

{ Finance 101 }

Understanding Municipal Budgets & Financial Reports



The Michigan Municipal League
in cooperation with the
Michigan Government Finance Officers Association



What we'll cover today

- **Why are municipal financial statements so much longer than those of a business?**
- **What is the financial statement trying to communicate?**
- **How does it accomplish that?**
- **What is important for me to look at and understand?**

Purpose of governmental financial statements

The purpose of governmental reporting is to demonstrate accountability for the money entrusted to it;

- The individual fund statements demonstrate how we spent our taxpayers' money;
- The governmentwide statements demonstrate whether the current set of taxpayers has paid the full cost of government services (or not).

(Today's presentation will focus on the individual governmental funds financial statements and budgets.)

What is a fund?

In the private sector, sometimes separate companies are set up for legal liability purposes, or tax purposes; in the public sector, separate activities are accounted for in separate funds, in order to show accountability.

- A specific revenue may be legally restricted, so it is reported in a separate fund to demonstrate that the revenue was spent only for the intended purpose;
- Any unspent amounts (in governmental funds) will then be reported as “restricted, committed, or assigned.”



What is the “General Fund?”

Individual funds are created because of laws, grant requirements, or the desires of the governing body;

All activity that has not been assigned to a specific individual fund is then accounted for in the General Fund.

- As a result, most people find the General Fund to be the most important fund. That is the fund that contains uncommitted resources that may be used for general purposes.

Funds other than the General Fund

What kinds of funds would we have, other than the General Fund?

Funds are normally created to show accountability (to show how specific revenue is being spent); sometimes they are created to pay for goods or services in advance (internal service funds and capital project funds).

Types of funds

Different fund types that a government may have:

GOVERNMENTAL FUNDS	<ul style="list-style-type: none">• General fund• Special revenue funds• Debt service funds• Capital project funds *• Permanent funds
PROPRIETARY FUNDS	<ul style="list-style-type: none">• Enterprise funds• Internal service funds *
FIDUCIARY FUNDS	<ul style="list-style-type: none">• Trust funds (pension and other employee benefit, investment, private purpose)• Agency funds

** Capital projects and internal service funds have a somewhat higher potential for resources that could be available for general unrestricted spending; the specific funds would need to be evaluated.*

Key take-away

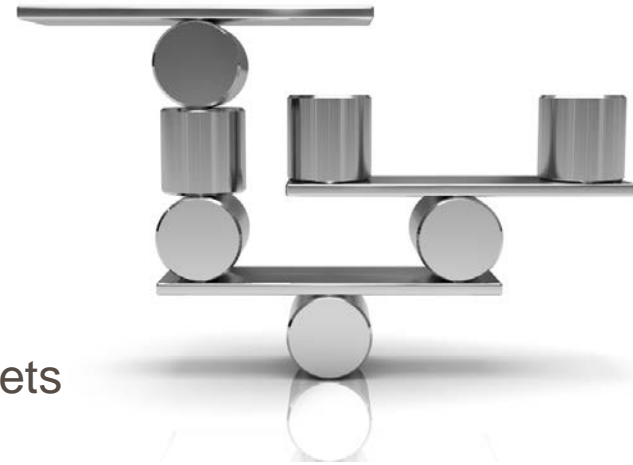
Take the time to learn about all of your local unit's funds, not just the General Fund; some of them may be important to understanding your overall financial health.



What is fund balance?

Accounting 101 tells us that we have:

- Assets (things we own); and
- Liabilities (amounts we owe others);
 - The difference between assets and liabilities is equity. In the governmental funds, this equity is called fund balance.
- Since governmental funds generally report only assets that are available (cash or will be cash within 30-60 days), and only report liabilities that are current claims, the resulting fund balance represents amounts available to be spent.



Is fund balance available to be spent as our governing body sees fit?

Maybe – but not necessarily

- Fund balance is reported based on how constrained it is; the categories are:
 - Nonspendable (not in spendable form)
 - Restricted (external legal restrictions)
 - Committed (internally – by formal action)
 - Assigned (internally; less formally)
 - Unassigned

The governing body always has the authority to re-commit or re-assign fund balances.

Key take-aways.

Fund balance is the measure of financial health of an individual fund;

That fund balance may or may not be freely available to your local unit – you need to understand the levels of constraints (nonspendable, restricted, committed, assigned, unassigned).



How much fund balance should my local unit have?

There is not a single answer to that question, so let's start with some concepts:

- **Zero is not an option.** You need some level of fund balance for cash flow purposes, and some level for responses to emergencies.
- There is an appropriate range of fund balance, because it is possible to have too little, but it is also possible to have too much.
- The right amount is dependent on several factors, which we will detail on the next slide:



Fund balance factors

RISK TOLERANCE

- (If you can tolerate some risk that you will not have enough, then you can live with less.)

KNOWN UPCOMING SPENDING

- (Is the local unit saving for a large purchase?)

TAX YEAR DIFFERENT THAN FISCAL YEAR

- (Property taxes are generally the single largest revenue source, but sometimes tax revenue comes in at the end of the year, rather than at the beginning; those local units need cash to make it to the next tax collection.)

Fund balance factors.

As the size of your budget grows larger, so does the required minimum level of fund balance — but not linearly.

So a larger government requires a larger fund balance, but not as a “percentage of the budgeted expenditures” – that percentage target would be smaller.

Before considering individual risk, upcoming spending, or tax year differences, most use the guidelines on the next slide.

Fund balance factors

- **Most governments should be in the 10–20% range (fund balance as a percent of expenditures).**
- **A very small government might have a 20–25% target.**
- **A very large government might have 5–10% as a target.**
- **The State of Michigan, on its fiscal distress indicator scores, uses 13% (for everybody).**

Key take-aways

It is important for the governing body to deliberate and agree upon appropriate fund balance targets.

The appropriate level will vary greatly between communities, because their circumstances are different (risk tolerance, size, fiscal year, upcoming spending plans).

It is a best practice to have a range of appropriate fund balance – how much is too little, and how much is too much.



Understanding the budget

Budgets serve a different purpose in a government than they do in a business

- In a business, they are a plan to shoot for; often they can be a aggressive plan that you may or may not be likely to achieve;
- In a government, the expenditure side of the budget is called “appropriations,” and it is the legal authority for management to provide a given level of services. It is actually illegal to spend more than the budget appropriations (P.A. 2 of 1968).



Understanding the budget

The budget appropriation is not a forecast of the amount your local unit expects to spend; it is **the maximum amount that management is allowed to spend.**

Therefore, do not misinterpret the results of the year-end financial report – if most expenditure categories are somewhat below budget, that does not mean management was “sandbagging” you, or asking for more than it needed – management was merely following the law.

Understanding the budget

What does it mean to have a balanced budget?

- A budget is considered to be balanced if the projected ending fund balance is positive.
- In any one year it may be appropriate for expenditures to exceed revenue.

Importance of the budget

The budget is the most important financial planning tool that the governing body has. This is where you shape the financial direction that your local unit is going in.

Consider:

- How does activity fit in with the local unit's overall goals and objectives?
- Is this level of service sustainable over a long run (based on financial forecasts, or multiple year budgets)?

Key take-aways

- **The annual budget is where you will influence the financial direction of your local unit;**
- **Make the discussion center on service levels, accomplishment of goals and objectives, results or outcomes, etc. – not just on line item dollar amounts.**
- **Expect actual results to be somewhat better than the budget**



What can I do to improve or protect my local unit's financial health?

Nearly every community that is in excellent financial health today has one thing in common:

- In addition to the required budget process, your local unit should perform a three- to five-year look into the future. This can be done via:
 - A multi-year budget; or
 - A financial projection.

Thank you

The MGFOA's primary goal is the education and development of local unit finance officials.

We encourage you to inquire whether your finance staff participates in the MGFOA programs.