The published financial report of a local government provides a wealth of information to anyone with an interest in the government's economic condition. Taking advantage of this information, however, poses a real challenge to many users of these reports. This chapter aims at helping potential users of local government financial statements to meet this challenge.

PUBLIC SECTOR V. PRIVATE SECTOR

The primary goal of a private-sector business is economic — to make a profit. While local governments also have economic goals, their principal objective is social rather than economic — to provide services to citizens. Stated differently, economic goals in the public sector are a means to an end, rather than an end in themselves. Therefore, the approach taken to interpreting financial statements in the public sector must necessarily differ in important respects from the approach taken in the private sector.

Ratio analysis provides a good illustration of this point. It is common in the private sector to combine various financial statement elements into ratios to serve as a point of reference for analysis. Yet few of the most commonly used private-sector ratios can be applied meaningfully to local governments. A number of them, in fact, cannot even be calculated for a typical local government because they presume the ownership of stock and operations focused on the sales of goods and services to customers.

> Users of local government financial statements must assess a local government's financial health from three different perspectives.

Consequently, even when local government financial statements most closely resemble those of a private-sector business (e.g., the accrual-based government-wide financial statements), it is not possible simply to apply private-sector analytical techniques. A fundamentally different approach is needed, consistent with the unique objectives and circumstances of local governments.

FOCAL POINTS FOR ANALYSIS

It is common in the private sector to speak of a "bottom line" for evaluating financial performance (i.e., *net income*). Local government financial statements offer no single measure suitable for this purpose. Instead, users of local government financial statements must assess a local government's financial health from three different perspectives.

- **Near-term financing.** One particularly pressing concern is a local government's *near-term financing situation*. Is the government able to meet its short-term financial obligations in a timely manner? Are its operating inflows adequate to cover its operating outflows? Is the government financially prepared for contingencies (e.g., budgetary shortfalls and natural catastrophes)?
- **Financial position.** It would be shortsighted, of course, to focus exclusively on the near term. An equally important concern is a government's overall *financial position* as represented by the totality of its assets and liabilities, as well as the difference between them (i.e., net assets). Financial position is an essential point of reference for determining whether a government's overall financial situation is improving or deteriorating.
- **Economic condition.** Needless to say, a local government's finances do not exist in a vacuum. Inevitably, a government's financial position will be affected by its circumstances (e.g., the vitality and diversification of the local economy, the breadth and depth of the government's tax base). Likewise, a government does not exist in a time warp. Past experience often is vital to predicting future developments (e.g., Have intergovernmental revenues been increasing or decreasing over time? Has the government's population been growing or shrinking?).

  Consideration of such factors provides the necessary *context* for interpreting current-year financial data. When financial statement users consider a local government's financial position in the light of such factors, they are said to be concerned with its *economic condition*. Viewed another way, *economic condition* focuses on the likelihood that today's *financial position* will improve or deteriorate in the future. These three perspectives are summarized in Exhibit 1.

ASSESSING A GOVERNMENT'S NEAR-TERM FINANCING SITUATION

Local governments present both *fund financial statements* and *government-wide financial statements*. Fund accounting reflects the fact that local governments segregate their financial resources for specific purposes based on special regulations, restrictions, or limitations. Such restrictions naturally

Exhibit 1: Perspectives for Analyzing Local Government Financial Statements

Perspective	Significance
Near-termfinancing situation	Will the government be able to pay its bills (both expected and unexpected) on time?
Financial position	Is the government's financial health improving or deteriorating?
Economic condition	Is it likely that today's financial position will improve or deteriorate?

have an important effect on near-term financing. Consequently, assessments of a local government's near-term financing situation tend to focus almost exclusively on the fund financial statements rather than on the government-wide financial statements.

Governmental funds — balance sheet. Not all assets and liabilities are directly relevant to near-term financing. Some assets, for instance, cannot be used to pay bills (e.g., assets used in operations, such as land, buildings, improvements, equipment, and infrastructure). Likewise, some liabilities will not come due in the near future (e.g., long-term debt) and therefore will not require the use of financial resources in the short term. Such assets and liabilities are excluded from governmental funds in accordance with their unique *current financial resources measurement focus*. Consequently, governmental funds are especially well suited for the purpose of evaluating near-term financing needs.

The difference between a governmental fund's assets and liabilities is described as *fund balance*. As a practical matter, despite their measurement focus, governmental funds still commonly include certain assets that are not actually available for near-term financing purposes (e.g., supplies inventories, long-term receivables, debt service "reserves"). Accordingly, an equivalent portion of fund balance is reported as *reserved fund balance* to focus readers' attention on the remaining component of fund balance, which is, in fact, available to meet near-term financing needs: *unreserved fund balance*. It is important that the amount of unreserved fund balance in a government's chief operating fund (i.e., *general fund*) be large enough to serve as a cushion against unanticipated budgetary shortfalls, disasters, and other contingencies, thereby mitigating risk and helping to stabilize tax rates.

A point of reference is needed for assessing the adequacy of the level of unreserved fund balance maintained in the general fund. For many, this point of reference is operating revenues (i.e., revenues adjusted to remove the effect of any items that would distort trends). For others, it is operating expenditures. As a rule, the choice between the two will depend on which is considered more predictable in a given government's specific circumstances.

Perhaps the most common question posed in connection with local government financial statements is "How much unreserved fund balance is enough?" Although there is no single right answer to this question, it is possible, nonetheless, to offer some practical guidance. The Government Finance Officers Association (GFOA) has formally recommended that the *minimum* level of unreserved fund balance in the general fund be no less than five to 15 percent of regular general fund operating revenues, or one to two months of regular general fund operating expenditures, depending upon the point of reference selected.[1]

The guidance just described addresses only the *minimum* amount of unreserved fund balance that should be maintained in the general fund. Prudent financial management often will suggest that higher than minimum levels be maintained, especially in the case of smaller governments, which may not enjoy the economic depth and revenue diversification of their larger counterparts.

Levels of unreserved fund balance will naturally vary with fluctuations in revenues and expenditures. Furthermore, it is only to be expected that a budgetary cushion will temporarily diminish when the contingencies being planned for actually occur. It would be a mistake, therefore, to place undue emphasis on the level of unreserved fund balance at a single point in time. What really is important is the pattern of unreserved fund balance over time (e.g., 10 years). Is fund balance *normally* in excess of minimum levels? How rapidly has unreserved fund balance been replenished in the wake of events requiring its use?

Governmental funds — statement of revenues, expenditures and changes in fund balances. The statement of activities for governmental funds is titled the *statement of revenues*, *expenditures*, and *changes in fund balances*. The key item on this statement, from a near-term financing perspective, is the *excess of revenues over expenditures*.

It is to be expected that revenues of the general fund normally will equal or exceed fund expenditures. What is true in general, however, is not necessarily true of any particular year. Thus, a local government that had revenues in excess of budgetary projections in one year might deliberately choose (or even be required) to reduce its revenues the following year to bring fund balance back to a level consistent with the government's fund balance policy (a practice commonly known as "budgeting fund balance"). Thus, a sound analysis of the *excess of revenues over expenditures* needs to consider patterns in this amount *over time* (e.g., 10 years).

Proprietary fund statement of net assets. Proprietary funds, unlike governmental funds, report both capital assets and long-term debt, even though neither is directly relevant to near-term financing. Therefore, the difference between proprietary fund assets and liabilities (described as either *net assets* or *equity*) is *not* equivalent to the *fund balance* reported in governmental funds.

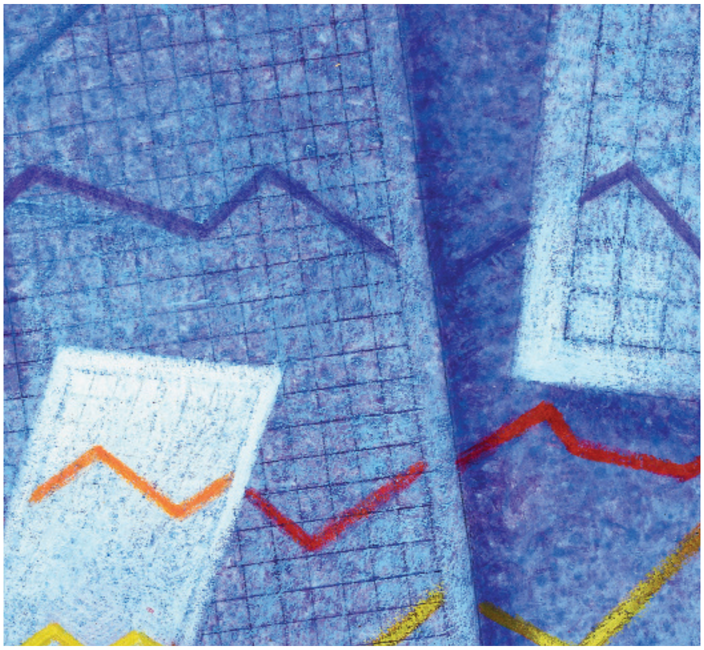
That is not to say, however, that proprietary funds do not provide information useful for assessing their near-term financing situation. Those funds do, in fact, present their assets and liabilities on a *classified basis* that distinguishes *current assets* and *current liabilities* from noncurrent items in both categories. It is possible to take advantage of this distinction to calculate *working capital*. Working capital bears important similarities to *fund balance*, although there also are important differences.

Typically, users of financial statements are more interested in the relationship between the two components of working capital than in the actual number itself. That is, they tend to focus on the ratio between current assets and current liabilities, known as the working *capital ratio* or, more commonly, the *current ratio*. The adequacy of a given proprietary fund's current ratio is probably best assessed by comparing it to that of other funds involved in similar operations.

Proprietary fund statement of activities. In the public sector, it is service, rather than profit, that provides the motivation for sponsoring the various business-type activities reported in enterprise funds. Indeed, public policy considerations often cause governments to deliberately set fees and charges for selected activities at levels lower than what would be needed to recover operating costs. The issue of cost recovery then is more complicated for enterprise funds than it is for private-sector businesses. While some enterprise funds have cost-recovery goals quite similar to those of a private-sector business (e.g., an electrical utility), others aim at only partial cost recovery (e.g., a transit authority). Accordingly, cost-recovery goals legitimately vary from fund to fund and from government to government. Still, cost recovery should be a matter of choice rather than of chance.

The format of the proprietary fund statement of activities, known as the *statement of revenues, expenses, and changes in net assets*, highlights the extent to which an enterprise fund has been successful at meeting its cost-recovery target. It does so by juxtaposing *operating revenues* (i.e., fees and charges received from customers) and *operating expenses* (i.e., the cost of the goods or services provided to customers) to calculate *operating income*.

Familiarity with an enterprise fund's cost-recovery policy is essential to a sound analysis of the fund's operations. Assume, for example, that it is the policy of a particular enterprise fund to recover 90 percent of its operating expenses through fees and charges. Further assume that operating expenses and revenues for the most recent period were $100,000 and $95,000, respectively. In that case, the enterprise fund would, in fact, be meeting its cost-recovery policy goals (i.e., $95,000/$100,000 = 95 percent > 90 percent target), *despite a deficit in operating income.*



ASSESSING FINANCIAL POSITION

Governmental funds have a relatively short time horizon because of their special current financial resources measurement focus. The government-wide financial statements, on the other hand, suffer from no such limitation. Therefore, it is to the government-wide financial statements that interested parties should turn for information on a government's financial position.

Government-wide statement of net assets. The principal measure of financial position is net assets. Care is needed to properly interpret the significance of one of its components, unrestricted net assets.

Because a government has the power to tax, its failure to recover costs in one period can be made up by raising additional taxes in a subsequent period. To the contrary, the customer of a private-sector business cannot be assessed an additional amount at some later date for goods and services already received and paid for just because the amounts charged ultimately prove insufficient to cover costs. Accordingly, a deficit for a private-sector business is always a matter for concern, whereas a deficit for a local government means only that the government has committed a portion of its future taxing power, which may be either good or bad, depending upon the circumstances. Therefore, the focus of analysis should be on the direction and magnitude of *change over time* and the underlying reasons for the change. Is the rate of change troubling or reassuring? Is the reason for committing future taxing power valid or just an excuse to place the burden of paying for today's services on tomorrow's taxpayers?

Government-wide statement of activities. From the viewpoint of financial position, the single most important element in the government-wide statement of activities is *changes in net assets*. The statement of activities also provides valuable information on the cost of each of the government's programs.

Changes in net assets. The amount reported as changes in net assets measures the extent to which a government's financial position has ultimately improved or deteriorated as the result of events and transactions of the period.

Nowhere is the analysis of changes in net assets more important than for *governmental activities*, which restate the data from the governmental funds using a different measurement focus. Specifically, by comparing *changes in fund balances* (as reported in the governmental fund statement of activities) with changes in net assets — *governmental activities* (as reported in the government-wide statement of activities), the financial statement user can better appreciate the long-term economic impact of the near-term financing activities reported in the governmental funds.

Functional cost data. Another important benefit of the government-wide statement of activities is that it provides an accrual-based measure of the cost of a government's various functions and programs. Such information is clearly of value for appreciating the impact of individual functions and programs on a government's overall financial position. Still, care must be taken to avoid certain misunderstandings that can easily arise in connection with the use of accrual-based cost data.

Budgeting. The accrual basis of accounting, by definition, divorces the recognition of transactions and events from the timing of related cash flows. Accordingly, such data must be used with caution in the context of the operating budget, which of necessity must be concerned with ensuring that projected cash inflows are sufficient to cover anticipated cash outflows.

Contracting decisions. The decision to outsource a service involves, among other things, comparing prices quoted by vendors with the cost to the government itself of providing the same service directly. It is intuitively appealing to use the functional cost data provided in the government-wide statement of activities as a measure of the government's costs for this purpose. Such a use of the data, however, would be mistaken for two reasons.

First, the amount reported as functional expense typically does not include sometimes substantial amounts of indirect cost (i.e., overhead) related to a given function (often reported in the *general government* function). A sound contracting decision, however, must take into account the *full cost* of providing services (i.e., both direct and indirect costs).

Conversely, rarely can the full cost of a given function be completely eliminated through outsourcing. A portion of the indirect costs assigned to a given function as part of the calculation of full cost typically will reflect costs that are relatively inflexible to changes in demand (i.e., *fixed costs* or *sunken costs*). Thus, the elimination of one tenth of a government's employees, for instance, ordinarily would not be expected to result in a proportionate decrease in the costs of the personnel department. Accordingly, contracting decisions should focus exclusively on the *avoidable* (or *incremental*) portion of full cost.

In short, the use of functional cost data taken from the government-wide statement of activities is inappropriate for contracting decisions unless appropriate adjustments are made to ensure that *all* and *only* the avoidable costs associated with a given function are considered.

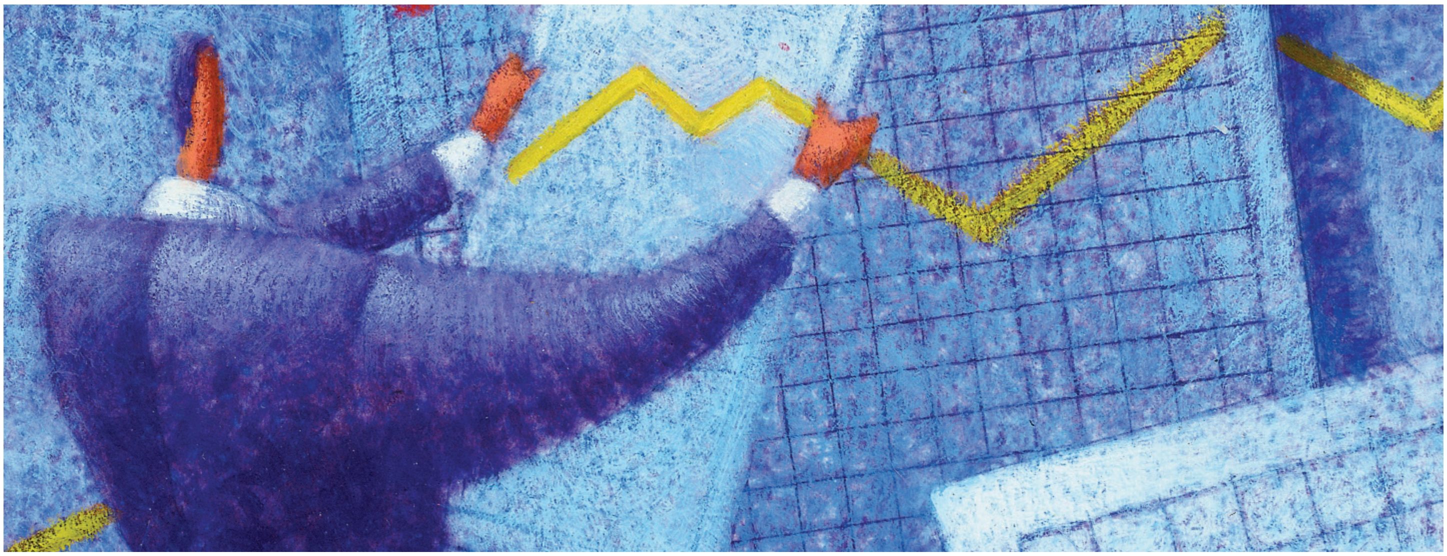
Intergovernmental comparisons. Financial statement users commonly wish to compare the functional costs of one government with those of another. Such comparisons can pose special challenges in the case of functions that utilize significant capital assets.

Capital assets that provide essentially the same service can generate significantly different amounts of depreciation expense. This phenomenon creates a challenge when comparisons among governments are motivated by considerations of economy and efficiency, because governments with older capital assets could easily be mistaken for being somehow more efficient than governments with newer assets. For this reason, it is important when comparing capital-intensive functions that depreciation expense be removed from consideration. The information needed to make such an adjustment can be found in the notes to the financial statements, which disclose the amount of depreciation expense included as part of the direct expense reported for each function.

Capital grants. Under the accrual basis of accounting, revenues associated with capital grants typically are recognized in total by the time the capital asset is ready to be placed in service. Normally it is advisable to remove program revenues related to capital grants and contributions from functional cost when analyzing the latter. Since GAAP require that *capital grants and contributions* be reported as a separate column in the government-wide statement of activities, this adjustment can be made easily.

Assessing Economic Condition. The third focus of financial analysis for local governments is their *economic condition*. That is, what are the factors that affect the likelihood that today's financial position will improve or deteriorate in the future? Much of the information needed for assessing economic condition involves either nonfinancial data (e.g., population and unemployment) or financial data presented for multiple years (e.g., 10-year trends). Such data typically are located either in the statistical section of the comprehensive annual financial report (CAFR) or as part of required supplementary information (RSI).[2]

Summary. Because of the nature and purpose of local governments and the unique environment in which they operate, the approach taken to analyzing their financial statements must necessarily differ in important respects from the approach taken in the private sector. Local governments offer no equivalent to a business's "bottom line." Instead, users of local government financial statements typically approach a government's finances from three different but complementary perspectives: near-term financing situation, financial position, and economic condition. These three perspectives correspond to the questions: Will the government be able to pay



its bills on time? Is the government's financial health improving or deteriorating? And is it likely that today's financial position will improve or deteriorate?

Assessments of a local government's near-term financing situation tend to focus on the fund financial statements. The government-wide financial statements provide the most useful information for assessing financial position. Much of the information most useful for assessing economic condition can be found in the statistical section of the CAFR.

Notes

1. See GFOA's recommended practice on *Appropriate Level of Unreserved Fund Balance in the General Fund* (2002).
2. The data in the statistical section are best understood and appreciated in the context of a government's long-term financial planning efforts, as described in the GFOA's recent publication *Financing the Future: Long-Term Financial Planning for Local Government*.

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