

Guidelines for Creating and Evaluating Funds and Accounts

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Introduction

This section presents a general background of government budget and accounting principles and concepts. The document is not an accounting manual that defines accounting rules to be applied to state government spending and revenue transactions. The development of these rules is clearly the role of the Department of Finance and other government accounting agencies such as the Government Accounting Standards Board (GASB). Rather, this document describes the accounting structure and how it affects the budget decision process as a fiscal policy issue. Accounting principles are considered because they inform policy deliberations. These are broad principles that are appropriate for policy issues, not minor rules that are required for day-to-day operations.

Why is this background important? First, it provides the context needed to understand state accounts and funds. Second, it provides a context for analyzing state accounts and funds. What is the rationale for the current structure? How does it affect the decision process? Are there ways to simplify the structure to facilitate priority setting? This background can aid in the development of criteria to evaluate the current fund and account structure. These criteria could also be used in the future as new funds and accounts are developed.

Funds and Accounts Definitions

Governmental accounting systems are organized and operated on a fund basis. A fund is the basic unit used to segregate resources and expenditures in the state treasury.

A fund is defined as:

“a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions or limitations.”¹

There are other related entities that have some of the same characteristics as a fund but do not fully meet the definition. The general purpose of these entities is to segregate resources and restrict expenditures to clearly identifiable purposes. These entities include a number of specifically defined “accounts”, reserves, and dedicated revenues with related restricted expenditures. In each case, revenue is dedicated or appropriated, spending is restricted and any balance remains in the account and does not cancel to the general or other fund.

Number of Funds

Are there accounting rules that should be applied when establishing funds, accounts and reserves? (The remainder uses the term funds but for simplicity this is meant to include separate accounts and reserves.) The general rule is that the number of funds should be as few as possible.

“Governmental units should establish and maintain those funds required by law and sound financial administration. *Only the minimum number of funds consistent with legal and operating re-*

¹Hay, Leon, Accounting for Governmental and Nonprofit Entities, Homewood, Illinois 1989, p13

quirements should be established, since unnecessary funds results in inflexibility, undue complexity, and inefficient financial administration.”²

According to the National Conference of State Legislatures:

“ Having a large number of separate funds is a relic of 19th century state budgeting, when the practice was to assign a revenue source and a fund to each of the many different activities and to get along without a comprehensive budget. A large number of funds unnecessarily complicates revenue forecasting, budgeting and accounting, and is likely to confuse the public. Money management can be a profitable revenue source for state governments; consolidated fund management can simplify it”

We can dismiss an examination of the legal aspects of fund establishment. If a fund is written into law, it is legal. The policy issue presented each time a fund or account is established is the inherent conflict between the reasons the new account is established and increased inflexibility, complexity and inefficiency that generally results from the expansion.

How many funds should there be? In the simplest possible situation, a governmental unit could be in conformity with generally accepted accounting principles if it used a single fund, the General Fund, to account for all events and transactions. ³ But there are very good reasons for more than one fund. These are:

- *Constitutional* - the state's constitution establishes separate funds which controls the actions of the Legislature. The several transportation funds, the Permanent School Fund, the Permanent University Fund, and the Environment and Natural Resources Fund are examples of constitutionally established funds.
- *Federal Requirements* - There may be requirements under federal law to segregate resources from the federal government into a separate fund.
- *Policy Reasons* - There may be policy reasons to establish a separate fund. One may be to improve control and oversight. A separate fund may enhance the Legislature's ability to maintain proper oversight. A second reason may be to address the concerns of interest groups affected by a related tax or fee increase. A third reason may be that the new spending activity is significantly different from general fund spending so that a new fund is required. Since new funds create other problems identified above, these reasons should be well articulated and should demonstrate a clear need for the separate fund. A fund should not be established when the accounting system can accomplish the same goals. Funds established for policy reasons should be reviewed periodically to determine whether those reasons remain valid. For example, a fund may be established to segregate revenue for a specific need. Once that need is met the separate fund should be abolished and the revenue should be deposited in the general fund.

Accounting Purposes- Government accountants have identified eight different types of funds that are useful for sound accounting administration. These are:

²Hay, P14

³Hay, P 14. A single fund would also require at least two separate accounts for long-term debt and the value of fixed assets.

- 1) General Fund - to account for all financial resources except those required to be accounted for in another fund.
- 2) Special Revenue Funds - to account for the proceeds of specific revenue sources (other than major capital projects) that are legally restricted to expenditures for specified purposes.
- 3) Capital Projects Funds - to account for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds and trust funds).
- 4) Debt Service Funds - to account for the accumulation of resources for, and the payment of, general long term debt principle and interest.
- 5) Permanent Funds – to account for resources that are restricted to the extent that only earnings, not principal, may be used to support that program.
- 6) Enterprise Funds - to account for operations (a) that are financed and operated in a manner similar to private business enterprises - where the intent of the governing body is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges; or (b) where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.
- 7) Internal Service Funds - to account for the financing of goods or services provided by one department or agency to other departments or agencies of the governmental unit, or to other governmental units, on a cost reimbursement basis.
- 8) Trust and Agency Funds - to account for assets held by a governmental unit in a trustee capacity or as an agent for individuals, private organizations, other governmental units, and/or other funds. These include pension, investment trust and agency funds.

The last type, Trust and Agency Funds, usually comprise pension funds but may include other funds with similar fiduciary responsibility. Types six and seven are referred to as proprietary funds and are usually tied to some activity by a state agency that sells goods or services internally or externally. Types three and four are quite specific and deal with capital projects and the servicing of debt for those projects. The first two types, the general fund and special revenue funds are the types where the proliferation of accounts, reserves and dedication occurs.

Fund Related Problems

What occurs when the number of funds operated by state government grows? The following are possible outcomes:

- *Complexity and Budget Priorities* - As the number of funds increase, setting the budget at the macro level becomes more complex. Setting overall budget targets is the essence of the prioritization process of the Legislature. Should more resources be put into education and housing or into tax reductions? Setting program priorities becomes difficult when there are one or two funds to consider. An expansion in the number of funds currently in law significantly exacerbates this problem. Without giving consideration to all resources, the priorities ostensibly established for the general fund may not in fact be reached in the end.

- *Public Accountability* - A complex accounting structure makes it more difficult for the public to understand the system. Government, unlike the private sector, does not have the information produced by the marketplace to demonstrate that it is performing efficiently. While there is much more to accountability than an accounting system, a system more complex than needed makes public accountability more difficult.
- *Inflexibility* - Resource balances may be tied up in separate funds and could be made available for other priorities, but identification can be difficult. The inflexibility created by the separate fund may prevent priorities from being fully met.
- *Program Funding Confusion* - Government is a complex business, and often a program structure used when allocating resources can be difficult to understand. Programs may receive resources from a number of funds or accounts. At times, the extent of these resources may not even be known to the decision makers and a program may receive more resources than decision makers would have otherwise chosen. Creating complex funding schemes can only make understanding the process more difficult.
- *Inefficiency* - Inflexibility and complexity may result in inefficient allocation of resources. Since government is under a great deal of pressure to use taxpayers' resources efficiently, the accounting structure should not hinder the allocation process.

Recommendations

1. Fund and Account definition should be standardized. If the intent is gather data for control or reporting information at the account level, then the word “account” should be used rather than the word “fund”.

2. The following criteria should be considered before a “fund” is created.

The Department of Finance has used the following criteria for evaluating the need to create a new fund based on agency needs and accounting requirements:

- A. Does the law require the agency to establish a new fund? - *legal requirement*
- B. Will the fund need to create discrete financial statements? - *GAAP requirement*
- C. Does an agency currently use a separate side system to duplicate accounting information to facilitate fund reporting? - *efficiency*
- D. Will the new fund improve information necessary for the agency's management of resources? - *information*
- E. Does the activity require the tracking of assets or liabilities beyond the fiscal year? - *continuity*
- F. Are activities across agency lines going to be consolidated for reporting purposes? - *multiple entities impact*
- G. Will the activity, as a fund, have sufficient resources to make timely payments on its obligations? - *cash flow requirements*
- H. Will the activity be material in relationship to other funds so as to require that it be tracked discretely? - *materiality*
- I. Will there be appropriations made from an accumulated balance of which any unused portion will cancel back? - *appropriations*

A “fund” should be created or continue to exist when a majority of the following criteria apply:

- A. If either the revenues or expenditures of the activity will exceed \$10 million dollars.**
- B. If the activities create assets or liabilities that will continue beyond a normal budget cycles.**
- C. If multiple agencies will be involved in collection or use of fund resources.**
- D. If there are enough resources available to cash flow the activity when the program begins operating.**
- E. If a separate fund is necessary to comply with constitutional requirements, federal regulatory requirements, or generally accepted accounting principles.**

While the limit on creating funds based on size is a reasonable beginning point, it is difficult to establish an absolute threshold on the dollar values necessary to create a new fund. However, it is more appropriate to ask if the new activity is material enough in relationship to other activities so as to require a new fund. The Department of Finance has been using \$10,000,000 as the guide in discussions of materiality.

The ongoing nature of an activity is an important criterion. But since all funds are subject to legislative intervention, it is also appropriate to specify the creation of a new fund if the activity will create new assets or liabilities that will extend beyond the normal budget cycles.

The complexity of a program and the necessary level of oversight again are difficult criteria to objectify when deciding on the need to create a new fund. It may be more appropriate to respond to this recommendation in two parts: complexity and oversight.

The complexity of the program would include the number of agencies that will participate in the collection and use of resources in the fund. The complexity of the program may also include the regulatory requirements imposed on the activities by federal agencies, e.g. entitlements, pensions.

Despite the use of terms in statute, some agencies have administratively requested that a fund be created to maintain the discrete accounting information necessary to report by "account". The creation of a fund to respond to the creation of each new "account" in law would result in many new funds being created each legislative session. While the creation of funds may make oversight easier, that is not practical or desirable in light of other goals e.g. simplification.

3. The use of the term "account" in statute or appropriations law should be limited since there is no automatic mechanism to manage or report on them outside of their individual agencies.

The general purpose of “accounts” has been to segregate resources and restrict expenditures to a clearly identified purpose. Generally, amounts are either dedicated or appropriated, spending is restricted to a specified purpose, and any balances do not cancel to the general fund or other funds.

Where necessary for oversight and reporting “accounts” may be created:

- A. Revenues or resources of an "account" should be limited and collected into one MAPS appropriation account.
- B. Authority for spending the resources of an "account" should be authorized by specific transfer authority.

- C. Alternatively, if multiple appropriations with dedicated receipts are designated as an “account” the individual appropriation accounts should have specific dedicated receipt caps.
- D. Agencies with an "account" must designate a unique identifier to be used on all MAPS appropriation accounts included in the "account" in order to aggregate information for reporting and management purposes.

The most effective oversight and reporting are created by individual direct appropriations. "Accounts" are not practical oversight mechanisms since there is no counterpart in the MAPS chart of accounts and there are no automatic reporting vehicles available.

The definition of "Accounts" however, appears to mean a collection of related appropriation or revenue sources. The term "Account" is not defined in statute, nor does it exist as a discrete accounting entity in the state's financial systems. An account by standard usage in statute generally refers to a single unique component or part of the accounting structure that matches sources and uses of revenues, but is a part of a larger fund. Because of the unique structure of an account it is not easily consolidated or combined with similar or related accounts. As a result, agencies have had to respond by manually compiling information related to individual appropriation and spending accounts in the accounting system to meet consolidated reporting needs.

4. The fund (and account) structures used in managing the state's funds should be periodically reviewed.

Although sunseting some funds seems appropriate as a review mechanism, sunseting could create problems with budgeting. For instance, if a fund is to be sunset, should the activity be consolidated by default to the general fund? It may be more appropriate for the legislature to have a scheduled review of all new funds or accounts that are created and that an affirmative decision is made as to their continuation or consolidation with other funds.

Oversight of activities should be most effectively accomplished by:

- A. Direct legislative appropriations of specific dollar amounts to be used for specific programs.**
- B. Placing dedicated receipts caps (spending limits) on non-direct appropriated activities.**
- C. Periodic and systematic review of all new funds and accounts created by legislation after four years.**
- D. Periodic and systematic review of all existing funds and accounts every eight years.**