of fund balance in capital projects funds to be reported simply as "reserved for capital projects" without any further explanation; similarly, fund balance in debt service funds is often reported as "reserved for debt service." Such titles convey little information to the financial statement user about the nature of the limitations placed on a government's resources.

In the financial statements of local governments other than counties reviewed by the GASB, the combination of unspecified reservations and reservations for capital projects or debt service in general averaged 50 to 60 percent of reserved fund balance. For county governments, 59 percent of reserved fund balance in the general fund had no specific categories, and the combination of unspecified reservations and reservations for capital projects or debt service in general averaged 70 to 84 percent of reserved fund balance in the other funds.

Detail is an equally serious problem for designations, which often carry titles such as "designated for future appropriations." By definition, *all* fund balance that is in a spendable form is available for appropriation in the future, so such a designation is meaningless. It serves only to shrink the size of the unreserved-undesignated fund balance. Although less than 5 percent of the designated fund balance of the general funds of the respondents to the GASB's preparer survey was unspecified, the proportion rose to 56 percent of designated fund balance in the major special revenue funds, 18 percent in the major capital projects funds, and 60 percent in the nonmajor funds. Furthermore, 100 percent of the designated fund balance in the major debt service funds was designated "for debt service" and 80

Fund Balance: It May Not Be What You Think It Is

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percent of the designated fund balance in the major capital projects funds was designated "for capital projects." The review of financial reports found that almost 75 percent of the designated fund balance of county governments lacked detail, and it was almost 77 percent for other local governments.

Although unreserved-undesignated fund balance is an essential number for many financial statement users—71 percent of the respondents to the GASB survey rated it "very important"—most governments do not report designations. The GASB found that 38 percent of the financial statements it reviewed displayed designations on the face of the balance sheet, 3 percent included designations in the notes, and 6 percent combined display and disclosure—but 53 percent did not report designations at all. This presents a significant comparability problem.

The GASB Fund Balance Reporting Project

The GASB has been working to improve the comparability of the fund balance information reported in financial statements and to make it more useful to the public. The GASB plans to issue a document later this year—an Invitation to Comment—that will suggest improvements to current accounting and financial reporting standards. One area the GASB has concentrated on is clarifying the definitions of governmental fund types in order to emphasize that when resources are transferred to another governmental fund, the government plans to use those resources for the purpose of that fund—it is not temporarily reporting the resources in that fund. The government may be able to call those resources back if a project is completed under budget or there is a financial pinch; however, barring an emergency or unexpected change in plans, a financial statement user should be able to presume that resources in a debt service fund will be used to repay debt, for instance.

The GASB is considering possible ways to improve the level of detail with which reservations and designations of fund balance are reported. The GASB also is contemplating making the reporting of designations mandatory in order to make fund balance information more comparable from government to government and to provide the public with the unreserved-undesignated fund balance number it prizes.

The centerpiece of the Invitation to Comment will be a set of alternative approaches to reporting fund balance, each of which will emphasize a particular kind of fund balance information that financial statement users have indicated they consider useful. The GASB plans to survey users to assess which approach would offer the most useful information.

What You Can Do in the Meantime

Until the standards for fund balance reporting have been revised, it is advisable to use fund balance information with some caution. To begin with, you need to understand the purpose of the funds a government reports. The summary of significant accounting policies, which is usually the first note disclosure, should include a description of the funds that are shown individually in the financial statements. Governments that include combining schedules in their financial reports showing each of the smaller funds that are aggregated under the heading "other governmental funds" or "nonmajor funds," typically will describe those funds on the pages preceding the schedules. Understanding how broadly or narrowly a fund's purpose is defined will help you to understand what is communicated by the reservations and designations of its fund balance.

If there is scant detail regarding reservations and designations, check the notes to the financial statements. Some governments provide additional detail there. You may also find some clues in the section of management's discussion and analysis (MD&A, the narrative section preceding the financial statements) that analyzes fund information. Failing that, contact the government. MD&A is required to include information about how to contact the government's finance officials. Ask them if there is any backup detail available for broad reservations and designations like "other." You can ask what specific projects or programs, if any, the reservations and designations relate to. You might also ask if there are any generally available resources outside of the general fund and where they might be found.

Finally, take a look at the new disclosure about interfund transfers. The disclosure of information about significant transfers that do not occur routinely or are inconsistent with the activities of the transferring fund may help to identify instances of unusual financial activity between funds, such as resources being temporarily transferred out of the general fund.