

**Performance Audit
Financial Condition Indicators**

April 2011

City Auditor's Office

City of Kansas City, Missouri



Office of the City Auditor

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April 20, 2011

Honorable Mayor and Members of the City Council:

This performance audit of financial condition indicators was initiated by the city auditor pursuant to Article II, Section 216 of the city charter. This report is intended to provide elected officials and city management with information related to existing or emerging financial issues and provide context for assessing and discussing the city's financial condition.

We focused on evaluating the city's financial condition using financial data from Comprehensive Annual Financial Reports and analysis of financial indicators, looking at the flow or use of resources during a fiscal year, the stock of resources available at the end of a fiscal year, and ratios related to the city's pension systems and general fund balance. Ratio analysis provides a broad overview of the city's financial condition and no single indicator demonstrates the overall financial condition of the city.

The city's overall financial condition is mixed. The majority of the indicators associated with the flow of resources were favorable and suggest a relatively strong financial condition related to the city's ability to meet current obligations. However, the stock of resources indicators were mostly unfavorable. Three raise concerns of potential financial stress and suggest a relatively weak financial condition associated with the city's ability to meet future or long-term obligations. The financial indicator for the pension systems is favorable, while the general fund indicators are unfavorable and another area of potential financial stress.

The city has debt and fund balance policies in place that should assist efforts to monitor and improve the city's financial condition. Although benchmarks were identified for many indicators (such as liquidity), based on financial literature, professional standards, or recommended practices, they were not identified for other indicators (such as leverage). We recommend the city manager develop benchmarks for evaluating the city's financial condition and measuring progress towards achieving financial goals.

The draft report was sent to the interim city manager on April 5, 2011, for review and comment. His response is appended. We appreciate the courtesy and cooperation of staff in the Finance Department. We also want to acknowledge the assistance and feedback of Professor William Rivenbark, University of North Carolina School of Government. The audit team for this project was Joyce Patton, Jason Phillips, and Douglas Jones.

A handwritten signature in black ink, appearing to read "Gary L. White".

Gary L. White
City Auditor

Financial Condition Indicators

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Financial Condition Indicators

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Introduction

Objectives

We conducted this audit of financial condition indicators under the authority of Article II, Section 216 of the Charter of Kansas City, Missouri, which establishes the Office of the City Auditor and outlines the city auditor's primary duties.

We did this audit because the city is facing a difficult and uncertain economic period, which can have an impact on the city's ability to meet ongoing financial, service, and capital obligations.

The report objective is:

- To provide elected officials and city management with information related to existing or emerging financial issues, provide context for the city's financial condition, and encourage discussion on strengthening the city's financial condition.

Elected officials and city management can use analysis of the city's financial condition as a tool in financial policy decisions, long-range financial planning, and budget development.

A performance audit provides assurance or conclusions based on an evaluation of sufficient, appropriate evidence against stated criteria. Performance audits provide objective analysis so that management and those charged with governance and oversight can use the information to improve program performance and operations, reduce costs, facilitate decision making, and contribute to public accountability.¹

¹ Comptroller General of the United States, *Government Auditing Standards* (Washington, DC: U.S. Government Printing Office, 2007), p. 17.

Scope and Methodology

Our review focused on evaluating the city's financial condition. Our audit methods included:

- Reviewing financial analysis literature to identify ratios or models to evaluate the city's financial condition.
- Reviewing and analyzing financial information from the city's CAFRs from fiscal years 2005 through 2010 to provide trend information on the city's financial condition.
- Developing financial ratio medians from the most recent (2009) CAFRs of 10 comparable cities for comparison with Kansas City's results.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. No information was omitted from this report because it was deemed privileged or confidential.

Background

The Comprehensive Annual Financial Report (CAFR) is a city's official financial statement and contains a wide range of information about a city's finances. It presents financial information on the primary government, which includes governmental activities principally supported by taxes and business-type activities (enterprise funds) that recover a significant portion of their costs through fees and charges. These statements are designed to show an overall economic picture of the government rather than individual funds.²

We used CAFRs as the source of the data for our review of financial condition as the financial data is prepared under generally accepted accounting principles and reviewed by external auditors in accordance with government auditing standards, resulting in information that is

² Gregory S. Allison, "How to Read Governmental Financial Statements, Part 2," *Popular Government*, Fall 2001, pp. 25-27. < <http://www.sog.unc.edu/pubs/electronicversions/pg/pgfal01/article4.pdf> >

considered consistent and reliable. The data for our financial condition analysis is found in the basic financial statements and notes to the financial statements from CAFRs for Kansas City, Missouri, fiscal years 2005 through 2010 and 10 comparable cities for fiscal year 2009. We did not include discretely reported component units³ in our analysis of financial condition, with the exception of the police departments in Kansas City and St. Louis. Because these police departments represent a significant use of each city's resources, our analysis of governmental activities included their financial data.

Financial condition evaluation model. Faculty at the University of North Carolina's School of Government developed a model for evaluating and communicating financial condition to elected officials.⁴

The authors 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.”⁵

This definition was aligned with how a city's CAFR reports on:

- the flow (inflow and outflow) of resources used during the fiscal year to meet the city's current obligations and
- the stock of resources (assets, liabilities, and fund balances) at the end of the fiscal year available to meet the city's obligations over time.

The financial condition evaluation model uses four financial dimensions and corresponding indicator ratios to evaluate the flow of resources used to meet current obligations for both the governmental and business-type activities. Four financial dimensions and indicator ratios also evaluate the stock of resources used to meet longer term obligations. (See Exhibit 1.)

³ A component unit of a government is an organization that is legally separate from the government, but that government has some level of financial accountability for the organization.

⁴ The North Carolina State Treasurer's Office uses this model to provide a web-based dashboard management tool to help county and municipal governments in that state analyze and communicate financial condition.

⁵ William C. Rivenbark, Dale J. Roenigk, and Gregory S. Allison, "Communicating Financial Condition to Elected Officials in Local Government," *Popular Government*, Fall 2009, pp. 4-13.

< <http://www.sog.unc.edu/pubs/electronicversions/pg/pgfal09/article1.pdf> >

Exhibit 1. Financial Condition Evaluation Model Indicators

	Financial Dimension	Financial Indicator
Flow of Resources	Interperiod Equity	Total margin ratio
	Financial Performance	Percent change in net assets
	Self-Sufficiency	Charge to expense ratio
	Financing Obligation	Debt service ratio
Stock of Resources	Liquidity	Quick ratio
	Solvency	Net assets ratio
	Leverage	Debt to assets ratio
	Capital	Capital assets condition ratio

Source: "Communicating Financial Condition to Elected Officials in Local Government," *Popular Government*, Fall 2009.

We also developed financial condition indicators related to the city's pension systems and general fund. (See Exhibit 2.) In total, we used 11 financial indicators to evaluate the city's financial condition. See Appendix A for detailed descriptions of the financial indicators.

Exhibit 2. Additional Financial Condition Indicators

Financial Indicator
Pension payments to pension assets ratio
Unreserved general fund balance as a percent of general fund expenditures
Unreserved general fund balance as a number of operating days

Comparable cities. We developed a list of comparable cities based on population, land area, budget, and geographic location. (See Exhibit 3.)

Exhibit 3. Comparable Cities

City	Estimated 2008 Population	Land Area (square miles)	Total Budget
Milwaukee, WI	604,179	96.1	\$1,443,560,586
Denver, CO	593,086	153.4	1,300,000,000
Minneapolis, MN	381,978	54.9	1,283,257,679
Fort Worth, TX	704,299	292.5	1,282,451,647
Kansas City, MO	480,129	313.5	1,230,443,937
Memphis, TN	676,660	279.3	1,123,332,879
St. Louis, MO	356,730	61.9	937,627,402
Indianapolis, IN	800,730	361.5	909,521,013
Oklahoma City, OK	551,875	607.0	876,645,916
Omaha, NE	448,050	115.7	581,314,144
Tulsa, OK	385,755	182.7	560,039,000

Sources: U.S. Census Bureau and budgets from comparable cities for fiscal year 2010 or 2011.

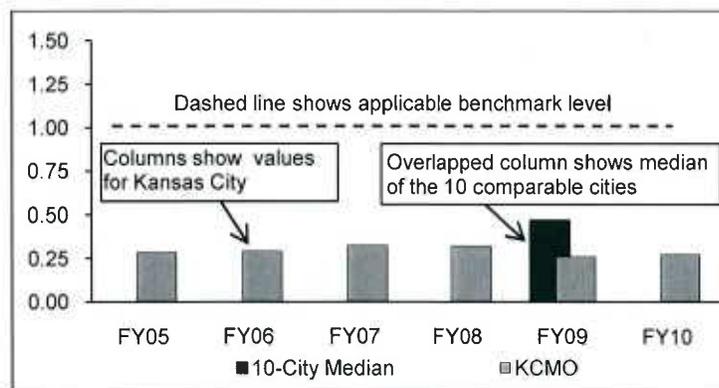
How We Analyzed the Financial Condition Ratios

Our evaluation of the financial indicator ratios considers the trend over time, the indicator ratio for Kansas City compared to the median indicator ratio of 10 other cities, and comparisons to applicable benchmarks. Ratios are useful tools for financial statement analysis because they summarize data in a form that makes it easier to understand, interpret, and compare. Calculating a ratio over time enables analysis of trends. Comparing ratio results to other jurisdictions and identifying benchmarks (standards, results from comparable jurisdictions, policies, etc.) for comparison provide context for analyzing and interpreting the results.

We looked for any trends in Kansas City's ratios from fiscal years 2005 through 2010 and whether the ratio was better or worse in fiscal year 2010 than fiscal year 2005. We also compared Kansas City's fiscal year 2009 ratios to the median of the 10 comparable cities⁶ and compared the results to any applicable benchmarks. The results determined whether a financial indicator was favorable, inconclusive, or unfavorable.

How to Read the Graphs

The financial indicator ratios are presented as graphs throughout the report. Kansas City, Missouri's ratios are shown as columns in each graph. The 10-city median indicator ratio is represented by an overlapped column, and any applicable benchmarks are shown by a dashed line.



⁶ City-to-city comparisons are difficult, due to the variety of programs or services. Instead, our comparisons are based on the median ratio results of the 10 comparable cities. Median were used to minimize the effect of outliers.

Findings and Recommendations

Summary

The city's overall financial condition is mixed, with seven favorable indicator results, nine unfavorable, and three inconclusive. The majority of the indicators associated with the flow of resources were favorable and suggest a relatively strong ability to meet the city's current obligations. However, the stock of resources indicators are mostly unfavorable. Three of these indicators raise concerns of potential financial stress and suggest a relatively weak ability to meet the city's future or long term obligations. (See Exhibit 4.)

Exhibit 4. Results for Financial Condition Evaluation Model Indicators

	Financial Indicator	Description	Governmental Activities Results	Business-Type Activities Results
Flow of Resources	Total margin ratio	Addresses whether the government lived within its financial means during the fiscal year.	Favorable	Favorable
	Percent change in net assets	Addresses extent to which the government's financial position improved or deteriorated as a result of resource flow.	Inconclusive	Favorable
	Charge to expense ratio	Addresses the extent to which service charges covered total expenses.	Favorable	Unfavorable
	Debt service ratio	Addresses service flexibility, or the amount of total expenses committed to annual debt service.	Unfavorable	Favorable
Stock of Resources	Quick ratio	Addresses the government's ability to meet short-term obligations.	Unfavorable	Unfavorable
	Net assets ratio	Addresses the government's ability to meet long-term obligations.	Unfavorable	Unfavorable
	Debt to assets ratio	Addresses the extent to which total assets are financed with long-term debt.	Inconclusive	Inconclusive
	Capital assets condition ratio	Addresses the condition of capital assets as defined by remaining useful life.	Favorable	Unfavorable

The financial indicator for the pension systems is favorable, while the general fund indicators are unfavorable and another area of concern suggesting potential financial stress. (See Exhibit 5.)

Exhibit 5. Results for Additional Financial Condition Indicators

Financial Indicator	Description	Results
Pension payments to pension assets ratio	Measures pension payments in relation to pension assets.	Favorable
Unreserved general fund balance as a percent of general fund expenditures	Measures the size of a government's unreserved general funds available for unexpected expenditures or emergencies.	Unfavorable
Unreserved general fund balance as a number of operating days.	Measures the number of days a government can operate on the unreserved general fund balance.	Unfavorable

Between fiscal years 2005 and 2010, the total margin ratio indicated the city's governmental and business-type activities lived within their financial means. The percent change in net assets showed business-type activities posting positive growth for six consecutive fiscal years. Over the past six fiscal years the charge to expense ratio for governmental activities improved as user fees and service charges covered an increasing percentage of expenditures. The capital assets ratio increased for governmental activities during the period and was significantly higher than the 10-city median, suggesting the city is investing in capital assets.

There are three unfavorable indicators for governmental activities and one unfavorable indicator for the business-type activities exhibiting signs of potential financial stress. The debt service ratio steadily increased (\$71 million to \$140 million) for governmental activities during the period, reducing the amount of flexible resources available to the City Council. The quick ratio decreased for both governmental and business-type activities since 2005 and is below the 10-city median. In addition, the fiscal year 2010 ratio for the business-type activities is below the 1.0 benchmark. The governmental activities net assets ratio experienced a sharp decline from a positive to a negative ratio between fiscal years 2005 and 2010. The city's unreserved general fund balance is unfavorable, has been significantly below the recommended minimum balance for the past six fiscal years, and was also significantly below the 10-city median in fiscal year 2009.

The city has adopted debt and fund balance policies to better monitor and improve some aspects of its financial condition. Both policies identify benchmarks and should assist efforts to monitor and improve the city's financial condition relative to debt service levels and general fund balance. Although many of the financial dimensions (such as liquidity)

used benchmarks based on financial literature, professional standards, or recommended practices, benchmarks were not identified for the financial dimensions of solvency, leverage, capital, and pension benefit payments.

Establishing additional financial benchmarks would improve the city's ability to monitor its financial condition and achievement of financial goals. The interim city manager should develop, for Council consideration, financial benchmarks for the financial dimensions of solvency, leverage, capital, and pension payments that can be used to evaluate the city's financial condition and progress towards achieving financial goals.

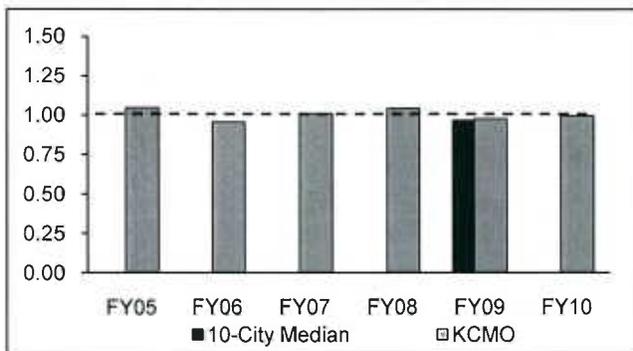
Flow of Resources

Four indicators or ratios evaluate the flow or use of resources associated with the city's ability to meet current obligations. We calculated these indicators for both the governmental and business-type activities of the city. The majority of these indicators were favorable.

Total Margin Ratio

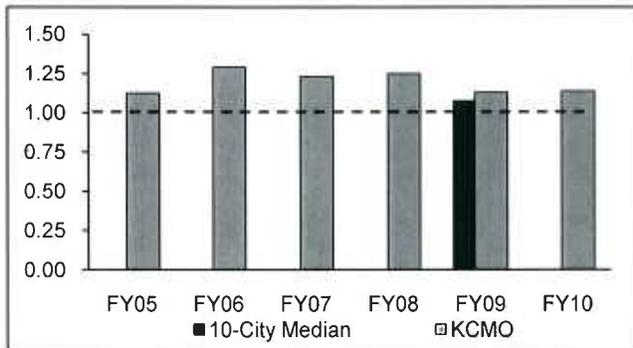
The total margin ratio is used to calculate interperiod equity by measuring the total inflow and outflow of resources. This ratio is used to identify whether or not the entity lived within its financial means. The ratio is calculated as total resource inflow (program revenues plus total general revenues and net transfers) divided by total resource outflow (total expenses). A ratio of one or higher indicates that a government lived within its financial means.

Exhibit 6. Total Margin Ratio – Governmental Activities



Governmental activities. The total margin for the city's governmental activities is more favorable as this ratio has been at or above the 1.0 ratio benchmark four of the last six fiscal years. The fiscal year 2009 level is more favorable (higher) compared to the 10-city median. In general, the city's governmental activities have operated within the city's financial means over the past six fiscal years. This financial indicator is favorable for the city's governmental activities. (See Exhibit 6.)

Exhibit 7. Total Margin Ratio – Business-Type Activities

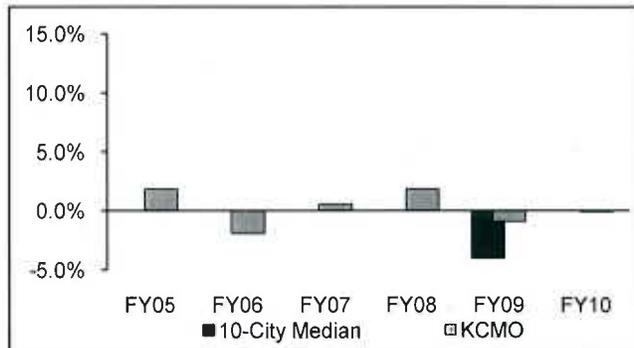


Business-type activities. The total margin trend for the city's business-type activities is more favorable as this ratio has been above the 1.0 ratio benchmark for the last six fiscal years. The fiscal year 2009 level is more favorable (higher) compared to the 10-city median. The city's business-type activities have operated within their financial means for the past six fiscal years. This financial indicator is favorable for the city's business-type activities. (See Exhibit 7.)

Percent Change in Net Assets

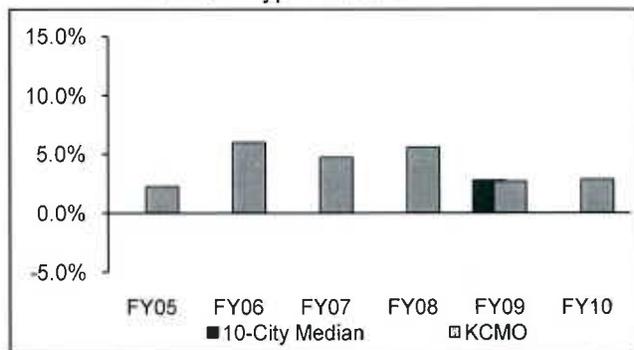
The percent change in net assets is used to evaluate financial performance. This indicator shows how much a government’s financial position has improved or deteriorated during a fiscal year as a result of resource flow. The indicator is calculated as the change in net assets divided by beginning net assets. The benchmark for this indicator is positive change, which indicates that a government’s financial position has improved.

Exhibit 8. Percent Change in Net Assets – Governmental Activities



Governmental activities. The percent change in net assets trend for the city’s governmental activities is inconclusive as there has been positive change in only three of the last six fiscal years and no positive change in the last two fiscal years. The fiscal year 2009 level is more favorable (higher) compared to the 10-city median. This financial indicator is inconclusive for the city’s governmental activities. (See Exhibit 8.)

Exhibit 9. Percent Change in Net Assets – Business-Type Activities

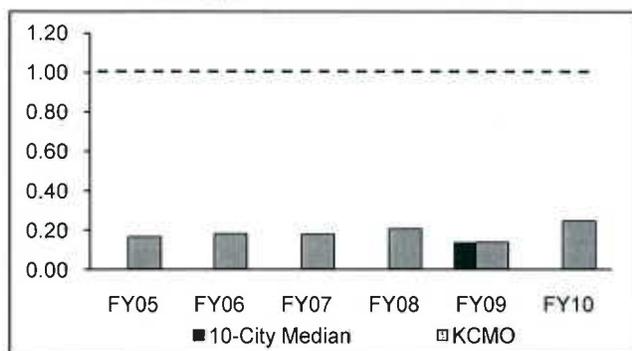


Business-type activities. The percent change in net assets trend for the city’s business-type activities is more favorable as there has been positive change in each of the last six fiscal years even though the fiscal year 2009 level is less favorable (lower) compared to the 10-city median. This financial indicator is favorable for the city’s business-type activities. (See Exhibit 9.)

Charge to Expense Ratio

The charge to expense ratio measures self-sufficiency by analyzing the extent to which fees and charges for services covered total expenditures. This ratio is calculated as charges for services (fees, fines, and charges for services) divided by total expenses. A ratio of 1.0 indicates that an entity or activity is self-supporting. However, while this benchmark may not be applicable for governmental activities, which are primarily funded by taxes and not intended to be self-sufficient, the ratio can show the extent to which user fees and service charges cover expenses related to governmental activities. The benchmark is more relevant to the business-type activities or enterprise funds as the goal is often to cover total expenses through fees and service charges.

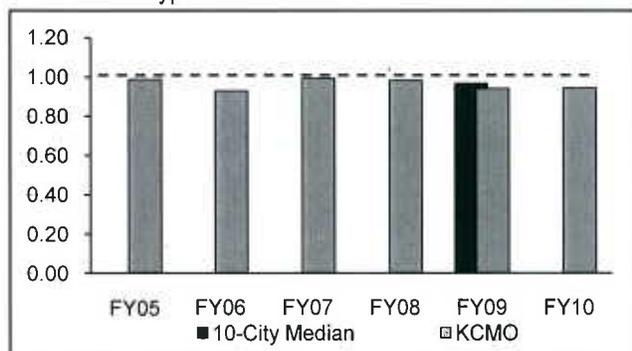
Exhibit 10. Charge to Expense Ratio – Governmental Activities



Governmental activities. The charge to expense trend for the city’s governmental activities is more favorable as this ratio has generally been increasing over the last five fiscal years. Compared to fiscal year 2005, fees and service charges collected in fiscal year 2010 covered a higher percentage of governmental activity expenditures. The fiscal year 2009 level is more favorable (higher) compared to the 10-city median. Although below the 1.0 benchmark,

governmental activities generally do not cover all expenditures with fees or service charges. This financial indicator is favorable for the city’s governmental activities. (See Exhibit 10.)

Exhibit 11. Charge to Expense Ratio – Business-Type Activities



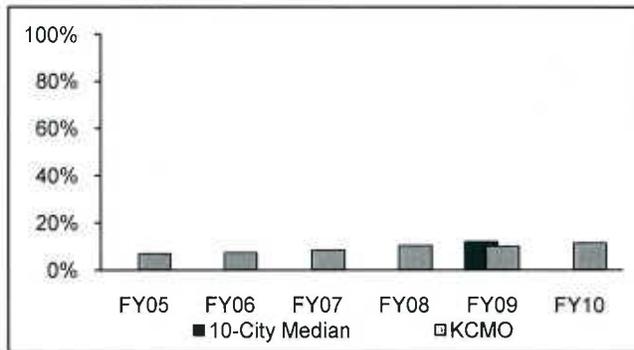
Business-type activities. The charge to expense trend for the city’s business-type activities is less favorable with year-to-year ratio decreases in three of the last five fiscal years and the ratio for fiscal year 2010 lower than fiscal year 2005. The fiscal year 2009 level is also less favorable (lower) compared to the 10-city median. The benchmark comparison is also less favorable as the ratio was below the 1.0 benchmark for all six fiscal years. This financial indicator is

unfavorable for the city’s business-type activities. However, the business-type activities have covered between 93 percent and 99 percent of expenditures over the last six fiscal years and this ratio does not take into account other revenue sources, such as grants or investment earnings that may be used to cover expenditures. (See Exhibit 11.)

Debt Service Ratio

The debt service ratio is used to evaluate financing obligation by analyzing total expenses committed to debt service. This ratio is calculated as debt service (principal and interest payments on long-term debt) divided by total expenses plus principal payments. As this indicator increases, service flexibility decreases as more of the government’s resources are committed to annual debt service. The benchmark for this indicator could be based on a policy decision or a comparison against comparable cities.

Exhibit 12. Debt Service Ratio – Governmental Activities

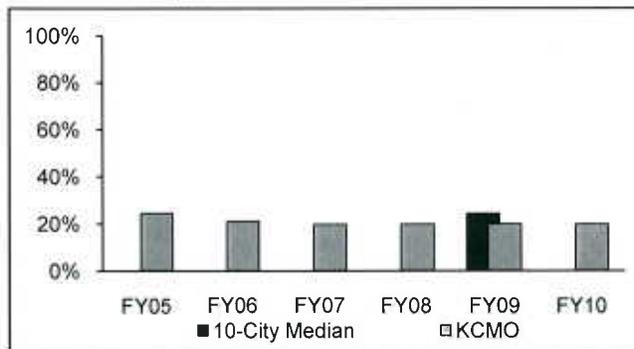


Governmental activities. The debt service trend for the city’s governmental activities is less favorable with year-to-year ratio increases in four of the last five fiscal years. The fiscal year 2009 level is more favorable (lower) compared to the 10-city median. The city’s service flexibility was steadily reduced during the period as more resources (\$71 million to \$140 million) were committed to debt service between fiscal years 2005 and 2010. This financial indicator is unfavorable for the city’s governmental activities

and the increasing resources committed to debt service, which reduce the city’s service flexibility, could be a warning sign of potential financial stress. (See Exhibit 12.)

The city’ debt policy⁷ has a general obligation debt service target range of 5 to 15 percent; calculated as net tax-supported debt service as a percent of net general municipal revenues. This debt service ratio calculation varies from our model as it is based on specified revenues and types of city debt. The evaluation model we used calculates debt service based on total expenditures and total debt service.

Exhibit 13. Debt Service Ratio – Business-Type Activities



Business-type activities. The debt service trend for the city’s business-type activities is more favorable with year-to-year ratio decreases in three of the last five fiscal years and an overall decreased ratio between fiscal years 2005 and 2010. The fiscal year 2009 level is more favorable (lower) compared to the 10-city median. This financial indicator is favorable for the city’s business-type activities as fewer resources, as a percent of total expenditures, are committed to debt service. (See Exhibit 13.)

⁷ Ordinance 070981, November 1, 2007.

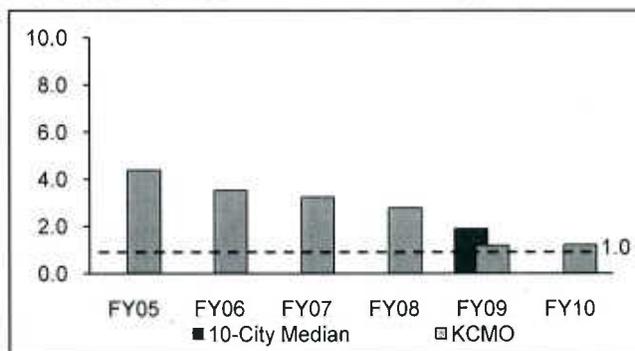
Stock of Resources

Four indicators evaluate the stock or availability of resources associated with the city’s ability to meet future or long term obligations. We calculated these indicators for both the governmental and business-type activities of the city. The majority of these indicators were unfavorable and showed warning signs of potential financial stress.

Quick Ratio

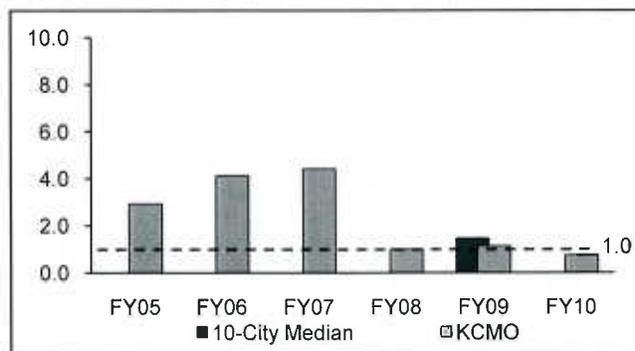
The quick ratio is used to evaluate liquidity by measuring an organization’s ability to meet short-term obligations. The quick ratio is calculated as cash and investments divided by current liabilities (not including deferred revenue). A high ratio suggests that a government is able to meet its short-term obligations. In general, the quick ratio should be 1.0 or higher. A liquidity ratio of less than one, particularly over several years, could be considered a negative factor.

Exhibit 14. Quick Ratio – Governmental Activities



Governmental activities. The quick ratio trend for the city’s governmental activities is less favorable with decreases in four of the last five fiscal years. The fiscal year 2009 level is less favorable (lower) compared to the 10-city median. Although above the 1.0 benchmark all six fiscal years, this financial indicator is unfavorable for the city’s governmental activities because the significant decrease in this ratio between fiscal years 2005 and 2010 could be a warning sign of potential financial stress. (See Exhibit 14.)

Exhibit 15. Quick Ratio – Business-Type Activities



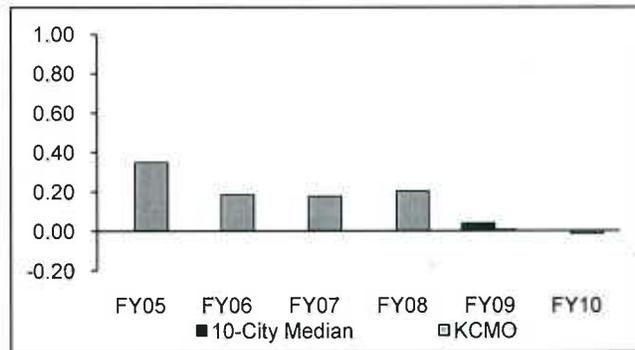
Business-type activities. The quick ratio trend for the city’s business-type activities is less favorable and decreased significantly between fiscal years 2005 and 2010. The fiscal year 2009 level is less favorable (lower) compared to the 10-city median. Although above the 1.0 benchmark five of the last six fiscal years, the fiscal year 2010 ratio was only .75. This financial indicator is unfavorable for the city’s business-type activities and because of the

decrease since 2005 and the fiscal year 2010 ratio below 1.0, this indicator is also showing warning signs of potential financial stress. (See Exhibit 15.)

Net Assets Ratio

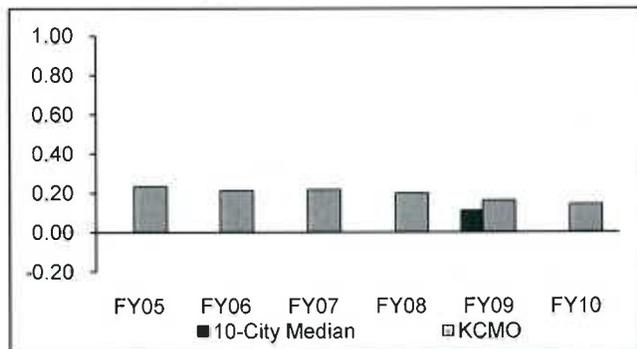
The net assets ratio evaluates solvency by analyzing a government’s ability to address long-term obligations. This ratio is calculated as unrestricted net assets divided by total liabilities. The probability of meeting long-term obligations increases as this ratio increases and a high ratio suggests that a government is able to meet long-term obligations. The benchmark for this indicator could be based on a policy decision or a comparison against comparable cities.

Exhibit 16. Net Assets Ratio – Governmental Activities



Governmental activities. The net assets ratio trend for the city’s governmental activities is less favorable as reflected by decreases in this ratio in three of the last five fiscal years. The fiscal year 2009 level is less favorable (lower) compared to the 10-city median. Because of the large decrease in this ratio between fiscal years 2005 and 2010 and the current negative ratio, this financial indicator is unfavorable for the city’s governmental activities and could be a warning sign of potential financial stress in meeting the city’s long-term obligations. (See Exhibit 16.)

Exhibit 17. Net Assets Ratio – Business-Type Activities



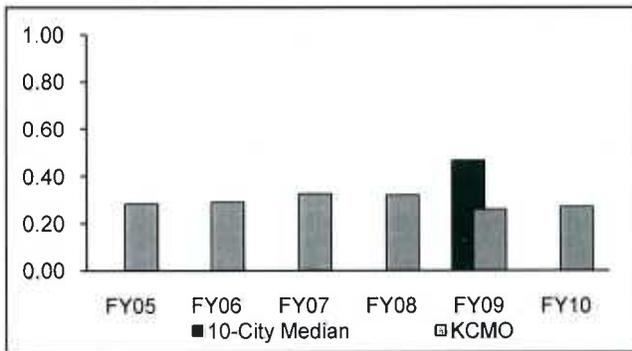
Business-type activities. The net assets ratio trend for the city’s business-type activities is less favorable as reflected by decreases in this ratio in four of the last five fiscal years and a fiscal year 2010 ratio that is lower than fiscal year 2005. The fiscal year 2009 level is more favorable (higher) compared to the 10-city median. This financial indicator is unfavorable for the city’s business-type activities. (See Exhibit 17.)

A benchmark for solvency was not identified. We recommend the interim city manager develop one for council consideration.

Debt to Assets Ratio

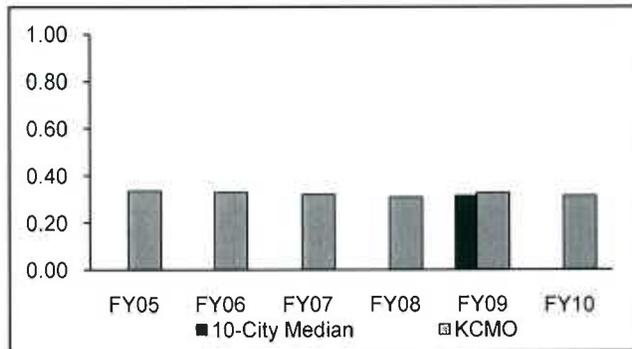
The debt to assets ratio is used to evaluate leverage by measuring the extent to which a government's total assets are financed with long-term debt. The debt to assets ratio is calculated as long-term debt divided by total assets. A high or increasing ratio suggests that a government is overly reliant on debt for financing assets. Overreliance on debt could compromise service flexibility as more resources are needed for debt service obligations and could also have unfavorable implications for bond ratings. The benchmark for this indicator could be based on a policy decision or a comparison against comparable cities.

Exhibit 18. Debt to Assets Ratio – Governmental Activities



Governmental activities. The debt to assets trend for the city's governmental activities is less favorable with year-to-year increases in this ratio in three of the last five fiscal years and only a slight overall decline between fiscal years 2005 and 2010. The fiscal year 2009 level is more favorable (lower) compared to the 10-city median. This financial indicator is inconclusive for the city's governmental activities. (See Exhibit 18.)

Exhibit 19. Debt to Assets Ratio – Business-Type Activities



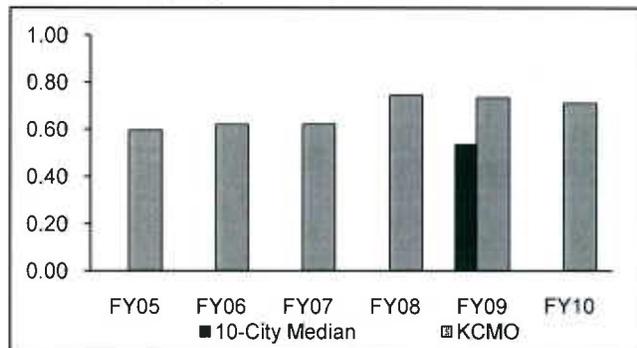
Business-type activities. The debt to assets trend for the city's business-type activities is more favorable, with small year-to-year decreases in four of the last five fiscal years and a small overall decline between fiscal years 2005 and 2010. The fiscal year 2009 level is less favorable (higher) compared to the 10-city median. This financial indicator is inconclusive for the city's business-type activities. (See Exhibit 19.)

A benchmark for leverage was not identified. We recommend the interim city manager develop one for council consideration.

Capital Assets Condition Ratio

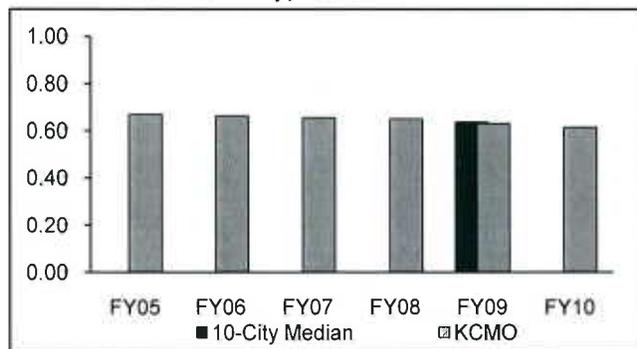
The capital assets condition ratio measures the condition of capital assets by their remaining useful life. This ratio is calculated as one minus the accumulated depreciation divided by capital assets being depreciated. An increasing or high ratio suggests that a government is investing in its capital assets. The benchmark for this indicator could be based on a policy decision or a comparison against comparable cities.

Exhibit 20. Capital Assets Condition Ratio – Governmental Activities



Governmental activities. The capital assets condition trend for the city's governmental activities is more favorable. Although year-to-year changes have been mixed, there was an overall increase in this ratio between fiscal years 2005 and 2010. The fiscal year 2009 level is more favorable (higher) compared to the 10-city median. This financial indicator is favorable and suggests the city is investing in capital assets. (See Exhibit 20.)

Exhibit 21. Capital Assets Condition Ratio – Business-Type Activities



Business-type activities. The capital assets condition trend for the city's business-type activities is less favorable with small year-to-year decreases in four of the last five fiscal years and an overall decrease in this ratio between fiscal years 2005 and 2010. The fiscal year 2009 level is less favorable (lower) compared to the 10-city median. This financial indicator is unfavorable for the city's business-type activities and could indicate aging assets or slowing investment in capital assets. (See Exhibit 21.)

A benchmark for capital was not identified. We recommend the interim city manager develop one for council consideration.

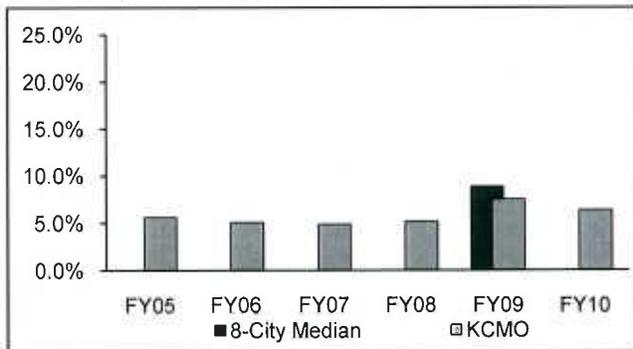
Additional Financial Indicators

The interim city manager and the finance director expressed interest in ratios not included in our model that evaluated the city’s pension systems and general fund balance. The city’s pension systems represent a significant use of city resources and the unreserved general fund balance provides resources for unforeseen emergencies and can affect the city’s credit rating. The financial indicator for the pension systems is favorable. The general fund indicators are unfavorable and show signs of potential financial stress.

Annual Pension Benefits and Assets

The city’s pension systems (Employees, Fire Fighters, Police Officers, and Police Civilian Employees) assets are primarily held as cash or investments. The financial indicator used to evaluate the pension systems is pension benefits as a percent of pension assets. The ratio is calculated by dividing pension plan benefit payments by pension plan assets. Changes in plan benefits and investment market results can contribute to changes in this ratio. An increase in the ratio of plan benefits to pension assets could be a warning of potential financial stress.

Exhibit 22. Pension Benefits to Pension Assets Ratio



The trend for the pension systems is more favorable with year-to-year ratio decreases in three of the last five fiscal years and only a small overall increase between fiscal years 2005 and 2010. The fiscal year 2009 level is more favorable (lower) compared to the 8-city median.⁸ This financial indicator is favorable for the city. (See Exhibit 22.)

A benchmark for pension benefit payments was not identified. We recommend the interim city manager develop one for council consideration.

Unreserved General Fund Balance

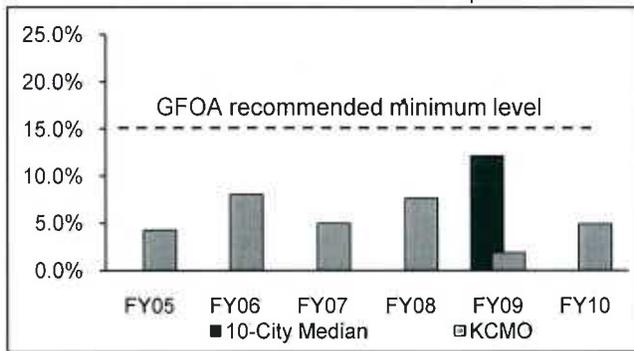
A government’s financial health is in part determined by the levels of fund balances maintained. The size of the unreserved general fund balance can affect the government’s ability to withstand financial emergencies, accumulate funds for capital purchases without borrowing, and obtain favorable credit ratings. The two financial indicators we used

⁸ Only eight cities included the pension data we used to calculate this ratio in their CAFRs.

to evaluate unreserved general fund balance measure the level or size of a government’s reserves by comparing the unreserved general fund balance to general fund expenditures and calculating the number of operating days. A low or declining fund balance can be a warning of potential financial stress.

The first indicator divides the unreserved general fund balance by total general fund expenditures plus transfers out. The Government Finance Officers Association (GFOA) recommended an unreserved general fund balance of 15 percent of general fund revenues or expenditures.⁹

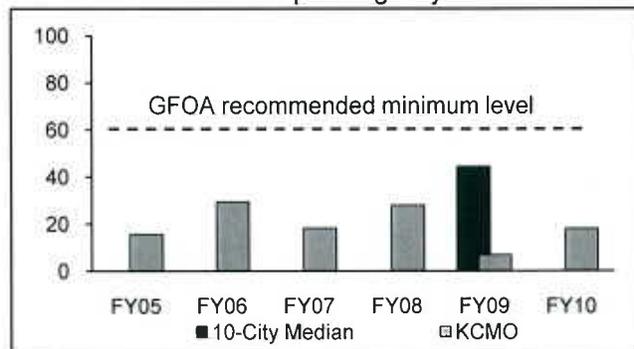
Exhibit 23. Unreserved General Fund Balance as a Percent of General Fund Expenditures



The trend for the unreserved general fund balance is less favorable because the level was well below GFOA’s recommended level of 15 percent all six fiscal years. The fiscal year 2009 level is also less favorable (lower) compared to the 10-city median. This financial indicator is unfavorable for the city and could be a warning sign of potential financial stress because the low balance may not be adequate for the city’s needs in an emergency or continued economic downturn. (See Exhibit 23.)

The second financial indicator divides total general fund expenditures plus transfers out by 365 days to calculate daily general fund expenditures and then the unreserved general fund balance is divided by daily general fund expenditures. GFOA recommends an unreserved general fund balance of no less than two months of operating revenues or expenditures.⁸

Exhibit 24. Unreserved General Fund Balance as a Number of Operating Days



The trend for operating days is less favorable because the number of days of available general fund balance was far below the recommended level. This fiscal year 2009 level is also less favorable (lower) compared to the 10-city median. At the end of fiscal year 2010, Kansas City only had 18 days of general fund expenditures. This financial indicator is unfavorable and an additional area of concern. (See Exhibit 24.)

⁹ Recommended Practice: Appropriate Level of Unreserved Fund Balance in the General Fund, Government Finance Officers Association, February 2002, and Stephen Gauthier, “GFOA Updates Best Practice on Fund Balance,” *Government Finance Review*, December 1, 2009.

In October 2009, GFOA revised its general fund balance best practice by recommending "...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."¹⁰

The revised best practice incorporates accounting standards¹¹ that will be in effect for fiscal year 2012 and rather than focusing on *unreserved* fund balance now focuses on *unrestricted* fund balance which is defined as the sum of the committed fund balance, assigned fund balance, and unassigned fund balance. The city's fund balance policy¹² incorporates the upcoming accounting change and GFOA's revised best practice for fund balance.

Recommendation

1. The interim city manager should develop, for council consideration, financial benchmarks related to solvency, leverage, capital, and pension benefit payments that can be used to evaluate the city's financial condition and progress towards achieving financial goals.

¹⁰ *Best Practice: Appropriate Level of Unrestricted Fund Balance in the General Fund*, Government Finance Officers Association, October 2009.

¹¹ Governmental Accounting Standards Board (GASB) Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. This standard is effective for financial statements for periods ended June 30, 2011 or later.

¹² Ordinance 110183, March 31, 2011.

Appendix A

Financial Condition Indicators

Financial Condition Indicators

The following tables provide a detailed description of the financial indicators we used to analyze the city's financial condition, how we calculated the ratios, and the source of the financial data used.

Financial Condition Indicators from the Evaluation Model¹³

Financial Dimension	Interperiod Equity (<i>flow of resources</i>)
Financial Indicator	Total margin ratio
Description	Addresses whether government lived within its financial means during the fiscal year.
Interpretation	Ratio of 1.0 or higher indicates that government lived within its financial means.
Calculation and Data Source	Total resource inflow (program revenues plus total general revenues and net transfers) divided by total resource outflow (total expenses)
Governmental Activities	$\frac{\text{Program Revenues} + \text{Total General Revenues} + \text{Net Transfers}}{\text{Total Expenses}}$
	Data Source: Statement of activities
Business-Type Activities	$\frac{\text{Operating Revenues} + \text{Nonoperating Revenues} + \text{Transfers In}}{\text{Operating Expenses} + \text{Nonoperating Expenses} + \text{Transfers Out}}$
	Data Source: Statement of revenues, expenses, and changes in net assets
Financial Dimension	Financial Performance (<i>flow of resources</i>)
Financial Indicator	Percent change in net assets
Description	Addresses extent to which government's financial position improved or deteriorated as result of resource flow.
Interpretation	Positive percentage change indicates that government's financial position improved.
Calculation	Change in net assets divided by net assets, beginning
Governmental Activities	$\frac{\text{Change in Net Assets}}{\text{Beginning Net Assets}}$
	Data Source: Statement of activities
Business-Type Activities	$\frac{\text{Change in Net Assets}}{\text{Beginning Net Assets}}$
	Data Source: Statement of revenues, expenses, and changes in net assets

¹³ William C. Rivenbark, Dale J. Roenigk, and Gregory S. Allison, "Communicating Financial Condition to Elected Officials in Local Government," *Popular Government*, Fall 2009, pp.4-13.

Financial Dimension	Self-Sufficiency (<i>flow of resources</i>)
Financial Indicator	Charge to expense ratio
Description	Addresses extent to which service charges covered total expenses.
Interpretation	Ratio of 1.0 or higher indicates that service is self-supporting.
Calculation	Charges for services (fees, fines, and charges for services) divided by total expenses
Governmental Activities	$\frac{\text{Charges for Services (fees, fines, and charges for services)}}{\text{Total Expenses}}$
	Data Source: Statement of activities
Business-Type Activities	$\frac{\text{Charges for Services}}{\text{Operating + Nonoperating Expenses}}$
	Data Source: Statement of revenues, expenses, and changes in net assets
Financial Dimension	Financing Obligation (<i>flow of resources</i>)
Financial Indicator	Debt service ratio
Description	Addresses service flexibility, or amount of total expenses committed to annual debt service.
Interpretation	Service flexibility decreases as more resources are committed to annual debt service.
Calculation	Debt service (principal and interest payments on long-term debt) divided by total expenses plus principal payments
Governmental Activities	$\frac{\text{Debt Service (Long-Term Debt Principal + Interest Payments)}}{\text{Total Expenses + Principal Payments}}$
	Data Source: Statement of activities; statement of revenues, expenditures, and changes in fund balances
Business-Type Activities	$\frac{\text{Debt Service (Long-Term Debt Principal + Interest Payments)}}{\text{Operating Expenses + Nonoperating Expenses + Principal}}$
	Data Source: Statement of revenues, expenses, and changes in net assets - proprietary funds; statement of cash flows - proprietary funds; and notes to financial statements
Financial Dimension	Liquidity (<i>stock of resources</i>)
Financial Indicator	Quick ratio
Description	Addresses government's ability to meet short-term obligations.
Interpretation	High ratio suggests that government is able to meet short-term obligations. Financial literature suggests a ratio of 1.0 to 1.0 (\$1 in assets for every \$1 of liabilities). A ratio of less than 1.0 is considered a negative factor.
Calculation	Cash and investments divided by current liabilities (excluding deferred revenue)
Governmental Activities	$\frac{\text{Cash + Investments}}{\text{Current Liabilities (excl. Deferred Revenue)}}$
	Data Source: Statement of net assets
Business-Type Activities	$\frac{\text{Cash + Investments}}{\text{Current Liabilities (excl. Deferred Revenue)}}$
	Data Source: Statement of net assets—proprietary funds

Financial Dimension	Solvency (<i>stock of resources</i>)
Financial Indicator	Net assets ratio
Description	Addresses government's ability to meet long-term obligations.
Interpretation	High ratio suggests that government is able to meet long-term obligations.
Calculation	Unrestricted net assets divided by total liabilities
Governmental Activities	$\frac{\text{Unrestricted Net Assets}}{\text{Total Liabilities}}$
	Data Source: Statement of net assets
Business-Type Activities	$\frac{\text{Unrestricted Net Assets}}{\text{Total Liabilities}}$
	Data Source: Statement of net assets-proprietary funds
Financial Dimension	Leverage (<i>stock of resources</i>)
Financial Indicator	Debt to assets ratio
Description	Addresses extent to which total assets are financed with long-term debt.
Interpretation	High ratio suggests that government is overly reliant on debt for financing assets.
Calculation	Long-term debt divided by total assets
Governmental Activities	$\frac{\text{Long-term Debt}}{\text{Total Assets}}$
	Data Source: Statement of net assets
Business-Type Activities	$\frac{\text{Long-term Debt}}{\text{Total Assets}}$
	Data Source: Statement of net assets-proprietary funds
Financial Dimension	Capital (<i>stock of resources</i>)
Financial Indicator	Capital assets condition ratio
Description	Addresses condition of capital assets as defined by remaining useful life.
Interpretation	High ratio suggests that government is investing in capital assets.
Calculation	1 - (accumulated depreciation divided by capital assets being depreciated)
Governmental Activities	$1 - \left(\frac{\text{Accumulated Depreciation}}{\text{Capital Assets being Depreciated}} \right)$
	Data Source: Notes to financial statements
Business-Type Activities	$1 - \left(\frac{\text{Accumulated Depreciation}}{\text{Capital Assets being Depreciated}} \right)$
	Data Source: Notes to financial statements

Additional Financial Condition Indicators

Financial Indicator	Pension Payments to Pension Assets Ratio
Description	Measures pension payments in relation to pension assets.
Interpretation	An increasing percentage of pension payments to assets could be a warning sign of financial stress.
Calculation	<p>Pension plan benefit payments divided by pension plan assets.</p> $\frac{\text{Pension Benefits}}{\text{Pension Plan Assets}}$ <p>Data Source: Combining statement of changes in pension trust net assets (Employees', Firefighters', Police Officers', and Police Civilians' pension systems)</p>
Financial Indicator	Unreserved General Fund Balance as Percent of General Fund Expenditures
Description	Measures the size of a government's unreserved general fund balance available for unexpected expenditures or emergencies.
Interpretation	Low or declining unreserved general fund balance as a percentage of general fund operating expenditures could be a warning sign of potential financial stress. Recommended practice is a minimum level of 15 percent of operating revenue or expenditures. ¹⁴
Calculation	<p>Unreserved general fund balance divided by total general fund expenditures plus transfers out.</p> $\frac{\text{Unreserved General Fund Balance}}{\text{Total General Fund Expenditures} + \text{Transfers Out}}$ <p>Data Source: Governmental funds balance sheet and governmental funds statement of revenues, expenditures and changes in fund balances</p>
Financial Indicator	Unreserved General Fund Balance as a Number of Operating Days
Description	Measures the number of days a government can operate on the unreserved general fund balance.
Interpretation	Low or declining number of operating days of unreserved general fund balance could be a warning sign of potential financial stress. Recommended practice is a minimum level of two months of operating revenue or expenditures. ¹⁴
Calculation	<p>Unreserved general fund balance divided by total general fund expenditures plus transfers out divided by 365 days.</p> $\frac{\text{Unreserved General Fund Balance}}{(\text{Total General Fund Expenditures} + \text{Transfers Out})/365 \text{ Days}}$ <p>Data Source: Governmental funds balance sheet and governmental funds statement of revenues, expenditures and changes in fund balances</p>

¹⁴ *Recommended Practice: Appropriate Level of Unreserved Fund Balance in the General Fund*, Government Finance Officers Association, February 2002, and Stephen Gauthier, "GFOA Updates Best Practice on Fund Balance," *Government Finance Review*, December 1, 2009.

Appendix B

Interim City Manager's Response

**Office of the City Manager****RECEIVED**

APR 11 2011

CITY AUDITOR'S OFFICE

DATE: April 11, 2011
TO: Gary L. White, City Auditor
FROM: Troy M. Schulte, Interim City Manager
SUBJECT: Draft Report on Financial Condition Indicators

Agreed. The Finance Director and I have discussed the development, analysis and practical use of financial indicators within the context of long-term financial planning and the annual budget process. I, of course, concur with the recommendation to develop financial benchmarks related to solvency, leverage, capital and pension benefit payments to monitor and evaluate the city's financial condition and track progress towards achieving the city's financial goals.

In support of the City Auditor's report, I believe it both breathes life into the City's comprehensive annual financial report (CAFR) and adds yet another set of tools to help strengthen the City's financial condition joining adopted financial policies, long-term financial planning goals, etc. Going forward, I believe the City should develop and routinely review its own unique financial management indicators, which may include those cited in the audit or other relevant measures. Identifying the most appropriate set of financial indicators for the city will require additional analytical review (including any major accounting changes).

cc: Randall J. Landes, Director of Finance
Eric Clevenger, City Controller