

Appropriate Level of Unreserved Fund Balance in the General Fund (2002)

Background. Accountants employ the term fund balance to describe the net assets of governmental funds calculated in accordance with generally accepted accounting principles (GAAP). Budget professionals commonly use this same term to describe the net assets of governmental funds calculated on a government's budgetary basis.¹ In both cases, fund balance is intended to serve as a measure of the financial resources available in a governmental fund.

Accountants distinguish reserved fund balance from unreserved fund balance. Typically, only the latter is available for spending. Accountants also sometimes report a designated portion of unreserved fund balance to indicate that the governing body or management have tentative plans concerning the use of all or a portion of unreserved fund balance.

It is essential that governments maintain adequate levels of fund balance to mitigate current and future risks (e.g., revenue shortfalls and unanticipated expenditures) and to ensure stable tax rates. Fund balance levels are a crucial consideration, too, in long-term financial planning.

In most cases, discussions of fund balance will properly focus on a government's general fund. Nonetheless, financial resources available in other funds should also be considered in assessing the adequacy of unreserved fund balance in the general fund.

Credit rating agencies carefully monitor levels of fund balance and unreserved fund balance in a government's general fund to evaluate a government's continued creditworthiness. Likewise, laws and regulations often govern appropriate levels of fund balance and unreserved fund balance for state and local governments.

Those interested primarily in a government's creditworthiness or economic condition (e.g., rating agencies) are likely to favor increased levels of fund balance. Opposing pressures often come from unions, taxpayers and citizens' groups, which may view high levels of fund balance as "excessive."

Recommendation. GFOA recommends that governments establish a formal policy on the level of unreserved fund balance that should be maintained in the general fund.² GFOA also encourages the adoption of similar policies for other types of governmental funds. Such a guideline should be set by the appropriate policy body and should provide both a temporal framework and specific plans for increasing or decreasing the level of unreserved fund balance, if it is inconsistent with that policy.³

The adequacy of unreserved fund balance in the general fund should be assessed based upon a government's own specific circumstances. Nevertheless, GFOA recommends, at a minimum, that general-purpose governments, regardless of size, maintain unreserved fund balance in their general fund of no less than five to 15 percent of regular general fund operating revenues, or of no less than one to two months of regular general fund operating expenditures.⁴ A government's particular situation may require levels of

unreserved fund balance in the general fund significantly in excess of these recommended minimum levels.¹ Furthermore, such measures should be applied within the context of long-term forecasting, thereby avoiding the risk of placing too much emphasis upon the level of unreserved fund balance in the general fund at any one time.

In establishing a policy governing the level of unreserved fund balance in the general fund, a government should consider a variety of factors, including:

- The predictability of its revenues and the volatility of its expenditures (i.e., 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 upon general fund resources from other funds (i.e., 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).
- Liquidity (i.e., a disparity between when financial resources actually become available to make payments and the average maturity of related liabilities may require that a higher level of resources be maintained).
- Designations (i.e., governments may wish to maintain higher levels of unreserved fund balance to compensate for any portion of unreserved fund balance already designated for a specific purpose).

Naturally, any policy addressing desirable levels of unreserved fund balance in the general fund should be in conformity with all applicable legal and regulatory constraints. In this case in particular, it is essential that differences between GAAP fund balance and budgetary fund balance be fully appreciated by all interested parties.

¹ For the sake of clarity, this recommended practice uses the terms GAAP fund balance and budgetary fund balance to distinguish these two different uses of the same term.

² Sometimes reserved fund balance includes resources available to finance items that typically would require the use of unreserved fund balance (e.g., a contingency reserve). In that case, such amounts should be included as part of unreserved fund balance for purposes of analysis.

³ See Recommended Practice 4.1 of the National Advisory Council on State and Local Budgeting governments on the need to "maintain a prudent level of financial resources to protect against reducing service levels or raising taxes and fees because of temporary revenue shortfalls or unpredicted one-time expenditures" (Recommended Practice 4.1).

⁴ The choice of revenues or expenditures as a basis of comparison may be dictated by what is more predictable in a government's particular circumstances. In either case, unusual items that would distort trends (e.g., one-time revenues and expenditures) should be excluded, whereas recurring transfers should be included. Once the decision has been made to compare unreserved fund balance to either revenues or expenditures, that decision should be followed consistently from period to period.

¹ In practice, levels of fund balance, (expressed as a percentage of revenues/expenditures or as a multiple of monthly expenditures), typically are less for larger governments than for smaller governments because of the magnitude of the amounts involved and because the diversification of their revenues and expenditures often results in lower degrees of volatility.

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