Analysis of Governmental Financial Performance
Learning Objectives

After studying Chapter 10, you should be able to:

- Explain the importance of evaluating governmental financial performance
- Distinguish among and describe key financial performance concepts, such as:
  - Financial position
  - Financial condition
  - Economic condition
Learning Objectives (Cont’d)

- Explain the relationships among environmental factors, organizational factors, and financial factors in determining governmental financial condition
- Identify, calculate, and interpret key ratios that measure financial performance
- Analyze financial performance using government-wide statements
- Describe how benchmarks can aid financial analysis
An “early warning” system of impending financial difficulty can serve to prevent disruption in critical government services.

Taxpayers now, more than ever, demand better performance from governmental officials.

Analytical tools have evolved to better track governmental financial performance.
Who Needs to Know About Governmental Financial Condition?

- Government managers
- Bond investors
- Creditors
- Legislators and oversight bodies
- Citizens
- Taxpayers
- Intermediaries, e.g., media, watchdog groups
What Do They Need to Know?

- Whether the government will continue as a viable entity providing the desired level of services to citizens in the future
- Whether future debt service payments will continue to be covered
- If the government is in compliance with all laws and regulations
**Financial position** focuses on assets and liabilities that require cash or are normally converted to cash in the short-term (i.e., liquidity)

**Financial condition** refers to a government’s ability to meet its financial obligations to creditors and others as they become due, as well as its service obligations to constituents currently and in the future (i.e., solvency)

**Economic condition** is a term GASB uses to capture a composite of the government’s financial health and its ability and willingness to meet its financial obligations and service commitments
Financial Condition: Types of Solvency

- **Cash solvency** — ability to generate enough cash over a 30- or 60-day period to pay its bills
- **Budgetary solvency** — ability to generate enough revenue over its normal budgetary period to meet its expenditures and not incur deficits
- **Long-run solvency** — ability in the long-run to pay all the costs of doing business
- **Service-level solvency** — ability to provide services at the level and quality that are required and desired for the health, safety, and welfare of the community

What Factors Affect Financial Condition?

ICMA’s *financial trend monitoring system* identifies three broad groups of factors (see III. 10-1)

- Environmental factors
- Organizational factors
- Financial factors
Environmental Factors

- **Community needs and resources** (e.g., population, age, income, employment, crime rate)
- **Intergovernmental constraints** (e.g., mandates and restrictions on revenue)
- **Disaster risk** (e.g., potential for natural disasters and local preparedness)
- **Political culture** (e.g., attitudes toward taxes and political processes)
- **External economic conditions** (e.g., national inflation and employment rates, financial markets)
Management practices and legislative policies that shape or influence how environmental factors affect the outcome of the financial factors.

The willingness and ability of managers to make tough fiscal decisions can prevent a fiscal crisis from occurring, even in the face of adverse environmental conditions.
Financial Factors

- **Revenues** (e.g., growth and diversity of revenue sources)
- **Expenditures** (e.g., priorities, mandates, and effectiveness of expenditures)
- **Operating position** (e.g., operating results, fund balances, reserves)
- **Debt structure** (e.g., short and long-term debt burden)
- **Unfunded liabilities** (e.g., pension, OPEB obligations)
- **Condition of capital plant** (e.g., deferred maintenance, capital outlay)
Ratios are useful analytical tools in examining relationships among elements of the financial statements.

Data are readily obtainable from sections of the comprehensive annual financial report (CAFR) and other publicly available documents.

Examining multiple-year trends in financial factors, as well as those for one year or a single point in time, is useful.
Data for Financial Ratio Analysis

Data for calculating financial ratios may come from:

- Government-wide statements
- Fund financial statements
- Notes to the financial statements
- Introductory section of the CAFR, including the MD&A
- Statistical sections of the CAFR and supplementary information
- Other publicly available sources
Ratios for Governmental Funds
(Ill. 10-3)

Revenue measures:
- Revenues per Capita
  - Operating revenues
  - Population
- One-time Revenues
  - One-time revenues
  - Operating revenues
Ratios for Governmental Funds, Cont’d.
(Ill. 10-3)

Expenditures measures:

- Expenditures by Function
  
  Operating expenditures for one function
  Operating expenditures

- Employees per Capita
  
  Number of municipal employees
  Population (or households)
Ratios for Governmental Funds, Cont’d. (Ill. 10-3)

Operating position measures:

- Fund balances: Unreserved fund balances
  Operating revenues

- Liquidity: Cash and short-term investments
  Current liabilities
Debt indicators:

- Long-term debt
  
  Net direct bonded long-term debt
  Assessed valuation (or population or personal income)

- Debt service
  
  Net direct debt service
  Operating revenues
Unfunded liability measures:

- Pension obligations
- Post-employment benefits

Pension obligations
Salaries and wages

Liability for postemployment benefits
Number of municipal employees
Ratios for Governmental Funds, Cont’d. (Ill. 10-3)

Capital plant measures:
- Maintenance effort
  - Expenditures for maintenance of general capital assets
    - Quantity of assets (e.g., square feet of buildings)
- Capital outlay
  - Capital outlay from operating funds
    - Operating expenditures
Performance Measures for Government-wide Statements (Ill. 10-4)

Financial Position Ratios:

- Unrestricted net assets – *How do our rainy day funds look?*
- GF budgetary fund balance – *How does our budgetary carryover position look?*
- Capital asset condition – *How much useful life do we have left in our capital assets?*
- Pension plan funding – *Will we be able to pay our employees when they retire?*
- Debt to assets – *Who really owns the governmental entity?*
- Current ratio – *Will our employees and vendors be pleased with our ability to pay them on time?*
- Quick ratio – *How is our short-term cash position?*
Financial Performance Ratios:

- Change in net assets — Did our overall financial condition improve, decline, or remain steady over the past year?
- Interperiod equity — Who paid for the cost of operating the city — current, past, or future tax and rate payers?
- Sales tax growth — What is the state of our local economy?
- Business-type activities self-sufficiency — Did current year BTA, such as utilities, pay for themselves?
- Debt service coverage — Were our revenue bond investors pleased with our ability to pay them on time?
Financial Capability Ratios:

- Revenue dispersion - *How much of our revenue is beyond our direct control?*
- Debt service load – *How much of our annual budget is loaded with disbursements to pay off long-term debt?*
- Bonded debt per capita – *What is our long-term general obligation debt burden on our taxpayers?*
- Legal debt limit – *Will we be able to issue more long-term general bonded debt, if needed?*
- Property taxes per capita – *What is our property tax burden on our taxpayers?*
- Sales tax rate – *Will our citizens be likely to approve an increase in sales tax rates, if needed?*
Benchmarking

- Analysis can be based on past performance and trends over time (e.g., 5 or 10 year trends) within a government

- Ratios can be compared to targeted values for performance indicators

- Ratios can be *benchmarked* against average data for similar governments (e.g., credit industry benchmarks)
Analysts at bond rating agencies, bond insurers, and underwriters (brokers) benchmark government ratios to the large set of information available to them from all municipalities whose bonds are rated or insured over time.

Bond rating agencies include Moody’s Investors Service, Standard & Poor’s, and Fitch Inc.
Bond analysts consider these factors important in assessing the current financial condition and long-term solvency of a government:

- Debt
- Finances
- Debt’s legal security
- Economy and demographics
- Management strategies (e.g., conservative budgeting techniques and fund balance policies)
Interpretation of trend or benchmark comparisons involves a great deal of professional judgment.

Usually a pattern of above or below average financial condition emerges.

Comparison to “red flag” levels is also useful.
Interpretation of financial analysis is challenging, but these are recognizable signs of fiscal distress:

- Decline in revenues relative to expenditures
- Declining property values
- Declining economic activity (e.g., retail sales)
- Erosion of capital plant
- Increasing levels of unfunded obligations
- Inadequate capital expenditures
It is vital to monitor government financial performance on an ongoing basis in order to sustain services in the long-run when governments periodically experience fiscal distress.

Numerous environmental, organizational, and financial factors affect governmental financial condition.

Analysis of financial ratios is a useful management tool, although interpretation is subjective.