FIT Financial Health Indicators

Reference Guide

This guide explains the different financial health indicators presented within the Office of the Washington State Auditor's [Financial Intelligence Tool (FIT)]. SAO provides financial health indicators as a way for local governments to monitor themselves using each government's own data they submit to our Office each year.

FIT FINANCIAL INTELLIGENCE TOOL

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Introduction

FIT uses the same ratios utilized in our audit process, but please be aware that FIT itself is not audited. Results of our audits can be found at https://sao.wa.gov/reports-data/audit-reports.

We broke this guide into two parts, excluding this introduction:

- Cash basis and school district indicators
- GAAP indicators

An appendix provides additional detail about what other organizations say about benchmarks.

Components of the financial health indicator

FIT's financial health indicators have two components: ratio and outlook.

The first component is the ratio – an equation that uses a local government's financial data to produce a result that can be compared against a benchmark.

The second is the outlook, which gives users a way to visualize whether the ratio meets or falls below the intended benchmark. Having a particular outlook does not necessarily indicate financial stability or distress. Outlooks are displayed as either good, cautionary or concerning. Criteria used to categorize outlooks differ by indicator and is explained in FIT and in this reference guide. You can find additional information about benchmarks in the appendix.

By comparing the ratios to our recommended thresholds and benchmarks, the indicators alert FIT users to potential financial health concerns in a government. In many cases, further inquiry is recommended, and it is important to note that governments may have their own measures to guide financial decision making, budgeting and more. If you have questions about a specific governments' financial decisions or financial data, please contact the respective government as they are in the best possible position to provide context.

Outlooks vs. group outlooks

Financial health indicators and their outlooks are typically applied at the fund level. For example, a single water utility fund may have up to five financial health indicators, each with their own measurement and outlook. A group outlook is applied to the fund as a whole based on the following rules:

- A **good** group outlook means all indicators are good.
- A **cautionary** group outlook means at least one indicator outlook is cautionary.
- A **concerning** group outlook means at least one indicator is concerning.

Group outlooks are not weighted and are not grades. They are intended to bring awareness to potential issues a government may be facing.

Part 1

Cash basis and school district indicators

Cash basis governments and school districts display up to four indicators per fund.

Please note that school districts utilize their own accounting manual, and as such the title of school district indicators use "fund balance," rather than "cash balance," where applicable.

Cash balance sufficiency

Meaning: This indicator shows the number of days a fund could operate based just on its ending cash and investments balance.

Benchmark: More than or equal to 60 days

Importance: It is important to maintain a cash and investments balance sufficient to operate for at least 60 days. This helps ensure the government has enough cash on hand to operate, as well as handle unexpected costs or emergencies. This indicator is a way to measure whether the government's level of "savings" or "reserves" is sufficient or concerning.

Good: Satisfactorily meets the benchmark for the current year (and trending toward meeting the benchmark for next year)

Cautionary: Next year would not meet the benchmark if the three-year trend continues

Concerning: Current year does not meet the benchmark

Change in cash position

Meaning: This indicator shows the percent change in ending cash and investments compared to the prior year. That is, it shows how much the government used or increased its cash balance during the year.

Benchmark: More than or equal to $0

Importance: The ability to "add" to the savings account (for example, cash and investments balance) is usually a positive sign that a government is building reserves or setting aside funds for future capital improvements. However, setting aside more cash than necessary could be a missed opportunity to provide programs or other services in the current year. Alternatively, when a government uses its "savings," this indicator will be negative, and users may ask more questions about it.

This cash use can be for good reasons, such as to pay for planned capital improvements or to pay off debt, but it can also indicate the government might be operating beyond its means. It is not uncommon for this indicator to fluctuate, and a negative indicator is not necessarily a concern. It is important to evaluate the reasons for the decline in cash balances. However, multiple years of cash balance declines might be more concerning.

Good: Satisfactorily meets the benchmark for the current year

Cautionary: Does not meet the benchmark for the current year

Concerning: Latest three years do not meet the benchmark

Governmental funds sustainability (governmental funds only)

Meaning: This indicator shows if the funds are spending in line with the revenue they receive (spending includes expenditures and debt service). General governmental activities usually do not have a lot of control over their primary revenue sources. For example, it may be difficult to increase taxes quickly since this may require voter approval annually. To help balance their budgets in the long term, governments might consider limiting their programs and services.

Benchmark: More than or equal to 0%

Importance: This ratio can help you evaluate whether the government is operating within its means. While the benchmark is 0%, the indicator results should ideally be greater. This would indicate the government has funds available for capital improvements or to build reserves. Negative indicators might suggest the government is operating beyond its means. However, further inquiry might be needed to make that conclusion. For example, if the government paid down extra debt in one year, this indicator would likely be negative for that year.

Good: Satisfactorily meets the benchmark for the current year

Cautionary: Does not meet the benchmark for the current year

Concerning: Latest two years do not meet the benchmark

Enterprise funds self-sufficiency
(enterprise funds only)

Meaning: This indicator shows if enterprise funds are generating enough revenue to cover their operating costs and pay debt service each year. Enterprise funds are typically expected to recover their own costs through charges for services and other revenues. Common examples of enterprise funds include water or sewer utilities, solid waste utilities, and other business-like functions.

The ratio does not include the cost of outlay for capital improvements. Ideally, the ratio indicator would be more than zero to allow for capital improvements.

Benchmark: More than or equal to 0%

Importance: Unlike governmental funds, most enterprise funds can increase revenues through rate changes. A ratio more than 0% indicates that enterprise funds are at least recovering expenditures and debt service through rates. However, the ratio does not consider the cost of capital improvements, which should also be recovered through rates. A ratio less than 0% indicates that enterprise funds relied on past reserves or fund balance, relied on future revenues to cover costs, or had to be subsidized by other means. The government should possibly evaluate spending or reconsider its rate structure. In some cases, the government may be relying on the general fund to subsidize the activity, for various reasons.

Good: Satisfactorily meets the benchmark for the current year

Cautionary: Does not meet the benchmark for the current year

Concerning: Latest year does not meet the benchmark, and there are two consecutive years of decline

Debt load (governmental funds only)

Meaning: This indicator shows the percentage of the government's revenue used to pay debt.

Benchmark: Less than or equal to 12%

Importance: Issuing debt is common in governments to finance capital improvements, but it can reduce financial flexibility and potentially become a burden. The more a government uses its revenue to pay debt, the less these funds are available to provide services and fund other programs. When evaluating the debt load, it is important to consider the length of the maturities for the outstanding debt, the nature of the debt (was it for operations or capital needs), and the timing of the payments (balloon payments or backloaded – payments are deferred for the first few years but then there is a catch-up). However, the debt is for capital purposes in most cases, and repayment is structured over a fixed period, typically 30 years.

Good: Satisfactorily meets the benchmark for the current year

Cautionary: Does not meet the benchmark for the current year

Concerning: Latest two years do not meet the benchmark

Part 2

Generally accepted accounting principles (GAAP) indicators

GAAP governments display up to five indicators per fund.

Fund Balance Sufficiency

Meaning: This indicator shows the number of days a fund could operate based just on its ending balance.

Benchmark: More than or equal to 60 days

Importance: It is critical to maintain a fund balance sufficient to operate for at least 60 days. This helps ensure the government has enough reserves on hand to operate, as well as handle unexpected costs or emergencies. This indicator is a way to measure whether the government's level of reserves is sufficient or concerning.

Good: Satisfactorily meets the benchmark for the current year (and trending toward meeting the benchmark for next year)

Cautionary: Next year would not meet the benchmark if the three-year trend continues

Concerning: Current year does not meet the benchmark

Change in fund equity

Meaning: This indicator shows the percent change in ending fund balance compared to the prior year. That is, it will show how much the fund balance increased or was used during the year.

Benchmark: More than or equal to 0%

Importance: The ability to "add" to reserves (for example, fund balance) is usually a positive sign that an entity is planning for uncertainties or setting aside funds for capital improvements. However, setting aside more reserves than necessary could be a missed opportunity to provide programs or other services with the current year's revenue. Alternatively, when governments use their reserves, this indicator will be negative, and users may ask more questions about it.

This use of reserves can be for good reasons, such as to pay for planned capital improvements or to pay off debt, but it can also indicate the government might be operating beyond its means. It is not uncommon for this indicator to fluctuate, and a negative indicator is not necessarily a concern. It is important to evaluate the reasons for the decline in reserves. However, multiple years of fund balance decline might be concerning.

Good: Satisfactorily meets the benchmark for the current year

Cautionary: Does not meet the benchmark for the current year

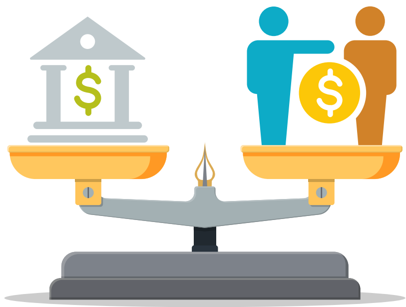
Concerning: Latest three years do not meet the benchmark

Governmental funds sustainability (governmental funds only)

Meaning: This indicator shows if the funds are spending in line with the revenue they receive (spending includes expenditures and debt service). General governmental activities usually do not have a lot of control over their primary revenue sources. For example, it may be difficult to increase taxes quickly since this may require voter approval annually. To help balance their budgets in the long term, governments might consider limiting their programs and services.

Benchmark: More than or equal to 0%

Importance: This ratio can help you evaluate whether the government is operating within its means. While the benchmark is 0%, the indicator results should ideally be greater. This would indicate the government has funds available for capital improvements or to build reserves. If the indicator is negative, it might indicate the government is operating beyond its means. However, further inquiry might be needed to make that conclusion. For example, if the government paid down extra debt in one year, this indicator would likely be negative for that year.



Good: Satisfactorily meets the benchmark for the current year

Cautionary: Does not meet the benchmark for the current year

Concerning: Latest two years do not meet the benchmark

Enterprise funds cost recovery (enterprise funds only)

Meaning: This indicator shows if enterprise funds are recovering their costs, considering all operating and nonoperating revenue sources.

Benchmark: More than or equal to 100%

Importance: A measure of at least 100% indicates that the fund was successfully recovering the full costs of service through charges and other revenues/sources. A measure of less than 100% indicates that the fund had to rely on past reserves, rely on future revenues, or be subsidized by other means.

Good: Satisfactorily meets the benchmark for the current year

Cautionary: Does not meet the benchmark for the current year

Concerning: Latest two years do not meet the benchmark

Debt load (governmental funds only)

Meaning: This indicator shows how much of the government's revenue is being used to pay debt.

Benchmark: Less than or equal to 12%

Importance: Issuing debt is common in governments to finance capital improvements, but it can reduce financial flexibility and potentially become a burden. The more the government uses its revenue to pay debt, the less these funds are available to provide services and fund other programs. When evaluating the debt load, it is important to consider the length of the maturities for the outstanding debt, the nature of the debt (was it for operations or capital needs), and the timing of the payments (balloon payments or backloaded – payments are deferred for the first few years but then there is a catch-up). However, debt is for capital purposes in most cases, and repayment is structured over a fixed period, typically 30 years.

Good: Satisfactorily meets the benchmark for the current year

Cautionary: Does not meet the benchmark for the current year

Concerning: Latest two years do not meet the benchmark

Current ratio

Meaning: This measure shows how many times current assets can cover the general fund's current liabilities.

Benchmark: More than or equal to 1.0

Importance: An amount above 1.0 implies the government will be able to pay short term fund expenses as they become due. However, governmental fund financial data does not include the liability for debt payments due immediately after year-end (even if the payment will be made the following day, which is often the case). Other short-term liabilities might also be excluded due to the accounting requirements for governmental funds. Therefore, many governments need to have a ratio well above 1.0.

If this amount is less than 1.0, it implies the government has more immediate obligations than assets available to make payments, and it will need to either borrow or earn additional revenue in the short term. This would be unusual because most governments would borrow from other funds or issue long-term debt to avoid this situation. However, these actions would be signs of fiscal distress.

Good: Satisfactorily meets the benchmark for the current year

Cautionary: Latest year is less than 1.25 and there are two consecutive years of decline

Concerning: Latest year's measure is less than 1.0

Appendix A

Background and additional information about financial health indicator benchmarks

Our Office set benchmarks based on a variety of factors, research and industry best practices, ultimately landing on a set of standard benchmarks used throughout FIT for all government types and bases of accounting. The information below is just a sample of some of the sources we used to determine appropriate benchmarks.

Cash balance sufficiency / fund balance sufficiency

FIT benchmark: at least 60 days

What do other organizations say? The Government Finance Officers Association (GFOA) applies the 60 day guideline. The GFOA Best Practice, "Determining the Appropriate Level of Unrestricted Fund Balance in the General Fund" recommends, at a minimum, that general- purpose governments, regardless of size, maintain unrestricted fund balance in their general fund of no less than two months of regular general fund operating revenues or regular general fund operating expenditures.

- Fund Balance Guidelines for the General Fund (gfoa.org)

Change in cash position / Change in fund equity

FIT benchmark: Greater than 0%

What do other organizations say? The International City/County Management Association (ICMA) calls the change in cash position "declining unreserved fund balances". **Evaluating Financial Condition A Handbook for Local Government** by Karl Nollenberger states on page 68, "In states that allow it, jurisdictions usually try to operate each year at a small surplus to maintain positive fund balances and thus maintain adequate reserves."

Governmental funds sustainability

FIT benchmark: Greater than 0%

What do other organizations say? The International City/County Management Association (ICMA) calls the operating margin "an operating deficit or surplus," and calculates it in a very similar manner.

On pages 62 and 63 of **Evaluating Financial Condition: A Handbook for Local Government**, author Karl Nollenberger states, "The following situations…would probably be considered negative factors:

- Two consecutive years of operating fund deficits;
- A current operating fund deficit greater than that of the previous year;
- An operating fund deficit in two or more of the last five years;
- An abnormally large deficit – more than 5 percent to 10 percent – in one year."

Debt load (governmental funds only)

FIT benchmark: Less than 12%

What do other organizations say? ICMA uses net direct debt service which is the amount of principal and interest a government owes annually on direct bonded long-term debt plus interest on direct short-term debt. The debt service ratio formula calculates net direct debt service divided by net operating revenues. Evaluating Financial Condition A Handbook for Local Government by Karl Nollenberger states on page 83, "Debt service on net direct debt exceeding 20 percent of operating revenues is considered a potential problem. Ten percent is considered acceptable."

FIT's 12% benchmark was set based on a range of benchmarks cited in the **Evaluating Financial Condition: A Handbook for Local Government** mentioned above and the **Handbook of Debt Management**, edited by Gerald J. Miller, Chapter 13. The handbook provides examples of benchmarks that range from 6%-20% based on type of government. 12% represented a number near the middle range for what was considered "high" across different types of governments.

We do not currently apply a benchmark to enterprise funds, largely due to the fact that enterprise funds often issue debt directly payable by similar increases to rates. This flexibility may allow some governments the ability to operate above the 12% debt load without the same type of concern that more restrictive governmental funds have.

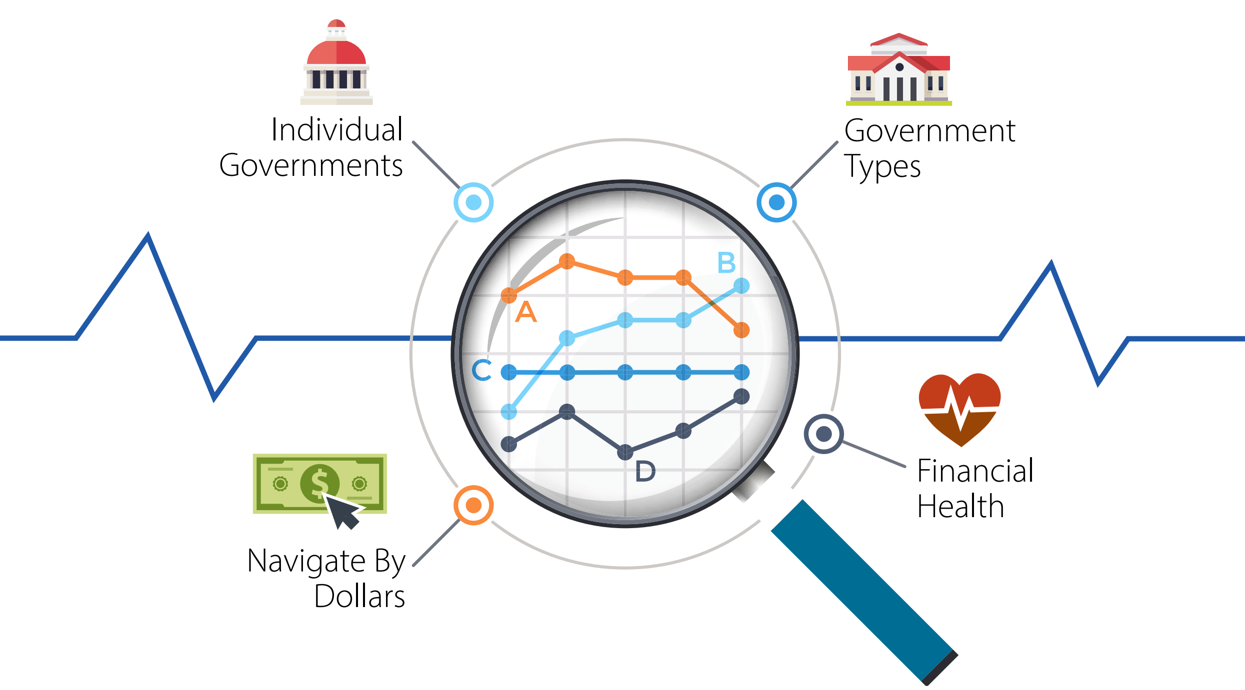
The Municipal Research and Services Center website provides information on the statutory limits on general obligation (GO) debt and permitted uses of local government debt:
[MRSC - General Obligation Debt Limits]

Enterprise fund self-sufficiency

FIT benchmark: Greater than or equal to 0%

What do other organizations say? The National Advisory Council on State and Local Budgeting Practice states in Principle 2, Element 4.2.1, "A government should adopt policies that identify the manner in which fees and charges are set and the extent to which they cover the cost of the service provided.

ICMA uses enterprise operating position, which has the option to use "…operating income before depreciation (enterprise profits or losses excluding non-operating income and expense such as interest expense, interest income and property taxes) as the measurement of financial condition." On page 66 of **Evaluating Financial Condition, A Handbook for Local Government**, author Karl Nollenberger suggests a policy statement such as: "All fees and charges for each enterprise fund will be set at a level that fully supports the direct and indirect cost of the activity."



Additional resources

The Financial Intelligence Tool (FIT) has functionality tips, explanations about ratios and benchmarks, and background on where the data comes from all throughout the application. Look for information icons and the "About" and "Help" tabs in FIT.

The Government Finance Officers Association, Best Practices and Resources, Budgeting Best Practices, contains several best practices for setting targets and guidelines for fund balance and working capital.

The Municipal Research and Service Center has a page dedicated to discussing fund balance and reserve policies.

For assistance

This resource was developed by the Center for Government Innovation at the Office of the Washington State Auditor.

Please send questions, comments or suggestions to Center@sao.wa.gov.

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This resource is provided for informational purposes only. It does not represent prescriptive guidance, legal advice, an audit recommendation, or audit assurance. It does not relieve governments of their responsibilities to assess risks, design appropriate controls, and make management decisions

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