



Governmental Accounting Standards Board
of the Financial Accounting Foundation

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Looking for a Way to Make Fund Balance More Useful

Fund balance—the difference between assets and liabilities in the modified-accrual-based governmental fund balance sheet—is undoubtedly one of the most widely used pieces of information in state and local government financial statements. Not only is fund balance a staple of the credit reviews performed by municipal bond analysts, but it also is commonly used by taxpayer associations, research groups, oversight agencies, and legislators and legislative staff at the state, county, and local level. All are looking for available liquid resources that can be used to repay long-term debt, reduce property taxes, add new government programs, expand existing ones, or enhance the financial position of the government.

Research conducted by the Governmental Accounting Standards Board (GASB) has found that despite the widespread appeal of fund balance, it is often misunderstood by both the preparers and users of financial statements. Furthermore, variations in the way governments report fund balance undermine its usefulness. The GASB has issued an Invitation to Comment (ITC), *Fund Balance Reporting and Governmental Fund Type Definitions*, to seek feedback on possible solutions that will address the problematic issues the GASB has identified and make fund balance information more useful to the people who need it to make decisions, draw conclusions, and perform analyses.

What Is Currently Wrong with Fund Balance?

The GASB initiated its research on fund balance in response to concerns that some users of governmental financial information did not understand the difference between reserved and unreserved fund balance. There was further concern that users would be confused about how reserved fund balance relates to unrestricted net assets, which governments began to report in the government-wide financial statements required by GASB Statement 34. The GASB's research identified a number of issues that diminish the usefulness of fund balance information, including:

- The actions taken to reserve or designate fund balance vary from government to government, leaving the financial statement user uncertain as to the force behind purpose limitations imposed on a government's resources.
- Some governments transfer resources from the general fund to other governmental funds without an intention to use the resources in the receiving fund—the resources

reside in the other fund temporarily and are subsequently transferred back. This practice may mislead financial statement users regarding the amount of available resources and the purposes for which those resources can be used.

- Some governments report some fund balance as reserved when, in fact, it should be unreserved. This occurs, in part, because these governments are not aware that, to result in a reservation of fund balance, limitations on how resources can be used should be more specific than the purpose of the fund they are reported in.
- Because the reporting of designations of unreserved fund balance is optional, a reporting dichotomy has arisen that undermines the comparability of information reported by governments that designate fund balance with those that do not.
- The needs of many users to identify generally available resources may not be sufficiently addressed by current fund balance reporting requirements, even when current requirements are appropriately met.

What Does the ITC Say?

An Invitation to Comment is a preliminary staff document that seeks input before the GASB members have reached a consensus opinion. Rather than set forth a draft of proposed standards, the ITC describes the issues and offers alternative approaches to addressing them. This ITC takes a two-pronged approach to resolving the issues affecting fund balance. First, it considers revisions to the definitions of governmental fund types in order to bring more consistency to the types of resources that can be reported in various funds and the circumstances under which resources can be transferred to them. Second, the ITC discusses how the important aspects of fund balance can be organized and reported in the balance sheet in order to best address the information requirements of users.

Fund definitions

A lack of clarity in the definitions of governmental fund types may be the cause of the substantial differences in how governments use them in external financial reporting. For example, the definition of special revenue funds states that they can be used to report revenue sources that are legally restricted for specified purposes, but the meaning of *legally restricted* is unclear. Does it mean *restricted* as defined by GASB Statement 34—limitations imposed by external parties or through constitution or enabling legislation—or does it also encompass other legal limitations imposed by a government itself? And what other resources may be accounted for in a special revenue fund in addition to the legally restricted revenue source? May it include matching amounts transferred by the government, or other resources legally limited to the same purposes, or even resources with no purpose limitation at all?

Possible revisions to the definitions of the debt service and capital projects fund types are presented, with the goal of minimizing, if not eliminating entirely, the practice of temporarily transferring resources to those types of funds without intending to use the

resources to repay debt or finance capital projects. One possibility would be to limit those fund types to reporting resources that are legally limited in some manner to being used for debt service or capital projects. An alternative might be to allow resources *intended* for those purposes.

Fund balance classifications

The ITC not only addresses *what* resources are reported in governmental funds, but also *how* those resources are reported in fund balance. The ITC discusses a number of issues relating to shortcomings in how fund balance is currently reported and sets forth possible new models for categorizing and reporting it.

Fund balance is currently reported in two basic categories—reserved and unreserved. Reserved fund balance represents resources that are not in a spendable form (such as inventory or long-term loans receivable) or that are *legally segregated* for a purpose more specific than the overall purpose of the fund (such as resources legally set aside for highway project in a broad capital projects fund). Unreserved fund balance is the remainder and can be used for any purpose of the fund.

The notion that fund balance should be interpreted from the perspective of the individual fund is not precisely laid out in the standards and newer generations of finance officers and auditors, as well as users of financial statements, are not aware of it. In general, if resources are allocated to a governmental fund other than the general fund, a government is communicating that those resources are to be used for the purpose of that fund—whether it be elementary and secondary education, debt service, or capital projects. For resources to be legally segregated to a specified purpose, they would have to be limited to a purpose that is more specific than the purpose communicated by the fund.

A related misconception is that unreserved fund balance is available for any purpose. In fact, under current standards unreserved fund balance should be understood to mean that resources are available for any purpose *of the fund*. Unreserved fund balance in a capital projects fund is available for capital projects, for instance. Unreserved fund balance in the general fund is available for any purpose and is not spoken for at all.

The standards allow governments to *designate* some or all of their unreserved fund balance to communicate the purposes for which they *intend* to use resources. The GASB's research shows that designations are very important to users. Yet, there are a number of issues that adversely affect the usefulness of designated fund balance information. First, because designating is optional, there is a comparability problem between governments that designate and those that do not. Second, it is unclear to users what authority or action, if any, stands behind a designation. Third, it is difficult to assess the likelihood that a government's intention to use resources for a particular purpose will actually come to fruition.

One of the three possible models for reporting fund balance included in the ITC would retain the current categories—reserved, unreserved, and designated—but clarify the requirement that limitations on uses or intended uses should be narrower than the purpose of the fund. A second model would also report from the perspective of the individual fund, but would focus on distinctions between resources that have been committed to more specific purposes within the fund they are reported in and those that can be used for any purpose consistent with the fund. The third model distinguishes fund balance based on whether it represents restricted or unrestricted resources, as defined by GASB Statement 34.

What Does the GASB Need to Know?

The ITC poses questions intended to elicit feedback on what options and alternatives would make fund balance information most useful and best address the current shortcomings in how it is reported. The GASB needs its constituents to answer these questions so that it can identify the best approaches and develop proposed changes to the accounting and financial reporting standards.

You can answer the questions using an Internet-based form or via mail or email. You are encouraged to read the ITC and all of the questions prior to answering. The ITC can be downloaded free from the GASB's Web site (www.gasb.org). The GASB also would welcome any other comments or suggestions that constituents may have.

If you have any questions about the ITC, please feel free to contact GASB staff members Ken Schermann (krschermann@gasb.org or 203-956-5206) or Dean Mead (dmmead@gasb.org or 203-956-5294).