



City Fund Balances 101: Critical Issues and Definitions

June 2009

City fund balances have become a popular topic of discussion among state policymakers and the media. Some of these discussions include basic misunderstandings of city finances. This heightened attention means it is important for city officials to be able to explain both the size of their city's fund balance and its role in city finances to citizens, legislators, and the media. While each city's financial situation is unique, this article provides an overview of the critical issues surrounding city fund balances, the different components of fund balances, and the basic characteristics that most city fund balances share.

Critical Issues/Talking Points

- Cities receive their two largest sources of revenue—the property tax and state aid distributions—twice each year. The equivalent for an individual would be to receive only two paychecks each year.
- The Office of the State Auditor's (OSA) report measures city fund balances on Dec. 31, shortly after the city receives its second property tax and state aid distribution. The timing is equivalent to measuring your personal wealth on the day after payday—before you've paid the mortgage, car loan, and other bills.
- Like individuals and businesses, cities have monthly bills and expenditure needs. Reserves are used for day-to-day cash flow for the following five to six months of city operations—until the next property tax and state aid distributions.
- Cities may also set aside a portion of their reserve as a rainy day fund to help them through emergencies, like cuts to state aids or natural disasters. This is similar to families aiming to set aside enough funds to cover three months' worth of bills should household income drop due to illness or unemployment.
- The OSA's official position on city fund balances is that the unreserved portion should be equal to 35 to 50 percent of general fund operating revenues.
- After the December 2008 unallotment of local government aid (LGA) and market value homestead credit (MVHC) reimbursement, at the very end of the city budget year, many cities had to draw down their reserves in order to balance their budgets.

Different components of fund balances

The city fund balance is not one pot of money but is comprised of three distinct components with three very distinct purposes. Minnesota cities report these three different components of fund balances to the OSA each year: a) unreserved, undesignated fund balance, b) unreserved, designated fund balance, and c) reserved fund balance. These three components are defined below.

Unreserved, undesignated fund balance: all funds for which no legally binding commitment has been made. There has also been no resolution passed by city council designating the funds for a specific purpose. This is the component that meets the city's cash flow needs between its receipt of the two payments of property taxes and state aids.

Unreserved, designated fund balance: funds for which there are no legally binding commitments, but the city council has designated how they will be used in the future. This portion of the fund balance is where a city can set aside dollars for major projects, such as street improvements or water treatment system upgrades. City councils can also designate that funds in this component of the reserve be kept as a rainy day fund to be available during times of emergency.

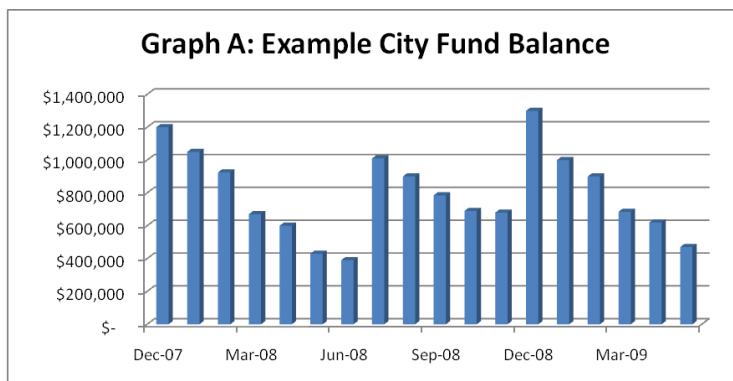
Reserved fund balance: funds for which there is a legally binding external commitment (e.g., contract with bidder).

The OSA position statement on fund balances states that local governments must identify reserved and unreserved fund balances separately. The OSA recommends that the unreserved fund balance in the general fund and any special revenue funds be equal to 35 to 50 percent of general fund operating revenues.

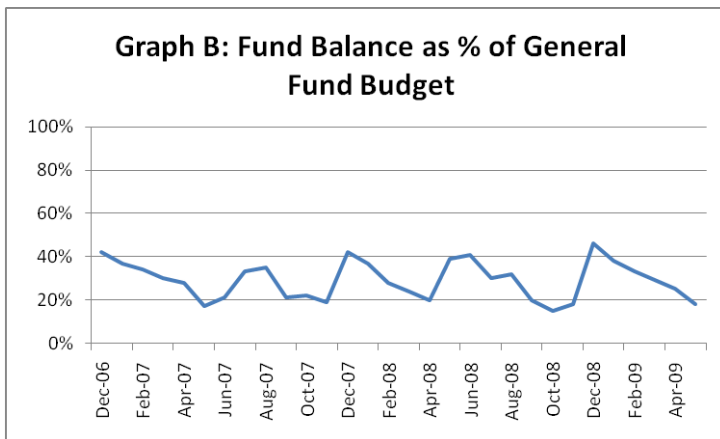
Cash flow funds (i.e., unreserved, undesignated)

Cities receive the two largest sources of revenue—the property tax and state aid distributions—twice each year. The OSA report measures city fund balances on Dec. 31, shortly after the city receives its second property tax and state aid distribution. These reserves are used for day-to-day cash flow for the next five to six months of city operations—until the next property tax and state aid distributions in May and July. Like families and businesses, cities have monthly bills and expenditure needs. Measuring a city’s fund balance on Dec. 31 is equivalent to measuring your personal wealth on the day after payday—before you’ve paid the mortgage, car loan, and other bills. Without adequate cash flow reserves, cities would be forced to borrow to pay for operating expenses, which increases the overall cost of city services to taxpayers. A city with low reserves may also choose to delay major purchases; turn to other revenue sources such as fees, fines, service charges, interest from investments, or other grants and aids; or adjust their budgets in other ways.

Graph A shows a one-year cash balance for a hypothetical Minnesota city. The cash balance is highest in December and July, after taxes and state aids are distributed to the city. The difference between the peaks and valleys is the city’s cash flow need. A city may need to rely more or less on reserves during the months between tax and state aid distributions, depending on its other revenues sources such as fees.



The annual state auditor’s report shows city fund balances as a percentage of total current expenditures for the year. **Graph B** illustrates the general fund cash balance as a percentage of the general fund budget for a hypothetical city. In December, when the state auditor’s report measures fund balances, the city’s general fund cash balance is over 40 percent of budgeted expenditures. That percentage dips below 20 percent in May and November in each of the past two years.



Rainy day funds (unreserved, designated)

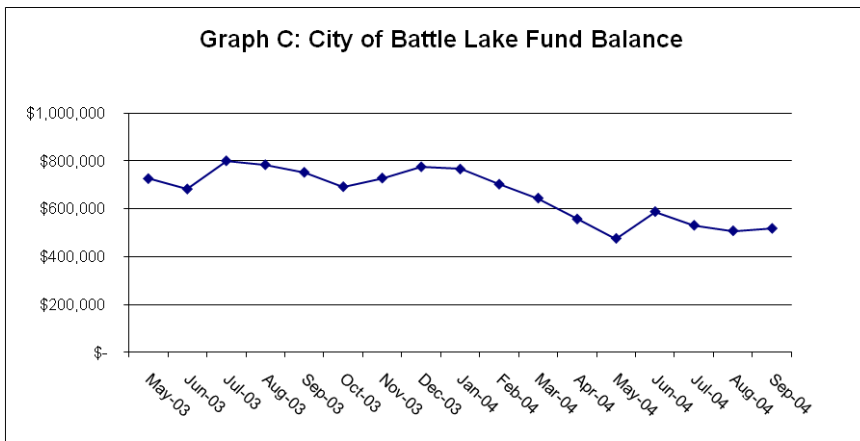
The city fund balance acts as a rainy day fund to help the city cope with revenue shortfalls, unexpected expenditures, or emergencies. Given that cities only receive property taxes and state aids twice a year, the reserve funds can be critical for responding to unforeseen local needs. To help close the 2008-2009 state budget deficit, the governor reduced the December 2008 payment of aid and credit reimbursement to cities with populations over 1,000. Some cities relied upon their fund balance to meet immediate budget needs. Emergencies, including natural disasters such as floods or tornados, may also require a city to rely on rainy day funds.

The state also has a budget reserve. The reserve is commonly referred to as the rainy day fund. Due to the volatility in estimating state income and sales tax revenues, this fund helps the state address unexpected economic downturns, other fluctuations in state revenues, or unexpected expenditure needs. Prior to the budget shortfalls of 2003, the state of Minnesota had a budget reserve of \$653 million. The entire budget reserve was used as part of the 2003 budget fix. The reserve was built back up to \$300 million in 2004, \$580 million in 2005, and was fully restored to \$653 million in 2006. The 2008 state Legislature used \$500 million of the reserve to balance the budget. However, a larger-than-expected deficit for the 2008-2009 biennium required withdrawal of the reserve’s remaining \$155 million in late 2008. Thanks to one-time federal stimulus aid, the state is now expected to end the 2008-2009 biennium with a \$350 million cash flow account.

Savings for projects or dedicated uses (unreserved, designated)

Prior to undertaking a capital project, a city may increase reserves to help pay for a portion of the project, thus reducing the need to issue debt. Setting aside money over a period of time can be an easier way to pay for a project, especially for smaller cities. City fund balances may include savings for a major project or purchase.

Graph C shows a two-year fund balance for Battle Lake. In January 2004 the city began construction of a new city hall, for which it had funds saved. By September 2004, the project was complete and the city’s fund balance was less than two-thirds what it had been in July 2003.



Cities may have reserves in dedicated funds, such as sewer and water utilities, or enterprise funds, which are generated from user fees. These reserves are dedicated for operation, maintenance, and improvement of the utility or enterprise and must be used for those purposes.

Fund balances and credit ratings

Cash flow needs, savings for projects, and reserves for unforeseen needs are three reasons why fund balances are important. Another reason is favorable bond ratings. Good bond ratings mean that a city will get lower interest rates when borrowing money. The bond rating is similar to an individual’s credit score and its impact on interest rates for mortgages and car loans. Wall Street (e.g., firms such as Moody’s) takes into account the financial well-being of a city when determining that city’s municipal bond rating. The city’s reserves are an important indicator of a city’s overall financial health; a city is more likely to be given a higher bond rating if it is deemed to have a healthy city fund balance. Other indicators of financial viability can include an unreserved, undesignated fund balance of approximately 20 percent, direct debt of less than 3 percent of full value, per capita income of approximately \$25,000, and a tax collection rate for the previous three years of greater than 95 percent.

A high rating for a city reflects the strength of the local economy and indicates its sound fiscal management. A high rating bolsters the confidence of other investors and its taxpaying residents. This high bond rating is significant for taxpayers as its issuance enables the city to borrow at a lower interest rate, thereby lowering the cost of municipal debt and ultimately saving the taxpayers money. While a city cannot directly control all of the factors that are considered by Wall Street, sound financial management planning can help cities assess their financial health and anticipate future needs. A financial management plan gives cities a context for decisions and can lead to a more stable tax rate because future growth and infrastructure needs are incorporated into the plan.

The state’s financial health is taken into account for the state bond rating. After the 2003 budget shortfall, Gov. Pawlenty met with analysts from the major bond houses on Wall Street in an attempt to retain Minnesota’s triple-A rating. Since then, two of the three firms continue to give Minnesota the highest possible rating, but Moody’s has downgraded the state slightly (from Aaa to Aa1). The Moody’s analysts cited concerns that the state used too many accounting shifts and too much nonrecurring revenue in order to fix the state budget shortfall of slightly more than \$4 billion in 2003.

Resources

Office of the State Auditor
<http://www.osa.state.mn.us/>

- Statement of Position: Fund Balances for Local Governments http://www.auditor.state.mn.us/other/Statements/fundbalances_0708_statement.pdf
- City finances reports <http://www.osa.state.mn.us/list.aspx?get=4>

League of Minnesota Cities
<http://www.lmc.org>