

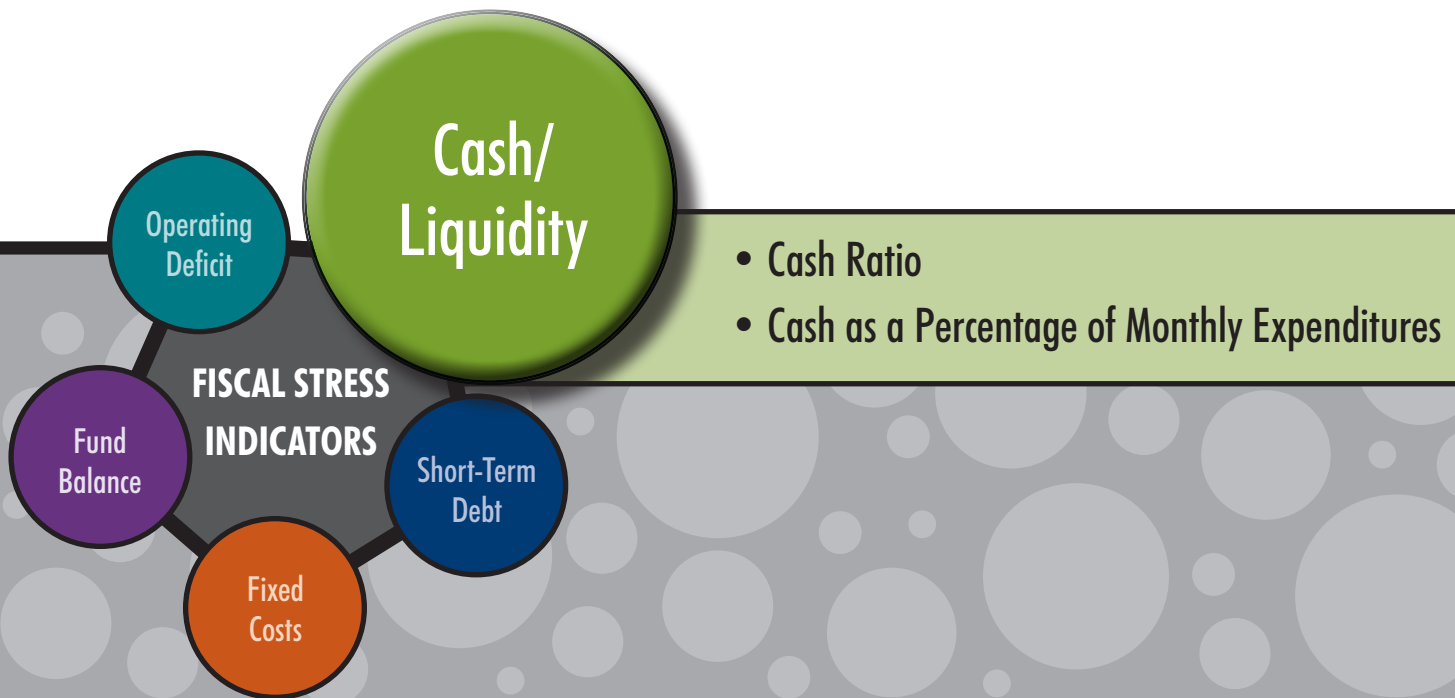


Fiscal Stress Close-Up

Cash/Liquidity

Just as taxpayers must ensure they have enough funds in the bank to pay their bills, local officials must manage municipal finances to ensure that they have the necessary cash to pay their local government's bills as they come due.¹ If at any point in the fiscal year, there is not enough cash in the government's coffers to pay for expected expenses, there is the potential that the local government will be unable to pay an important bill, such as payroll or debt service. A local government in this situation is described as having "low liquidity," a "poor cash position" or "weak cash flow."

By any name, weak cash flow is often a strong indicator that a local government is experiencing some level of fiscal stress, even if that low cash level has not yet impacted the government's ability to pay for current expenses. To illustrate, consider an individual with a steady paycheck (positive cash flow) and some savings. That person will be able to pay bills between paychecks, set aside resources for upcoming expenses, and cope with unexpected events better than someone without a dependable cash flow or no cash savings. In the same way, a local government with reliable income streams, along with cash and liquid assets (known as the available, unexpended, or surplus fund balance) on hand to fall back on, is unlikely to experience a cash crunch.



The Fiscal Stress Monitoring System (FSMS) developed by the Office of the State Comptroller (OSC) measures the concept of liquidity using two indicators that consider end-of-year cash levels. The FSMS calculates both cash and short-term investments as a percentage of current liabilities (bills due), a measure known as the “cash ratio”, and as a percentage of average monthly expenditures (i.e., the share of a typical month’s expenditures that cash and liquid investments on hand could cover). Points are assigned based on the resulting percentage for each indicator. The lower the ratio of cash and investments to either current liabilities or monthly expenditures, the worse the locality’s liquidity or cash position would be and therefore the higher the number of points that would be assigned for the indicator.

Although all local government officials are encouraged to monitor their budgets closely on a monthly basis and create cash flow plans, it is particularly important that municipalities at risk for cash flow difficulties do so. Whenever possible, these local governments should also implement longer term budget plans or strategies that can help lower the risk of cash flow problems.²

Fiscal Stress Monitoring System (FSMS): What Does It Measure?

“Fiscal stress” refers to the difficulties in generating enough revenues to meet expenditures in the long term. OSC’s FSMS measures a local government’s ability to balance its budget, pay its bills, keep its debt in check and have some funds left over at the end of the fiscal year. It does not measure the quality or quantity of services provided, their cost-efficiency or how hard local officials have worked to achieve this balance given the local economic climate.

FSMS has five categories of indicators: fund balance, liquidity, short-term debt, operating deficits, and fixed costs. These indicators contribute to a local government’s final classification of Significant Stress, Moderate Stress, Susceptible to Stress or No Designation. More information on the scoring system for each of the indicators can be found in OSC’s “Fiscal Stress Monitoring System” report.

This report, which focuses on the liquidity indicators, is one of a series examining each of the five FSMS indicator categories. These reports will discuss the circumstances under which a high score in any category is cause for concern.

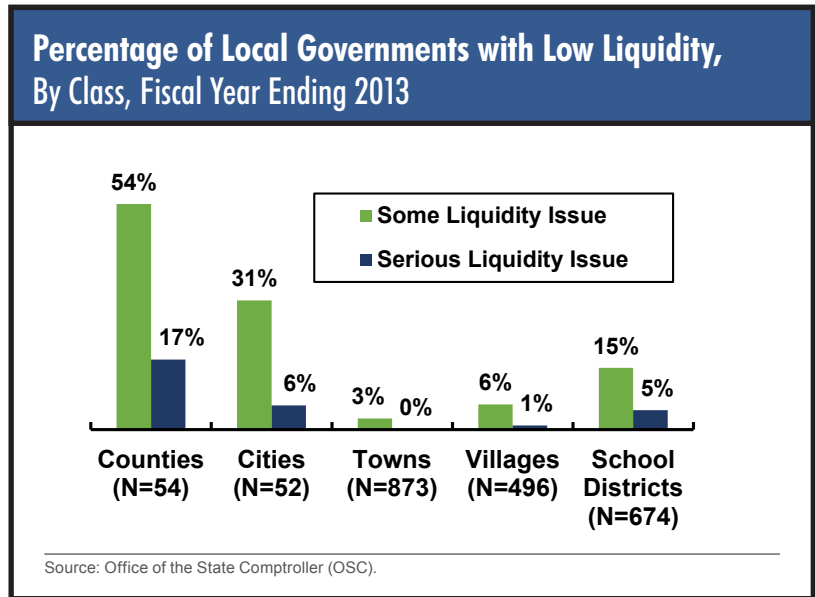
How common are cash flow problems?

Certain classes of government face unique cash flow challenges due to the nature of their revenue and expenditure streams. For example, counties share the costs of many social services programs with the federal and State governments. In most cases, counties are reimbursed for the costs of these programs after the services are provided. Delays in claim submissions on the part of counties or in providing reimbursement on the part of State and federal governments can contribute to a county's cash flow challenges.

This may help explain why a majority (54 percent) of counties showed evidence of cash flow problems based on their FSMS scores for the fiscal year ending in 2013 (i.e., they scored at least one point out of six on either one of the two cash indicators). And although fewer than one in five counties (17 percent) appeared to be facing serious cash flow challenges (by scoring four or more points out of six possible on the cash indicators), this share was still well above that of other classes of local government.

Counties also tend to have lower cash ratios and cash as a percentage of expenditures than other types of local government. The median cash ratio for all counties was just 122 percent—slightly above the FSMS threshold of 100 percent (which indicates some concern about liquidity). More than one-third (20 out of 54 counties scored) had a cash ratio under 100 percent. Generally, a cash ratio of 100 percent ensures that the cash and current assets on hand cover at least the amount of a government's short term obligations. However, a ratio greater than 100 percent provides additional cushion against unforeseeable incidents that may arise in the short term.

Cities, according to the most recent FSMS scores, were also somewhat more likely than other classes of local government to experience cash flow challenges: 31 percent received at least one fiscal stress point (of six possible) on the cash indicators, but only 6 percent received four or more points, suggesting that many cities had some cash issues, but just a few were facing very severe cash problems. The median city measures for cash ratio and cash as a percentage of monthly expenditures of 225 and 221 percent, respectively, were not as low as county measures in this category, but were still only half as high as the medians for other types of municipal government.



School districts, while half as likely as cities to have any FSMS points for the indicators of cash flow problems (15 percent), were almost as likely as cities (5 percent) to have four or more points, and their median liquidity measures of 254 percent for cash ratio and 229 percent for cash as a percentage of monthly expenditures are similar to cities. Some school districts might be vulnerable to cash flow problems because of the statutory limit on excessive fund balance, while others may be very dependent on State aid, which is sometimes subject to delays. Additionally, because of the distribution method, schools on Long Island can be subject to timing delays in the receipt of property taxes. However, many of these timing problems are known in advance, and many districts forestall cash flow problems with strong budget monitoring and short-term borrowing where necessary. Although short-term borrowing can be associated with distinctive issues related to fiscal stress, it can – when implemented in a planned manner – at least mitigate cash flow issues.

Towns and villages tend to have the fewest signs of cash flow difficulties, with only 3 percent of towns and 6 percent of villages getting any points for the liquidity indicators in the FSMS, and median cash ratios of 473 percent and 551 percent, respectively. Very few villages show signs of extreme cash flow issues, with just one percent of villages getting four or more points (of six possible).

In general, however, local governments designated as “fiscally stressed” – regardless of class – exhibit cash flow difficulty. Fiscally stressed local governments had median cash ratios ranging from 48 percent in counties to 87 percent in schools, with stressed towns and villages having medians of 65 and 50 percent, respectively – all well below the minimum of 100 percent.

Liquidity Indicators: Performance by Type of Local Government and Fiscal Stress Status for the Fiscal Year Ending in 2013

Class	Number of Local Governments Scored	Median Cash Ratio	Median Year-End Cash as a Percentage of Monthly Expenditures
Counties	54	122%	157%
In Fiscal Stress	10	48%	79%
No Designation	44	150%	175%
Cities	52	225%	221%
In Fiscal Stress	7	70%	89%
No Designation	45	259%	246%
Towns	873	473%	520%
In Fiscal Stress	17	65%	77%
No Designation	856	514%	525%
Villages	496	551%	458%
In Fiscal Stress	16	50%	75%
No Designation	480	569%	465%
School Districts	674	254%	229%
In Fiscal Stress	87	87%	89%
No Designation	587	286%	249%
Total	2,149		
In Fiscal Stress	137		
No Designation	2,012		

Source: OSC. "In Fiscal Stress" includes all three levels of fiscal stress: significant, moderate and susceptible.

Why is weak cash flow considered a symptom of fiscal stress?

A cash crunch can be the first obvious sign of a significant fiscal problem, especially for local governments without formal cash management policies and effective budget monitoring. An immediate inability to pay expenses without borrowing or delaying payment of other bills is sometimes the event that raises a red flag for local government officials, who may have been unaware of the depth of fiscal difficulties they faced until then.

Cash flow problems usually arise only after a number of other decisions or events have made the local government susceptible to them. In this sense, it is a lagging indicator of fiscal stress. For example, local governments with ample available fund balance will typically not encounter cash flow difficulties because they can draw on such funds, much in the way that an individual with money in the bank can use those funds to pay for unanticipated expenditures or to cover a bill that needs to be paid before the next paycheck arrives. However, when local governments deplete their available fund balance—in some cases by using it over several years to fund recurring costs—it can no longer rely on that cushion to forestall cash flow difficulties. School districts tend to have less available fund balance (also known as unexpended surplus) than other types of local government because the New York State Real Property Tax Law limits the amount of unexpended surplus funds that may be retained to no more than 4 percent of the amount of the budget for the upcoming school year. However, schools (and other local governments) can use legally restricted reserves to accumulate funding for special purchases or to pay certain anticipated expenses.

Operating deficits are another precursor to cash flow problems. A current-year operating deficit can arise if revenues (such as sales tax receipts) come in below projections, or if a natural disaster leads to unanticipated expenditures. Monitoring the budget is critical to identifying deficits in time to take corrective action before they become critical cash flow issues.

Audit Findings: Municipalities³

A 2014 OSC audit of a city found that inaccurate records and misstated account balances prevented city officials from recognizing and responding to the city's fiscal crisis until it had a substantial cash flow deficiency. The city issued short-term debt (a revenue anticipation note (RAN)) for over \$2 million. Subsequently, the State enacted legislation authorizing the city to issue over \$5 million in deficit financing to address accumulated deficits from previous fiscal years.

A 2013 OSC audit of a village found that the village board did not adequately monitor the financial condition of the water and sewer funds. Without adequate financial reports, the board was not able to ensure that enough cash was available to fund expenditures as they came due. The village used inter-fund advances to support the water and sewer funds; however, these funds did not have the resources to repay the loans without affecting their operations.

A 2012 OSC audit of a town found that unplanned operating deficits in some funds led to cash flow problems that were addressed by inter-fund advances—mostly from the water fund — to pay for recurring expenditures.

A 2011 OSC audit found that poor recordkeeping and financial reporting left the board of the village unable to adopt realistic budgets or monitor revenues and expenditures. As a result, combined fund balances in the general, water and sewer funds fell by 62 percent over five years, causing cash flow problems. These led in turn to the overuse of inter-fund advances to maintain services.

The timing of revenues and expenditures can also lead to cash flow difficulties. Local officials can manage most known timing issues by conducting cash flow analyses and planning for known cash flow problems. Unanticipated timing issues, however, can pose a significant challenge to local officials' ability to manage their cash flow. Delays in intergovernmental funding – whether from the State or between local governments (such as property tax remittances from towns to counties or sales tax distributions from counties to towns) – can be a common source of such timing issues. If delays in receipts are brief or the shortfall amounts are relatively small, good cash management and budget practices (i.e., having some fund balance, flexibility in timing expenditures, or other means of cushioning the impact) will typically enable a local government to see a cash crunch coming and avoid it. But if the delay is long or the amounts are large, even good planning may not be enough to enable a local government to avoid a cash crunch and its consequences. Cash flow borrowing is one of the most commonly used mechanisms to address this situation. This is when local officials issue short-term debt to meet current obligations. This practice can itself contribute to fiscal stress because it results in additional costs to issue and service the debt. If the cash crunch persists, and the entity is at risk of failing to make important payments, it may have to seek authorization for deficit financing, which can result in credit downgrades, increased interest costs and cost containment measures that can affect service delivery or other core government functions.

Audit Findings: School Districts

A 2009 OSC audit of a school district found that the school board did not effectively monitor district finances nor did it adopt realistic budgets. A cash flow analysis by OSC found that the district's general fund had not been cash solvent for years. In 2008, the district had accumulated a general fund deficit of over \$3 million—12 percent of the general fund budget for that year. To manage the deficit, district officials issued over \$3 million in deficit financing bonds (a move that required State legislation).

A 2014 OSC audit of another school district found that although the district had adopted realistic budgets, it relied heavily on appropriated fund balance for two consecutive years. As a result of the associated planned operating deficits, by the end of the 2011-12 fiscal year, the district had no more available fund balance, and turned to borrowing to meet short-term cash flow needs, incurring about \$150,000 for interest costs in the next fiscal year. The district's cash flow was further harmed by cash flow difficulties in the city where it is located. Beginning in 2011-12, the city no longer paid the district its entire property tax levy (including unpaid taxes) by the end of the year, but only collections to date. The district issued a tax anticipation note (TAN) for more than \$1 million to cover this shortage.

Is having a weak cash flow ever justifiable?

Unlike some other indicators, a weak cash flow almost always indicates some level of fiscal stress. However, the lack of adverse cash flow indicators does not necessarily indicate fiscal health.

Cash flow indicators are based on a single “snapshot” of cash position at the end of a local government’s fiscal year. As such, they do not measure cash flow on a monthly or quarterly basis. In some cases, the timing of revenue inflows and expenditure outflows can create a liquidity problem only in a particular month of the year. If that happens to be at the end of the fiscal year in one local government, its fiscal condition can look particularly bad by this measure, and conversely, a local government which tends to receive revenue toward the end of its fiscal year may look healthier by this measure than its cash position at another time of year would indicate.

Also, unlike some other FSMS indicators, the two cash flow indicators do not take into account trends. They measure only the most recent year’s performance and therefore do not show deterioration or improvement in a local government’s ability to pay its bills. The best use, therefore, of these static liquidity measures is either through comparison to other similar governments for one period or through analysis over a period of time. The analysis above provides a benchmark by class of local government, while the OSC Fiscal Stress Monitoring System website provides an individualized analysis by local government entity.⁴ The self-assessment tool there uses smaller, more focused comparison groups and multiyear data where available.

No single indicator, on its own, can provide a perfect measure of a local government’s fiscal health or stress. However, by combining cash flow measures with other FSMS indicators that examine fund balance, use of short-term debt, operating deficits and fixed costs, the FSMS represents a powerful tool for assessing fiscal condition.

Notes

- ¹ “Local governments,” as used in this report refers to counties, cities, towns, villages and school districts, and excludes New York City.
- ² OSC has a number of resources to help local officials manage cash flow. A set of training modules on cash management are available at:
<http://www.osc.state.ny.us/localgov/training/modules/cashmgmt/index.htm>.
See also, “Trouble Ahead: Managing Your Budget in Times of Fiscal Stress,” available at:
<http://www.osc.state.ny.us/localgov/pubs/lmgmg/managingbudget.htm>.
- ³ The audit findings discussed in this report are from the following OSC audits: *Franklin County: Fiscal Stress* (2013M-252), *Montgomery County: Financial Condition* (2013M-234), *Warren County Financial Condition* (2011M-31), *Chenango Valley CSD: Financial Condition and Internal Controls Over Selected Financial Activities* (2009M-190), *Utica City School District: Financial Condition* (2013M-341), *City of Lockport Fiscal Stress* (2013M-330), *City of Lockport: Cash Flow* (2014M-195), *Village of Bolivar: Financial Condition of Water and Sewer Funds* (2013M-125), *Town of Poughkeepsie: Financial Operations* (2012M-38), *Village of Dansville: Internal Controls Over Selected Financial Operations* (2010M-166).
- ⁴ The cash and liquidity indicators carry a weight of 20 percent in the calculation of a local government’s fiscal stress score. For more detail on the FSMS indicators, visit the Comptroller’s Fiscal Stress Monitoring website: **<http://www.osc.state.ny.us/localgov/fiscalmonitoring/>**.

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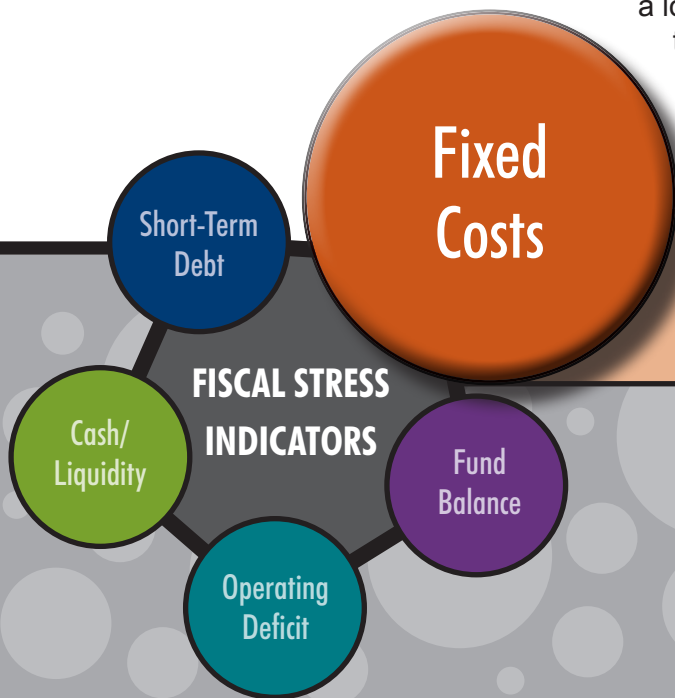
Fiscal Stress Close-Up

Fixed Costs

Fixed costs are expenditures that are required and recurring. Both individuals and governments often find that much of their spending goes toward fixed costs. Similar to an individual who has certain costs that are difficult to reduce and control such as a vehicle loan, a home mortgage or rent, local governments also have fixed costs that must be paid, regardless of other priorities or problems.¹

An individual who goes through a difficult financial period may look to try to reduce expenses, but this will usually involve eliminating nonessential purchases or putting off purchases that are not urgent. Required and recurring costs can only be reduced to a limited degree, or with considerable sacrifice. When local governments need to reduce spending, they look to make similar adjustments in their budgets, cutting more flexible items. Once a local government has maximized these types of reductions, however, the remaining fixed costs will make up a larger proportion of what remains. As a result, the local government will then have reduced budget flexibility, so that any additional needed cuts may likely affect essential services.

This close-up focuses on two kinds of fixed costs, debt service and personal services costs. Debt service is the amount necessary to pay principal and interest on a local government's bonds and notes. Defaulting on debt service payments is likely to have serious consequences on credit ratings, the ability to borrow and the local government's finances in general. Costs for personal services – salaries, wages and benefits – can also be reduced, but reductions in staff may reduce the ability of a local government to perform necessary functions, and must take into account collective bargaining agreements or other employment contracts.



- High Debt Service Expenses
- High Personal Service and Employee Benefit Costs

Fixed costs is one of five categories of indicators for the Office of the State Comptroller's (OSC's) Fiscal Stress Monitoring System (FSMS).² The FSMS defines fixed costs as either:

- Debt service as a percentage of revenues; or
- Personal services (salaries and wages) and employee benefits as a percentage of revenues.

Local governments borrow for various purposes, including the funding of long-term infrastructure construction or improvement projects, so some level of debt service costs is normal. Under OSC's FSMS, the threshold for high debt service costs is 10 percent of total revenues, with any level over 20 percent receiving maximum FSMS points.

Since every local government provides various services, it is to be expected that a fairly large proportion of local expenditures will be on associated costs for personal services and employee benefits. The threshold in the FSMS for high personal service and employee benefit costs is 65 percent of total revenues, with anything over 75 percent assigned the maximum FSMS points. Increases in employee benefit costs in recent years (including things like health insurance and pension fund payments) have been a significant factor driving increases in total fixed costs for local governments.

Fiscal Stress Monitoring System (FSMS): What Does It Measure?

"Fiscal stress" refers to the difficulties in generating enough revenues to meet expenditures in the long term. OSC's FSMS measures a local government's ability to balance its budget, pay its bills, keep its debt in check and have some funds left over at the end of the fiscal year. It does not measure the quality or quantity of services provided, their cost-efficiency or how hard local officials have worked to achieve this balance given the local economic climate.

FSMS has five categories of indicators: fund balance, liquidity, short-term debt, operating deficits, and fixed costs. These indicators contribute to a local government's final classification of Significant Stress, Moderate Stress, Susceptible to Stress or No Designation. More information on the scoring system for each of the indicators can be found in OSC's "Fiscal Stress Monitoring System" report.

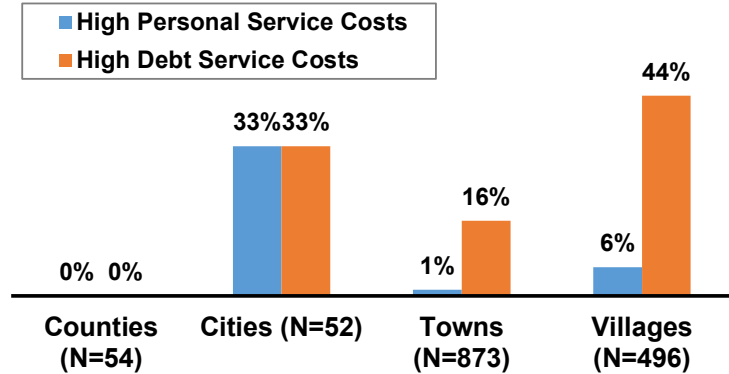
This report, which focuses on fixed cost indicators, is one of a series examining each of the five FSMS indicator categories. These reports will discuss the circumstances under which a high score in any category is cause for concern.

How common are high fixed costs?

High fixed costs are common for school districts, which devote a large share of their expenditures to personnel, and also for other local governments that provide services associated with high personnel costs, such as public safety. Since there is not much variation in the level of fixed costs across school districts, fixed cost indicators were not used to evaluate fiscal stress in the FSMS for schools. However, a look at personal service costs and debt service costs show quite a different picture for the other classes of government.

Cities usually have high personal service and benefit costs because they typically are responsible for providing a set of services that are more labor intensive (police and fire departments, for instance) than those delivered by towns and most villages. About one-third of all cities exceeded the FSMS threshold for high personal service and employee benefit costs (greater than 65 percent of revenue). The median city had personal service and employee benefit costs that equaled 63 percent of revenues. Only about 1 percent of towns had comparably high personal service and employee benefit costs, while 6 percent of villages had high personal service and employee benefit costs.

Percentage of Local Governments with High Fixed Costs, By Class, Fiscal Year Ending 2013



Source: Office of the State Comptroller (OSC).

Fixed Cost Indicators: Performance by Type of Local Government and Fiscal Stress Status for the Fiscal Year Ending in 2013

Class	Number of Local Governments Scored	Median 3-Year Average of Personal Services and Employee Benefits as a Percentage of Revenues	Median 3-Year Average of Debt Service as a Percentage of Revenues
Counties	54	40%	3%
In Fiscal Stress	10	40%	4%
No Designation	44	40%	2%
Cities	52	63%	8%
In Fiscal Stress	7	57%	15%
No Designation	45	63%	8%
Towns	873	42%	4%
In Fiscal Stress	17	54%	5%
No Designation	856	42%	4%
Villages	496	38%	8%
In Fiscal Stress	16	42%	10%
No Designation	480	38%	8%
Total	1475		
In Fiscal Stress	50		
No Designation	1425		

Source: OSC. "In Fiscal Stress" includes all three levels of fiscal stress: significant, moderate and susceptible.

Villages are most likely to exceed the FSMS threshold for debt service, with 44 percent above that level (greater than 10 percent of revenue); the median village has debt service equal to 8 percent of revenues. Cities also tend to have high debt service costs, with about one-third exceeding the FSMS threshold. The median city in fiscal stress has debt service costs of 15 percent of revenues. For towns, 16 percent exceed the FSMS threshold; the median town has debt service equaling 4 percent of revenues.

No counties had high enough fixed costs to score any FSMS points. This is likely because a large part of a county's budget is devoted to Medicaid, which is jointly funded by the federal and State government and passes through the county with relatively low local personnel costs. The median county has personal service and employee benefit costs that account for about 40 percent of revenue, and debt service equal to 3 percent of revenue.

Personal Service Cost Containment

In 2008, the Office of the State Comptroller released a publication on Personal Service Cost Containment as part of the Local Government Management Guide (LGMG) series. This publication offers ideas on containing certain personal service costs. The LGMG breaks down options for reducing personnel costs in the following areas:

- **Health Insurance Costs.** Employers can try to reduce costs by:
 - Bringing in competition,
 - Offering cash payments in lieu of health insurance,
 - Offering a self-insurance health plan,
 - Offering a pre-tax benefit plan, and
 - Providing health and wellness programs.
- **Unemployment Insurance Costs.** Savings can be found through the employer selecting the most economical funding method, either through a tax contribution method or a benefit reimbursement method.
- **Workers Compensation Costs.** Employers can:
 - Manage costs by seeking out competition,
 - Assess for accuracy of existing job classification and the apportionment of gross wages and salaries,
 - Emphasize prevention of accidents, and
 - Establish strong claims procedures.
- **Overtime Planning and Management.** In particular, the use of alternative work schedules can be beneficial.

For more information, see the OSC publication:

<http://www.osc.state.ny.us/localgov/pubs/lgmg/costcontainment08.pdf>.

Why are high fixed costs considered a symptom of fiscal stress?

When fixed costs begin to comprise an exorbitant portion of a budget, the ensuing loss of financial flexibility can signal an upcoming inability to respond to changes in policy, unexpected events, or swings in the economy. For example, high debt service costs may be an indication that the local government is borrowing more than it can easily pay back. Excess debt, and the associated interest costs, can lead to cash flow problems and difficulty meeting other obligations, such as payroll. Other high fixed costs, such as personal service and employee benefit costs, in many ways can be considered part of doing business for some local governments. However, when they become too high they diminish the ability of governments to react to changing economic circumstances. The manageable level of fixed costs varies, and can depend on the local cost of living and the tax base, among other circumstances.

Are high fixed costs ever justifiable?

Some regions have higher personnel and equipment costs than others areas. These higher costs might not be related to municipal fiscal stress but could still present a financial challenge. For example, downstate municipalities (Westchester County and Long Island, especially) have a higher cost of living than the rest of the state. Therefore, salaries and employee benefits would also tend to be higher. Nevertheless, the required and recurring nature of these costs tend to make it more difficult for these local governments to deal with any other stress factors, should they arise.

Notes

¹ “Local governments,” as used in this report refers to counties, cities, towns, villages and school districts, and does not include New York City.

² The FSMS financial indicators are calculated using data filed by local governments in annual update documents (AUDs) and by school districts in annual financial reports (ST-3s). All FSMS results presented in this report relate to the fiscal years ending between December 31, 2012 and July 31, 2013. FSMS points are assigned based on the resulting percentage for each indicator; high scores signify fiscal stress. The fixed costs indicators carry a weight of 10 percent in the calculation of a local government’s fiscal stress score. For more detail on the FSMS indicators, visit the Comptroller’s Fiscal Stress Monitoring website: <http://www.osc.state.ny.us/localgov/fiscalmonitoring/index.htm>.
See also, OSC, Fiscal Stress Monitoring System, <http://www.osc.state.ny.us/localgov/pubs/fiscalmonitoring/pdf/fiscalstressmonitoring.pdf>.

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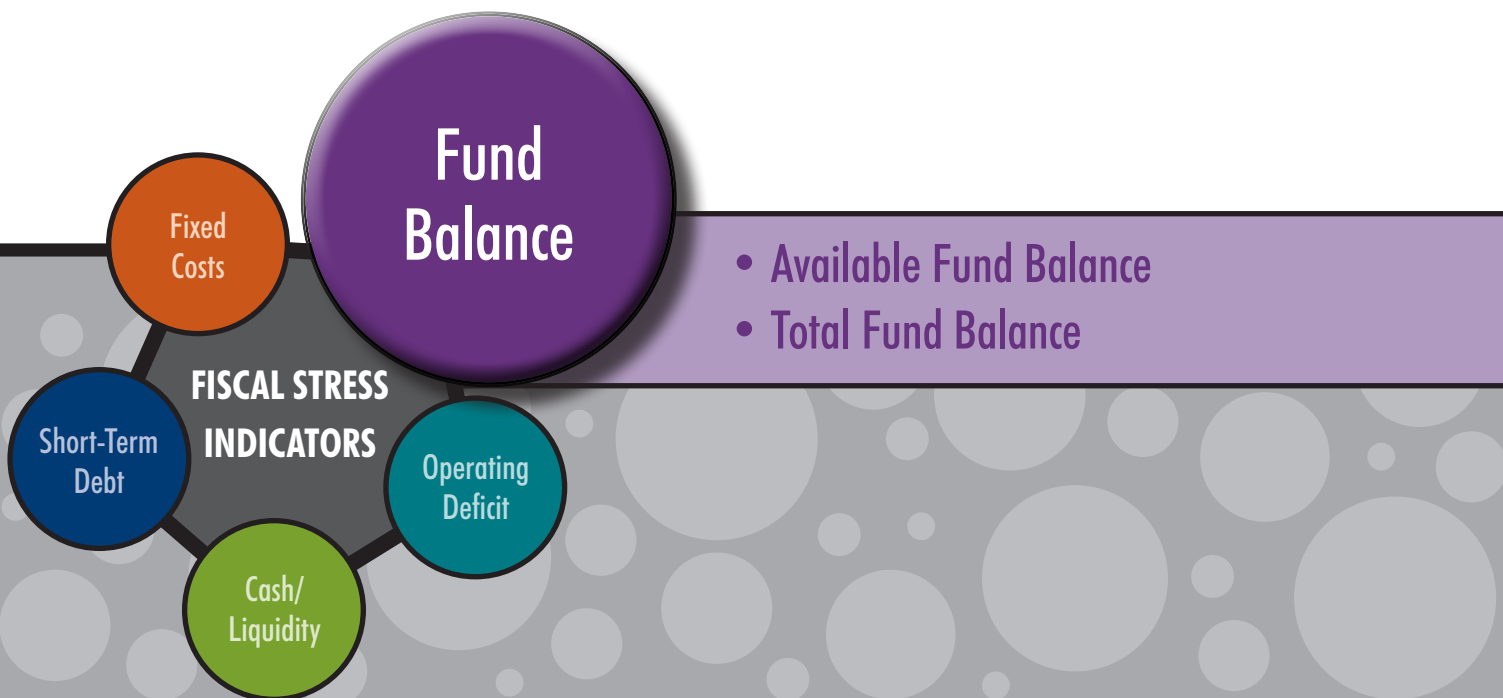


Fiscal Stress Close-Up

Fund Balance

Fund balances, often called “rainy day funds” or “budgetary reserves,” are a key part of local government finances.¹ A local government can set aside funds for a variety of needs. There are planned uses, such as the periodic repair and replacement of infrastructure like buildings or roads, and unplanned circumstances such as enduring the effects of economic fluctuation. Fund balance also acts as a cushion against normal variations in cash flow. If a local government lacks sufficient fund balance, it may find itself resorting to short-term borrowing, late payments, deferring necessary spending or other undesirable actions.

Technically, fund balance is the cumulative differences between revenues and expenditures for a particular account or fund. When a local government ends a fiscal year with more money than budgeted (more revenues than expenditures), its fund balance increases. Conversely, when the fiscal year ends with less money than budgeted (more expenditures than revenues), fund balance decreases. Since fund balance is the accumulated result of operations over time, it is a strong measure of a local government’s long-term financial condition. Low fund balance can be the result of fiscal stress and — since having a low fund balance makes it more difficult for a local government to deal with future problems — it can even potentially cause fiscal stress.



The close relationship between low fund balance and fiscal stress makes fund balance an important measure in the Office of the State Comptroller's (OSC's) Fiscal Stress Monitoring System (FSMS).²

The FSMS includes two indicators relating to fund balance:

- Available fund balance (all fund balance that is not in a reserve, or otherwise restricted, committed or appropriated) as a percentage of expenditures,³ and;
- Total fund balance (all fund balance including that which is reserved for specific future purposes) as a percentage of expenditures.⁴

For counties, cities, towns and villages, the threshold for low available fund balance is defined in the FSMS as less than 10 percent of expenditures, and low total fund balance is defined as less than 20 percent of expenditures. For school districts, the threshold for low available fund balance is defined as less than 3 percent of expenditures, and a low total fund balance is defined as less than 10 percent of expenditures. The school district thresholds are lower because the Real Property Tax Law limits the amount of unexpended "surplus funds" that can be legally retained by district officials to no more than 4 percent of the next fiscal year's budgeted appropriations.⁵

There is no set amount of fund balance that is universally considered to be sufficient for local governments to maintain. Circumstance may dictate the maintenance of higher fund balances for some local governments, such as those having a locale with a particularly volatile revenue base or that has unusual exposure to economic fluctuations.

Local governments sometime report negative available fund balances. This "fund balance deficit" usually does not mean that the local government truly has an operating deficit, but does mean that the government is likely experiencing serious cash flow problems, and must act soon to improve its fiscal position.

Fiscal Stress Monitoring System (FSMS): What Does It Measure?

"Fiscal stress" refers to the difficulties in generating enough revenues to meet expenditures in the long term. OSC's FSMS measures a local government's ability to balance its budget, pay its bills, keep its debt in check and have some funds left over at the end of the fiscal year. It does not measure the quality or quantity of services provided, their cost-efficiency or how hard local officials have worked to achieve this balance given the local economic climate.

FSMS has five categories of indicators: fund balance, liquidity, short-term debt, operating deficits, and fixed costs. These indicators contribute to a local government's final classification of Significant Stress, Moderate Stress, Susceptible to Stress or No Designation. More information on the scoring system for each of the indicators can be found in OSC's "Fiscal Stress Monitoring System" report.

This report, which focuses on the fund balance indicators, is one of a series examining each of the five FSMS indicator categories. These reports will discuss the circumstances under which a high score in any category is cause for concern.

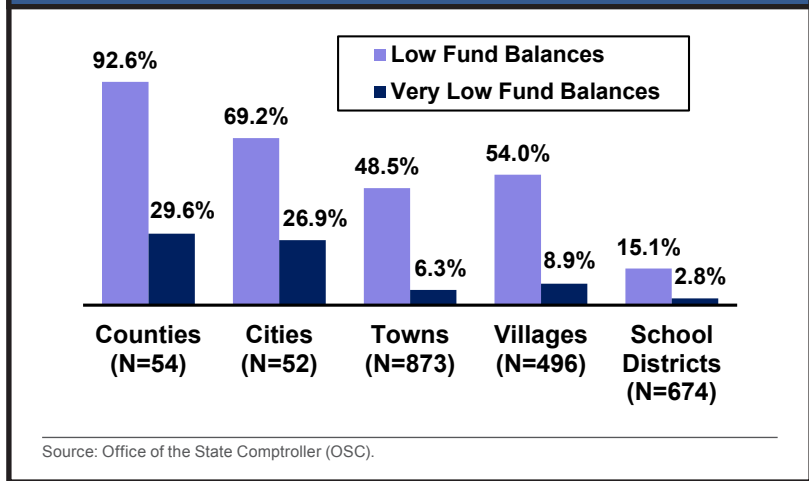
How common is low fund balance?

Almost 93 percent of counties have fund balances that are less than the FSMS threshold, as do 69 percent of cities, 54 percent of villages, and over 48 percent of towns. School districts are much less likely to have low fund balance (only 15 percent), partially because the school district threshold for low fund balance (3 percent available fund balance and 10 percent for total fund balance) is much lower than the threshold for other local governments (10 percent and 20 percent, respectively).

Over one-quarter of counties and cities have very low fund balance, usually meaning that they have little or nothing in either available or total fund balance. Fewer than 10 percent of towns and villages have very low fund balance, while only 2.8 percent of school districts have very low fund balance. Again, the threshold for very low fund balance is lower for school districts (1 percent available and 0 percent total), than for other local governments (3.33 percent available and 10 percent total).

Local governments that were found to be in one of the FSMS stress classifications were much more likely than those with no stress designation to have low levels of fund balance. This is most noticeable in the case of towns, where the 17 towns in a stress category have a median available fund balance of only 0.2 percent of expenditures and a median total fund balance of 2.1 percent, while the 856 towns with no designation have a median available fund balance of 32.1 percent of expenditures and a median total fund balance of 52.3 percent.

Percentage of Local Governments With Low Fund Balances, By Class, Fiscal Year Ending 2013



Fund Balances by Class and Fiscal Stress Status, Fiscal Year Ending 2013

Class	Number of Local Governments Scored	Median Fund Balance as a Percentage of Expenditures	
		Available	Total
Counties	54	11.8%	18.2%
In Fiscal Stress	10	1.7%	5.5%
No Designation	44	12.6%	20.4%
Cities	52	10.0%	20.3%
In Fiscal Stress	7	0.7%	2.0%
No Designation	45	14.0%	22.2%
Towns	873	31.3%	51.8%
In Fiscal Stress	17	0.2%	2.1%
No Designation	856	32.1%	52.3%
Villages	496	26.6%	43.6%
In Fiscal Stress	16	2.0%	2.6%
No Designation	480	28.7%	45.1%
School Districts	674	4.3%	23.6%
In Fiscal Stress	87	2.1%	9.9%
No Designation	587	4.4%	25.1%

Source: OSC. "In Fiscal Stress" includes all three levels of fiscal stress: significant, moderate and susceptible.

The spread between the fund balance levels of school districts that were in a fiscal stress category and those with no designation was smaller than those for other local governments. The lower fund balance thresholds for school districts in the FSMS contributes to this closer distribution.

Why is low fund balance considered a symptom of fiscal stress?

Low fund balance may be a symptom of ongoing fiscal stress for a local government, and can also lead to future fiscal stress. Since fund balance is the cumulative result of financial performance and decisions over the history of the local government, a low level of fund balance may reflect an ongoing financial challenge. The goal in sound budgeting practice is to come as close as possible to a balanced operating budget (meaning actual expenditures equal actual revenues), or even to err on the side of a small surplus in order to preserve a sufficient fund balance. The reduction in available fund balance to a low level over a number of years reflects a problem with maintaining sufficient operating revenues to cover operating expenditures, also called a structural imbalance. In particular, the consistent use of fund balance to close sizable operating deficits is a troubling practice.⁶

A local government that has insufficient fund balance will have a much more difficult time withstanding future financial emergencies. If it has not established reserves, it may not be able to cover needed capital purchases without resorting to borrowing. The government will face cash flow and liquidity problems, and may have to rely on short-term borrowing to alleviate these, with associated interest costs.

The presence of sufficient fund balance reflects good financial performance in prior years, and constitutes some protection against adverse events that may occur in the future. Low fund balance, on the other hand, may be a sign of poor financial practices.

Audit Findings: School Districts

A financial condition audit released by OSC in 2014 found that a school district had been using fund balance to finance its budget for several years, overestimating expenditures and underestimating revenues and then using the unspent money to fund the ensuing year's budget. This caused a \$2.5 million fund balance surplus to be reduced to a \$1.4 million fund balance deficit over four years. The district reduced appropriations by \$2 million, but still faced possibly significant structural budget gaps.

A 2013 OSC financial condition audit of another school district found that it had depended on using fund balance to stabilize its budgets, and had ended the 2011-12 fiscal year with a \$1.2 million fund balance deficit. While the district was able to end the 2012-13 fiscal year with a \$1.1 million fund balance surplus, this amount was still only 0.8 percent of the next year's planned spending. This shortage of fund balance created cash flow problems and necessitated short-term borrowing that added \$150,000 annually in interest costs.

Is a low fund balance ever justifiable?

Generally, local governments should try to keep a healthy fund balance for all of the reasons given above. However, the exact level of fund balance desirable may differ from place to place. Even for the same local government, fund balance may be higher in good times and lower in economic bad times without necessarily reflecting on its long-term fiscal condition. The situation is also different for school districts in New York State, since they are limited to retaining 4 percent of the next year's appropriations in fund balance, after some adjustments. This means that school districts cannot build up as much available fund balance as other local governments.

Excessive fund balance, however, can also be a problem. A high fund balance can indicate that the level of taxation is too high and should probably be reduced. A very large excess fund balance may also be an invitation to, and could obscure, financial mismanagement or even misappropriation and fraud.

Local governments may use some fund balance (in the form of planned operating deficits) in order to keep tax rates low and/or maintain services in the face of short-term economic fluctuations, or just to reduce an unnecessarily large fund balance. Even though this results in lower fund balances, spending down of fund balance can be an acceptable practice as long as it is done in conjunction with long-term financial planning and does not reduce fund balance below the critical point.

Audit Findings: Municipalities

A 2013 OSC audit of a city found that, due to lack of financial control, its fund balance in the general fund had declined by \$12.8 million over four years, resulting in a fund balance deficit of \$11.4 million. Meanwhile its debt service costs increased by 45 percent. This has caused fiscal stress that could affect the level of services that the City can provide.

A 2013 OSC financial condition audit of a county found that it had been consistently appropriating fund balance over five years. In that time, its fund balance had declined from a surplus of \$11 million to a deficit of \$1.7 million. This had deprived the County of its financial cushion for unforeseen events, and had led to cash-flow problems and the issuance of short-term debt that will cost the County \$261,000 in interest payments.

A 2014 OSC financial condition audit of a village found that it had not balanced budgets in either the general fund or the sewer fund. This led to a decline in fund balance in the general fund over six years, from a surplus of \$219,000 to a deficit of \$19,000, and a decline in fund balance in the sewer fund from \$94,000 to \$18,000.

Notes

- ¹ Counties, cities, towns, villages and school districts are all referred to as “local governments” in this report. Excludes New York City.
- ² The FSMS financial indicators are calculated using data that is filed by local governments in annual update documents (AUDs) and by school districts in annual financial reports (ST-3s). All data in this report relates to each local government’s fiscal year ending in 2013. FSMS points are assigned based on the resulting percentage for each indicator; high scores signify fiscal stress. The fund balance indicators carry a weight of 50 percent in the calculation of a local government’s fiscal stress score. For more detail on the FSMS indicators, see Office of the State Comptroller, *Fiscal Stress Monitoring System*, <http://www.osc.state.ny.us/localgov/pubs/fiscalmonitoring/pdf/fiscalstressmonitoring.pdf>.
- ³ For counties, cities, towns and villages, “available fund balance” is the assigned fund balance, except for assigned appropriated fund balance, plus unassigned fund balance. For school districts, “available fund balance” is unassigned fund balance, except for any reserve for tax reduction. An additional FSMS point is awarded if the available fund balance in the general fund divided by general fund expenditures is greater than the available fund balance in the combined funds divided by combined fund expenditures. For more detail on the FSMS indicators, see Office of the State Comptroller, *Fiscal Stress Monitoring System*, <http://www.osc.state.ny.us/localgov/pubs/fiscalmonitoring/pdf/fiscalstressmonitoring.pdf>.
- ⁴ An FSMS point is also awarded if the total fund balance in the general fund divided by general fund expenditures is greater than the total fund balance in the combined funds divided by combined fund expenditures. See Office of the State Comptroller, *Fiscal Stress Monitoring System*.
- ⁵ Real Property Tax Law, Section 1318.
- ⁶ The audit findings discussed in this report are from the following OSC audits: *Lackawanna City School District* (2014M-119), *Utica City School District* (2013M-341), *City of Poughkeepsie* (2013M-30), *St. Lawrence County* (2013M-46), and *Village of Port Dickinson* (2014M-154). OSC audits of local governments are available online at: <http://www.osc.state.ny.us/localgov/audits/index.htm>.

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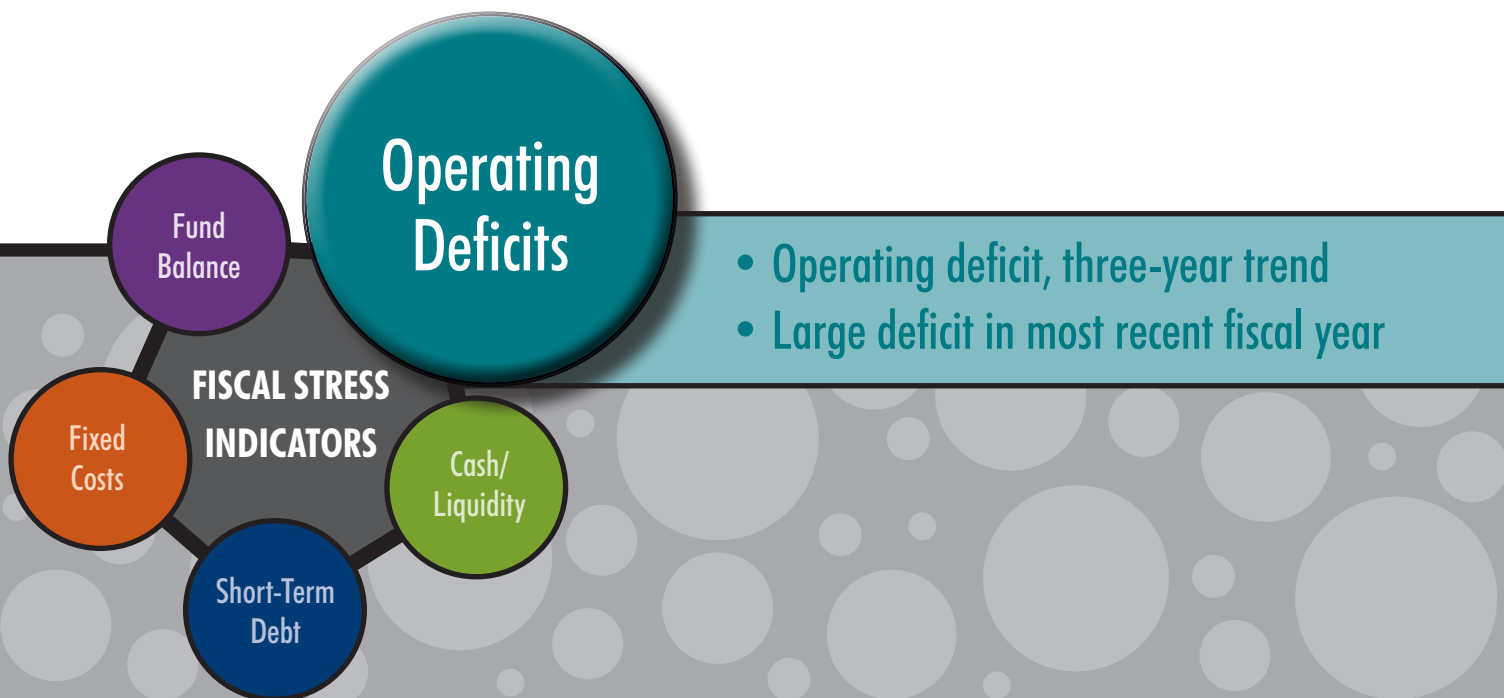


Fiscal Stress Close-Up

Operating Deficits

Local governments have operating deficits when annual expenditures exceed annual revenues.¹ Having an operating deficit in one year does not necessarily imply that a government is in financial distress. However, repeated annual operating deficits—particularly sizeable ones—are a clear sign that a government’s budgets are structurally imbalanced.

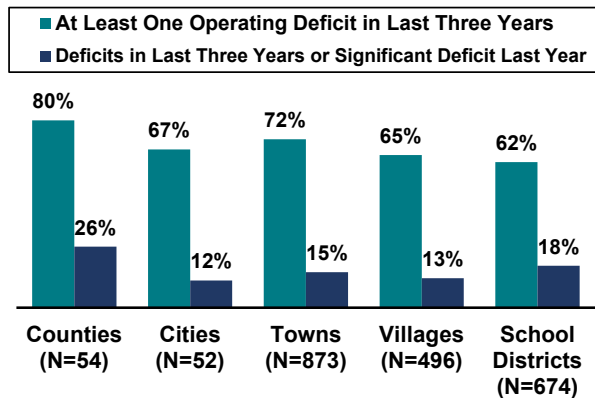
The Fiscal Stress Monitoring System (FSMS), developed by the Office of the State Comptroller (OSC), includes one indicator that scores local governments based on the results of their operations (deficit or surplus) over three years. Frequent operating deficits or a large operating deficit in the most current fiscal year result in higher fiscal stress scores and indicate a higher level of stress. For cities, counties, towns and villages, the indicator uses a combination of funds (i.e., the general fund and highway, water, sewer and enterprise funds) to capture all major expenses. For school districts, the indicator uses only the general fund, which accounts for most district spending.² The operating deficit indicator carries a weight of 10 percent in the calculation of local governments’ fiscal stress scores.



How common are operating deficits?

Most local governments experience operating deficits from time to time. Indeed, of the 2,149 local governments with fiscal stress scores for the fiscal year ending in 2013, 40 percent had an operating deficit in the last fiscal year and 67 percent had at least one operating deficit during the previous three fiscal years. Counties were the most likely to experience operating deficits. Four out of five counties had at least one operating deficit in the last three years; more than one-quarter had experienced either operating deficits in each of the last three years or a large deficit in the most recent year (measured as a percentage of expenditures, including interfund transfers). Roughly two-thirds of cities, towns and villages had at least one operating deficit in their combined funds in the last three years, and 14 percent either had operating deficits for three years in a row or had a significant deficit in the most recent year. School districts were only slightly less likely (62 percent) to have experienced an operating deficit (defined for school districts in FSMS as more than 1 percent of expenditures) during the previous three years. Nearly one in five school districts (120 out of 674 districts scored) either had operating deficits in each of the last three years or a significant operating deficit in the most recent fiscal year.

Percentage of Local Governments Scoring Points on the Operating Deficits Fiscal Stress Indicator, By Class, Fiscal Year Ending in 2013



Source: Office of the State Comptroller (OSC).

Fiscal Stress Monitoring System (FSMS): What Does It Measure?

“Fiscal stress” refers to the difficulties in generating enough revenues to meet expenditures in the long term. OSC’s FSMS measures a local government’s ability to balance its budget, pay its bills, keep its debt in check and have some funds left over at the end of the fiscal year. It does not measure the quality or quantity of services provided, their cost-efficiency or how hard local officials have worked to achieve this balance given the local economic climate.

FSMS has five categories of indicators: fund balance, liquidity, short-term debt, operating deficits, and fixed costs. These indicators contribute to a local government’s final classification of Significant Stress, Moderate Stress, Susceptible to Stress or No Designation. More information on the scoring system for each of the indicators can be found in OSC’s “Fiscal Stress Monitoring System” report.

This report, which focuses on operating deficit indicators, is one of a series examining each of the five FSMS indicator categories. These reports will discuss the circumstances under which a high score in any category is cause for concern.

Counties, cities and school districts had very small median deficits (close to 0 percent) as a percentage of expenditures. Towns and villages actually had median surpluses of 1.9 percent and 3.6 percent, respectively, but with a large range of deficits and surpluses.

As we would expect, local governments in fiscal stress were more likely to experience operating deficits than local governments that were not designated in fiscal stress. In the most recent fiscal year, 72 percent of local governments in some level of fiscal stress had operating deficits compared to 38 percent of those with no designation.

Operating Deficit Indicators: Performance by Type of Local Government and Fiscal Stress Status for the Fiscal Year Ending in 2013				
Class	Number of Local Governments Scored	Number of Local Governments with an Operating Deficit	Percentage of Local Governments with an Operating Deficit	Median Operating Surplus (Deficit) as a Percentage of Expenditures (EOU)
Counties	54	25	46.3%	0.1%
In Fiscal Stress	10	6	60.0%	-0.4%
No Designation	44	19	43.2%	0.2%
Cities	52	23	44.2%	0.6%
In Fiscal Stress	7	4	57.1%	-1.7%
No Designation	45	19	42.2%	1.1%
Towns	873	361	41.4%	1.9%
In Fiscal Stress	17	14	82.4%	-6.9%
No Designation	856	347	40.5%	2.0%
Villages	496	157	31.7%	3.6%
In Fiscal Stress	16	8	50.0%	-0.2%
No Designation	480	149	31.0%	3.8%
School Districts	674	303	45.0%	0.3%
In Fiscal Stress	87	66	75.9%	-2.4%
No Designation	587	237	40.4%	0.7%
Total	2,149	869	40.4%	
In Fiscal Stress	137	98	71.5%	
No Designation	2,012	771	38.3%	

Source: OSC. "In Fiscal Stress" includes all three levels of fiscal stress: significant, moderate and susceptible.

Why are operating deficits considered a symptom of fiscal stress?

Operating deficits are the result of an imbalance between revenues and expenditures. Inaccurate revenue or expenditure projections, whether due to unpredictable circumstances such as economic downturns or natural disasters, or to overly optimistic estimates, are frequently cited as causes. When revenues are lower than anticipated and/or expenditures are higher than budgeted, an imbalance can be expected. Failure to continually monitor - and amend - the budget at early signs of expenditure overruns or revenue shortfalls during the year can also contribute to a deficit.

Operating deficits aren't always a surprise, however, as the government may have planned to cover operating costs by using extra or surplus funds from prior years, or may have one-time or other non-current revenues it can use. To elaborate, local governments can end a year with surplus funds; the accumulated value of such surpluses is called the fund balance. While local governments may set aside some of the fund balance for a specific purpose, some is unassigned and could be available to be appropriated as part of the next year's budget. When a budget is designed with a gap that is expected to be filled with these accumulated savings (fund balance), the resulting gap is called a planned deficit. However, planned deficits can also be a problem, since the budget is essentially relying on a one-time source of funding. In the long run, as the fund balance dries up, the local government would become much more vulnerable to fiscal stress.

Audit Findings: Municipalities

A 2013 audit of a village found that the board overestimated water and sewer rent revenues, resulting in unplanned operating deficits and deficit fund balances in the water and sewer funds. The poor financial condition of the water and sewer funds created cash flow problems in both funds. The village used advances from its general fund to offset the water and sewer fund deficits. Failure to repay the interfund advances in a timely manner caused cash flow problems in the general fund.

A 2014 audit of found that a town incurred substantial storm-related expenditures in 2011 for which reimbursement was not received from FEMA until 2012. This resulted in an operating deficit in the highway fund in 2011. The town issued \$260,000 in Revenue Anticipation Notes (RANs) and used interfund advances to address the shortfall. A one-year operating deficit is an unexceptional financial occurrence in the wake of a disaster, when some projects must be completed soon after the damages. However, the town exacerbated its financial problems by failing to develop detailed cost estimates and plans for financing additional storm-related work initiated in 2012. The town budget assumed federal and State aid would cover some of these additional costs, but the town's State Emergency Management Office disaster assistance representative said the town was unlikely to receive any significant reimbursement by the end of 2013.

A 2013 audit found that a city adopted budgets that have routinely relied on the appropriation of fund balance as a financing source, causing the city to incur planned operating deficits in the general fund. This has led to a significant reduction in the city's unexpended surplus funds from 2010 to 2012. During that period, the unexpended surplus funds remaining at year end declined 84 percent — from \$841,747 in 2010 to \$136,068 at the end of 2012 — leaving the city with little cushion to manage unforeseen events.

A 2013 audit of a county found that the board routinely relied on planned operating deficits by appropriating significant amounts of fund balance to finance operations. In addition, two of the county's enterprise funds were not self-sufficient and required subsidies from the general fund. These trends could lead to fiscal instability if they are allowed to continue.

In some situations, a deficit planned on faulty assumptions is the reason for fiscal difficulties. OSC audits have found cases where local governments appropriated more fund balance than was actually available, or were taken by surprise by deficits that were larger than budgeted. Repeated or large deficits are often an early sign that a local government may be falling into fiscal stress.

Indeed, OSC found that an increased occurrence of operating deficits was an important early warning indicator of government financial stress in the FSMS. For example, a local government had planned a deficit with the intent of applying fund balance to cover it but did not budget for an impending tax certiorari judgment, and expenditures ended up being much higher than planned. As a result, the appropriated fund balance was not enough to satisfy that year's deficit. In other cases, local governments relied on advances from other funds to plug operating deficits. This action is most useful in situations where a shortfall occurs in anticipation of revenues that are assured, since interfund advances must be paid back prior to the next fiscal year. The recurring use of interfund borrowing to fill operating gaps is another sign that a local government is experiencing a structural imbalance and showing signs of fiscal stress.³

Audit Findings: School Districts

A 2014 OSC audit of a school district found that declining State aid revenues and increased expenditures for debt service, personal services and employee benefits resulted in operating deficits in each of the four years from 2009-10 through 2012-2013. As a result of the operating deficits, the district relied on fund balance to fund operations. Preliminary results of operations for the 2013-14 fiscal year showed that the district has a remaining unexpended surplus fund balance of \$17.8 million, which district officials stated will be used to help finance future budgets. In addition, due to the district's continued need to make tax certiorari payments, the district will likely end the year with an operating deficit of approximately \$6.4 million, necessitating the use of fund balance to fund operations. With the continued depletion of its fund balance, district officials will have to identify new revenue sources or ways to reduce expenses.

A 2014 audit of another school district found that the board planned operating deficits in its budgets for the 2009-10 through 2012-13 fiscal years and appropriated fund balance to help finance the ensuing year's operations. However, it underestimated revenues and overestimated expenditures when developing budgets, which caused the district to have operating surpluses totaling approximately \$1.2 million for these four years rather than deficits. As a result, the district did not use the appropriated fund balance as intended and instead accumulated unexpended surplus funds at levels that were about 10 to 12 percent of the ensuing years' budgets, up to nearly three times greater than the amount allowed by law.

A 2014 audit of a third school district found that in 2011-12 and 2012-13, the board appropriated significant amounts of fund balance to finance operations, which contributed to an accumulated fund balance deficit of approximately \$275,000 at the end of the 2012-13 fiscal year. In addition, the district expended \$741,000 more than the total amounts authorized for two capital projects, causing a fund balance deficit in the capital projects fund in that amount. The audit noted that the district would ultimately need to transfer money from the general fund to eliminate the deficit in the capital project fund. However, at the time of the audit, the general fund did not have sufficient funds available to do so.

Is an operating deficit ever justifiable?

Operating deficits are not always a bad thing. In some cases, a local government may even plan to spend down money it has saved from prior years, generally for a specific purpose. For example, a city may have saved some money in a capital reserve fund in order to purchase a fire truck. In the year when it needs to purchase that truck, it will spend down the savings in that account, instead of raising additional taxes. Sometimes, local leaders may decide that they have too much saved from prior years' surpluses, and choose to use some of the unreserved fund balance to reduce tax levy growth in that year.

A single instance of an operating deficit that is managed thoughtfully will not likely cause immediate and long-lasting fiscal stress, so long as a local government's fiscal picture is otherwise healthy. If the local government has an accumulated surplus sufficient to cover the difference, and if officials take steps to avoid the problem in future budgets, a local government's general financial picture may be relatively unharmed. Care must be taken when doing so, however, since using an operating deficit in this way can artificially depress levy growth and/or artificially hold the property tax rates constant over a year or two. Once the extra fund balance has been exhausted (by being appropriated annually in place of increased property taxes, water or sewer rents, or other charges), the tax levy increase necessary to maintain existing levels of spending will look much higher by comparison with the low base level from several years earlier. OSC recommends adopting a fund balance policy to guide these decisions and govern the level and use of excess fund balance in a manner that benefits taxpayers.

Because operating deficits can occur for many reasons, the FSMS operating deficit indicator does not by itself provide a complete picture of a local government's fiscal health or stress. No single indicator can serve that purpose. Instead, the FSMS examines a range of indicators in addition to operating deficits in determining fiscal condition, including measures of fund balance, use of short-term debt, cash flow, and high fixed costs.

Notes

- ¹ “Local governments,” as used in this report, refers to counties, cities, towns, villages and school districts, and does not include New York City.
- ² The “combined funds” for each class of local government were selected by including the funds that are the most common for each class and also the funds that generally account for the largest percentage of each class’s financial activity. The Fiscal Stress Monitoring System (FSMS) financial indicators are calculated using data filed by most local governments in annual update documents (AUDs) and by school districts in annual financial reports (ST-3s). All FSMS results presented in this report relate to the fiscal years ending between December 31, 2012 and July 31, 2013. For more detail on the FSMS indicators, visit the Comptroller’s Fiscal Stress Monitoring website:
<http://www.osc.state.ny.us/localgov/fiscalmonitoring/index.htm>.
See also OSC, *Fiscal Stress Monitoring System*,
<http://www.osc.state.ny.us/localgov/pubs/fiscalmonitoring/pdf/fiscalstressmonitoring.pdf>.
- ³ The audit findings discussed in this report are from the following OSC audits: *Village of Speculator: Financial Condition* (2013M-381), *Town of Scio: Highway Fund Financial Condition and Records and Reports* (2013M-279), *City of Fulton: Fiscal Stress* (2013M-310), *Essex County: Financial Condition and Internal Controls Over Payroll* (2013M-177), *Haverstraw-StonyPoint Central School District: Financial Condition* (2014M-275), *Shelter Island Union Free School District: Financial Condition* (2014M-132), *Watervliet City School District: Fiscal Stress* (2014M-149), and *Village of Goshen: Financial Condition* (2014M-75). OSC audits of local governments are available online at: **<http://www.osc.state.ny.us/localgov/audits/index.htm>**.

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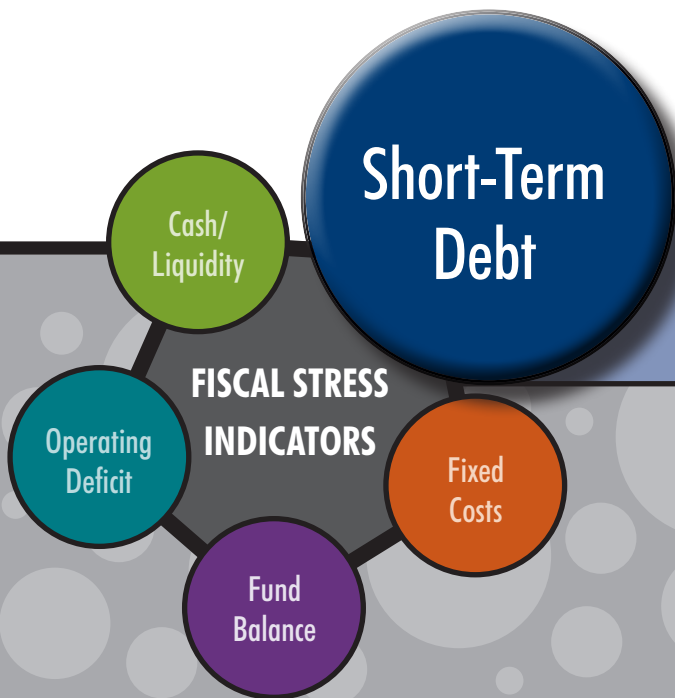


Fiscal Stress Close-Up

Short-Term Debt

Local governments issue debt for many reasons.¹ Most local debt is like a homeowner's mortgage or a car loan: the local government borrows money to finance an item, such as a building, road or truck, and then repays the money over time. Usually the local government issues a bond, which will be paid off over a maximum period equivalent to the amount of time the purchased item will last.² For example, a bond for police cars might have to be repaid within 3 years, while a bond for a new building might have a term of as long as 30 years. Loans and financial obligations lasting more than one year are known as *long-term* debt.

Local government *short-term* debt is different, and can be compared to a "bridge loan" for a business or an individual. Money is borrowed for an immediate need and will ultimately be paid back from future taxes, or other kinds of revenue. There are many reasons why local governments utilize this type of borrowing. Sometimes short-term debt is used in cases of an emergency such as a natural disaster, when a clean-up must be completed and paid for much sooner than a local government can expect to receive federal or State disaster assistance. More often, however, short-term debt is used to pay for normal operating expenses when local governments are having cash flow issues. Cash shortfalls occur when bills must be paid before revenue is received to pay them, or when expenditures exceed revenues in a fiscal year. Borrowing for operating expenses is not advised, since it means that the local government would be paying interest and other related expenses (e.g., legal and financial advisor fees) instead of maintaining sufficient cash flow to pay for expenses as they occur.



- Short-Term Debt Issued
- Short-Term Debt Trend

Since the use of short-term debt may be tied to cash flow problems, the presence of short-term debt is measured in the Office of the State Comptroller's (OSC's) Fiscal Stress Monitoring System (FSMS).³ [See "Fiscal Stress Monitoring System: What Does It Measure?" below for details.]

The FSMS includes two indicators relating to short-term debt:

- Amount of short-term debt issued in the most current fiscal year – a local government with more debt will receive a higher score; and
- Short-term debt issued over the last three fiscal years – a local government that has issued debt more frequently will receive a higher score.⁴

What types of short-term debt are available and how are they used?

Several kinds of short-term debt are authorized under New York State law, including:

- **Tax Anticipation Notes (TANs):** Issued to cover expenses in anticipation of the collection of budgeted real property taxes and assessments.
- **Revenue Anticipation Notes (RANs):** Issued to cover expenses in anticipation of the collection of certain kinds of future revenues, such as State aid.
- **Budget notes:** Most commonly issued to finance expenditures required by unforeseeable public emergencies or to finance higher-than-expected expenditures that were not provided for in the annual budget.
- **Deficiency notes:** Issued to help address situations where revenues are coming in lower than what is estimated in the annual budget.⁵
- **Bond Anticipation Notes (BANs):** Typically issued in anticipation of issuing long-term bonds. They may be renewed for up to five years, after which bonds usually must be issued. Since BANs are essentially issued for long-term debt purposes, they are not included in the FSMS short-term debt category and will not be discussed in this report.

Fiscal Stress Monitoring System (FSMS): What Does It Measure?

"Fiscal stress" refers to the difficulties in generating enough revenues to meet expenditures in the long term. OSC's FSMS measures a local government's ability to balance its budget, pay its bills, keep its debt in check and have some funds left over at the end of the fiscal year. It does not measure the quality or quantity of services provided, their cost-efficiency or how hard local officials have worked to achieve this balance given the local economic climate.

FSMS has five categories of indicators: fund balance, liquidity, short-term debt, operating deficits, and fixed costs. These indicators contribute to a local government's final classification of Significant Stress, Moderate Stress, Susceptible to Stress or No Designation. More information on the scoring system for each of the indicators can be found in OSC's "Fiscal Stress Monitoring System" report.

This report, which focuses on short term debt indicators, is one of a series examining each of the five FSMS categories. These reports will discuss the circumstances under which a high score in any category is cause for concern.

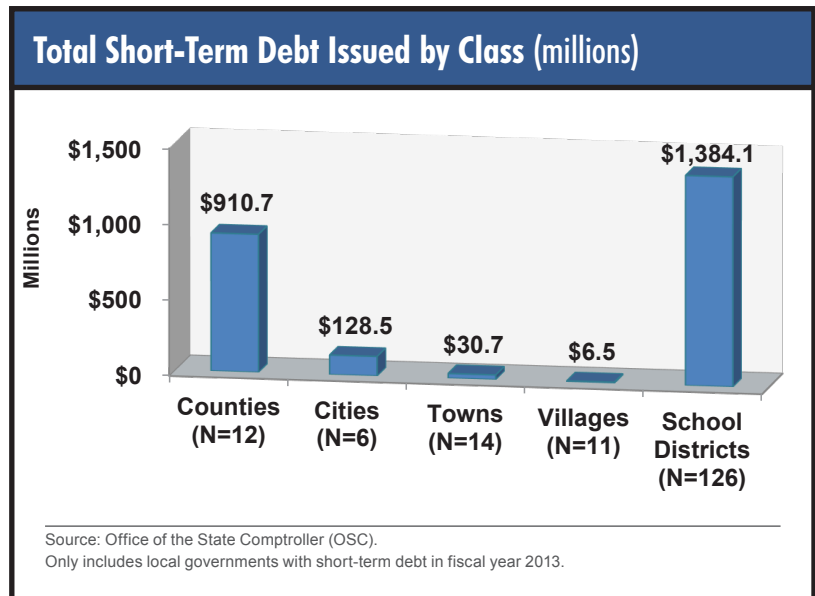
How common is short-term debt?

Counties and school districts are by far the biggest issuers of short-term debt, accounting for 93 percent of the \$2.5 billion issued by 169 local governments in fiscal year 2013. Counties and school districts typically use short-term debt to bridge financial gaps caused by poor timing of revenue receipts (generally property taxes or State aid).

By contrast, very few towns issue short-term debt, but those that do are likely to borrow a lot. Short-term debt as a percentage of total revenues for the median town with such debt was 47.6 percent. Usually this debt covers emergency disaster recovery spending, which is eventually reimbursed by the Federal Emergency Management Agency (FEMA). This is also true for villages, although generally their short-term debt for these purposes was less (relative to revenues) than that of towns.

In fiscal year 2013, 7.9 percent of all local governments scored had issued short-term debt in the most current fiscal year; 5.9 percent of units scored had done so in each of the previous three fiscal years.

Even though there are many issues that may contribute to the overall level of fiscal stress for school districts, such as a deteriorating economic situation and reductions in State school aid, the total number of school districts that have issued short-term debt has been decreasing over the past decade. This may be due to several factors, not the least of which is that State budgets have been



Audit Findings: Counties

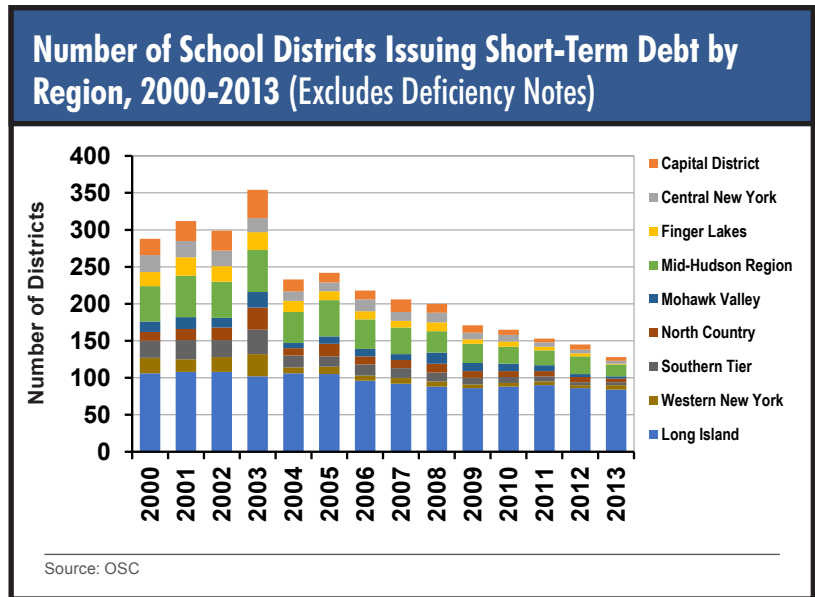
A 2013 OSC audit found that one county's use of fund balance to finance operations critically impacted the county's cash flow. Consequently, the county had to issue short-term debt in order to cope with a delay in State aid payments. The audit noted that, had the County maintained healthier fund balances, it could have had sufficient resources to sustain operations until aid was received.

A 2010 OSC audit of real property tax collections in another county found that town tax collectors did not always collect and remit property tax moneys to the county in a timely manner. The delay in receiving tax revenue contributed to cash flow problems that required the county to issue TANs totaling \$4.5 million dollars in January 2009 and to incur \$33,000 in related fees and interest expenses.

enacted on time since 2011. Aside from a very late budget in 2010, State budgets have been no more than a few days late since 2004. Prior to that, in 2003, the number of school districts issuing RANs increased by 18 percent over 2002. The amount of those RANs increased by 72 percent, or by over \$300 million more in debt that school districts had to finance in that year.

The Long Island region has traditionally had the greatest number of school districts that have issued short-term debt. While other regions have seen a decline in the number of school districts that have issued short-term debt, the number has been much more stable in the Long Island region over the last decade.

Suffolk County accounted for \$515 million (57 percent) of the \$911 million in short-term debt issued by counties in 2013. Rockland County accounted for 18 percent. Over the past decade, only a small number of counties have issued short-term debt every year or nearly every year: Monroe, Nassau, Putnam, Rockland and Suffolk counties. But, more recently, Albany, Broome, St. Lawrence, Sullivan and Westchester counties have been issuing short-term debt on a yearly basis.



Audit Findings: Municipalities⁶

A 2012 OSC audit found that one city's poor financial records prevented officials from making sound financial decisions. In November 2009, city officials issued a TAN for \$5.6 million and renewed it in November 2010 and 2011 without a comprehensive cash flow analysis, which would have shown that the city could have paid off or retired the TAN and still had sufficient cash available. Instead, the TAN was renewed in November 2011 at an interest rate of 5.25 percent, leading to \$271,489 in unnecessary interest costs.

A 2013 audit of a town's financial condition by OSC found that poor budgeting practices, including unrealistic revenue estimates, led to a fiscal decline. Cash flow problems led to the issuance of RANs for three consecutive years, as well as the issuance of deficiency notes in the third year. Since deficiency notes must be repaid with revenues from the following year, the audit anticipated that operating expenses would be even more difficult to fund in that year.

Why is short-term debt considered a symptom of fiscal stress?

While there are some exceptions, a heavy or ongoing reliance on short-term debt indicates that the government has cash flow issues that are not being resolved. Borrowing to balance an operating budget with no realistic plan to replace such temporary resources in subsequent years is especially problematic. Repeated use of this type of borrowing may lead to a fiscal crisis. Another problem with a dependence on short-term debt is that interest rates and market access are not always ideal. For part of 2008, temporary disruptions in the credit markets made the issuance of short-term debt difficult or impossible. In such a situation, a local government or school district that relies on short-term debt may find itself suddenly unable to meet payroll or cover other operating expenses.⁷

For these reasons, credit rating agencies may characterize the existence of this type of debt as a “credit negative,” raising the possibility that it could lead to higher borrowing costs for local governments.

RANs and **TANs** are sometimes used for several consecutive years because a government repeatedly has a particularly difficult period when incoming bills exceed cash on hand. In some instances, short-term notes may even be rolled over year to year, essentially turning them into long-term debt for operating expenses. The entity’s ongoing revenues may be insufficient to cover ongoing expenditures, and the “short-term” debt is being used to temporarily cover the problem.

Budget notes are not as common as RANs or TANs, being used in only two towns and six villages in 2013. However, since they are usually issued to fund unbudgeted expenditures, they may indicate poor budget practices.

Deficiency notes were authorized in 2010 and began being used in 2012, when they were issued by only one town. None were issued in 2013. They are designed to handle situations where revenue falls short of what is expected in the budget, such as when the last recession caused county sales tax collections to drop in 2009.

Audit Findings: School Districts

A 2011 financial condition audit by OSC found that poor revenue projections and budget monitoring had caused one school district to rely on RANs to finance operations and alleviate cash flow problems in two consecutive years. Interest costs for RANs amounted to \$15,000 for one year.

A 2011 OSC audit of another school district faulted the district for relying on annual RAN borrowings not only to alleviate cash flow difficulties, but to finance operations. It also found that the district failed to set aside revenues in a special bank account to pay the principal on the notes.

Is short-term debt ever justifiable?

The issuance of short-term debt alone cannot determine the level of stress a municipality is facing. In fact, there are some instances in which the use of short-term debt is justifiable and may be necessary.

An example of this can be found on Long Island. Unlike school districts in most other parts of the State, school districts in Nassau and Suffolk counties do not receive the bulk of their real property tax revenue during September. Instead, they get two payments, one approximately midway through the school fiscal year – January in Suffolk, November in Nassau – and the other in May, near the end. Since school districts must have money for expenditures throughout the fiscal year, this makes short-term debt a reasonable option, even when the school districts are not in fiscal stress by other measures. In order to bridge the gap between when expenditures must be made and when revenues come in, many of these districts depend regularly on issuing TANs.

Another appropriate use of short-term debt is for payment of emergency and disaster-related costs in anticipation of federal or State reimbursement. In these circumstances, RANs or budget notes may be issued in anticipation of FEMA aid. Necessarily, this kind of short-term debt is included in the indicator scores. However, if a local government with such emergency/disaster-related costs does not have other kinds of stress indicators, it would not receive a high FSMS score for fiscal stress based on this indicator alone.

Recurring Debt: A Caution

Even when recurring short-term debt is not a sign of immediate stress, it can increase costs unnecessarily, possibly contributing to stress in future years. Like long-term bond debt for capital improvements, short-term debt involves the payment of interest, which adds to the cost of government. However, while this additional cost may be justified for long-term projects which will benefit the taxpayers of the local government over the period of the capital improvement's life, the same cannot be said of short-term interest expenditures. Therefore, local governments should be cautious in the use of short-term debt.

Notes

- ¹ Counties, cities, towns, villages and school districts are all referred to as “local governments” in this report.
- ² This period of time is determined by State law in accordance with Article VIII, section 2 of the State Constitution.
- ³ The FSMS financial indicators are calculated using data that is filed by local governments in annual update documents (AUDs) and by school districts in annual financial reports (ST-3s). All data in this report relates to each local government's fiscal year ending in 2013.
- ⁴ For more detail on the FSMS indicators, see Office of the State Comptroller, *Fiscal Stress Monitoring System*, at <http://www.osc.state.ny.us/localgov/pubs/fiscalmonitoring/pdf/fiscalstressmonitoring.pdf>.
- ⁵ Deficiency notes were not included in the first year of the FSMS system. They will be part of the scores in future years.
- ⁶ The audit findings discussed in this report are from the following OSC audits: *Saugerties Central School District: Financial Condition and Internal Controls Over Information Technology (2011M-50)*, *Town of Oyster Bay: Financial Condition and Selected Financial Operations (2013M-54)*, *Clinton Central School District: Financial Condition (2011M-133)*, *Warren County: Financial Condition (2011M-31)*, *Broome County: Financial Condition (2013M-224)*, *City of Newburgh: Council Oversight and Revenue Enhancement Opportunities (2012M-77)*. OSC audits of local governments are available online at: <http://www.osc.state.ny.us/localgov/audits/index.htm>.
- ⁷ Office of the State Comptroller, *The Credit Crunch: Implications of Local Government Short-Term Debt*, November 2008, at <http://www.osc.state.ny.us/localgov/pubs/research/creditcrunch.pdf>.

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