

TOWN OF EAST LYME

Policies and Procedures

Fund Balance

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POLICY

The Town of East Lyme Board of Finance adopts the following policy:

A. Defining Target Fund Balance

In the context of financial reporting according to the GFOA, the term *fund balance* is used to describe the net position of governmental funds calculated in accordance with generally accepted accounting principles (GAAP). Budget professionals commonly use this same term to describe the net position of governmental funds calculated on a government's budgetary basis. While in both cases *fund balance* is intended to serve as a measure of the financial resources available in a governmental fund; it is essential that differences between GAAP *fund balance* and budgetary *fund balance* be fully appreciated.

1. GAAP financial statements report up to five separate categories of fund balance based on the type and source of constraints placed on how resources can be spent (presented in descending order from most constraining to least constraining): *non-spendable fund balance*, *restricted fund balance*, *committed fund balance*, *assigned fund balance*, and *unassigned fund balance*. The total of the amounts in these last three categories (where the only constraint on spending, if any, is imposed by the government itself) is termed *unrestricted fund balance*. In contrast, budgetary fund balance, while it is subject to the same constraints on spending as GAAP fund balance, typically represents simply the total amount accumulated from prior years at a point in time.
2. The calculation of GAAP fund balance and budgetary fund balance sometimes is complicated by the use of sub-funds within the general fund. In such cases, GAAP fund balance includes amounts from all of the sub-funds, whereas budgetary fund balance typically does not.
3. Often the timing of the recognition of revenues and expenditures is different for purposes of GAAP financial reporting and budgeting. For example, encumbrances arising from purchase orders often are recognized as expenditures for budgetary purposes, but never for the preparation of GAAP financial statements.

The effect of these and other differences on the amounts reported as *GAAP fund balanced* *budgetary fund balance* in the general fund should be clarified, understood, and documented.

This policy clarifies East Lyme's practices. See the GFOA guidelines: [Fund Balance Guidelines for the General Fund \(gfoa.org\)](https://www.gfoa.org/fund-balance-guidelines)

This policy defines which components of fund balance would be included in the Town's "Target Fund Balance". We will use the term Target Fund Balance to mean the components of fund balance we combine to form the numerator in the Fund Balance/Revenue equation for determining the Fund Balance percent.

- The GFOA's discussion was in terms of unrestricted fund balance, but stated it may be appropriate to focus on unassigned fund balance or a measure in between.
- Moody's discussion includes the unassigned and assigned fund balance to be the available fund balance used in its calculations.

- Standard & Poor's uses the unassigned fund balance in its calculations.

To determine the basis that we should use as our Target Fund Balance, we reviewed the definition of each category and what the Town of East Lyme has traditionally included in each category and expects to include in the future:

- Committed Fund Balance is used for funds that are set aside by the highest level of government, which in our case is a Town Meeting or Referendum. The Town generally uses committed fund balance for capital projects which have been approved by a Town Meeting or Referendum. This is rarely reported in the general fund. Because we are measuring and benchmarking our fund balance for the purposes of financial flexibility, and committed fund balance is not easily available for financial flexibility, we will not include committed fund balance in our calculation of Target Fund Balance.
- Assigned fund balance is used to designate funds for specific purposes. This is done by, and can be changed by, layers of government lower than a Town Meeting or Referendum. Because we will be using assigned fund balance in growing our fund balance as discussed below, we will want to include assigned fund balance as part of our Target Fund Balance.
- Unassigned fund balance makes up the balance of unrestricted fund balance in the General Fund. This has no allocations against it. This will be included in our Target Fund Balance.

This policy also defines how East Lyme defines "Revenue" which will make up the denominator in the Fund Balance/Revenue equation for determining the fund balance percent on a consistent basis. There are different acceptable methods of determining the Revenue amount for the equation. Sometimes the total revenues on a GAAP basis is used. Sometimes the annual budgeted revenue is used. The largest differences between the two are the pension and OPEB benefit expenses which the State pays on behalf of our teachers. This is not known to us until after the end of the year and can have substantial variations from year to year which are out of our control. For that reason, we will define revenue in our fund balance percent as the revenue shown in the annual budget for the same year as the fund balance. For example, June 30, 2022 will be compared to the 2022-23 budget. This would exclude other financing sources which tend to be one-time financing sources.

To summarize - our policy is based on the formula:

Numerator	<u>Assigned Fund Balance + Unassigned Fund Balance</u>
Denominator	Budgeted Revenue excluding Other Financing Sources

B. Contingency Appropriation

The Town has used an appropriation for contingency in the budget to hedge against extreme events, expenditure increases, etc. The proposed policy would recognize this portion of the budget as an important tool in maintaining our Target Fund Balance.

During the annual budget process, the Town will include a contingency appropriation. The contingency appropriation may be used to offset unanticipated, unbudgeted revenue shortfalls or expenditure overages which cannot be mitigated by reducing other operating expenditures.

The Town will include an undesignated contingency of ½% of the total budget. Additional designated contingencies may be added for items such as union negotiations or other unmeasurable costs, or potential costs, at the time the budget is prepared. The Board of Selectmen or Board of Finance may reduce the contingency with a specific motion approved by a majority of the Board, understanding that this will lessen the mitigating effects of the contingency appropriation and may, upon review of the fund balance policy justify increasing the Target Fund Balance.

Any unused contingency appropriation automatically (based on the accounting process) closes out into the unrestricted fund balance at the end of the fiscal year.

C. Appropriate Level for East Lyme

After considering all the information gathered, the Town will work towards a Target Fund Balance of 17% of budgeted revenues.

This Target Fund Balance was determined after review of the GFOA Risk Assessment Worksheet and the policies of AA/AAA-rated towns in Connecticut.

D. Reaching and Replenishing the Unrestricted Fund Balance

To increase Target Fund Balance initially, or when it falls below the desired Target, we will:

- Present a balanced operating budget to the citizens each year. Anticipated revenues should cover all the operating costs. One-time costs, such as for a specific capital or non-recurring expenditures, could necessitate the use fund balance, but that would be limited to the restrictions noted below.
- Assign ½ of any net budget surplus (including revenues and expenditures) for the year as “Unrestricted Fund Balance Available for Appropriation” in the financial statements until this assigned fund balance reaches 1% of the total annual Town budget based on the latest approved budget. This assigned fund balance will be available to fund additional appropriations, when necessary, using the approval process required by the Town Charter.
- This policy strongly discourages, but does not prohibit the use of fund balance in excess of the “Unrestricted Fund Balance Available for Appropriation” when it is considered absolutely necessary as long as it is not to replace operating revenues or cover operating costs.

Once the Target Fund Balance has reached the desired balance, if it were to fall below the desired balance, the Town will increase the contingency appropriation amount

discussed above by ½% of the budgeted revenues until the Target Fund Balance is met. This will add additional funds to mitigate risk in the budget year. And, if these funds are not needed, they will add to the Target Fund Balance at the end of the year thereby working to increase the Target Fund Balance back towards the desired Target.

E. Use of Unrestricted Fund Balance above Formal Policy Requirements

Target Fund Balance should not be used in the place of normal operating revenues in the annual budget process. When Target Fund Balance exceeds the maximum desired Target, and is not needed to support a long-term projection, Target Fund Balance may be used to reduce the Town's long-term costs such as:

- Capital improvements demonstrated to reduce the future operating expenses
- Funding projects with authorized, but unissued debt
- Retire existing debt early
- Employer contributions to the Pension or Other Post-Employment Benefits Trust Funds above the amount required under each respective funding policy.

F. Policy Review

This policy and the related risk assessment will be reviewed at least every 4 years for possible improvements, changes and updates.