

## City Fund Balances 101

Updated March 2025

City fund balances are often 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 document 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. Fund balances 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 fund balance 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.

### Different components of fund balances

The city fund balance is not one pot of money but is comprised of distinct components with very distinct purposes. The fund balance statement of position from the Office of the State Auditor (OSA) was last reviewed in 2014. That document is available [here](#). According to the OSA, "local government should identify fund balance separately based on a hierarchy of the constraints placed on the use of the financial resources within governmental funds." Under GASB 54, Minnesota cities need to report five different components of fund balances to the OSA each year: a) non-spendable, b) restricted, c) unrestricted-committed, d) unrestricted-assigned, and e) unrestricted-unassigned. These five distinct classifications are defined below.

**Restricted components:**

- a) Non-spendable: These are dollars that cannot be spent because they are not in a spendable form or they are legally or contractually required to remain intact. Examples here are inventories, pre-paid items or long-term receivables in the city's general fund.
- b) Restricted: These are dollars on which there are constraints placed regarding their use. External constraints include those imposed by creditors, grantors, or laws of other governments. Other constraints might be those imposed by law. Examples of the former are debt covenants and grants earned but not yet spent. Examples of the latter include taxes dedicated to a specific purpose and revenues restricted by some enabling legislation.

**Unrestricted components:**

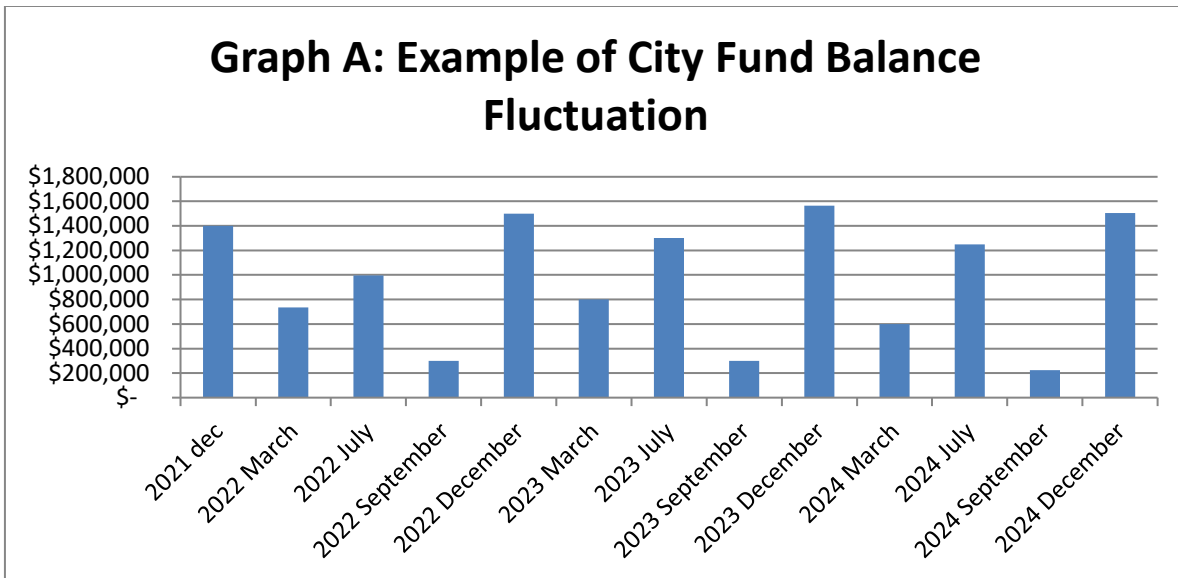
- c) Unrestricted-Committed: These are dollars that must be kept for specific purposes as determined by formal action of the decision-making authority. An example is funds set aside by the council for a specific capital project.
- d) Unrestricted-Assigned: These are dollars that the city intends to use for a specific purpose but they are not committed. An example is regularly using fund balance to balance the city's budget at the end of the year.
- e) Unrestricted-Unassigned: Finally, these are dollars that do not fall into any of the other classifications.

The OSA position statement on fund balances states that local governments must identify each of these classifications separately. The OSA offers two criteria for cities to consider when establishing a fund balance policy and assigning fund balance dollars. The first is that the unrestricted fund balance in the general fund and any special revenue funds be equal to 35 to 50 percent of general fund operating revenues. The second is that the unrestricted fund balance should be no less than five months of operating expenditures.

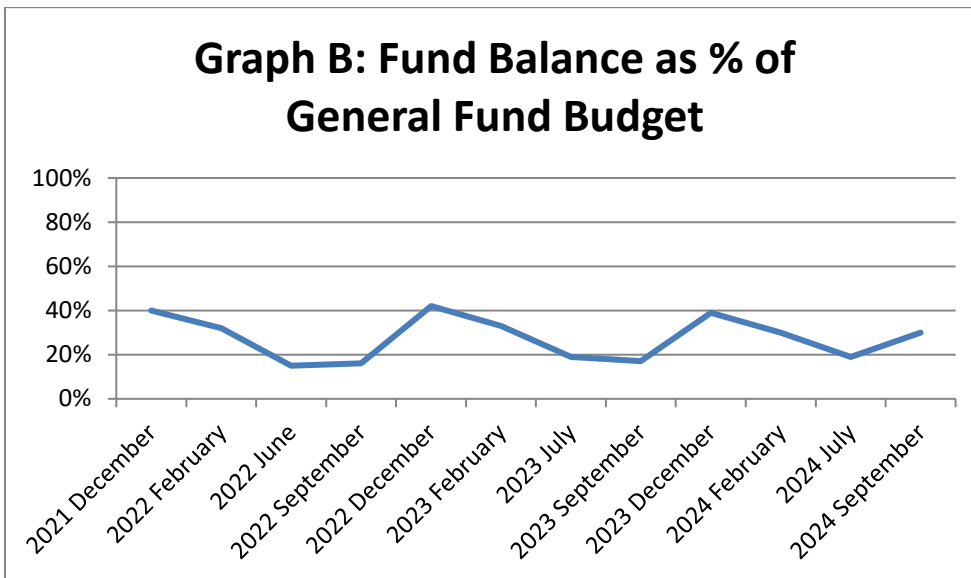
**Cash flow funds**

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 everyone's favorite hypothetical city, Mosquito Heights. 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 at certain times of the year.



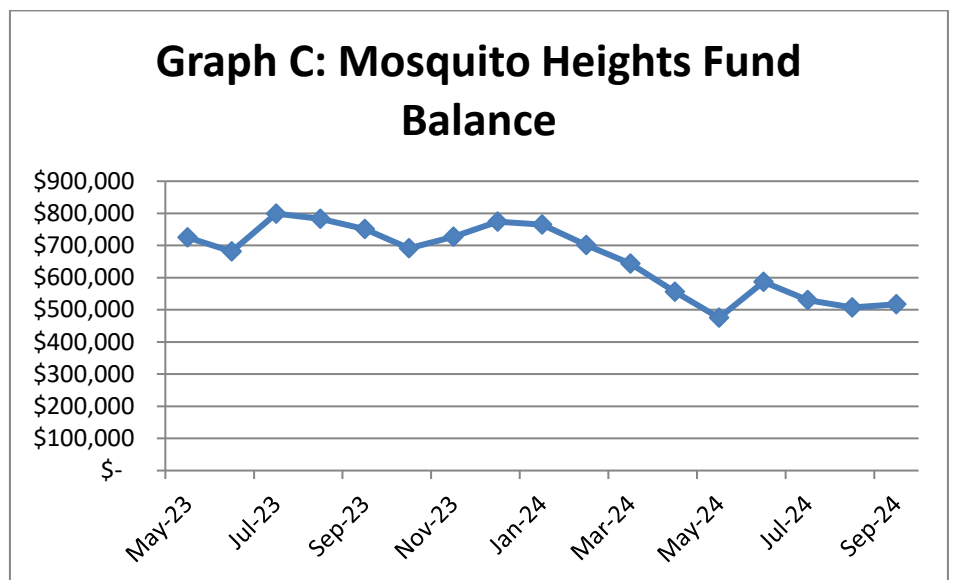
#### **Rainy day funds**

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. Some

cities have 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.

### **Savings for projects or dedicated uses**

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 Mosquito Heights. In January 2023 the city began construction of a new city hall, for which it had funds saved. By May 2024, the project was complete and the city's fund balance was less than two-thirds what it had been in early 2023.



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 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.

## **Resources**

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

- Statement of Position: <http://www.osa.state.mn.us/default.aspx?page=20110527.018>
- City finances reports: <http://www.osa.state.mn.us/list.aspx?get=4>

## **League of Minnesota Cities**

<http://www.lmc.org>

## **Contact with questions:**

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