

CONCEPTUALIZING FINANCIAL CONDITION IN LOCAL GOVERNMENT

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ABSTRACT. While the passage of Statement No. 34 by the Governmental Accounting Standards Board (GASB, 1999) created a more robust financial reporting model, local officials continue to struggle with defining financial condition, interpreting it from annual financial statements, and communicating it in a systematic way. This review presents a framework for analyzing, interpreting, and communicating financial condition within the fund and government-wide reporting structure. It specifically responds to the void in the public administration literature for a manageable, yet comprehensive, approach to financial condition analysis. The goal is to help local officials conceptualize financial condition from the interpretation of resource flow and stock as presented in annual financial statements.

INTRODUCTION

Determining the financial position of a local government is relatively straight forward. Management prepares external financial statements at fiscal year end, which are subjected to an independent audit. An unqualified audit opinion informs the reader that the statements were prepared in conformity with generally accepted accounting principles (GAAP) and that they present, in all material respects, the financial position of the organization. While receiving an unqualified audit opinion is extremely important, how does a local official respond when a stakeholder moves beyond financial position and inquires about financial condition?

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The local official is faced with two fundamental problems. First, unlike private firms with one income statement and one balance sheet, a local government's annual financial report contains multiple operating statements and balance sheets. Second, while there is universal agreement on the importance of fiscal health, there is little agreement on what financial dimensions and indicators actually represent financial condition (Wang, Dennis, & Tu, 2007).

The Governmental Accounting Standards Board (GASB) responded to the first problem in 1999 with the passage of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, expanding the financial reporting model to include financial statements at the fund level and financial statements at the government-wide level (GASB, 1999). The government-wide financial statements, similar to those of private firms, include one operating statement (statement of activities) and one balance sheet (statement of net assets) for the entire organization, opening the door for a more comprehensive methodology for analyzing, interpreting, and communicating financial condition.

Frank and Gianakis (2008) found, however, that local officials are not using the expanded financial reporting model for many of the same reasons for which it was passed, including financial condition analysis. One possibility for this finding is that different reporting levels and different methods of applying the accrual concept have only increased the complexity of how financial statements are prepared and presented in local government.¹ Another possibility is that current approaches to analyzing, interpreting, and communicating financial condition do not align with the expanded financial reporting model, including the fundamental objectives of financial reporting.

This article reviews the financial reporting model, defines financial condition, and presents a comprehensive framework for conceptualizing financial condition from the interpretation of resource flow and stock within the fund and government-wide reporting structure. It then presents how a dashboard can be used to effectively communicate financial indicators to individuals with or without backgrounds in governmental accounting and financial reporting.² It concludes with a discussion on specific outcomes that

occurred when a small municipality in North Carolina implemented the framework.

REVIEWING THE FINANCIAL REPORTING MODEL

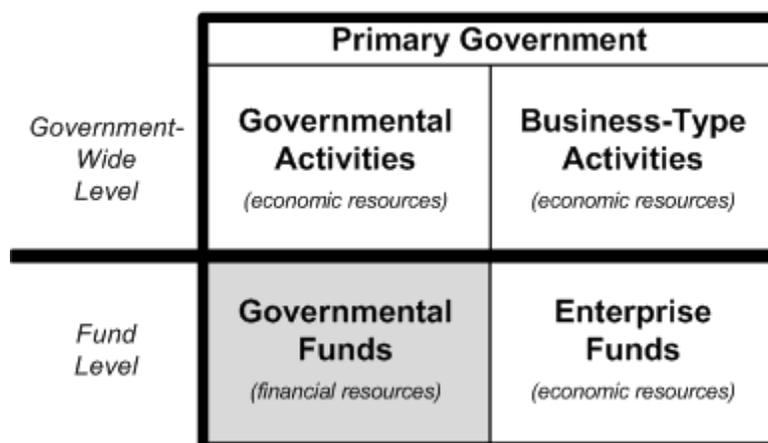
Mead (2002) made a strong case that government-wide statements have allowed us to make another step toward the objectives of financial reporting as contained in Concepts Statement No. 1—*Objectives of Financial Reporting*—and adopted by the GASB (1987). While we agree with his analysis, the irony of government-wide statements is that they provide a more complete financial picture for the entire organization and add another layer of complexity for analyzing, interpreting, and communicating financial condition.

An important part of communicating financial condition is providing users with a basic understanding of the financial reporting model, focusing on the fund and government-wide statements that drive the financial condition analysis. Our review is based on analyzing, interpreting, and communicating financial condition from governmental and business-type activities, governmental funds, and enterprise funds.

While certain stakeholders may need information on fiduciary funds and internal service funds, we do not include them in our approach for evaluating financial condition. We do not include fiduciary funds because the resources accounted for within pension trust, investment trust, private-purpose trust, and agency funds are owned by parties other than the local government. The local government plays a fiduciary role in the stewardship of these resources. We do not include internal service funds because of their unique position within the new accounting model; for example, multiple internal service funds are combined for presentation at the fund level and their accumulated resources are dispersed back to either governmental activities or business-type activities at the government-wide level as required by GAAP for external reporting purposes.³

Figure 1 contains the revised financial reporting model, excluding internal service funds and fiduciary funds, for conducting the financial condition analysis.⁴ Users need information on two important aspects

FIGURE 1
Revised Financial Reporting Model for Financial Condition Analysis



of the model before receiving data on financial condition. The first is an overview of the fund level, including a complete list of the governmental funds (general, special revenue, debt service, capital projects, and permanent funds) and enterprise funds being used by the local government and what services and activities are being accounted for within each fund. This also provides users with information on what governmental funds are being consolidated at the government-wide level for presenting the financial position of governmental activities and what enterprise funds are being consolidated at the government-wide level for presenting the financial position of business-type activities. The governmental activities and business-type activities also are combined at the government-wide level to present the financial position of the primary government.

The second aspect is how the accrual concept is applied differently at the government-wide level and for enterprise funds as compared to governmental funds. Government-wide activities (governmental and business-type) and enterprise funds measure *economic resources* using the accrual basis of accounting; therefore,

the value of capital assets and the amount of long-term debt associated with these activities and funds are included on their financial statements. Governmental funds measure *financial resources* using the modified accrual basis of accounting; therefore, the value of capital assets and the amount of long-term debt associated with these funds are not included on their financial statements.

The reality is that the financial reporting model created by GASB Statement No. 34 is complicated. While we acknowledge this reality, users must be provided with basic information on governmental accounting and financial reporting before they are informed about financial condition. This is especially true for elected officials, giving them the ability to ask more informed questions and the ability to read financial statements in carrying out their fiduciary responsibilities.

DEFINING FINANCIAL CONDITION

Although the literature contains numerous definitions of financial condition, the current ones are either specific in nature or broad in scope (Wang, Dennis, Tu, 2007). A specific definition, for example, would be defining financial condition as solvency. We could then select a financial indicator like fund balance as a percentage of expenditures to measure solvency with data taken directly from the annual financial statements.

There are two advantages to this approach. One is the simplicity of using a single financial ratio when communicating financial condition, including the ability to compare it against a fund balance policy or a professional standard for context. Another is that the financial ratio of fund balance as a percentage of expenditures is arguably the most recognized financial indicator in local government and is based on the extremely important general fund. A major limitation to this approach is that a narrow definition supported with a single financial ratio simply cannot capture the numerous financial dimensions of a local government across the multiple funds it uses to account for the multiple types of services and activities provided.

One of the most cited definitions of financial condition, which is much broader in scope, comes from the International City/County

Management Association (ICMA). Financial condition is defined as a government's ability to finance its services on a continuing basis, including a government's ability to maintain existing service levels, to withstand systematic and unsystematic risk, and to meet the demands of natural change over time (Nollenberger, 2003).⁵ This definition is supported with a methodology that contains over 40 financial and environmental indicators that reflect dimensions of financial condition and dimensions that impact financial condition, respectively, taking into account the characteristics of time, environment, multidimensional relationships, and implicit and explicit obligations (Berne, 1996).

A clear advantage of this definition is its similarity with how bond rating agencies measure financial condition and community risk, focusing primarily on the likelihood of fiscal deterioration and on a local government's ability to amortize debt. Local governments, like the cities of Rye, New York, and Scottsdale, Arizona, also have been successful in tailoring the ICMA model to conduct comprehensive financial trend reports.⁶

There are challenges with using a definition that is broad in scope. One is the complexity of mixing dimensions of financial condition with dimensions of the environment, representing a form of analysis beyond interpreting financial condition at fiscal year end. Another is that the ICMA model does not address government-wide statements. Chase and Phillips (2004) made a very strong argument that the new reporting model provides stakeholders for the first time with a comprehensive overview of a local government's financial position and condition, representing a financial reporting objective (GASB, 1987) and a primary reason for the passage of Statement No. 34 (GASB, 1999). Mead (2002) also concluded that the new reporting model has advanced a local government's ability to demonstrate financial position but suggested that more work is needed for better reporting of financial condition.

We recognize that any definition of financial condition in local government is going to contain advantages and disadvantages. Therefore, we turn to the two basic reasons why financial statements are prepared. The first is to report on the *flows* of resources during a given time period (Berne and Schramm, 1986), which is accomplished with an operating statement that shows the revenues

and expenditures (expenses) of an organization. Focusing on resource flow is aligned with two financial reporting objectives, which are to assess interperiod equity and to provide information about sources and uses of financial resources (GASB, 1987). The second reason for financial statements is to report on the *stocks* of resources at a given point in time (Berne & Schramm, 1986), which is accomplished with a balance sheet that shows the stocks of assets, liabilities, and fund balance (net assets). Focusing on resource stock also is aligned with a financial reporting objective, which is to provide information necessary to determine whether an organization's financial position improved or deteriorated as a result of resource flow (GASB, 1987).

Expanding on the two reasons why local governments prepare financial statements (Berne & Schramm, 1986) and on the objectives of financial reporting (GASB, 1987), we define financial condition as *a local government's ability to meet its ongoing financial, service, and capital obligations based on the status of resource flow and stock as interpreted from annual financial statements*. The next step is to select the financial dimensions and indicators that most closely align with resource flow and resource stock, which are applied to fund and government-wide statements for analyzing and interpreting a local government's ability to meet its ongoing obligations.

SELECTING FINANCIAL DIMENSIONS AND INDICATORS

The literature is rich with financial dimensions and indicators that have been used over the past 30 years for analyzing, interpreting, and communicating financial condition in local government. The ICMA published one of the most comprehensive approaches for monitoring financial and environmental factors in local government in 1980 (Nollenberger, 2003). This publication is now in its fourth edition. Groves, Godsey, and Shulman (1981) described the advantages and disadvantages of the ICMA model—which included technical and managerial problems—and Berne (1996) used it to advance his research on exploring alternative methods for measuring and reporting financial condition. As mentioned earlier, the ICMA model is more aligned with a bond rating approach (Wilson, Kattelus, & Reck, 2007) and does not address government-wide statements.

Brown (1993) created the ten-point test as a model to communicate financial condition to a broad range of stakeholders because evaluating and monitoring financial condition with a large number of financial and environmental indicators can be difficult for smaller organizations. The advantage of this approach is the ability to evaluate financial condition with only 10 indicators and to communicate it based on a scale created from the financial results of other local governments, ranging from among the worst to among the best. The major disadvantage is that the ten-point test was designed for governmental funds only. It does not address enterprise funds.

The ten-point test was updated by Mead (2006) in response to the new reporting model, using financial indicators to capture the financial dimensions of financial position, financial performance, liquidity, solvency, revenues, debt burden, coverage, and capital assets. While the ten-point test continues to represent a simplified approach for communicating financial condition, it does not apply the selected financial dimensions and indicators across the fund and government-wide reporting structure in a systematic way. The ten indicators also are given equal weight—which may not be appropriate for all local governments—and an overall positive score may hide a particular area of weakness shown by an individual indicator.

Numerous studies on analyzing the financial condition of state and local governments based on selected financial dimensions and indicators also provide a wealth of information on what constitutes financial condition. Chaney, Mead, and Schermann (2002) used the financial dimensions of financial position, financial performance, liquidity, and solvency to explore what the new financial reporting model means to financial condition analysis, using the comparison of two local governments for demonstrating relevance. Kamnikar, Kamnikar, and Deal (2006) used the financial dimensions of liquidity, solvency, and ability to provide basic services to rank the financial condition of 47 states. Wang, Dennis, and Tu (2007) recently published one of the most comprehensive approaches to analyzing financial condition in state government, using cash solvency, budget solvency, long-run solvency, and service solvency.

These studies, however, focused on financial condition at the government-wide level and did not address the financial condition of individual funds (governmental and enterprise). The problem with not

including funds when conducting financial condition analysis is that the majority of policy decisions in local government are made on a fund-by-fund basis, including the all important annual budget process. Other sources also were reviewed for selecting the financial dimensions and indicators used in our approach for analyzing, interpreting, and communicating financial condition in local government (Mead, 2001; Hendrick, 2004; Kloha, Weissert, & Kleine, 2005; Kloha, Weissert, & Kleine, 2005a; Ives, 2006; Wilson, Kattelus, & Reck, 2007).

Selection Criteria

Our challenge was selecting from the numerous financial dimensions and indicators contained in the literature to support our framework. We began by focusing on dimensions and indicators that most closely align with resource flow and stock, returning to the specific language contained within our definition of financial condition. This hierarchal process also is found in the performance measurement literature, where program managers are encouraged to identify higher order measures of efficiency and effectiveness from their mission statements, goals, and objectives. By tailoring this process, we have a mission (ability to meet obligations), goals (adequate resource flow and stock), objectives (financial dimensions), and performance measures (financial indicators).

We then moved toward dimensions and indicators that report on financial condition—not on environmental conditions. We exclude environmental factors because they do not represent actual financial condition as determined from analyzing resource flow and stock from annual financial statements, which represents the goal of our research. Our framework should inform an elected official on whether or not a local government's financial position improved from when the individual entered office four years ago. Including environmental factors represents a different form of analysis; for example, when local officials prepare for a bond rating presentation.

Another selection criterion that builds on the previous one is limiting the number of indicators used for analyzing financial condition. When the number increases and when environmental factors are added, the complexity of the model increases, the model's utility for communicating financial condition to a *broad* range of

stakeholders decreases, and more organizational capacity and management commitment are required (Groves, Godsey, & Shulman, 1981) for model implementation. This is why the ICMA model is used primarily by larger local governments.

We also wanted dimensions and indicators that lend themselves to specific interpretation. When the total margin indicator is above one, for example, we know that resources available exceeded resources consumed. In contrast, there is disagreement on how to interpret the financial indicator of revenues per capita, which is commonly found in the literature. Some have suggested that a low result gives local governments flexibility in obtaining additional resources. Others have interpreted a low result as local governments' not having the tax base to support services. We do acknowledge that subjectivity is more prevalent in some of our indicators as compared to others.

A final criterion was to select dimensions and indicators that could be used to analyze financial statements prepared on the accrual basis (government-wide statements and enterprise fund statements) and prepared on the modified accrual basis (governmental funds). While we were successful to some extent, we were not able to replicate all indicators because accrual statements account for economic resources and modified accrual statements account for financial resources. A reason for using the same measures when possible is that users become more attuned to them, reducing the complexity of using too many dimensions and indicators.

Flow and Stock of Economic Resources

Table 1 contains the four financial dimensions we have selected to analyze resource flow and the four financial dimensions to analyze resource stock for the government-wide level (governmental activities and business-type activities) and for enterprise funds, responding to how they measure *economic resources*. Table 1 also contains the description of each financial dimension, the indicator used to analyze it, the calculation for each indicator, and how to interpret the results.

The four financial dimensions to analyze resource flow are interperiod equity, financial performance, self-sufficiency, and financing obligation. The dimensions of interperiod equity and financial performance were selected to evaluate two important

aspects of resource flow. The total margin ratio—which is used to interpret interperiod equity on whether or not a government lived within its means—compares the amount of inflow (total revenues) to the amount of outflow (total expenses), representing the primary reason

TABLE 1
Government-Wide Level and Enterprise Funds
(Economic Resources and Accrual Basis)

Resource Flow				
Dimension	Description	Indicator	Calculation	Interpretation
Interperiod equity	Addresses whether or not a government lived within its financial means during the fiscal year	Total margin ratio	Total revenues divided by total expenses	A ratio of one or higher indicates that a government lived within its financial means
Financial performance	Provides the magnitude of how a government's financial position improved or deteriorated as a result of resource flow	Percent change in net assets	Change in net assets divided by net assets, beginning	A positive percent change indicates that a government's financial position improved
Self-sufficiency	Addresses the extent to which service charges and fees covered total expenses	Charge to expense ratio	Charges for services divided by total expenses	A ratio of one or higher indicates that the service is self-supporting
Financing obligation	Provides feedback on service flexibility with the amount of resources committed to annual debt service	Debt service ratio	Debt service (principal and interest payments on long-term debt) divided by total expenses plus principal	Service flexibility decreases as more resources are committed to annual debt service

TABLE 1 (Continued)

Resource Stock				
Dimension	Description	Indicator	Calculation	Interpretation
Liquidity	Government's ability to address short-term obligations	Quick ratio	Cash & investments divided by current liabilities (minus deferred revenue)	A high ratio suggests a government is able to meet its short-term obligations
Solvency	Government's ability to address long-term obligations	Net assets ratio	Unrestricted net assets divided by total liabilities	A high ratio suggests a government is able to meet its long-term obligations
Leverage	Extent to which total assets are financed with long-term debt	Debt to assets ratio	Long-term debt divided by total assets	A high ratio suggests a government is overly reliant on debt for financing assets
Capital	Condition of capital assets defined as remaining useful life	Capital assets condition ratio	1 - (accumulated depreciation divided by capital assets being depreciated)	A high ratio suggests a government is investing in its capital assets

for why operating statements exist. An analogy would be a water tank, determining whether or not water inflow was sufficient to cover water outflow during a given time period.

The percent change in net assets—which is used to interpret the financial performance dimension of how a government's net assets improved or deteriorated from resource flow—represents a new indicator created as a result of the new reporting model (Gauthier, 2007). Returning to the analogy of the water tank, percent change in net assets provides feedback on the magnitude of how the beginning

water level contained in the tank changed as a result of net water flow during a given time period.

The remaining dimensions—self-sufficiency and financing obligation—were selected to evaluate specific components of resource flow. Self-sufficiency addresses the extent to which service charges and fees cover total operating expenses. It has historically been used with enterprise funds and is now being used at the government-wide level, representing a primary reason for how the statement of activities was designed to present resource flow for governmental and business-type activities. A question may arise from applying the self-sufficiency dimension to governmental activities because governmental services with public good characteristics (e.g., police) are not designed to be self-supporting like governmental services with private good characteristics (e.g., water utility). However, elected officials are often interested in the mix between general taxation and user fee revenue when balancing the budget for the forthcoming fiscal year.

Financing obligation as measured by the debt service ratio provides feedback on service flexibility, focusing on the amount of resources committed to annual debt service and representing a key financial indicator used by financial analysts (Nollenberger, 2003). As a profession, we do not have an accepted benchmark for which the ratio should not exceed. However, we do know that an upward trend decreases flexibility and that local governments often adopt debt management policies that contain maximum percentages.

The four financial dimensions selected to analyze resource stock are liquidity, solvency, leverage, and capital. These dimensions, along with their indicators, are more prevalent in the literature as compared to the dimensions on resource flow. Liquidity, as measured with the quick ratio, evaluates a local government's ability to meet its short-term obligations. We selected the quick ratio over the current ratio to prevent current assets like inventory from being used to evaluate a local government's ability to meet its short-term obligations.

Solvency, as measured by the net assets ratio, evaluates a local government's ability to meet long-term obligations. While the literature contains several indicators for measuring this dimension, we modified the approach used by Kamnikar, Kamnikar, and Deal (2006) from unrestricted net assets divided by total expenses to

unrestricted net assets divided by total liabilities.⁷ Leverage, as measured by the debt to assets ratio, is the extent to which a local government has used long-term debt to finance assets. While the amount of debt carried by a local government is ultimately a policy decision, there is a direct correlation between leverage and financing obligation. Therefore, the two cannot be viewed in isolation of each other.

The fourth dimension we selected is capital, responding directly to the new reporting model and using the indicator of the capital assets condition ratio on the remaining useful life of capital assets being depreciated. Another popular measure for analyzing the capital dimension is the percent change of the net value of capital assets (Mead, 2006). We selected the capital asset condition ratio because the percent change of the net value of capital assets is more aligned with resource flow rather than resource stock.

Flow and Stock of Financial Resources

Table 2 contains the three financial dimensions we have selected to analyze resource flow and the three financial dimensions to analyze resource stock for governmental funds. Two of the dimensions for analyzing resource flow, along with their respective ratios, are similar to the approach as presented with financial statements that measure *economic resources*. They are service obligation and financing obligation.⁸ The dependency dimension, as measured by the intergovernmental ratio, replaces the self-sufficiency dimension and represents a common approach for evaluating resource flow for governmental funds. It provides feedback on risk by focusing on the extent to which a government is reliant on other governments for resources.

The three dimensions selected for analyzing resource stock for governmental funds are liquidity, solvency, and leverage. While these dimensions are used with financial statements that measure *economic resources*, different ratios are used to evaluate the dimensions of solvency and leverage given how financial statements are prepared for governmental funds. Solvency is measured with fund balance as a percentage of expenditures, which represents the most cited financial ratio in local government. The leverage dimension as measured by debt as a percentage of assessed value is often found

in state laws, which dictate the percentages in which this indicator cannot exceed.⁹

TABLE 2
Governmental Funds
(Financial Resources and Modified Accrual Basis)

Resource Flow				
Dimension	Description	Indicator	Calculation	Interpretation
Service obligation	Addresses whether or not a government's annual revenues were sufficient to pay for annual operations	Operations ratio	Total revenues divided by total expenditures (plus transfers to the debt service fund and less proceeds from capital leases)	A ratio of one or higher indicates that a government lived within its annual revenues
Dependency	Provides the extent to which a government is reliant on other governments for resources	Intergovernmental ratio	Intergovernmental revenue divided by total revenue	A high ratio may indicate that a government is too reliant on other governments
Financing obligation	Provides feedback on service flexibility with the amount of expenditures committed to annual debt service	Debt service ratio	Debt service (principal and interest payments on long-term debt, including transfers to the debt service fund) divided by total expenditures plus transfers	Service flexibility decreases as more expenditures are committed to annual debt service

TABLE 2 (Continued)

Resource Stock				
Dimension	Description	Indicator	Calculation	Interpretation
Liquidity	Government's ability to address short-term obligations	Quick ratio	Cash & investments divided by current liabilities (minus deferred revenue)	A high ratio suggests a government can meet its short-term obligations
Solvency	Government's ability to continue service provision	Fund balance as a percentage of expenditures	Available fund balance as a percentage of total expenditures plus transfers out	A high ratio suggests a government can continue to provide uninterrupted services
Leverage	Extent to which a government relies on tax-supported debt	Debt as percent of assessed value	Tax-supported, long-term debt divided by assessed value	A high ratio suggests a government is overly reliant on debt

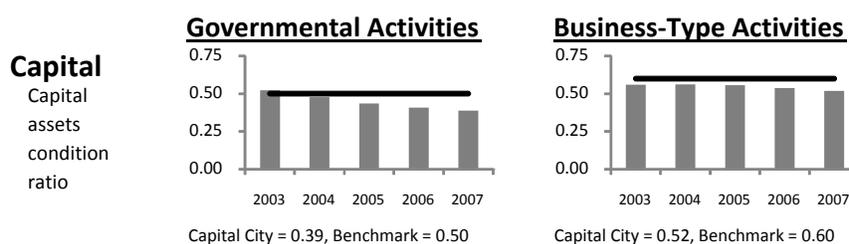
INTERPRETING FINANCIAL CONDITION

Similar to calculating performance measures, calculating a financial indicator at one point in time provides only limited information. Therefore, comparative data from trend analysis are needed. Also needed are benchmarks created from the financial results of other local governments, from professional standards as promoted by organizations like the Government Finance Officers Association (GFOA), or from thresholds established by internal financial policies or state laws to make a more robust interpretation of financial indicators for decision-making purposes. A critical element of this framework is the flexibility with establishing benchmarks. Each local government must identify appropriate benchmarks based on population, service provision, financial policies, and other related factors.

The financial ratio of fund balance as a percentage of expenditures used to evaluate the financial dimension of solvency for governmental funds represents an excellent example of using comparative data for interpretation. The indicator can be calculated at the end of each fiscal year for trend analysis, evaluating whether solvency is improving or deteriorating over time. It can be benchmarked against local governments of similar size, providing comparative data for further analysis. It can be compared against the GFOA’s recommended policy of maintaining a minimum amount of unreserved fund balance that equates to no less than 5 to 15 percent of revenues—the GFOA uses revenues as the denominator rather than expenditures.¹⁰ It also can be compared against the organization’s adopted fund balance policy, which represents one of the most important financial policies in local government.

Figure 2 contains the capital assets condition ratio for governmental activities and business-type activities, which is used to analyze the capital dimension of resource stock for “Capital City.”¹¹ The ratio calculates the remaining useful life of capital assets by subtracting accumulated depreciation divided by capital assets being depreciated from one. The ratio shows that, on average, capital assets for governmental funds have significantly less than half of their useful lives remaining with a value of .39.

FIGURE 2
Capital Dimension of Resource Stock for Capital City



Trend analysis over the past five years shows that capital assets will continue to depreciate faster than resources have historically been invested in them unless a policy decision is made to reverse the

trend. Benchmark data also show that Capital City has fallen behind in investing in its capital assets as compared to similar municipalities. While the ratio applied to capital assets of business-type activities reveals a downward trend and a similar comparison against other municipalities, the problem is not as alarming with a value of .52.

COMMUNICATING FINANCIAL CONDITION

Using dashboards to communicate information is becoming more common in local government. One purpose of a dashboard is to prevent “data overload” by selecting only the most important indicators for presentation. Another purpose is to take advantage of graphical designs, giving context in which to interpret data with a numerical and visual format. A dashboard also is promoted to help communicate financial condition to individuals with varying backgrounds in governmental accounting and financial reporting.

Appendix A presents a dashboard of how the four financial dimensions of resource flow and the four financial dimensions of resource stock are used to communicate the financial condition of governmental activities, business-type activities, and the primary government within the context of comparative data. Each indicator used to measure the respective financial dimension for Capital City is presented with five years of historical data for trend analysis, including a benchmark.

Appendix B presents a dashboard of how the same financial dimensions and indicators are used to evaluate the financial condition of the two enterprise funds of the local government. Capital City, in this example, operates a water and sewer system and an electric system in separate funds. We did not use the financial dimensions and indicators to evaluate the total enterprise column, which is the aggregate of major and non-major enterprise funds. With the exception of how internal funds are handled, the sum of business-type activities at the government-wide level approximates the total enterprise column.

Appendix C presents a dashboard of how the three financial dimensions of resource flow and the three financial dimensions of resource stock are used to communicate the financial condition of governmental funds, including the general fund and total

governmental funds for Capital City. Again, five-years of historical data and selected benchmark data are used to provide the necessary context for analyzing, interpreting, and communicating financial condition.

The next step for Capital City is to present the information found in Appendices A, B, and C to elected officials, for example—along with a written analysis of the financial condition of the municipality—providing them with a systematic assessment of financial condition within the fund and government-wide reporting structure as shown by the major financial dimensions and indicators of resource flow and stock. The importance of this approach also includes how the financial data taken from annual financial statements can be used to calculate financial indicators over time and compared against benchmarks, increasing their usefulness to decision makers.

VILLAGE OF PINEHURST, NORTH CAROLINA

Our framework for analyzing, interpreting, and communicating financial condition in local government is largely based on normative research. We selected this approach to focus solely on the conceptualization of financial condition rather than on the results from calculating either fund level or government-wide level financial indicators, which has been the preferred methodology of previous studies and has produced an ad hoc literature on financial condition. However, the stage is being set for descriptive research in the form of multijurisdictional case studies and empirical analysis as more local governments implement our framework.

The village of Pinehurst, North Carolina, a municipality of approximately 11,500 in population, implemented our framework after its annual audit for fiscal year 2008. While other local governments in North Carolina have implemented our framework, we selected Pinehurst to specifically demonstrate its utility for smaller local governments. The village's primary purpose for implementing the framework was to help board members understand the financial condition of the village and to help frame further policy discussions.¹²

Only twelve financial indicators were needed for the financial condition analysis because an overwhelming majority of the services and activities provided by the village are accounted for in the general

fund. The four flow indicators and four stock indicators contained in Table 1 were calculated over a five-year period for the governmental activities, responding to the accrual basis of accounting used at the government-wide level. The three flow indicators and three stock indicators contained in Table 2 were then calculated over a five-year period for the general fund, responding to the modified accrual basis of accounting used for governmental funds.

The village identified four municipalities to calculate the benchmark for each of the twelve indicators (Southern Pines, Hendersonville, Carrboro, and Cornelius). These municipalities were chosen because of population and because the majority of their services and activities are accounted for in the general fund. Similar size municipalities with major utilities (enterprise funds) were not selected. The village specifically used comparative data to calculate the benchmark for each indicator rather than using benchmarks from internal policies or from benchmarks determined by state law. The assistant village manager believed that this approach provided additional context for discussion, understanding that the board members were already aware of internal policies and state law. The village also decided to present and discuss the results of the financial indicators by financial dimension rather than by placing them on one dashboard. This modified dashboard approach was used specifically to highlight the financial strengths of the organization and the areas that need further work.

Three outcomes occurred from the village's implementing our framework to financial condition analysis. The first outcome was that board members asked more questions concerning financial condition as compared to previous years, when they received only audited financial reports. The assistant village manager responded that this outcome alone was worth the staff time invested in preparing the report.

The second outcome was that some board members were able to connect the dots between the specific flow and stock indicators and the financial statements from which they were calculated, which again resulted in more questions about the annual financial audit. The hope is that these connections also will further their understanding of governmental accounting and financial reporting.

The third outcome was that the board agreed that the village needed to improve its cash position by analyzing the liquidity dimension (quick ratio) and solvency dimension (fund balance as percentage of expenditures) for the general fund. While fund balance has always exceeded the percentage threshold contained in the village's fund balance policy, the benchmarking data provided the needed comparison for making this policy decision. The assistant village manager noted that it was liquidity and solvency together that magnified the need to improve the village's financial condition along these dimensions.

SUMMARY

An overarching question to financial condition is why should we be concerned with defining and communicating it beyond the notion that it represents sound financial management? One response is that administrators and elected officials should leave a local government in at least the same, or possibly even better, financial condition than which they found it, giving new decision-makers the ability to advance the organization rather than spend time on reversing financial deterioration. Financial stewardship is a major responsibility of administrators and elected officials.

Financial condition in local government is an extremely important part of financial management, which only increases the need for public administrators to agree on how to define it, how to measure it, and how to communicate it in a systematic way. Another reason that we promote the need for a systematic assessment of evaluating financial condition in local government is to improve our ability to effectively communicate with elected officials on how financial condition impacts policy decisions. Elected officials, who ultimately possess the fiduciary responsibility of the organization, need understandable and useable information on financial condition when making such policy decisions as increasing or decreasing the tax rate, making adjustments to service delivery, issuing debt, and investing in capital assets.

We responded to this need by developing a framework that is based on fund and government-wide statements, on the measurement focus of economic (accrual) and financial (modified accrual) resources, on statements that are designed to report on

resource flow and stock, on the most recognized financial dimensions and indicators in the literature, and on using a dashboard to present each indicator within the context of trend and benchmark data. Local governments spend an enormous amount of resources preparing their annual financial statements, which has only increased with the passage of Statement No. 34. It is now time to take the natural next step by using the fund and government-wide financial statements to advance our understanding of financial condition in local government.

NOTES

1. The different methods of applying the accrual concept are the measurement focus of economic resources presented on the accrual basis of accounting and the measurement focus of financial resources presented on the modified accrual basis of accounting. For more information on this subject, see Freeman et al. (2009).
2. The comprehensive framework of financial condition we present in this article is designed for communicating with any stakeholder of local government. However, our primary audience is administrators and elected officials who rely on financial statements on an ongoing basis.
3. The accumulated resources of internal services funds are disbursed to *either* governmental activities or business-type activities based on which group of activities used them the most. The profits or losses of internal funds are divided between governmental activities and business-type activities based on actual use. However, we acknowledge that internal service funds must be handled on a case-by-case basis and that it may make sense to include them in certain situations. Another issue is that using an actuarial analysis to interpret the financial condition of an internal service fund that accounts for such activities as risk management and health insurance coverage may provide better information for making decisions rather than using the financial dimensions and indicators presented in this research.
4. Each local government will have to modify Figure 1 based on the types of funds it uses for accounting purposes. For example,

many smaller local governments use only a general fund to account for its services and activities.

5. The definition was slightly altered to use the terms systematic and unsystematic risk based on the work of Hildreth and Miller (2002).
6. See www.ryeny.gov/finance/Reports/06reports/06ftms.pdf for more information on the city of Rye, New York. See <http://www.scottsdaleaz.gov/Finance/financialtrends.asp> for more information on the city of Scottsdale, Arizona.
7. The reason for the denominator change is that solvency is not about service continuation from an economic perspective. It is about an organization's ability to satisfy debt. Solvency is about service continuation from a financial perspective, where fund balance is standardized against total expenditures.
8. Another approach could have been to bring the financial performance dimension forward as well, changing the indicator to percent change in fund balance. The literature, however, does not contain this indicator and the indicator of fund balance as a percentage of expenditures provides feedback on performance and solvency under resource stock.
9. The financial data used to calculate all the financial indicators we have selected for measuring resource flow and stock—regardless of level or fund—are located in a local government's general purpose external financial statements, which include the notes to the financial statements. The one exception is assessed value, which may be located in the notes to the financial statements or in the statistical section for local governments that prepare a comprehensive annual financial report (CAFR).
10. The GFOA policy on fund balance—*Appropriate Level of Unreserved Fund Balance in the General Fund*—was adopted by the executive board on February 15, 2002. It can be found at www.gfoa.org.
11. Actual financial data from a selected municipality were used to populate the five-years of financial indicators. We used a hypothetical municipality to underscore the importance of our

framework elements for conceptualizing financial condition rather than on interpreting actual results.

12. The information on framework implementation was obtained from a telephone interview with the assistant village manager in December 2008. The complete financial condition assessment report for the village of Pinehurst, North Carolina, is available online at www.villageofpinehurst.org (located under financial services department).

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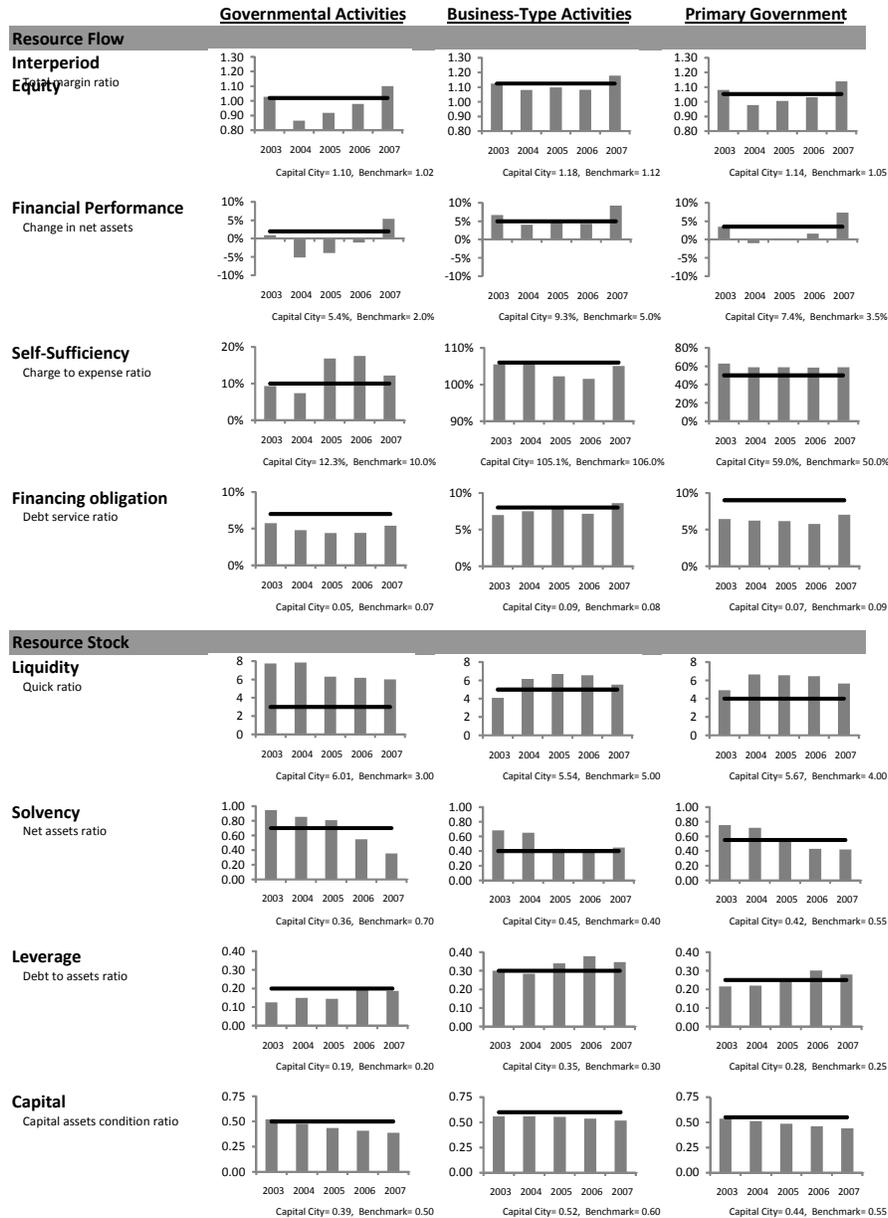
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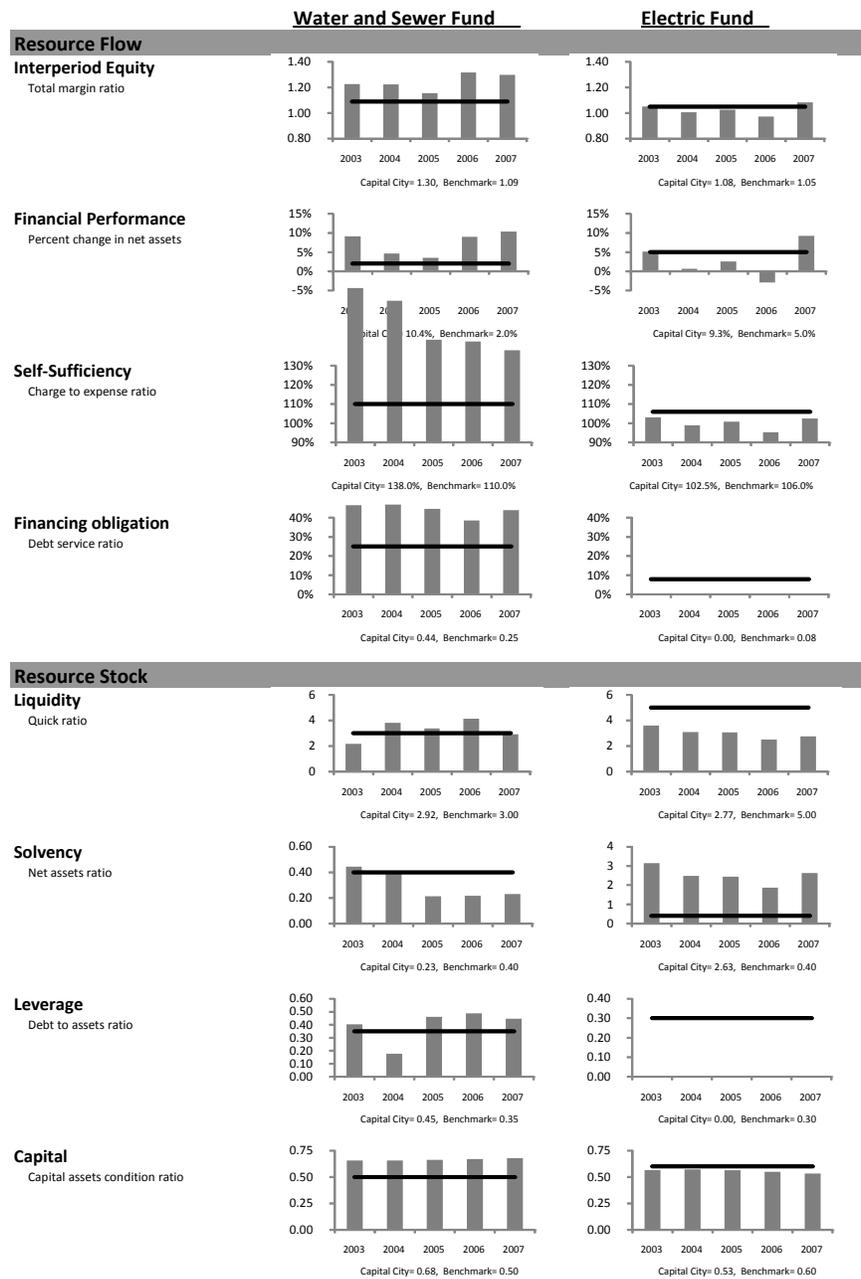
Appendix A: Financial Condition at Government-Wide Level

Key: Capital City ■ Benchmark Group ■



Appendix B: Financial Condition for Enterprise Funds

Key: Capital City ■ Benchmark Group —



Appendix C: Financial Condition for Governmental Funds

Key: Capital City Benchmark Group

