It's All in the QUESTIONS

THE MANAGER'S ROLE IN ACHIEVING FISCAL HEALTH

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As the fiscal reality facing local governments across the nation becomes more challenging to manage and the necessary financial choices become more difficult to make, local government managers must ensure that the right questions are being asked to assess their organization's state of fiscal health. In times of economic prosperity, the manager has the luxury of focusing on issues related to growth, enhanced service delivery, and community initiatives and can rely on increasing revenues and healthy fund balances to maintain the organization's fiscal health.

Today's reality for most if not all local governments is declining revenues, slower if not stagnant growth, and depleted reserves. The manager must depend on the finance officer to perform the diagnostic analysis necessary to identify the symptoms and causes of the organization's fiscal distress, and then they must work together, using the diagnosis, to correctly prescribe and apply the most appropriate and effective treatments.

Through a series of basic diagnostic questions, the manager will gain a better assessment of not only the positive signs of the organization's fiscal health but also the root causes of the fiscal "dis-ease" impacting long-term financial sustainability. With a thorough diagnosis, the manager can effectively answer important questions posed by the elected decision makers: Is it time to raise taxes? Should we begin cutting expenses by eliminating programs or staff? What do we do to balance the budget?

To provide the best answers to the governing body, it isn't enough to ask the questions of the finance officer. The manager must follow up with another question: Can you show me? Without documented and demonstrated analysis supporting the answer, the manager may be relying on inaccurate assumptions or unsubstantiated conclusions that don't treat the real symptoms.

A diagnostic approach helps an organization achieve fiscal health, the first step leading to long-term financial sustainability. By asking the right questions in five areas and then asking for basic diagnostic tests to be performed, the manager can obtain answers that help isolate the potential cause(s) of the fiscal issues and then focus on more in-depth analysis to identify and apply the most appropriate and effective treatments.

QUESTION 1: Are we truly spending within our means?

Seems like a simple question, but in a time when increases in costs—often fixed costs—are outpacing revenue growth, it becomes the most critical question of all. This question also requires a more detailed response than simply a yes or no.

Governments are experiencing skyrocketing expenses in almost every area of their budgets. Unfortunately, most are also seeing major revenue sources

EXECUTIVE SUMMARY

When elected officials start asking if it's time to make cuts or raise taxes, be prepared:

- Use a series of basic but critical diagnostic questions about spending within your means, maintaining adequate and appropriate reserves, understanding variances from budget, being transparent about the true cost of doing business, and incorporating economic analysis and long-term planning into decision making.
- Use documented analysis to support the answers.
- Use the answers to isolate the fiscal issues.

FIGURE 1. Assessing fiscal health

moving in the opposite direction. Few revenue forecasts predict that this trend isn't going to continue for the foreseeable future and beyond.

Spending within your means is a philosophy that should be adopted regardless of the economic crisis *du jour.* Understanding the sources of funding for operations, for one-time initiatives, and for investment in capital is a foundation of good fiscal health. Adhering to this philosophy is imperative for the fiscal sustainability of today's communities.

Without spending controls, some governments are looking toward bankruptcy, privatization, borrowing against future revenues, or even disincorporation as viable treatment options. Posing this first question helps the manager achieve these objectives:

- Establish alignment between ongoing revenues and ongoing expenditures.
- Establish alignment between one-time sources and one-time uses.
- Understand how services rely on general government revenues versus program revenues (user fees, grants, permits).
- Provide incentives for departments to manage and monitor program revenues.
- Shift the focus of forecasting and budgeting from expenditures to revenues.

To obtain a sufficient answer to the question of whether the community is truly spending within its means, a manager needs to review the diagnostic analysis carried out after getting answers to these questions:

1. Do we differentiate between one-time and ongoing revenues and expenditures? If so, how are they being tracked? Does our forecast demonstrate this differentiation?

- Develop an understanding of how revenues are classified as either one-time or ongoing in nature.
- Determine how recurring revenue streams exhibiting some degree of volatility or uncertainty are classified.
- Assess the clarity of the tool used (historically and for forecasting purposes) to demonstrate that fund balance (or any other one-time source) is not being used to support ongoing operational costs.
- Request a chart or graphic that demonstrates that ongoing revenues have historically been and are forecast to be greater than ongoing expenses.
- Ensure that multiyear forecasts consistently match ongoing revenues with ongoing expenses and one-time sources with one-time uses.

2. Are resource allocation decisions for budgetary purposes influenced by program revenues generated by each individual department, division, or elected office? If so, how are program revenues differentiated from general government revenues (taxes, investment earnings, franchise fees, and so forth)?

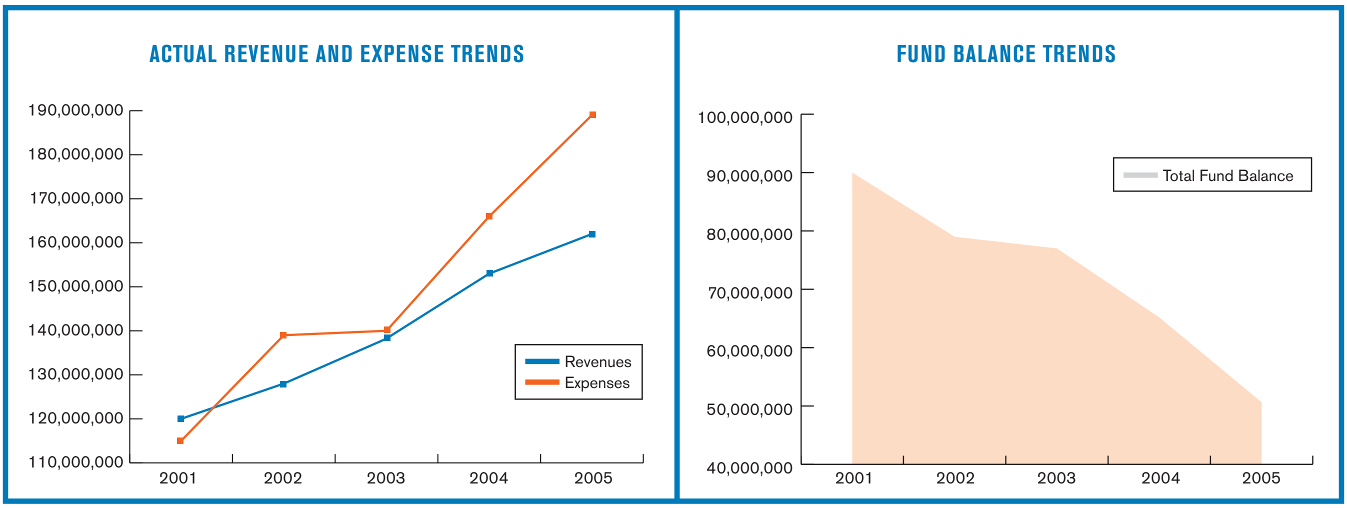
- Determine whether program revenues are allocated specifically to the operation responsible for generating them and whether increases or decreases in these revenue streams directly affect that operation's budget allocation.
- Assess the method by which resource allocations for operational expenses are established in the budget process: Are they based on prior year expenditure budgets for each department or are they based solely on available ongoing revenues?

3. Is there a formal revenue manual? If so, what information is included?

- Review the manual to see if all major revenue sources are included, if they are clearly described, if the source of authority for collecting them is clear, if historical and forecast trend data are present, if the forecasting methodology is clear, and if relevant statistical data (historical, economic, demographic) linked to forecasts are being tracked.
- Verify that fees for services, including permits and licenses, are updated regularly and that written policies support the level of cost recovery desired.

After the questions have been asked and the answers verified through a review of the appropriate diagnostic analysis, the manager should work closely with the finance officer to treat any symptoms that indicate a poor state of fiscal health. It

FIGURE 2. Ongoing fiscal health versus one-time fiscal health (general funds 2001–2005)



is critical that the manager partner with the finance officer in the development of policies, procedures, and philosophies that create an environment that supports good fiscal health practices.

After the treatment is determined, the manager's leadership role is to engage and empower the organization to achieve a strong state of fiscal health. The most critical elements of fiscal health that should be in place are:

- Use only ongoing revenues to fund ongoing expenses (and one-time sources for one-time uses).
- Understand the impact of decisions affecting one-time alignment and ongoing alignment.
- Establish a distinction between general government revenues and program revenues; create incentives for self-sustaining programs by allowing departments to keep 100 percent of program revenues generated.
- Require reductions in program revenues to be offset by reductions in the associated departmental operating budgets.
- Base resource allocations strictly on available revenues and one-time sources (as opposed to historical or forecast expenditures).

Figure 1 illustrates the distinction between ongoing alignment and one-time alignment. Note the pattern of persistent inability to "spend within your means" that emerged in the 2001–2002 period. This fiscal health problem was masked because the organization continued using one-time sources to plug the ongoing gap.

QUESTION 2: Are we maintaining required reserves? Are they adequate and appropriate?

The concept of having reserves set aside for emergencies and economic downturns is a no-brainer. But just as in the fairy tale *Goldilocks and the Three Bears*, the manager must assess whether the level of reserves is too high, too low, or just right. Maintaining inadequate reserve levels puts the long-term sustainability of the organization at risk. But in times when resources are scarce, assessing the right amount of reserves to maintain will ensure that funds critical to the operation are available.

Reserves are important not only during this period of economic disaster but during natural disasters as well. Floods, wildfires, hurricanes, tornadoes, drought—few local governments have sufficient rainy-day funds to deal easily with Mother Nature's wrath. Entities without adequate reserves for emergencies have been forced to make difficult choices to address the cost impacts from natural devastation.

Like finding buried treasure, understanding the nature of significant financial variances may yield a fortune of opportunities in achieving good fiscal health.

Working capital (or emergency) reserves are a critical element in establishing good fiscal health. The Government Finance Officers Association has set forth a best practice—Appropriate Level of Unreserved Fund Balance in the General Fund—that recommends that "general purpose governments, regardless of size, maintain unreserved fund balance in their general fund of no less than 5 to 15 percent of regular general fund operating revenues."

Similarly, ICMA recommends that the most influential guidance comes from the bond-rating firms, which use a rule-of-thumb figure of at least 5 percent of annual operating expenditures as an acceptable level of (accessible) reserves (on top of restricted reserves). Unfortunately, a brief scan of news reports reveals that local governments are experiencing lower bond ratings because they have failed to meet even these minimum requirements.

Establishing an appropriate working capital reserve is one of the most straightforward yet overlooked objectives for achieving fiscal health. Even with an adopted reserve policy, many governments have not instituted adequate monitoring mechanisms to ensure that those balances are securely maintained. In light of this practice, it's not enough to ask whether there is a formal reserve policy; the manager must verify that steps to monitor compliance with the policy are in place and being used.

In addition to working capital reserves, organizations normally have other reservations, restrictions, or designations of fund balance that may be statutory, required by bond covenant, established by the provider of a restricted revenue source, or set forth by ordinance. The manager should ensure that an up-to-date inventory of all reserves exists and that mechanisms are in place to ensure compliance with those reserve requirements—to both maintain adequate levels and ensure that the organization isn't holding too much.

In posing this second question, the manager:

- Establishes a working capital reserve policy and ensuring that there are monitoring mechanisms in place to demonstrate compliance with that policy.
- Creates an inventory of all reserves maintained across the organization to ensure that all reserve levels are adequate and appropriate—not too high, not too low.

When asking whether a community is maintaining required reserves and whether the reserves are adequate and appropriate, a manager should frame the question more specifically and ask to see the analysis that supports the answer:

Do we have a written fund balance reservation policy? If so, how are we monitoring those reserves to ensure they are maintained? How do we assess the adequacy and appropriateness of all restricted, reserved, designated, and unreserved fund balance levels?

- Review the written working capital reserve policy and compare with best practices.
- Require the appropriate degree of analysis to ensure that working capital reserves are sufficient to meet emergency needs or revenue shortfalls.
- Verify that an inventory of all reserved, restricted, or designated fund balances exists and states their purpose, the authority establishing them, and how they are to be calculated.
- Validate the presence of adequate controls and monitoring mechanisms that ensure compliance with reservations, restrictions, and designations of fund balance.
- Discuss the adequacy and appropriateness of all fund balance levels—excessive balances may be as much of an impediment to good fiscal health as insufficient levels.

After the manager has assessed the responses and the accompanying analysis, determining the existence of these critical elements of fiscal health is possible:

- Adopt a written policy establishing working capital reserves.
- Develop appropriate monitoring mechanisms to ensure that the organization is in full compliance with all required restrictions, reservations, or designations of fund balance.
- Inventory all fund balance reserves maintained across the organization and eliminate any that are excessive, unnecessary, or duplicated.
- Assess adequacy and appropriateness of the level of unreserved fund balance across the organization—having too much may be as problematic as having too little if there is no plan for how it is to be used to benefit the community.

QUESTION 3: Do we understand our variances–especially budget versus actual?

Like finding buried treasure, understanding the nature of significant financial variances may yield a fortune of opportunities in achieving good fiscal health. Explaining variances might be viewed only as an exercise to satisfy auditors or critique the finance department's forecasting skill, but this process is far more important than that.

Comparing last year's budget amounts with current year budget dollars provides a better understanding of what has changed from one year to the next in terms of service delivery needs, increased costs, and anticipated revenues. Looking at revenue and expenditure variances to compare prior year actuals with current year actuals provides an explanation of changes in spending patterns and revenue collections as well as helps identify emerging trends that need to be considered for forecasting purposes.

Negative variances normally garner a fair amount of attention, but positive variances should also be carefully analyzed to determine why they occurred. A primary responsibility of any manager is to ask for an explanation, supported by detailed analysis, that provides a clear understanding of why variances occurred, regardless of whether they are to the good or the not-so-good.

Another type of variance is largely overlooked by many organizations as they try to understand their fiscal health. Analyzing the reason behind budget-to-actual variances for any given fiscal period may uncover opportunities to address ongoing alignment concerns or projected budget shortfalls without looking to actual reductions in services or staffing levels.

Most organizations have controls in place that prevent negative expenditure variances from occurring, but they fail to understand the true reason for negative variances caused by revenue shortfalls. Significant negative revenue variances should be analyzed thoroughly to determine the specific reasons that they occurred and, more important, to look for emerging trends that need to be integrated into future revenue forecasts.

The manager should also require that the same level of attention, if not more, be placed on understanding positive budget-to-actual variances. Failure to understand the reason for a positive revenue variance may critically impact future forecasts if that variance was caused by a fluke or unusual circumstance rather than an upswing in economic activity or an increased demand for service.

Favorable budget-to-actual expenditure variances, especially those that recur year after year, must be analyzed carefully to ensure that permanent efficiencies are captured so the savings generated from these changes can be reallocated to other critical areas. Analysis of these positive variances may validate the need for more precise salary and benefit cost projections specifically related to vacancy savings and the timing of individual wage increases.

This analysis may also lead to the discovery of a multitude of contingency budgets spread throughout the organiza-

By asking some basic diagnostic questions, managers can gain a better assessment of both the positive signs of the organization's fiscal health as well as the root causes of the organization's fiscal "dis-ease".

tion that could be satisfied through a single, smaller amount budgeted in one central account or could uncover cyclical costs that are budgeted each year but are spent every three or four years.

By simply understanding the nature of these budget-to-actual variances and bringing future budget amounts more in line with actual experience, the manager may find opportunities to reduce the budget without actually having to eliminate a single employee or cut actual spending.

Asking this third question helps the manager:

- Determine the specific reasons variances have occurred and adjust the budget to be more in line with actual experience.
- Identify programs or services where resources have historically been over allocated, allowing for those resources to be reallocated to other areas of need.
- Eliminate the extras in departmental budgets for contingencies, cyclical needs, worst-case scenarios, or the proverbial "just in case we need it."
- Improve the accuracy of revenue and expenditure forecasts by better isolating and identifying emerging trends as well as eliminating the impact of recurring historical variances.

In seeking the answer to whether we understand our variances—especially budget versus actual—more specific questions will help obtain a better understanding:

1. At year end, are variances between budgeted and actual revenues and expenditures analyzed and explained? If so, how do those variances affect future budget cycles? How significant are reported variances related to capital projects?

- Determine the reasons for consistent variances that seem to occur year after year.
- Obtain an explanation of significant revenue variances in order to identify important trends that will help forecast future receipts or affect the level of funds available for future allocation of resources.
- Look closely at recurring patterns of carrying forward from one year to the next significant dollar amounts appropriated for multiyear capital projects, and gain an understanding of why project dollars are not expended in the year they are appropriated.
- Isolate any resources allocated on an ongoing basis as a place holder for one-time costs or costs that are projected to occur only cyclically.

2. Do we have a formal compensation plan that is used to establish employee salary or wage ranges? If so, how is this plan developed (for example, market comparisons, union negotiations, step and grade system), and how often is the plan updated?

- Ensure the plan is used to prepare salary and benefit projections.

CONTINUED ON PAGE 33