Diagnosing the Financial Condition of Your Local Government

Step 4 of GFOA's Fiscal First Aid Financial Recovery Process

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Government Finance Officers Association

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Recovering from financial distress requires local governments to assess where actions are appropriate. GFOA's Fiscal First Aid: A 12-Step Process for Financial Recovery identifies two kinds of diagnoses that are part of the recovery process. The first kind, and the subject of this paper, is an initial diagnosis focused on technical, financial elements of the local government. It is important to understand these elements early in the recovery process. This is Step 4 in the GFOA recovery process.

The second kind of diagnosis is focused on root causes of financial distress that are harder to spot and treat but must be addressed for a full recovery. You can read more about this under Step 6—Detailed Diagnosis at the Fiscal First Aid website.

In this paper, we will describe how to conduct the initial diagnosis. We'll start with the basic principles of diagnosis that include developing a financial health model. We'll suggest a model, and the rest of the paper will walk you through how to use that model.

The Basic Principles of the Diagnosis

Throughout the diagnosis, look for the problems that have the most recovery leverage. These are problems that:

- Can be solved or mitigated for a reasonable investment of time and money.
- Offer a significant return on that investment.
- Will provide a return soon enough to help stabilize the situation in the short term but without causing negative long-term side effects.

The diagnosis must be supported by **two types of forecasting.**

There are many things you *could* do in response to financial distress. The diagnosis will help focus your actions. For example, perhaps the diagnosis reveals problems that demand long-term solutions without near-term payoffs. These findings can be held until later in the recovery process.

The diagnosis must be supported by two types of forecasting. First, a short-term cash flow analysis forecast helps make sure operations can continue as planned for the coming months.

A long-term forecast of three to five years is important for helping people recognize the nature of the problem. ***Will a modest economic recovery solve your government's financial challenge? Are there deeper structural problems that need to be addressed for a full recovery?*** A credible forecast will help define the problem and help participants in the recovery process better gauge the size of the problem that must be overcome. Of course, long-term forecasts are inherently uncertain, especially during a financial crisis. Scenario planning can be used to show different, plausible futures. The government can then develop strategies to respond to possible futures. The assumptions used for each scenario should be articulated. You can vary the assumptions to see how sensitive your forecast is to changes in the assumptions. The sensitive assumptions should be monitored to see how they differ from reality as you move forward.

The diagnosis will work best if it is guided by a financial health model that helps organize your thinking about financial health. Figure 1 shows an example of a financial health model that uses the metaphor of a three-legged stool.

The benefits of diagnosing your financial condition using a financial health model, like the one shown, include:

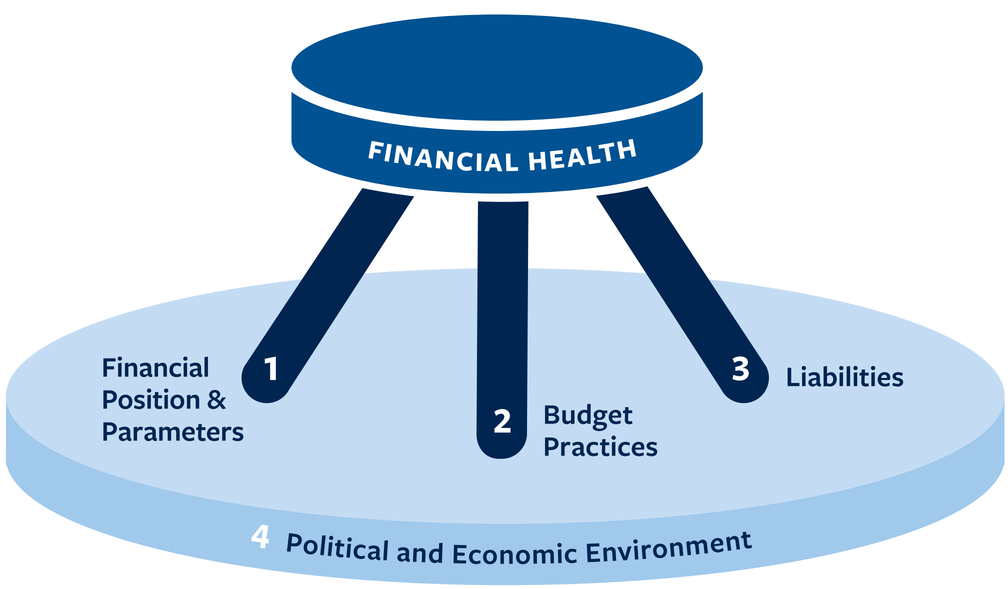
- It guides the diagnosis so that it is complete and gives people confidence in the process.
- It uses a metaphor to convey meaning. This helps the diagnosis resonate with a broad audience, not just financial experts.
- The model focuses on the fundamentals. In distressed situations, there are often opportunities in the fundamentals. It helps engage and educate nonexperts.
- It is not too focused on the short term. It should help the organization not only bridge the short-term challenges but also contribute to a solid financial foundation for the long term.

Finally, involve others in the diagnosis to bring in additional perspectives. Some parts of the diagnosis are more technical than others. You can match people's involvement with their level of expertise. For example, elected officials should be involved in a discussion of important but high-level financial governance policies that the government should adopt or emphasize. Examples include how reserves will be used and the role of temporary revenues. They should be involved in setting goals and priorities for services. Executive managers can take part in an analysis of the expenditures in their departments, including a review of how money is spent.

Involving others can relieve some of the unease associated with the recovery process. It removes some of the mystery around the process and promotes a sense of "doing something" about the situation. Involving others creates a deeper and broader recognition of the problems faced. This can increase support for strategies to address those problems.

In the rest of this paper, we will explore the four parts of the three-legged stool model. We will highlight key questions you should ask yourself. It will suggest financial strategies you might consider coming out of your diagnosis. Many of the recommendations made by the financial health

Figure 1: Financial Health Model



model have been covered by other GFOA resources. Links to these resources are included in the text. Some of these are webinars held earlier in 2020. The recordings are available at the linked locations.

Financial Position and Parameters

This part of the financial health model covers cash position, reserves, revenues, and expenditures.

Cash Position

Cash is king during financial distress, so you should get a handle on the amount of cash on hand and the cash flow situation. You need to know: ***When will we experience net negative cash flows? What will the size of those deficits be? How long will they last?*** Develop a monthly cash flow analysis that shows anticipated income and expenses for each month to answer these questions. The analysis will allow the recovery leader to examine year-over-year trends and apply spending controls when needed.

Reserves

Financial reserves can be used to buffer shocks and provide bridge financing to pursue a restructuring. It is important to answer the following questions about your reserves:

- ***Are there external restrictions on a portion of reserves that must be honored?***
- ***Are there internally imposed commitments of fund balance? Can those be removed?***
- ***Do certain reserves no longer have a bona fide purpose or mandate, which would mean the funds can be freed up for other purposes?***
- ***Are duplicate reserves being maintained in different funds?***
- ***What other** risks are your reserves expected to help you hedge against**? If you use some of the reserves to help with recovery, will you be protected against other risks?***

Your goal is to make sure reserves are maintained and used in accordance with a reserve policy and applicable restrictions. You should identify reserves maintained across the entire organization to make sure all reserves are appropriate: not too much and not too little.

If reserves are available, you should clarify what portions are available to help manage through the financial distress and for how long the organization is willing to use them to compensate for declining revenue.

Revenues

First, disaggregate your revenues to learn more about how your sources behave. ***Which revenues might be sensitive to the downturn? How important are those sources compared to more stable revenues?*** You might be able to disaggregate by type of taxpayer. ***Are there certain taxpayers that are harder hit by a bad economy than others? How important are those businesses to your revenues?*** This may point out trends you should be aware of. Develop graphs of this data. Graphs often reveal things tables of numbers don't. The GFOA webinar "Financial Decision-Making Under Uncertainty" showed how one city performed a disaggregation of its revenues and how that helped the city create recovery scenarios.*

Be Sure Not to Overestimate Rating Agency Requirements

Maintaining bond ratings is often cited as a reason not to use reserves. However, GFOA's experience is that local governments often overestimate the amount of reserves that rating agencies expect them to carry. Communicate with your rating agency representative to get clarification on this point.

* Dan Matusiewicz, CFO of the City of Newport Beach, presents on this point in the second half of the webinar.

Besides helping you find problems, an analysis of revenues could also help find solutions. Of course, revenue-raising strategies must be considered in terms of fairness to the community. The following are examples of how you might enhance revenues from GFOA's "Balancing the Budget in Bad Times" series, Part 1 and Part 2. You can access these papers for more detail, including considerations on when you should and shouldn't use these strategies.

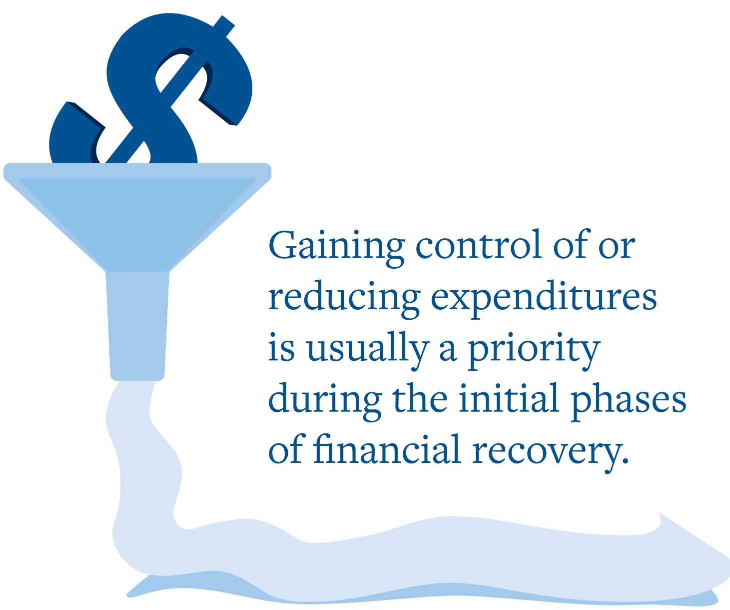
Strategies to Enhance Revenue

Lower Risk

- Maximize federal/state aid
- Examine fees for services
- Improve billing and collection methods
- Audit tax revenue sources

Higher Risk

- Revisit interfund transfer policies
- Obtain better returns on idle cash
- Levy a broad tax increase
- Create a special district with its own taxing ability



Gaining control of or reducing expenditures is usually a priority during the initial phases of financial recovery.

Expenditures

Gaining control of or reducing expenditures is usually a priority during the initial phases of financial recovery. The financial health model addresses the size and rate of growth of key expenditures; controls; the link between spending and service strategy; and inventorying your programs.

The most basic step is to answer questions like: ***Which areas of expenditure are the biggest? Which are growing the fastest?*** The answers suggest where to focus cost-control strategies. In most local governments, personnel is the largest area of expenditure. The following are examples of cost-control measures for personnel from GFOA's "Balancing the Budget in Bad Times" series, Part 1 and Part 2. You can access these papers for more detail and to see other strategies. You can learn more about these strategies at the GFOA webinar "Personnel Budgeting in a Recession."

Strategies to Reduce Personnel Spending

Lower Risk

- Vacancy control
- Monitor and limit overtime use
- Address health care costs
- Review the use of consultants and temporary staff

Higher Risk

- Wage freeze or hiring freeze
- Increase part-time labor
- Reduce hours worked and pay
- Layoffs

Next, examine the controls to make sure they are up to par. Position control and budget control are the most important. Position control is important because employees are expensive and personnel costs are not easy to change after positions have been filled. ***Have you prepared and validated a position budget for staffing?*** Budget controls help you control spending but examine the level of control. ***Is the cost of the control more than the benefit it produces?*** Consider placing control at a higher level (e.g., department), where a manager can be assigned the authority (and accountability) to manage within parameters.

A fully costed program inventory allows you to answer this question: **Where is the money going?**

Beyond these essentials, consider the following questions:

- ***Do some areas of the organization suffer from weaker controls than others?***
- ***Should a strategy of selective control be applied, where managers who have shown the capacity to manage their resources are given greater latitude?***
- ***Does the situation warrant temporary, greater centralization to gain control over outgoing funds?***

After controls, consider the link between expenditures and your service strategy.

During a financial crisis, local governments often resort to "across-the-board" budget cuts, where each department is expected to cut a given percentage from its budget. This approach is suboptimal for two reasons. First, it does not consider what the government will stop doing as a result of having less money. For example: ***Are there "nice-to-have services" that can be foregone? Will the government continue to do everything it did before but at a lower level of quality?*** Second, some departments will be deemed more important than others and be spared some of the cuts. Of course, some services are more important than others, but the imprecise nature of this approach often feels unfair to those not spared the cuts. Those who feel unfairly treated will be less likely to support other strategies the government will need to make a full financial recovery.

Therefore, consider these questions: ***Have we articulated a service strategy and priorities? How is our mission and service strategy translated into resource use?*** Expenditures should tie back to a plan of action that was anticipated during the budget process. There are ways to do this, ranging from a list of service priorities created by the governing board to strategic plans and priority-based budgeting systems. The GFOA webinar "Budgeting During a Recession" describes ways to link strategy and resources.

Finally, you could inventory the programs offered by your government as well as their direct and indirect cost. A fully costed program inventory allows you to answer this question: ***Where is the money going?*** It also is indispensable for budget reforms and alternative service delivery plans that may be developed later in the recovery process. An inventory may also highlight services that have survived due to inertia or tradition but are no longer of much value.

That said, a program inventory may be beyond the capabilities of some local governments during the first steps of the recovery process. If so, it can be deferred until later. But if you can develop one or already have one, you might answer questions such as:

- ***What mandates is the program subject to? What does the letter of the mandate require? What does the program provide? Are services being provided beyond mandated levels?***
- ***Is a program providing a high level of service that could be reduced in exchange for reduced costs?***
- ***Is the program facing increasing or decreasing demand?*** A program facing decreasing demand could be downsized. Techniques to manage demand and/or control costs might be needed for a program facing increasing demand.

Budget Practices

The budget ultimately creates or destroys fiscal balance. During the initial diagnosis, concentrate on issues that have the most potential for short-term recovery efforts. The financial health model covers the following budget practices: structural balance, variance analysis, and hidden sources of funding.

Assess Structural Balance

Structural balance refers to the alignment between ongoing, regular revenues and ongoing, regular expenditures. If ongoing expenditures are funded by temporary or highly unstable revenues, financial distress is almost inevitable. Therefore, ask: ***Is there a mismatch between recurring revenues and recurring expenditures?*** Check to see how one-time revenues have been used in the past. ***Is there a history of unsustainable uses of one-time revenues?*** If so, a policy governing the use of nonrecurring revenue is needed.

Variance Analysis

Variances are the difference between planned and actual spending. Analyze variances and understand the reasons behind them. The following types of variances should be considered:

- **Current budget vs. prior budget.** This helps you understand what has changed from one year to the next in terms of service delivery needs, increased costs, and anticipated revenues. For example, you can ask: ***Are there costs that were only expected to last for a short time but became a permanent part of the budget?***
- **Current actuals vs. prior actuals.** Find changes in spending patterns and revenue collections and identify emerging trends that need to be considered in forecasting. Also, identify volatile revenue or expenditures. For example, ask: ***Is there a need to smooth volatile expenditures or discontinue reliance on volatile revenues to fund recurring expenditures?*** This kind of information could be invaluable for your cash flow analysis.
- **Budget vs. actual revenues.** Ask: ***What revenues underperformed projections and why? How does this impact forecasts going forward?***
- **Budget vs. actual expenditures (negative).** Examine history to see where the overruns have been so you can focus control efforts on areas of greatest need. Ask: ***Which areas have been hardest to control and which might be in the future?***
- **Budget vs. actual expenditures (positive).** Understand positive variances. ***Have efficiencies resulting from positive variances been captured and budgets permanently reduced? Is more precision needed in forecasting areas like personnel costs and vacancy rates? Are there contingency budgets throughout the organization that can be consolidated?***

Hidden Sources of Funding

The budget may have sources of liquidity available to serve as a bridge. For example: ***Does each department budget its own contingency when one pooled contingency would cover risk and free up funds for other uses?***

Interfund charges may also be a source of funding. ***Are internal service funds charging appropriately? Are funds that receive services from the general fund supporting the general fund for the full and fair amount?*** It may be discovered that the general fund (often the fund most in distress) is being overcharged by internal service funds or under-reimbursed by funds to which it provides services, such as enterprise funds.

Liabilities

Liabilities represent potential obligations or unsustainable practices that could harm financial condition. The diagnosis finds the magnitude of problem areas and allows the government to begin looking for solutions. There are four types of liabilities that the financial health model considers: debt; risk management, self-insurance, and lawsuits; internal loans; and post-employment benefits.

Debt

Foremost, examine debt repayment schedules. ***Are there upcoming debt service payments that could strain cash position?*** Look for restructuring or refinancing opportunities for existing obligations.*

Compare debt levels to the amount of debt allowed under your customized local debt policy.

* See "Balancing the Budget in Bad Times, Part 1" for more information on refinancing debt. Part 2 addresses restructuring debt.

How much capacity for borrowing is available? This will tell you how much debt might be used to manage through financial distress (to pay for capital projects, for example). If a customized local threshold for acceptable indebtedness has not been established, then such a policy may need to be developed.

Risk Management, Self-Insurance, and Lawsuits

Risk management and self-insurance funds can be liabilities if not managed properly. ***Do claim trends for insurances suggest that operating practices and management policies need review? Are there opportunities for improving safety?***

Do the type and amount of lawsuits filed against the agency identify high-risk areas in terms of law enforcement, management behavior, and public safety liabilities?

If you have a self-funded employee health insurance plan, are there opportunities to better manage it?

The crisis may provide an opportunity for examining insurance deductibles, taking into account historical claims experience. For example: ***Is there sufficient reserve fund capacity to increase the level of self-insurance***? This can reduce insurance premium costs.

Internal Loans

Discern the purpose of interfund loans and the probability that the loans can be paid back. ***Is there a repayment schedule? Is the purpose of loans clear?*** arge and growing interfund loans may indicate a de facto subsidization of an unsustainable operation.

Also, interfund loans may signal a disconnect between when revenues come in and expenditures are made. Perhaps one fund needs to borrow from another to bridge a gap. ***Does this signal a structural weakness and a potential point of failure?***

"The Last Line of Financial Defense? Internal Loans in Emergency Situations" describes how to manage some of the risks associated with internal loans.

Post-Employment Benefits

Though it may be hard to change post-employment benefit policies in the near term, it is wise to take stock of the size and urgency of these liabilities early in the recovery process so they can be factored into the recovery strategy. Given the high profile these liabilities often have, if you don't include them in the diagnosis, you could lose credibility with part of your audience.

The political and economic environment is the foundation of financial health.

First, get a handle on expected future contributions to post-employment benefits. The most immediate concern is: ***Might pension contributions increase at some point to make up for market losses?***

Also, ask: ***Do we consistently underfund pension or OPEB liabilities?*** If so, this may suggest excessive personnel costs.

Finally, ask: ***What is our legal obligation to continue all post-retirement benefits in their current form?*** It may be possible to adjust or discontinue certain benefits.

Political and Economic Environment

The political and economic environment is the foundation of financial health. The initial diagnosis looks at the immediate relevant environmental factors, including the state of the economy; the state/provincial government financial situation; changing service demands; and internal leadership and management.

State of the Economy

The condition of the economy is a determinant of financial condition. Take stock of economic indicators such as unemployment rates, housing starts, and consumer confidence. You can visit the GFOA Economic Indicator Dashboard to get these statistics and more. Local universities or regional economic development agencies may also have statistics that focus on your geographic region. National and local economic indicators might help you answer questions such as:

- *Can economic growth be expected to help improve financial conditions?*
- *Might conditions worsen, thereby requiring a more robust recovery strategy?*

Economic forecasts can help inform the organization's forecasting.

State/Provincial Government Financial Situation

Financial distress in state/provincial government may cause problems for local governments. Consider the following:

- *Might the state/provincial government reduce shared revenues or redirect traditional local sources to state/provincial use?*
- *Could distress lead the state/province to raise taxes, thereby reducing citizens' tolerance for any increase in local taxes?*
- *Could states/provinces shift or mandate certain services to be performed at the local level that had traditionally been housed within a state/provincial agency?*

Pay attention to the state/province's financial situation to avoid being caught unaware by state/provincial policy decisions that could worsen local conditions. Contact your state/provincial GFOA chapter to see what information they can provide on how your state's or province's financial condition might impact local governments.

Changing Service Demands

The COVID-19 pandemic and the related economic downturn have implications for citizens' demands for services. You should ask: *Are there increases in service demands that could cause pressure for increased expenditures?* Public health concerns could loom in the COVID-19 downturn. In a depressed economy and period of high unemployment, human services could experience greater demand.

Also ask: *Are there areas of service that are experiencing reduced demand that could be cut back?* For instance, a slowed construction market might reduce demand for development planning, permitting, and inspection services.

Internal Leadership and Management

Examine leadership and management practices for opportunities. You might ask:

- *Do we have robust financial policies in place to guide difficult financial decisions?*
- *Is there an opportunity to engage the community and the employees in honest, open discussions about difficult topics like reassessing services and priorities, reducing staffing levels, and resetting compensation and benefit levels?*
- *Do we have the right people in the right positions?* The crisis may justify changing the organization's leadership structure in ways to better accomplish a recovery.

Conclusion

"Diagnosis before treatment" is a basic tenet of medicine. A financial health model described in this document will help you conduct a diagnosis of your financial condition. The diagnosis can then guide where you need to apply Fiscal First Aid.

For more information about GFOA's Fiscal First Aid program, visit **www.gfoa.org/FFA.**

Government Finance Officers Association (GFOA) represents approximately 20,000 public finance officers throughout the United States and Canada. GFOA's mission is to promote excellence in state and local government financial management. GFOA views its role as a resource, educator, facilitator, and advocate for both its members and the governments they serve and provides best practice guidance, leadership, professional development, resources and tools, networking opportunities, award programs, and advisory services.

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