

EXAMPLE LOCAL GOVERNMENTAL ENTITY FINANCIAL CONDITION ASSESSMENT INDICATORS AND RELATED PROCEDURES



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PREFACE

Legal Requirements

The Legislature created the Local Government Financial Emergencies Act (Part V, Chapter 218, Florida Statutes) to, among other things, preserve and protect the fiscal solvency of local governmental entities. Section 218.503(1), Florida Statutes, describes conditions under which an entity may be considered to be in a state of financial emergency. Local governmental entities are required to notify the Governor and the Legislative Auditing Committee when one or more of the conditions have occurred or will occur if action is not taken to assist the entity. Section 218.39(5), Florida Statutes, requires that independent auditors notify local governmental entities of deteriorating financial conditions that may cause a financial emergency, as contemplated by Section 218.503(1), Florida Statutes, to occur if actions are not taken to address such conditions. Section 10.556(8), Rules of the Auditor General, requires local governmental entity audits to include the use of financial condition assessment procedures, based on the auditor's professional judgment to detect deteriorating financial conditions. Section 10.554(1)(i)5.b, Rules of the Auditor General, requires that the auditor's management letter include a statement that financial condition assessment procedures were applied and, if deteriorating financial conditions are noted, a statement to that fact including a description of the conditions that caused the auditor to reach that conclusion.

Purpose

The purpose of this document is to provide example local government financial condition assessment indicators and related procedures. It was prepared based on recommendations from a task force comprised of representatives or staff of the Auditor General, Executive Office of the Governor, Department of Financial Services, Legislative Auditing Committee, and various professional organizations associated with local governmental entities or auditors of such entities. Local governmental entity auditors may incorporate the example indicators and related procedures described in this document into the methodology they deem appropriate to carry out their responsibilities pursuant to Section 218.39(5), Florida Statutes.

Financial Condition

Financial condition may be defined in a variety of ways. For purposes of this document, financial condition refers to a local governmental entity's ability to meet its financial obligations and provide services that are required for the health, safety, and welfare of the community, and that its citizens desire. Financial condition assessment procedures should be designed and applied by local governmental entity auditors to identify local governmental entities experiencing deteriorating financial conditions that could result in a financial emergency. Financial condition assessment indicators and related procedures, such as those example indicators and procedures included herein, may also be used by local governmental entity officials to supplement other methods of monitoring financial condition, such as cash flow analysis and forecasting of revenues and expenditures.

FINANCIAL CONDITION ASSESSMENT

Financial Indicators

Financial indicators, expressed as ratios or trends, facilitate comparisons with other local governmental entities and provide an illustration of what has been occurring with an entity over a period of years. A summary of example financial indicators for preliminary financial condition assessments is included as Appendix A. These financial indicators were selected after review of numerous sources of information, including the International City Management Association's Evaluating Financial Condition, A Handbook for Local Governments; procedures and indicators developed and published by Dr. Kenneth Brown of Southwest Missouri State University; procedures and indicators used by other states (primarily North Carolina, New York and Ohio); and information from various publications issued by the Governmental Accounting Standards Board, the Florida Institute of Certified Public Accountants, and the Florida Government Finance Officer's Association. There are numerous other financial indicators that may also be used in evaluating financial condition, and professional judgment must be exercised in determining those indicators that are the most relevant and meaningful under the circumstances.

NOTE: *The financial indicators should not be used as the sole basis for making conclusions regarding the entity's financial condition. Rather, financial indicators serve as analytical tools that will identify particular circumstances requiring additional inquiry. Appendix E contains a listing of Web sites that are sources of additional information.*

Data Accumulation

Data elements necessary to compute the example financial indicators were identified and are included as Appendix B. For each data element, the source of the information is specified including the account name, funds to include, and financial statement title, as applicable. Data are collected for the most recent five years for which information is available. Data elements accumulated by the Auditor General will be made available to local governmental entities and auditors. Financial data are generally obtained from audited financial statements submitted to the Auditor General. Population data are obtained from the Bureau of Economic and Business Research, University of Florida's *Florida Estimates of Population* publication. Millage rates and taxable property values are obtained from the Florida Department of Revenue's *Florida Property Valuation and Tax Data* publication.

For some financial indicators, it is necessary to adjust amounts for inflation. The price index used by the Auditor General is the September municipal cost index published by *American City and County Magazine*, which is a weighted average of the consumer price index, producer price index for industrial commodities, and construction cost index. These indices are available on the *American City and County Magazine* or the U.S. Bureau of Labor Statistics Web sites (see Appendix E for Web site addresses).

Benchmarks

The use of benchmarks is an essential part of assessing financial condition. Benchmarks provide a means of comparing financial indicator results for a local governmental entity to those produced for similar entities. Developing benchmarks involves determining benchmark groups (i.e., grouping similar local governmental entities together based on various financial and nonfinancial factors) and, for each benchmark group, calculating a

benchmark for each financial indicator. Methodologies for calculating the benchmarks include using a fixed benchmark value by taking the average or median of the financial indicator calculations for the benchmark group or using a range of benchmark values selected from the benchmark group. Depending on the method used to develop benchmarks, the calculations may require adjustments to produce reasonable benchmark calculations. For example, if the average is used in these calculations, it may be necessary to adjust the benchmark calculation if the financial indicator result for one or more entities within the group is significantly lower or higher than the remaining entities' financial indicator results. The adjustment would involve eliminating the significantly different financial indicator results from the benchmark calculation.

Example benchmark calculations made by the Auditor General will be made available to local governmental entities and auditors. The Auditor General determines these benchmark groups using such factors as reporting model, population or taxable property value (counties and municipalities), and function (special districts), and calculates benchmarks based on the average of the financial indicator calculations of all entities that fall within the benchmark group. Benchmarks developed by the Auditor General are based on the most recent data available to the Auditor General.

Financial Condition Assessment Procedures

The local governmental entity's auditor is responsible for assessing financial condition, and the methodology used is a matter of professional judgment. The following procedures provide guidance on using the data accumulated by the Auditor General:

1. Determine financial indicators to be used for preliminary financial condition assessments as deemed appropriate by the auditor. Appendix A includes example indicators that have been found to be useful by auditors and managers.
2. Obtain prior years' data elements and financial indicator calculations from the Auditor General and other sources as deemed appropriate by the auditor. Compile current year data elements and financial indicator calculations from the entity's records.
3. Determine comparable entities and develop appropriate benchmarks using the data elements provided by the Auditor General and other information as deemed appropriate by the auditor. **NOTE:** The Auditor General-provided benchmarks include unadjusted benchmark groupings.
4. Using the financial indicator results and benchmarks, perform a preliminary assessment of the entity's financial condition. The methodology used to accomplish this is left to the professional judgment of the auditor; however, it is suggested that the methodology include, the evaluation of each of the selected financial indicators on its own over a period of five years or as many years as data is available (trend analysis) and a comparison of the results for the selected financial indicator with those produced for similar local governmental entities (i.e., benchmarks).
5. If the auditor's use of the selected financial indicators discloses apparent deteriorating financial conditions, the auditor should review the data elements, financial indicator calculations, and benchmarks for reasonableness.
 - a. Data elements - Presumably, the auditor will take appropriate steps to ensure the proper reporting of data elements for the current fiscal year; however, the

auditor should also determine whether data elements were properly reported on the financial statements for prior fiscal years. For example, fund balance or net assets may not have been properly classified or transactions related to restricted revenues may have been improperly reported in the general fund rather than in the special revenue fund. If improperly reported data elements are disclosed, the auditor should consider whether the financial indicator calculations need adjustment.

- b. Financial indicators – The auditor should recheck the accuracy and completeness of financial indicator calculations. The auditor should also determine whether there are mitigating factors that are causing inappropriate trends in the financial indicators (for example, a change in accounting practice or misclassification of account balances or transactions) or other factors that would neutralize what, at first glance, appears to be a favorable or unfavorable trend. In addition, the auditor should consider the implementation of GASB Statements 67 and 68, which replaced “Funded Ratio” with “Fiduciary Net Position as a Percentage of Total Pension Liability”.
 - c. Benchmarks - The auditor should consider whether the benchmarks used to do the preliminary assessment need further refinement. For example, additional factors such as form of government (i.e., charter versus noncharter), regional location (e.g., coastal versus inland), services provided, or revenue types may be useful in refining comparable entities to be included in a benchmark group. Also, the auditor should consider whether the methodology used to calculate the benchmarks needs revision.
6. When the auditor is confident that the indicator calculations are accurate and complete, and the preliminary assessment discloses apparent deteriorating financial conditions, the auditor should subject the financial indicator/trend analysis results to further analysis. Appendix C provides suggested analysis for the example financial indicators. (Much of the information included in Appendix C was obtained from the International City Management Association’s Evaluating Financial Condition, A Handbook for Local Governments.) **NOTE:** The financial indicators should not be used as the sole basis for making conclusions regarding the entity’s financial condition. Rather, financial indicators serve as analytical tools that will identify particular circumstances requiring additional inquiry.
 7. If the auditor determines that an entity is experiencing deteriorating financial conditions, the auditor is required to include recommendations for improving financial condition in the management letter in accordance with Chapter 10.550, Rules of the Auditor General. To assist in developing such recommendations, a listing of potential factors that could cause deteriorating financial conditions is included as Appendix D.