AUDITOR OF PUBLIC ACCOUNTS
LOCAL GOVERNMENT FISCAL DISTRESS MONITORING OVERVIEW

Summary of the Fiscal Distress Process

Chapter 1 of the 2018 Virginia Acts of Assembly, Item 4-8.03, directs the Auditor of Public Accounts (Office) to establish a prioritized early warning system to identify potential local fiscal distress within localities across Virginia and monitor accordingly on an annual basis. During our first year of implementation in 2017, we developed criteria for making a preliminary determination of fiscal distress based on an analysis of calculating ten key financial ratios using audited financial data from the localities’ annual financial reports, as well as considering other qualitative factors, for the localities required to annually report to our Office. This ratio analysis, referred to as the Financial Assessment Model (FAM), calculated an overall score for each locality, which was based on an average of the ten ratio results compared and ranked against all localities’ ratio results. Using the FAM score results, we developed a threshold to use as an indicator for making our preliminary determination of the need to perform further follow up with a locality based on the results of the FAM ratio analysis. In March 2018, after completing the follow up process with the localities identified as part of the 2017 model, our office issued the Local Government Fiscal Distress Monitoring Report, which described an overview of the legislative requirements for this process, background on the process and ratio analysis that our office implemented during 2017 to initially develop an early warning monitoring system, the results of our reviews performed with specific localities identified as part of our analysis, and plans to refine our analysis to further enhance the early warning monitoring system for future years.

In 2018, the Office revised the criteria and made changes to the model we are now using to make a preliminary determination of where we will focus additional follow up with a locality that appears to show signs of potential fiscal distress. The new model calculates 12 financial ratios using audited financial statement data, along with considering demographic and other qualitative and external factors in a second assessment phase of the model. Based on the results of both the ratio analysis and the qualitative analysis, each locality is classified into either one of two categories: identified as needing further follow up through our financial assessment questionnaire review process, or not identified as needing any further follow up. Updates to the fiscal distress model and our monitoring process beginning in 2018 is described in further detail below.

Refinements during 2018 to the Early Warning System Model

Updated Ratio Analysis

During 2018, the Office worked on several areas to improve and enhance the ratio methodology and overall approach to our fiscal distress monitoring model. Primarily, we determined the need to change our approach to how we analyze each locality’s financial ratio performance results. In particular, we decided no longer to use the FAM model from our 2017 process. Based on numerous feedback the Office received about the original FAM analysis, we
noted a prevalent misunderstanding about our use and the intent of the FAM score calculation. As a result of this misunderstanding, some stakeholders and localities were inappropriately applying the FAM scores; for example, using the scores to compare localities better or worse against each other or interpreting a higher FAM score to mean it was a rating of fiscal health, which was contrary to the intent of our analysis. Accordingly, during 2018 and going forward for future analysis, we are no longer applying a calculated FAM score percentage as the threshold to determine the need for additional follow up with a locality. Further, we are no longer using the FAM ranking or comparison methodology when evaluating the financial ratio results.

For 2018, we revised our ratio analysis to focus on a new methodology to analyze each locality's ratio performance on an individual basis, and not compare the ratio results from one locality to another. Again using data directly from the audited annual financial reports, the new methodology calculates financial ratios for each locality. Based on the performance of the ratios, the model assigns a points based, quantifiable evaluation of the ratio’s performance depending on varying percentage levels. For example, if Ratio X indicates a weak or undesirable outcome, this ratio receives the maximum level of points assigned and weighted for that ratio. Conversely, if the performance outcome of Ratio X demonstrates a stronger, desirable outcome, this ratio receives no points. If the performance outcome demonstrates a fair or adequate level of performance, Ratio X receives an amount of points somewhere in between the lowest and highest levels.

In the points based evaluation, each ratio is weighted according to the ratio’s relative importance, which the Office has internally established based on our prior year analysis, discussions with Virginia state and local professionals, research of other states’ models, and our general understanding of the data and ratios for Virginia’s localities. Our judgment and considerations applied to the ratio percentage levels for weak, adequate, or strong performance results are based on our research and discussions with other states and professional groups, and review of common industry benchmarks established by professionals, such as those set by bond rating agencies and similar fiscal analysis from organizations like the International City/County Management Association. Overall, a higher number of points for each ratio, and in total for all ratios combined, indicates the locality is generally showing a weak or undesirable performance in the ratio analysis. After analyzing each locality’s points cumulatively for all ratios, we then perform further qualitative analysis on the localities that are scoring a high number of points. For the 2018 analysis, we set a threshold to review those localities receiving 30 total ratio points or higher as part of our second phase of the model, which reviews demographic and other qualitative factors, as discussed in further detail below.

As additional updates to the model in 2018, we reexamined the original ten ratios that were calculated in the 2017 FAM score model, as detailed in the March 2018 Local Government Fiscal Distress Monitoring Report. We determined there was duplicative analysis across some of the ten ratios and that certain ratios may not be the most beneficial for our analysis. Accordingly, we updated our analysis to include new ratios to look at different factors. We kept five ratios from the prior FAM analysis, which captured the main issues discussed during the follow up process with the localities identified in 2017. We added seven new ratios to our 2018 analysis,
to include ratios that analyze the change in overall net position and unassigned fund balance from year to year; an operations ratio that measures whether a locality’s annual revenues were sufficient to pay for annual operations; and ratios that examine a locality’s outstanding debt level and annual debt service payments. Finally, we added a new ratio that looks at the locality’s dependency on other governmental revenues from state and federal funds, along with a ratio that examines a locality’s business type, enterprise activity and whether those activities are self-sustaining from year to year. These enterprise activities may include water and sewer, landfill, storm water, or other non-essential activities such as a golf course or theater.

Refer to Appendix A below for a summary on the 12 ratios included in the updated ratio analysis of our model. Further detail on the ratio calculations and ratio points assignment is provided at the following document located on our website: APA Local Fiscal Distress Monitoring-2018 Updated Ratio Analysis.

Demographic and Qualitative Analysis

In addition to the changes made to the ratio analysis described above, we updated the model to include a second phase, which involves an additional assessment of demographic and other external, qualitative factors as part of our final evaluation to identify a locality for further review as part of our follow up process. This qualitative evaluation focuses on those localities we have identified in the ratio analysis as coming above an established threshold of total points for the 12 ratios. The qualitative analysis reviews trends in demographic factors, such as growth or decline in population, median household income, and the assessed value of a locality’s tax base for real estate, tangible personal property, and public service corporations; along with reviewing whether there has been a decrease or increase in factors such as unemployment rate and poverty rate. We also analyze how a locality compares to the national and state averages for several of these demographic factors.

Our qualitative analysis incorporates trends from other local government assessments that are performed each year by state entities to meet other monitoring objectives. One assessment includes a locality’s Fiscal Stress Index calculated by the Virginia Commission on Local Government, which focuses on a locality’s revenue capacity and effort. We have also incorporated a review of trends from the Virginia Department of Education’s calculations for the Composite Index and a locality’s Required Local Effort and Required Local Match, which focus on analyzing the local school divisions’ ability to pay education costs that are fundamental to the Commonwealth’s Standards of Quality. The local government analyses performed by the Commission on Local Government and the Virginia Department of Education are described in further detail in the Future Refinements to Early Warning System and Analysis section of our March 2018 Local Government Fiscal Distress Monitoring Report. Lastly, the qualitative analysis incorporates any external, economic, or other qualitative information that comes to our attention, such as through discussion with the locality or other state officials or through our continual review and monitoring of information made public in the news or in governing body meetings. We also include other external and qualitative factors obtained through our analysis.
of other information from a more in depth review of the locality’s annual financial report, such as management’s discussion or the footnote disclosures.

Follow Up Review Process

After completion of both the ratio and qualitative analyses, the Office makes a determination of the need to perform further follow up with a locality. Based on our final analysis, each locality is classified into one of two categories: either identified as needing further follow up through our additional review process, or identified as not needing any further follow up. If a locality is identified in the current year as needing further follow up review, we will follow the same process to notify the local governing body and chief executive officer of our preliminary determination. The locality must then notify our office regarding its decision to allow our additional follow up and review through completion of our financial assessment questionnaire and further discussions with our office. Once we receive a locality’s completed questionnaire, we will schedule a time to meet with representatives from the locality to discuss the information provided. We may also request any pertinent documents or supplemental information to assist in our review.

Localities not identified for further follow up review may also use the questionnaire as a self-assessment tool. A copy of the financial assessment questionnaire is available on our website, located at the Local Government Annual Guidelines, Manuals, and Other Procedural Documents. http://www.apa virginia.gov/data/download/local_government/guidelines/Fiscal Stress Monitoring Follow-Up Questionnaire.xlsx

Our additional follow up process focuses on qualitative factors impacting a locality's situation to gain information related to budget processes, debt, borrowing, expenses and payables, revenues and receivables, staffing, and any other external variables contributing to a locality's financial position, through use of the financial assessment questionnaire and further discussions with locality officials. The financial assessment questionnaire is a key component of our follow up process as it is designed to examine other qualitative and external factors unique to each locality that are not easily measured in a financial ratio, along with gaining an understanding of policy and procedural aspects that may contribute to the locality’s results in our ratio analysis and qualitative analysis. The primary objective of our follow up with each locality identified is to determine whether a locality is experiencing a situation of fiscal distress that warrants further assistance or intervention from the Commonwealth. Upon completion of our follow up with a locality, if a situation of fiscal distress is identified, the Auditor of Public Accounts is required to formally notify, in writing, the Governor, Chairmen of House Appropriations and Senate Finance Committees (Money Committees), and the locality’s governing body, concerning any specific issues identified at the locality that may require further assistance or intervention by the Commonwealth. At that point, the process is administered by the Governor’s office and the Money Committees for further consideration of any plan and action by the Commonwealth to help address the locality’s fiscal distress situation. Additionally, should a locality decline any further follow-up and review from our office as a result of our preliminary determination, we will notify the Governor and chairmen of the money committees accordingly.
Appendix A: Summary of Financial Ratio Analysis

Ratio 1
- Compares unrestricted reserves net of current liabilities to normal revenues – measures the locality's ability to make up revenue shortfalls or utilize unrestricted reserves during an unforeseen situation (Government-wide Activity)

Ratio 2
- Compares unrestricted reserves to total liabilities – measures the locality's ability to pay total liabilities without the need for additional revenue (Government-wide Activity)

Ratio 3
- Compares unrestricted net position to total expenses – measures the locality's ability to fund expenses in event of revenue shortfall or unforeseen situation (Government-wide Activity)

Ratio 4
- Change in net position – measures how the locality's financial position has improved or deteriorated as a result of resource flow (Government-wide Activity)

Ratio 5
- Compares total debt to total tax valuation – measures the locality's total outstanding tax supported debt as a percentage of total tax valuation of real estate and personal property (Government-wide Activity)

Ratio 6
- Compares assigned and unassigned fund balances, plus other available reserve fund balances to total expenditures – measures the locality's ability to fund expenditures from reserves in event of a revenue shortfall or unforeseen situation (General Fund Activity)

Ratio 7
- Compares total fund balance to total revenues – measures the locality's ability to make up revenue shortfalls with reserves (General Fund Activity)

Ratio 8
- Compares total revenues to total expenditures – measures whether annual revenues were sufficient to pay for operations (General Fund Activity)

Ratio 9
- Compares debt service principal and interest to total revenues available – identifies the percent of the locality's budget that is used or needed for repayment of debt (General Fund and Debt Service Fund activity, if applicable)

Ratio 10
- Change in unassigned fund balance – measures whether the locality's general fund unassigned fund balance has increased or declined from the prior year (General Fund Activity)

Ratio 11
- Compares intergovernmental revenues to total operating revenues – measures the locality's reliance on state and federal revenues (General Fund Activity)

Ratio 12
- Compares change in net position (less transfers to and from) to total expenses – measures if the locality's enterprise fund is self-sufficient and recovering the full costs through charges for services or other non-transfer revenues (Proprietary Enterprise Fund Activity)