

**APPENDIX A**

**FACTORS INFLUENCING GENERAL AND SPECIAL REVENUE  
UNRESTRICTED FUND BALANCES**

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## **Appendix A - Factors Influencing General and Special Revenue Unrestricted Fund Balances**

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It is important to provide context on fund balance as reported by cities for this report. Fund balances are reported at the close of the fiscal year, which runs concurrent with the calendar year. City fund balances should be relatively large at the end of the year because of local government cash-flow cycles. Cities must rely on their fund balances to meet expenses during the first five months of the next fiscal year, until they receive the first property tax payments (May) and aid payments from the state (July).

Unlike state government, which collects income tax withholding and sales tax receipts regularly throughout the year, Minnesota's cities do not have a constant flow of revenue from which they are able to fund local government operations. Property tax levies, state-aid, and property tax credits comprise the majority of city discretionary revenues. Minnesota statutes govern the flow of these major revenue sources into city treasuries:

- Counties distribute the cities' share of the first half of property tax levies in late May and early June. Cities receive the first half of their state-aid and property tax credits from the state in July of each year.
- Counties distribute the cities' share of the second half of property tax levies in late October and early November.
- Cities receive the second half of their state-aid and property tax credits from the state in December of each year.

Given this state-controlled flow of revenue, city fund balances (which are measured on December 31) are the primary sources of funds available to cities for their operating expenses during the first five months of the next fiscal year. An adequate fund balance will provide a local government with the cash flow required to finance expenditures without short-term borrowing.

### **Unique Circumstances of Each Jurisdiction Determine the Size of Fund Balance Needed**

While cities must rely on the fund balances for cash flow purposes during the first five months of a year, the unique circumstances of each local government will determine the size of a fund balance that must be maintained to avoid the need for short-term borrowing and to operate effectively.

Numerous factors must be considered in determining the size of a fund balance necessary for a city to avoid short-term borrowing, including:

- If cities receive relatively large amounts of revenue from sources such as fees, fines, charges for services, other intergovernmental grants and aids, or interest on investments during the first five months of the calendar year, then they will be less dependent on their fund balances for cash flow purposes.
- Cities may be able to delay certain purchases until after the initial property tax and state-aid payments are received. While payments for employee salaries, wages, and most benefits cannot be delayed during the first five months of the year, purchases of supplies and capital equipment may be delayed.

The individual cash flow needs of a city will determine the minimum fund balance that is necessary for a city to operate effectively. Cities that are able to generate significant revenues from sources other than property taxes and state-aid payments may require relatively smaller fund balances to support their cash flow requirements. Conversely, cities that rely heavily on property taxes and state-aid for the majority of their revenues will need larger fund balances to meet their cash flow needs from January through June of every calendar year.

While there are many factors that help determine the minimum fund balance needed to maintain financial health, the Office of the State Auditor recommends that, at year-end or other key times of the year, local governments that rely significantly on property taxes maintain an unrestricted fund balance in their General Fund and Special Revenue Funds of approximately 35 to 50 percent of operating revenues, or no less than five months of operating expenditures.<sup>10</sup> If the local government's unrestricted fund balance is less than or greater than this recommendation, the local government should be able to explain the reason for the difference.

The Office of the State Auditor recommends that each local government establish a formal policy on the level of unrestricted fund balance that should be maintained in the General Fund and other significant governmental 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 unrestricted 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 fund balance policy should include a provision for a regular review of the sufficiency of the minimum fund balance level.

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<sup>10</sup>The Governmental Accounting Standards Board's (GASB) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, went into effect for the 2011 reporting year. This statement provides new guidelines and classifications for fund balances. The new classifications: *nonspendable*, *restricted*, *committed*, *assigned*, and *unassigned*, replace the old designations *reserved*, *unreserved designated*, and *unreserved undesignated*. Previously, the analysis of fund balance focused on the unreserved portion of the fund balances of the General and Special Revenue Funds. The new focus is on the unrestricted portion of these fund balances and includes the *committed*, *assigned*, and *unassigned* classifications. For more information on GASB 54, please see the Office of the State Auditor's Statement of Position entitled, *Statement of Position: Fund Balances for Local Governments Based on GASB Statement No. 54* on the OSA website.

## Fund Balance Classifications/Definitions for Governmental Funds

The fund balance classifications of a local government’s governmental funds are based on the definitions in the following table:

<i><b>Fund Balance Reporting</b></i>			
<i><b>Classification</b></i>	<i><b>Definition</b></i>	<i><b>Examples</b></i>	
<b>Nonspendable</b>	“Amounts that cannot be spent because they are either (a) not in spendable form or (b) legally or contractually required to be maintained intact.” <sup>11</sup>	<ul style="list-style-type: none"> <li>• Inventories,</li> <li>• Prepaid items,</li> <li>• Long-term receivables, and</li> <li>• Permanent principal of endowment funds.</li> </ul>	
<b>Restricted</b>	<p>“Fund balance should be reported as restricted when constraints placed on the use of resources are either:</p> <p style="margin-left: 40px;">a. Externally imposed by creditors (such as through debt covenants), grantors, contributors, or laws or regulations of other governments; or</p> <p style="margin-left: 40px;">b. Imposed by law through constitutional provisions or enabling legislation.”<sup>12</sup></p>	<ul style="list-style-type: none"> <li>• Restricted by state statute,</li> <li>• Unspent bond proceeds,</li> <li>• Grants earned but not spent,</li> <li>• Debt covenants,</li> <li>• Taxes dedicated to a specific purpose, and</li> <li>• Revenues restricted by enabling legislation.</li> </ul>	
<b>Unrestricted</b>	<b>Committed</b>	“Used for specific purposes pursuant to constraints imposed by formal action of the government’s highest level of decision-making authority.” <sup>13</sup>	<ul style="list-style-type: none"> <li>• The governing board has decided to set aside \$1 million for a new city hall, and</li> <li>• Property tax levies set for a specific purpose by resolution.</li> </ul>
	<b>Assigned</b>	“Amounts that are constrained by the government’s intent to be used for specific purposes, but are neither restricted nor committed.” <sup>14</sup>	<ul style="list-style-type: none"> <li>• The governing board has set aside \$2 million for a county hospital, and the county manager may amend this up to \$100,000;</li> <li>• The governing body delegates the authority to assign fund balance to the finance officer;</li> <li>• The governing board has appropriated fund balance usually titled “subsequent year’s expenditures;” and</li> <li>• Positive residual balances in governmental funds other than the General Fund.</li> </ul>
	<b>Unassigned</b>	Unassigned fund balance is the residual classification for the General Fund. This is fund balance that has not been reported in any other classification. The General Fund is the only fund that can report a positive unassigned fund balance. Other governmental funds would report deficit fund balances as unassigned. <sup>15</sup>	

<sup>11</sup>GASB Statement 54, ¶ 6

<sup>12</sup>GASB Statement 54, ¶ 8

<sup>13</sup>GASB Statement 54, ¶ 10

<sup>14</sup>GASB Statement 54, ¶ 13

<sup>15</sup>GASB Statement 54, ¶ 17

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