OFFICE OF THE NEW YORK STATE COMPTROLLER

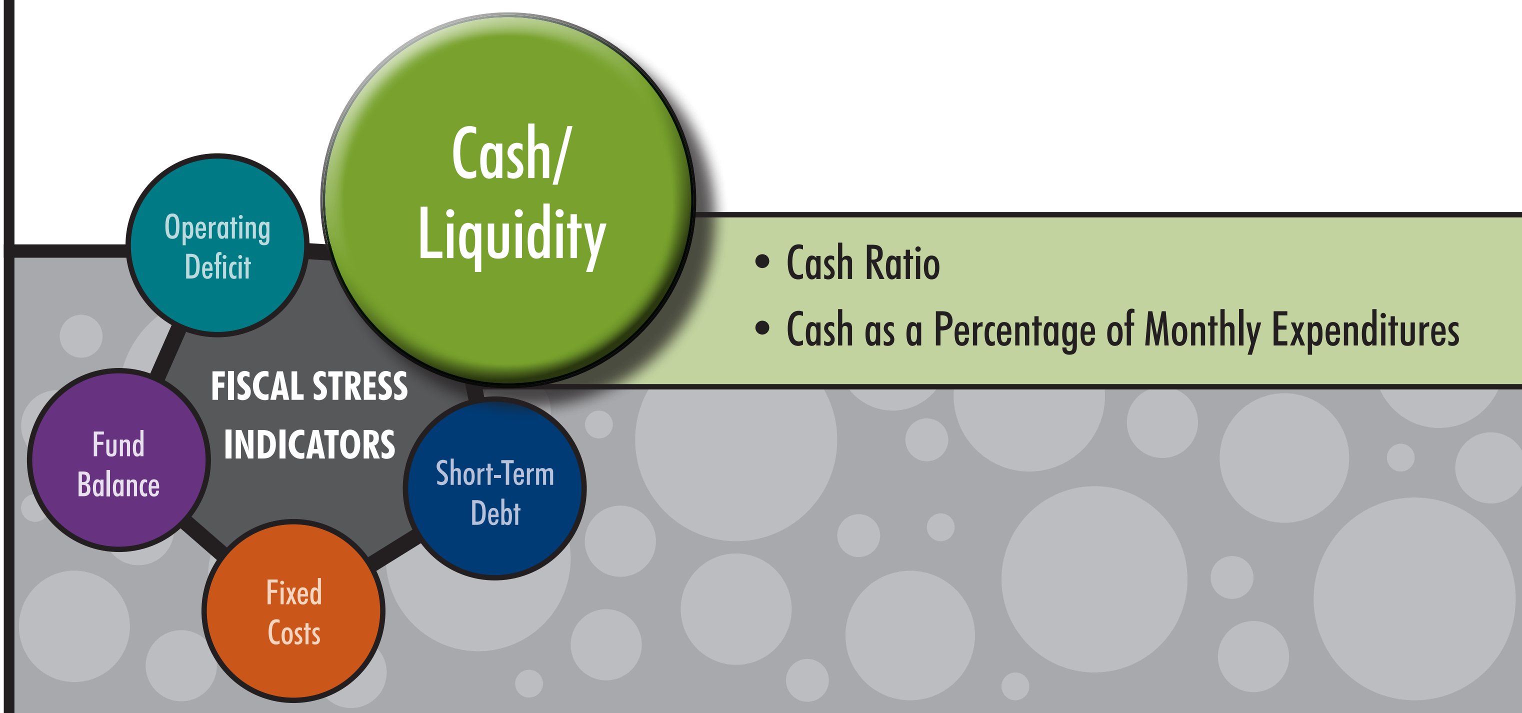
Thomas P. DiNapoli • State Comptroller

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.



Division of Local Government and School Accountability

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.

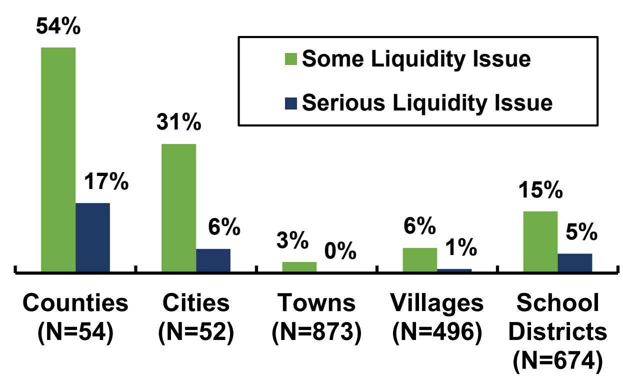
This report, which focuses on the liquidity indicators, is one of a series examining each of the five FSMS indicator categories. These reports will discuss the circumstances under which a high score in any category is cause for concern.

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.

Percentage of Local Governments with Low Liquidity,
By Class, Fiscal Year Ending 2013



Source: Office of the State Comptroller (OSC).

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: Municipalities[3]

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/lgmg/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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