Financial Trend Monitoring

Municipal Officials Handbook, Pages 158-160

5.601 Importance of Financial Analysis

Perhaps the most important responsibility of a local government's finance professional, other than the preparation of the budget, is financial analysis. Financial analysis can encompass many areas. Our focus here is financial analysis designed to determine the financial health of the local government, determine if the financial health is getting better or worse, and identify emerging trends the council should be addressing. Unfortunately, this highly critical area of responsibility is oftentimes neglected or simply not performed at all. If a local government's clerk-treasurer or City/Town Council is not fully aware of the municipality's financial health, does not know if its financial health is getting better or worse, and is unable to identify emerging trends affecting its financial health, who is in control? This lack of attention to one of the most important responsibilities of the local finance official can cause problems ranging from unexpected budget problems to actual insolvency.

5.602 What to Analyze

A local government's financial trend monitoring system can be wide-ranging and cover a multitude of variables or it can be quite simple. Simple monitoring systems can be very effective, especially for small governmental entities. At a minimum, the clerk-treasurer should establish a formalized annual monitoring system of the financial position of its major funds. This analysis will assist the clerk-treasurer in understanding the "big picture" of his/her government's finances and will act as an early warning mechanism for emerging problems. Financial trend monitoring books are available and provide examples of the many kinds of analyses that can be performed. However, once the local finance professional is able to master monitoring of the city's financial position, monitoring of other variables becomes increasingly easy and is just an extension of the same principles.

The financial position of a local government is best measured by what accountants call fund balance. Fund balance is defined as the assets of a fund (primarily cash & accounts receivable) less liabilities of a fund (primarily accounts payable). In other words, fund balance essentially means the net worth of a fund at any given point in time—typically at the end of the fiscal year. However, the trend of the financial position of a fund is much more important than its absolute value, thus, setting up the need for a multi-year trend analysis.

The term fund balance applies only to governmental funds, which includes the city's general fund, special revenue funds, debt service funds, and capital project funds. Accounting requirements for the city's proprietary funds (enterprise funds) are different and so is the financial analysis that is needed for these funds. The best measure of the financial position of an enterprise fund is working capital. Working capital is defined as the current assets (primarily cash & accounts receivable) of the fund, less current liabilities (primarily accounts payable) of the fund. Current means due within one year. Therefore, a wastewater system's physical plant would be excluded from the calculation as would the associated debt (bonds payable) of the wastewater plant. The end result is the fund's liquid net worth. The city's audited financial statements will separately identify the current assets of an enterprise fund as well as the current liabilities, making this analysis relatively easy.

In lieu of evaluating fund balance and working capital levels, some local governments (primarily smaller units), opt for a simpler approach—that is simply monitoring cash balances. While analyzing cash balances may occasionally omit some critical information, such as a large payment the government is due or a large disbursement that just occurred after year-end, the simple monitoring of each fund's cash balance can provide the smaller local governments with an effective alternative to evaluating fund balance and working capital balances. Regardless of the approach, it is critically important that the clerk-treasurer perform a financial trend analysis of its entity's financial position on an annual basis, develop a multi-year trend analysis and regularly present this information to the City Council. This information is absolutely critical to an elected official's understanding and management of the city or town's finances.

Once the financial analysis is performed and any unwanted or danger trends are revealed, the next step is to identify the primary causes of the changes in financial position. For example, fund balance in the general fund could be declining for three or four years in a row. The fact that fund balance is declining does not automatically indicate a problem. The government could be making a concerted effort to repair or replace needed equipment, fully understanding the impact on its general fund. Assuming the government has adequate reserve levels, this situation does not necessarily indicate an impending problem. The reason is that the expenditures causing the decline in fund balance levels can easily be eliminated in subsequent years. On the other hand, fund balance in the general fund could be declining due to increased on-going/recurring costs, which poses an entirely different situation, resulting in a structural imbalance in the budget.

5.603 Structural Balance

Staff members from New York City wrote a paper on what they termed "Structural Balance". The author describes structural balance as: "the situation in which the structure of the revenue budget and the structure of the expenditure budget are sufficiently complementary: of similar size and growth rate over time." In other words, the ongoing revenues of a fund should be able to support the on-going expenditures of a fund. One-time expenditures are not part of a structural balance analysis, nor are one-time revenue sources. For example, it would be prudent for a City Council to add a new police car to its fleet with a one-time

$30,000 revenue source. In a subsequent year, when the revenue disappears, the city simply eliminates that capital purchase.

Imagine, however, the consequences of a City Council adding a new police officer with this same one-time revenue source. The budget will balance in the first year, but what will happen in subsequent years? Quite simply, the government would unknowingly place its general fund in a state of structural imbalance. On-going revenues will not support on-going expenditures, setting up the council for a budget that is out-of-balance.

Structural balance sounds logical, simple and easy to understand, so why would such an easy concept require the publication of an extensive paper? Only someone intimately familiar with public budgeting can fully appreciate the concept of structural balance and the full range of implications. When crafting a government budget, the finance professional deals with literally hundreds, if not thousands of variables. Each of these variables can affect the city's finances in different ways. Some variables are clearly one-time revenues or one-time expenditures. Just as often, however, many of the variables fall into a gray area, not neatly fitting into either the one-time category or the on-going category. Combine these complexities with the sheer volume of issues and data inherent in the budgeting process and quite often the simple concept of structural balance becomes lost. Structural balance must be at the forefront of the finance professional's thought process at all times and most importantly, throughout the development of the budget.

Furthermore, it is difficult to take one budget in isolation and determine if it is structurally balanced or not—giving rise to a multi-year trend analysis, as described above. A structurally balanced budget or financial plan may produce surpluses in some years and deficits in another year. The term deficit implies something is awry. However, there will undeniably be times when reserve levels will decline (i.e. the expenditures of a fund will exceed the revenues of a fund), causing a deficit for that particular year. The key is in knowing what is causing a reduction in a fund's financial position and be able to take action, if necessary, to remedy the situation in a timely manner. A financial structure that is balanced at one point in time can become unbalanced when underlying circumstances change.

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