III. The Audit

Even though the annual audit is one of the most important documents in the city, and is absolutely necessary in order to know the city's financial condition at the end of the fiscal year, it can be the least understood and/or ignored city document by elected officials and citizens. Nevertheless, it is the most valuable document for revealing the city's financial condition and financial philosophy. Since an annual audit is required by law, recent copies should be readily available for review of interfund transfers, fund balances, accounts payable, pending lawsuits, accrued employee fringe benefits, long term debt retirement, and many other financially related items that impact the city now and in the future.

Interfund Transfers

Interfund transfers are the moneys that are transferred between funds for a variety of reasons. Some examples of such transfers are illustrated below:

Interfund Transfers

Funds Source	Recipient	Purpose	Reason	Repaid?
Utility	General	Mgt. & Street Operations	Subsidy	No
Utility	I & S	Debt Retirement	Utility rates pledged to debt retirement	No
Any Fund	Capital Project	Capital Improvements	Accounting procedural requirement	No
Utility	General	Operations	Interim loan for low tax collections	Yes

Frequently such transfers are an outright grant or "gift" to another fund and will not be repaid. Such "gifts" are not necessarily considered good or bad financial management, but some rationale should be made for such transfers, and should be consistent with previous trends. Some cities can demonstrate that the transfer is payment for a service rendered by the receiving fund. The best example of a payment for service is the transfer from the Utility Fund to the General Fund for general governmental services such as managerial, personnel, and accounting, street utility cut patching services, and other services required by the Utility Fund's water and sewer operations and provided by the General Fund.

Usually the best illustration of transfers is between the General Fund and the Utility Fund when the General Fund considers the transfer a revenue source and does not reimburse it. The rationale behind this transfer is either that the General Fund provides services to the Utility Fund (for example, either management or general ledger services) which should be reimbursed, or the City Council adheres to the belief that utility rates should be used to subsidize the General Fund in lieu of increasing taxes. Regardless of the rationale, Texas courts have ruled that cities are entitled to make a reasonable profit from their utility systems and such transfers are legal and within the policymaking authority of the City Council.[1]

In order to find these transfers, look at the Statement of Revenues and Expenditures example which follows. This statement indicates that the General Fund is receiving $195,000 in transfers, the Debt Services Fund $41,000 and the Capital Projects Fund $15,000.

[1] *Town and City* (TML, Austin, Number 9,1997) p. 11.

Any City
Statement of Revenues & Expenditures -- September 30, 2000

	Governmental Fund Types			
	General	**Special Revenue**	**Debt Service**	**Capital Projects**
Revenues ($1,000's):				
Taxes - *ad valorem*	$415	$	$68	$
- sales	649			
- franchise	261			
- other				
Licenses and permits	15			
Federal & state governments		249		3
Charge for services	150			
Fines & forfeitures	100			
Interest earned	16	10	8	35
Rental income	63			
Contributions				160
Total revenues	**$1,669**	**$259**	**$76**	**$198**
Expenditures ($1,000's):				
General government	$399	$4	$	$
Public safety	611			
Highways & streets	397			
Health	79			
Culture & recreation	380	32		
Debt Service -interest			19	
-principal			90	0
Capital outlays		195		331
Total expenditures	**$1,866**	**$231**	**$109**	**$331**
Excess (deficiency) of revenues over expenditures	$(197)	$ 28	$ (32)	$(132)
Other sources (uses):				
Transfers from other funds	$195	$	$41	$15
Transfers to other funds	(36)	47		(13)
Total expenditures and other uses	$ 159	$(47)	$41	$2
Excess (deficiency) of revenues and other sources over expenditures and other uses	$ (38)	(19)	$8	$(130)
Fund balance at beginning of year	$ 40	$158	$58	$188
Fund balance at end of year	$2	$139	$66	$58

To analyze these transfers, especially in the operating funds, determine what percentage of the fund resources such transfers constitute:

Total General Fund Revenues	$1,669,000
Transfers from Other Funds	+ 195,000
Total Revenues & Other Sources	$1,864,000

$$\frac{\text{Transfers from Other Funds}}{\text{Total Revenues \& Other Sources}} = \frac{\$\ 195{,}000}{\$1{,}864{,}000} = 10.4\%$$

This 10.4% figure is not necessarily poor management or an indication of financial problems, because it may be customary for the city to transfer 10% to the General Fund, or the 10% may represent fewer transfers than in the previous few years.

In order to be sure, you should check the interfund transfers for any drastic changes over the most recent years, because large increases could be a signal of trouble. This is exactly what the bond rating agencies do when they are reviewing your city's financial condition. Standard and Poor's believes that "deterioration in revenue transfers that represents a deviation from past policy could be viewed as a sign of fiscal stress." [2] For example, if the General Fund's use of such transfers increases significantly in any one year or over a period of years, as in the illustration below, then this could mean that the regular General Fund revenue sources such as property and sales taxes, user fees, and fines are not keeping pace with increased expenditures:

Year	Transfers	Total Revenues & Sources	Percentage of Total Revenue
1997	$25,000	$1,475,000	1.7
1998	$40,000	$1,500,000	2.6
1999	$160,000	$1,670,000	9.5
2000	$195,000	$1,864,000	10.4

In some cities, the percentage of General Fund resources attributed to transfers varies between 2% on up to 20% while in other cities, the percentage may be 20-30%. There is no set rule on what the proper percentage should be, because in some communities it is more politically acceptable to increase utility rates rather than General Fund taxes or user fees. In other words, it depends on the political environment that exists and just how much out of line the community's tax rates and user fees are compared to the cost of furnishing city services. (From my perspective, I have always felt that the Utility Fund is a profit-oriented fund; if a city can maintain competitive water and sewer rates and still make a profit, then the council should transfer funds into the General Fund.)

If the use of interfund transfers is a problem, there are several possible solutions that either eliminate the transfer or curtail the amount of the transfer:

1. Eliminate or decrease the expenditures that require the transfer.

2. Increase revenues by increasing fees or taxes in the fund receiving the transfer.

[2]Public Finance Criteria 1997, Standard and Poor's

3. Reassign fund functions or responsibilities so there is no need for a transfer. For example, if moneys are being transferred from the Utility Fund to the General Fund to compensate for the street department patching pavement cuts for water lines, then list this item as an expenditure under the water department instead of showing it as a transfer to the General Fund.

Of course, solutions 1 and 2 are easier said than done. However, either solution 1 or 2 or a combination thereof are the real solutions to the problem, since solution 3 is more of a cosmetic action.

Fund Balances

Fund Balances are the moneys and equity remaining after the liabilities are subtracted from the assets on the Balance Sheet. Such balances are a good indication of the strength of various funds, because these balances are a combination of cash, which is available as a contingency or reserve, and other assets in the fund (such as water and sewer mains in the Utility Fund) which increase the operational capacity/capability of the fund. You should note the difference between reserved and unreserved fund balances. "Reserved fund balance consists of portions of fund balance that are either legally restricted to a specific future use or are not available for appropriation or expenditure."[3] Examples of reserved fund balances would be those reserved for encumbrances (e.g., outstanding construction contract or purchase order) or compensated absences (e.g., holiday pay, vacation pay, etc.).

A good rule of thumb for the operating fund balances is for them to equal the costs of operating the city for 6 weeks without any additional revenues. For example, if it costs $150,000 to run your city's operating departments (that is, the General and Utility Funds) for 6 weeks, then your fund balances should total at least $150,000. Another common standard is 5% of annual operations expenditures, which is considered sufficient to guard against the effects of most types of uncertainty.[4] For example, if your city's general fund budget was $5,000,000, then your fund balance would be $250,000 (.05 X $5,000,000 = $250,000).

The balance sheet shown on the next page indicates that this particular city may have problems in the General Fund if an emergency or cash flow problem should arise, because it has only a $4,000 General Fund Balance.

Any City
General Fund Balance Sheet ($1,000)
September 30, 2000
With Comparative Figures for the Year Ended September 30, 1999

Assets	**2000**	**1999**

[3]"Unreserved Fund Balance and Local Government Finance," Ian J. Allan, Research Bulletin, The Government Finance Officers Association, (Washington, DC, November 1990), p. 2
[4]Ibid., p. 6

Cash	$51	$162
Receivables (Net allowance for uncollectibles):		
Taxes	2	3
Accounts	50	41
Due from other funds	7	-
Inventory (at cost)	39	29
Total Assets	**$149**	**$235**
Liabilities and Fund Balance		
Liabilities:		
Accounts payable	$31	$27
Due to other funds	116	168
Total Liabilities	**$147**	**$195**
Fund Balance:		
Unreserved:		
Designated for specific activity	$ 3	$4
Undesignated	1	36
Total Fund Balance	**$4**	**$40**
Total Liabilities and Fund Balance	**$151**	**$235**

2000 General Fund Balance = $4,000

Cost of Operating General Fund Department 6 Weeks Without Revenue =

$$\frac{\text{Total Expenditures x 6 weeks}}{\text{52 weeks}} = \frac{\$1{,}866{,}000^{5} \times 6}{52} = \$215{,}308$$

Therefore, the General Fund Balance should equal approximately $215,000.

Some experts determine an adequate fund balance as a percentage of the budget. For example, Moody's believes that "a fund balance that is 5% to 10% of the budget is a 'comfortable number'." [6] Such a percentage in the example would indicate that the fund balance should be between $93,300 and $186,600:

General Fund Budget =	$1,866,000
5% of the General Fund Budget =	93,300
10% of the General Fund Budget =	186,600

There is a lot of difference between the $215,000 "cost of operating for six weeks" method versus the $93,300 "five percent of the budget" method, but the ideal amount probably lies somewhere in between. Regardless of which method one uses, the $4,000 fund balance is certainly too low.

[5] From Statement of Revenue and Expenses

[6] "Ratings Are No Game," City & State, (Crain Communications, Inc., Chicago, April 16, 1984.)

On the other hand, there are some cities that budget their fund balance every year with the idea that a city should not be in the money making business and any fund balance is an indication of unused resources. Such reasoning reflects some of California's Proposition 13 sentiment. If you recall, one of the reasons Proposition 13 passed in California in the late 1970's was the $4-5 billion fund balance the state had accumulated. The voters thought that this large fund balance should be used in lieu of increasing state taxes.

Regardless of one's personal beliefs about fund balances, when financial credit analysts such as Moody's Investor Service, Standard and Poor's Corporation, or Fitch review a city's financial records prior to rating the city for a bond sale, they give extreme importance to the size of the fund balances. They think a sizable fund is an indicator of a financially healthy city and is indicative of the city council's and/or city staff's fiscal conservatism. In other words, the larger the fund balance, the more confident the credit analysts tend to be about the city's financial condition, and the city's bond rating should benefit if other rating criteria are equal. Of course, their "primary concern is that governments have an adequate level of financial resources to ensure the timely payment of principal and interest on their outstanding debt." [7]

At the same time, however, they realize that large fund balances can be misleading and not necessarily a healthy financial sign. They review the city's cash flow and other reserves or contingencies that would be available for emergencies. For example, if a large fund balance at the end of the fiscal year is spent within two months of the new fiscal year without a large inflow of revenues, then the size of the fund balance would be misleading and the city would have cash flow problems.

There is not necessarily a direct relationship between the amount of the fund balance and the quality of city services in a community. Managers should not ignore or postpone expenditures necessary to maintain the city's infrastructure and quality of services just to have a good fund balance. A large fund balance does not indicate that a city's infrastructure and service delivery systems are in good shape. In fact, the systems may have been underfunded over the years in order to build up an impressive fund balance. The city looks great on paper and in the bottom line, but it is not providing the public services for which it was incorporated.

In order to ascertain any problems developing in your city's fund balances, analyze the last few years in order to detect any trends.

Analyzing Fund Balance Trends

			Method of Reviewing Balance	
Year	**Fund Balance**	**Percentage Change**	**6 Weeks Operating Cost Method**	**5% of Budget Method**
1997	$75,000		$150,000	$65,000
1998	$55,000	-26%	$165,000	$70,500
1999	$40,000	-26%	$200,000	$86,600
2000	$4,000	-89%	$215,308	$93,000

This city is facing financial problems as is evidenced by the downward trend of its fund balance and especially illustrated by the fund balance's drastic change in the year 2000. These large increases probably indicate that revenues are declining or expenditures are increasing more than budgeted, causing the fund to utilize the fund balance as a revenue source.

[7] "Unreserved Fund Balance & Local Government Finance," p. 5.

Solutions to low fund balances include some of the same solutions previously listed for over-reliance on interfund transfers:

1. Cut expenditures by eliminating services, improving productivity, or postponing purchases.

2. Increase revenues and hold expenditures constant.

3. Adopt a Financial Policy that formally establishes a minimum level for fund balances in the major operating funds.

Regardless of your approach to fund balances, the fact remains that you must have fund balances in your operating funds. Just as any private business, household, or other governmental agency has a "cushion" upon which to rely in the event of unanticipated events, cities need the same "cushion" and the fund balances provide this security.

Accounts Payable

The accounts payable item under liabilities on the balance sheet indicates the amount of money owed to others. Private business uses this same indicator to determine the ability to pay current debt. If the accounts payable are too high and cannot be paid with current assets, then there is an immediate problem.

To determine what is too high, calculate the liquidity ratio:

$$\frac{\textbf{Current Assets}}{\textbf{Accounts Payable}} = \textbf{Liquidity Ratio}$$

For private business, any ratio below one (1) may be bad. For cities, this ratio of one may not be completely accurate, but the important point is for the manager to compare liquidity ratio over several years and determine if there are unexplained fluctuations. Certainly, a city has to pay current debt just as any private business. For example, checking the balance sheet the liquidity ratio was much better in 1999 than in 2000.

	1999	**2000**
Cash & Accounts Receivable	$206,000	$103,000
Accounts Payable	$27,000	$31,000
Liquidity Ratio	7.6%	3.32%

There are various possibilities for the decline in the liquidity ratio in the year 2000, but the most obvious explanation would be an increase of expenditures over revenues. This means that the cash component of the Fund Balance is being used as a revenue source and is not available to cover accounts payable. Also, an increase in accounts payable would evidence increasing expenditures and delayed payments.

Be sure that the accounts receivable are collectible and not bad debt. If you have $52,000 in accounts receivable and $35,000 of this is due from a bankrupt company or due from unemployed residents, then do not include this amount in the liquidity formula. In such a situation, the liquidity ratio in 2000 would have been much lower.

Cash		$51,000
Receivable		$52,000
Less Bad Debt		($35,000)
Current Assets	$68,000	

$\frac{\$68,000}{\$31,000}$ = 2.19 % new liquidity ratio

Pending Lawsuits

In the audit's footnotes there should be reference to any outstanding lawsuits involving the city. A review of these suits will provide an idea on potential future settlement costs and legal fees. Certainly you should visit with the city attorney and obtain first hand information on pending lawsuits. Make sure the budget includes these legal-related costs. This is certainly an example of where a good fund balance actually can be a contingency for such costs.

The number and type of lawsuits may indicate problem areas in the city organization. Three or four lawsuits relating to personnel termination actions may mean that there is a personnel management or procedural problem. If all the lawsuits pertain to the same department, then certainly that department merits a close review by management. The types and number of lawsuits may also be a good indicator of the types of liability insurance coverage you should be considering for the city.

Accrued Employee Fringe Benefits

The audit provides an estimated cost of future employee benefits, such as sick leave days accumulated, vacation days accumulated, and bonuses. In fact, it is becoming standard practice for cities to establish reserves for many types of future employee benefits. Without a reserve, your city could be in for a shock if a major personnel action occurred which involved the payment of employee benefits. For example, if your city pays accumulated sick leave to employees upon retirement and 10 employees are retiring the next fiscal year, then this will have an impact on the budget.

Future Long Term Debt Retirement

In order to ensure that you will not be surprised by a higher than normal debt retirement (that is, the amount budgeted this year for debt retirement), check the bond retirement schedules that are usually provided in the audit. Retirement schedules are normally arranged for easier budgeting with an equal total payment due each year. However, if for some reason, long term debt was issued with only interest payments due the first four years and, thereafter, the principal is included in the payments, the amount of funds required will increase significantly as illustrated below:

Year	Principal	Interest	Total Debt Payment
1994	$0	$83,271	$83,271
1995	$0	$99,925	$99,925

Year	Principal	Interest	Total Debt Payment
1996	$0	$99,925	$99,925
1997	$0	$99,925	$99,925
1998	$50,000	$99,925	$149,925
1999	$60,000	$94,425	$154,425

Since the 1998 debt service requirements increase by $50,000 or by 50%, then you should make arrangements for additional revenues or less expenditures to cover this increase.

Unless you review the payment schedules for large increases in the future, such redemption schedules can be misleading regarding the amount required to retire the bonds. Theoretically the best method for bond redemption is the constant level of redemption with the principal and a declining level of interest payments.[8] However, I have managed cities where we issued new debt with minimal principal payments up front, so that the new debt would mesh with the old debt for level debt retirement payments. This way eliminates peaks and valleys in the annual payments from the Debt Service Fund, and the portion of the property tax rate reserved for debt retirement remains constant over the years.

Debt Free?

Another word of caution about a city council which has the goal of "being debt free" in five years, or is already debt free. This is an admirable goal if the city can really afford it--e.g., if the city has significant revenue sources, such as a shopping mall in its city limits on the outskirts of a major metropolitan city, and can either afford to pay for capital improvements out of current revenues or has built up a capital improvements reserve so that debt is not required. However, for most cities, being debt free may be a cruel hoax because, while the city may be debt free, its infrastructure may actually be crumbling around it. I observed this situation in one jurisdiction that had low water and sewer rates and bragged about them. At the same time, they needed $3.5 million in sewer line rehabilitation. I do not believe that they were looking at the entire picture, but were just focused on one component, which was the outstanding debt.

[8] Intergovernmental Brief, No. 77-1, (Texas Advisory Commission Intergovernmental Relations, Austin), p. 11.