

Performance Audit: Financial Indicators

August 2008

City Auditor
City of Lawrence, Kansas

August 12, 2008

Members of the City Commission

This performance audit of financial indicators for Lawrence is intended to identify significant existing or emerging financial problems, put the city's financial condition in context, and encourage discussion of the city's financial condition. Analysis of financial indicators for 2003-2007 suggests that the city's financial condition has been good, but has weakened in the last couple of years. Based on the analysis, I made two recommendations. The city should monitor the level of long-term liabilities and document the method for allocating overhead for the utilities and other business-type services. I also identified general areas to consider for the 2009 annual audit work program: reviewing measures of service levels and quality, reviewing fees, updating the financial indicator analysis, and analyzing city expenditures.

I provided the City Manager with a draft of this report on August 4, 2008. His response is included in the report.

I appreciate the cooperation and assistance I received from the City Manager's Office, the Finance Department, and the Utilities Department, as I conducted this performance audit.

Michael Eglinski
City Auditor

Performance Audit: Financial Indicators

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Performance Audit: Financial Indicators

Results in Brief

This performance audit of Lawrence's financial indicators for 2003-2007 suggests the city's financial condition has been good, but has weakened in the last couple of years. Based on the analysis, the city should:

- Monitor the level of long-term liabilities; and
- Document the method for allocating general fund overhead to enterprise activities and the basis for transfers from enterprise activities;

An important limitation of the financial indicator analysis is that it doesn't explicitly address the level and quality of city services and infrastructure.

The City Manager agrees with both recommendations.

The analysis of financial indicators also suggests several areas to consider in the 2009 audit work program:

- Review measures of service levels and quality;
- Review fees;
- Update the financial indicator analysis; and
- Analyze city expenditures in more detail.

Figure 1 Summary of ratio analysis

	Governmental Activities	Business-Type Activities
	Public safety, public works, and general government represent over 80 percent of the expenses	Water, sewer, and sanitation represent almost 90 percent of the expenses
	Mostly supported by taxes	Mostly supported through user fees and charges
Stronger measures of Lawrence finances	Ability to maintain provision of services (financial position)	Ability to maintain provision of services (financial position)
	Funding mix of general tax revenues, grants and service charges (general support)	Funding mix of general tax revenues, grants and service charges (general support)
	Access to resources to meet immediate needs (liquidity)	Access to resources to meet immediate needs (liquidity)
Weaker measures of Lawrence finances	Burden of long-term debt (long-term liabilities)	Burden of long-term debt (long-term liabilities)
	Growth rate of resources to provide services and operate (financial performance)	Growth rate of resources to provide services and operate (financial performance)
	Current impact of paying interest (interest coverage)	

Performance Audit: Financial Indicators

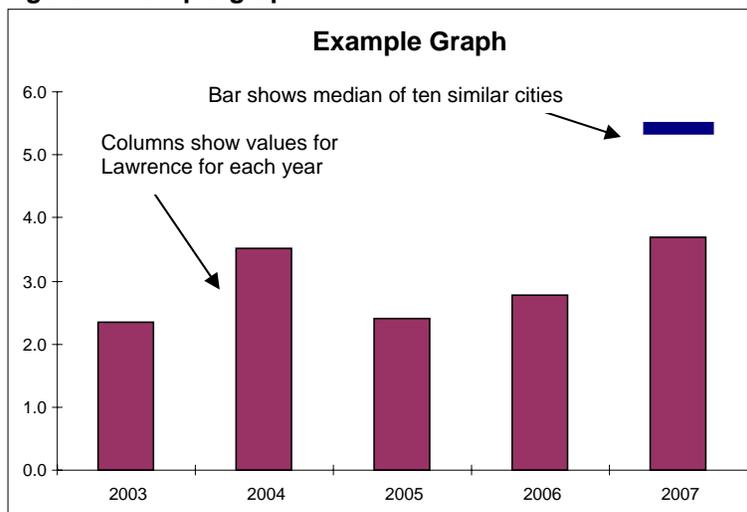
Financial ratios provide assessment of Lawrence's financial condition

This performance audit, which analyzes financial ratios, provides the City Commission and city management with an assessment of Lawrence's financial condition. The performance audit is intended to encourage discussion of the city's financial condition and to:

- identify significant existing or emerging financial problems
- put the city's financial condition in context by compiling data for five years and comparing to the median of ten cities similar to Lawrence

Financial ratios are presented as graphs throughout the report. To evaluate the ratios, consider both the trend and the level compared to the median (see figure 2). Trends can be characterized as more favorable, less favorable, or unclear. Likewise, levels can be characterized as more favorable, less favorable, or neutral. Characterizing each indicator using this method allows for overall conclusions about relative strengths and weaknesses of the city's finances.

Figure 2 Example graph



The City Auditor selected ratios to include in the performance audit. Most of the ratios come from *The New Governmental Financial Model: What it Means for Analyzing Government Financial Condition*.¹

This report includes 5-years of data for Lawrence (2003-2007), and compares data for Lawrence with the median of ten similar cities. Comprehensive annual financial reports provide most of the data. Information from the annual financial reports provides consistent, reliable data because it conforms to generally accepted accounting principles and is audited under generally accepted government auditing standards.

The cities used for comparison have characteristics similar to Lawrence. Based on 2006 data from the U.S. Census Bureau, the areas have similar urban area population, portion of population under the age of 18, per capita income, and median age of housing. See the Scope, Method and Objectives section for more detailed information on the similar cities.

Analyzing financial ratios provides an assessment of Lawrence’s financial condition, but it is important to recognize strengths and limitations to this sort of analysis. Figure 3 highlights major strengths and limitations of the ratio analysis

Figure 3 Strengths and limitations of the ratio analysis

Key strengths	Key limitations
Lawrence data compiled under consistent accounting principles and audited under Government Auditing Standards	Analysis provides a broad overview rather than detailed analysis
Ratios developed independent of city management and provides a new view of Lawrence finances	Excludes information on level and quality of services and infrastructure
Comparative data compiled under consistent accounting principles and audited under Government Auditing Standards	Excludes external factors, such as demographic and economic trends, that may affect city finances
	Provides historical analysis rather than projections of future condition

¹ Barbara A. Chaney, Dean Michael Mead, and Kenneth R. Scherman, “The New Governmental Financial Reporting Model: What it Means for Analyzing Government Financial Condition,” *Journal of Government Financial Management*, Spring 2002.

Governmental Activities Ratio Analysis

Governmental activities include public safety, public works, and general government, and are mostly supported by taxes. Figure 4 summarizes the analysis of ratios for governmental activities.

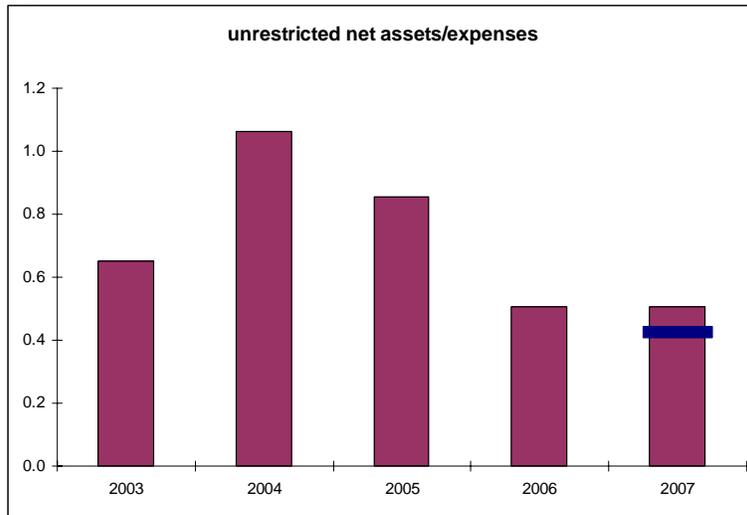
Figure 4 Governmental activities: summary of ratio analysis

Stronger measures of Lawrence finances	Ability to maintain provision of services (financial position)
	Funding mix of general tax revenues, grants and service charges (general support)
	Access to resources to meet immediate needs (liquidity)
Weaker measures of Lawrence finances	Burden of long-term debt (long-term liabilities)
	Growth rate of resources to provide services and operate (financial performance)
	Current impact of paying interest (interest coverage)

Financial position

Lawrence's financial position has a less favorable trend in recent years and the position is above the median (figure 5). Financial position measures the city's ability to maintain the provision of services. Should the trend continue to decline, the indicator might warn of difficulty maintaining services.

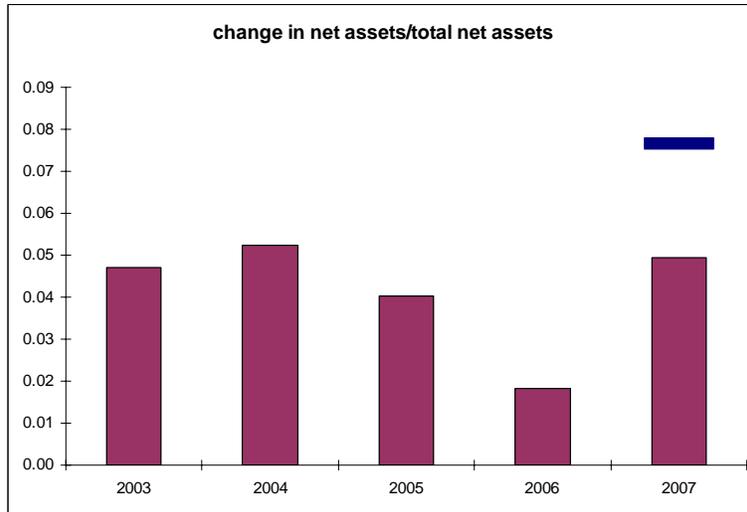
Figure 5 Governmental activities: financial position ratio



Financial performance

Lawrence’s financial performance shows no clear trend and is below the median (figure 6). Financial performance measures the rate at which the city’s net resources grow. Compared to the median of ten similar cities, Lawrence’s net resources grew slowly.

Figure 6 Governmental activities: financial performance ratio

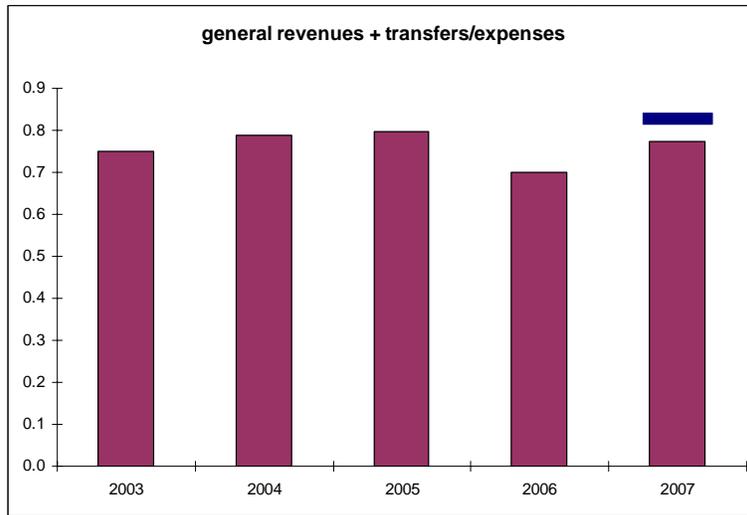


Assets grew relatively little in 2006 because property and sales tax revenues decreased while expenses grew. As a result, the change in net assets for the city’s governmental activities was the lowest it had been during the entire 5-year period. The next year, property and sales tax revenues grew a bit, while expenses decreased, and transfers from business-type activities increased, resulting in better growth in net assets for governmental activities.

General support level

The level of general support for government activities shows no clear trend and is below the median (figure 7). General support level reflects the extent to which the city relies on general taxes, rather than services charges and grants, to pay for expenses. In evaluating the general support level, focus on any unexpected substantial changes more than the level.

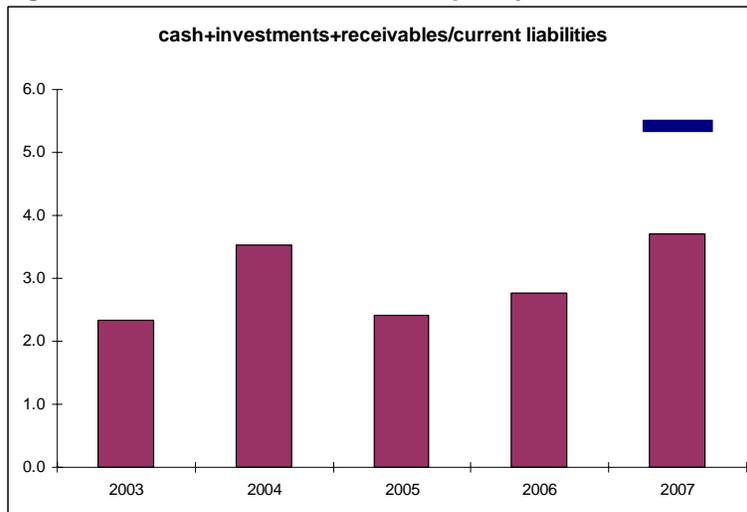
Figure 7 Governmental activities: general support ratio



Liquidity

Lawrence's liquidity shows a favorable trend but is below the median (figure 8). Liquidity measures access to resources to meet immediate needs. For this analysis, current liabilities include those long-term liabilities that are due within one year.

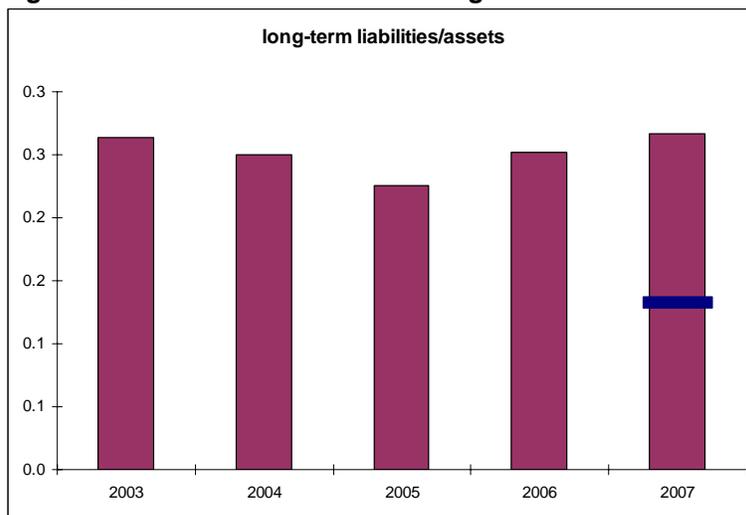
Figure 8 Governmental activities: liquidity ratio



Long-term liabilities

Lawrence's measure of long-term liabilities indicates a potential weakness as the level of long-term liabilities to assets is both above median and the trend is less favorable (figure 9). The ratio measures debt burden and suggests that Lawrence's debt burden increased in the last few years.

Figure 9 Governmental activities: long-term liabilities ratio



Growing levels of long-term liabilities above median warrant further analysis and monitoring of the city's debt.

The appropriate level of debt depends on a community's needs, operating costs, revenue, and willingness and capacity to raise additional revenue if needed. When a city borrows, it creates both an asset and a liability. Usually, cities borrow to create infrastructure that serves the community and, by borrowing, the city is able to create the infrastructure sooner rather than later.

Because borrowing creates a long-term liability and has direct costs, such as interest expense, a city should control and manage it. Lawrence has a debt policy and debt issuance guidelines. The guidelines, shown in figure 10, provide measurable benchmarks to help evaluate the city's long-term liabilities.

Figure 10 Lawrence debt issuance guidelines

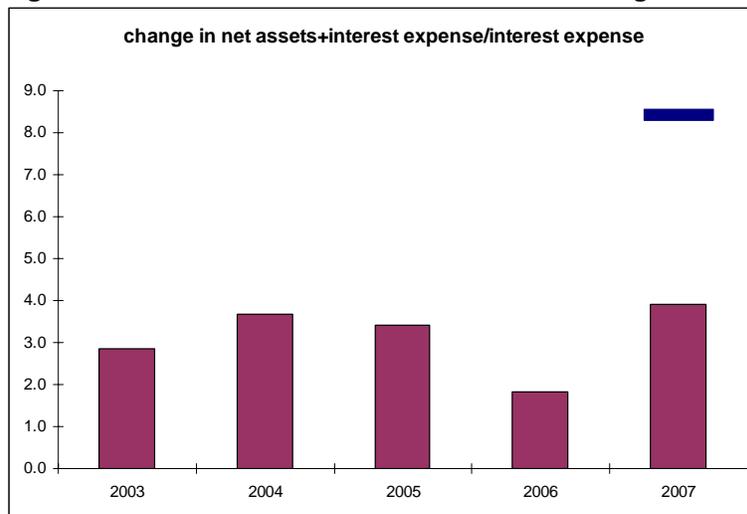
Measure	Limit
General obligation bonds outstanding/appraised valuation	2.2 percent
General obligation bonds and temporary notes outstanding/statutory debt limit	60 percent
Debt service payments from the bond and interest fund/governmental expenditures	15 percent
Amount of general obligation bonds outstanding/population	\$1,100
Amount of overlapping general obligation bonds outstanding/population	\$2,500
Bond and interest mill levy	10 mills

By regularly reporting on where the city stands relative to the debt issuance guidelines, management could help the City Commission monitor debt and provide opportunities for further analysis and discussion of debt.

Interest coverage

Lawrence’s interest coverage shows no clear trend and is below median (figure 11). The ratio evaluates the extent to which interest payments reduce flexibility in the near term. A very low level would indicate that the organization had little near term flexibility because so much was devoted to making interest payments. Lawrence’s level suggests that the impact of interest payments is larger in Lawrence than the median of similar cities, which is expected because the level of long-term liabilities is above median.

Figure 11 Governmental activities: interest coverage ratio

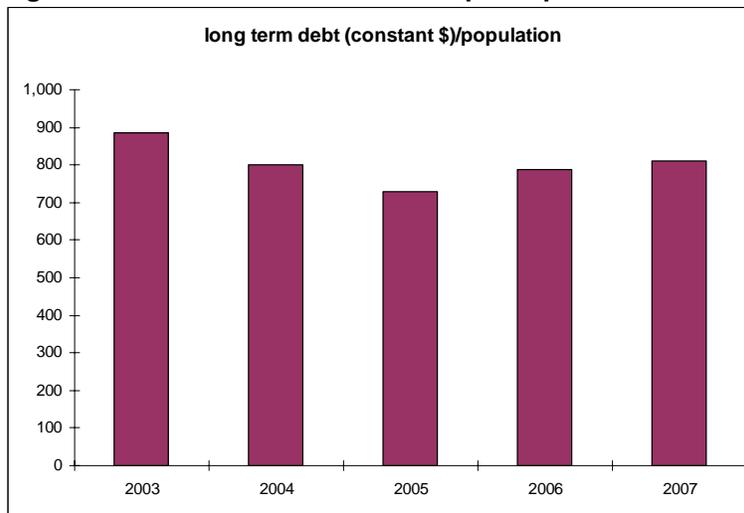


Debt, Revenue and Expenditure Trends

Debt, revenue and expenditure trends for governmental funds provide information on financial flexibility and sustainability. The graphs show data for all governmental funds on a per capita basis and adjusted for inflation. In this analysis, the governmental fund indicators aren't compared to medians.

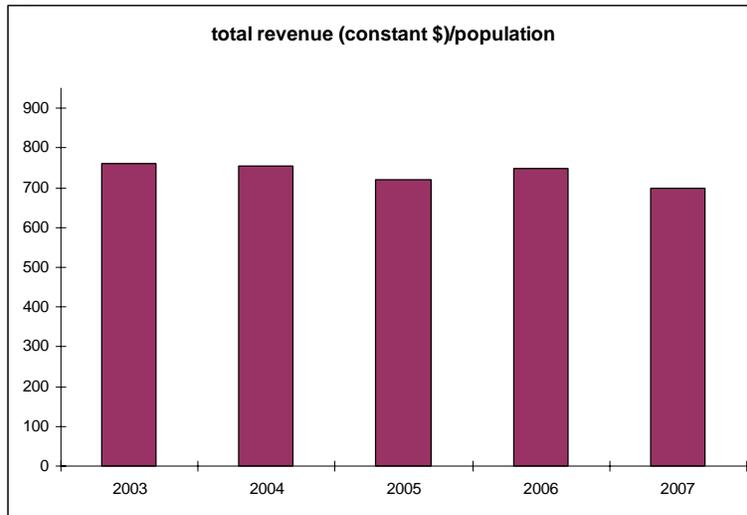
Long-term debt per capita increased in the last two years after decreasing from 2003 to 2005 (figure 12).

Figure 12 Governmental funds: debt per capita



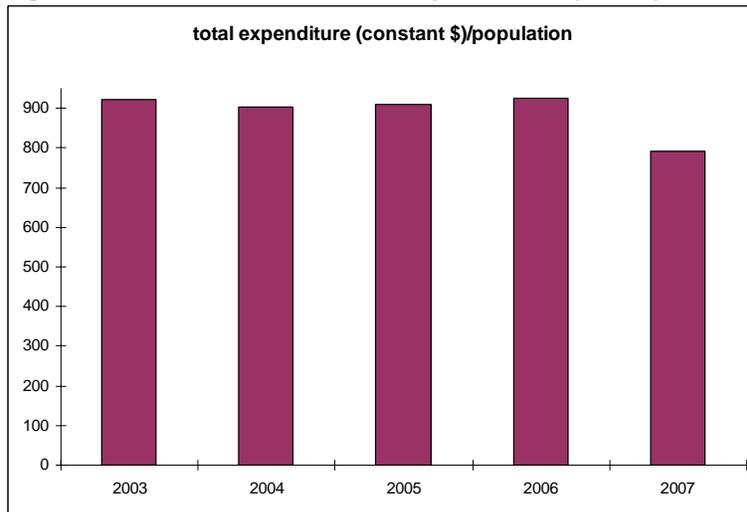
Revenue declined three out of four years and declined most in 2007 (figure 13). The decline could indicate that the city will have difficulty maintaining existing levels of service with current revenue sources.

Figure 13 Governmental funds: revenue per capita



Expenditures declined two out of four years and declined most in 2007 (figure 14). The decline in 2007 reflects steps taken to keep expenditure growth under control. A significant decline could warn of problems providing services at the levels of previous years.

Figure 14 Governmental funds: expenditures per capita



Throughout the period, governmental fund expenditures exceeded revenues. Transfers and issuance of general obligation bonds make up the difference between revenues and expenditures. The gap between expenditures and revenues decreased substantially in 2007.

Business-Type Activities Ratio Analysis

Business-type activities include water, sewer, and sanitation utilities, and are mostly supported by user fees and charges. Figure 15 summarizes the analysis of ratios for governmental activities.

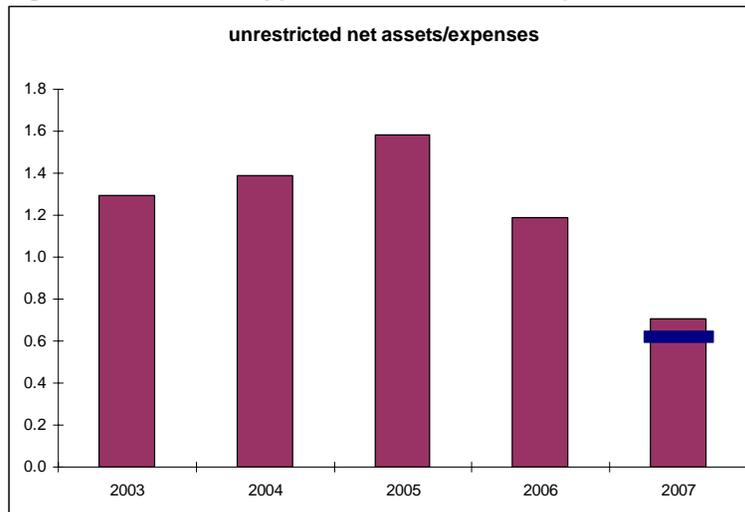
Figure 15 Business-type activities: summary of ratio analysis

Stronger measures of Lawrence finances	Ability to maintain provision of services (financial position)
	Funding mix of general tax revenues, grants and service charges (general support)
	Access to resources to meet immediate needs (liquidity)
Weaker measures of Lawrence finances	Burden of long-term debt (long-term liabilities)
	Growth rate of resources to provide services and operate (financial performance)

Financial position

The financial position for business-type activities showed a less favorable trend in recent years and the position is above the median (figure 16). Financial position measures the ability to maintain the provision of services.

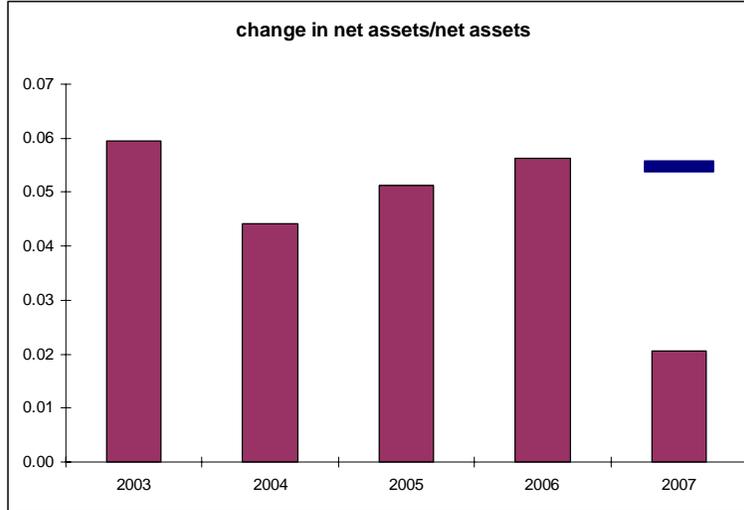
Figure 16 Business-type activities: financial position ratio



Financial performance

Business-type financial performance showed a favorable trend through 2006 but the level in 2007 was well below median (figure 17). Financial performance measures the rate at which resources grow.

Figure 17 Business-type activities: financial performance ratio



Assets grew relatively little in 2007, largely because business-type activities recovered less of their expenses, and transfers from the business-type activities increased.

Figure 18 shows the difference between revenue and expenses (i.e. net revenue) for each of the business-type activities in 2006 and 2007. Overall, the business-type activities net revenue was \$3.2 million less in 2007 than in the previous year.

Figure 18 Business-type activities: net revenue

Activity	2006	2007	change
water sewer	\$6,694,331	\$4,124,858	-\$2,569,473
Sanitation	-\$322,906	-\$595,396	-\$272,490
Parking	\$20,457	-\$233,451	-\$253,908
Stormwater	\$1,085,129	\$1,058,478	-\$26,651
Golf	\$82,828	-\$2,301	-\$85,129
Total	\$7,559,839	\$4,352,188	-\$3,207,651

In addition to weaker net revenue, transfers from the business-type activities increased by over \$2 million in 2007 (figure 19). Most of that increase was from water and sewer.

Figure 19 Business-type activities: transfers

Year	Transfers from business-type activities
2003	\$1,288,000
2004	\$1,441,718
2005	\$1,892,038
2006	\$2,102,194
2007	\$4,269,392

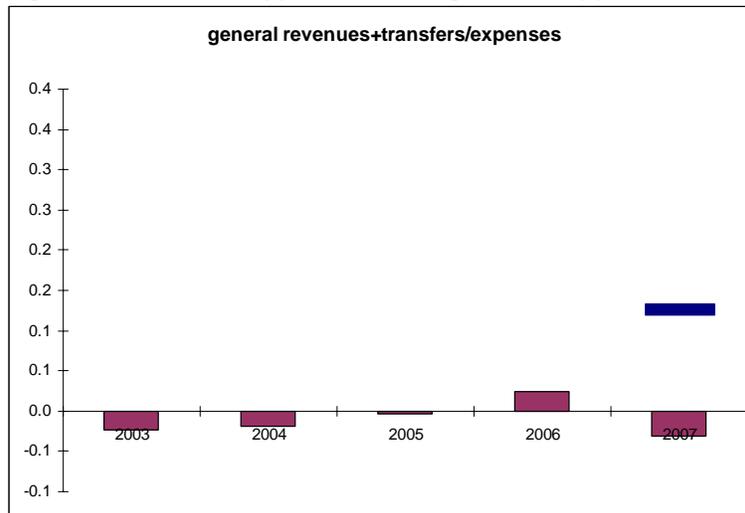
The basis for the increase in transfers from 2006 to 2007 wasn't clearly defined and documented. The city transfers money from business-type activities to governmental activities to cover general overhead including administrative services, information services, finance, and legal services. In general, the transfer amount is budgeted to increase by 5 percent each year. Not all of the business-type activities make budgetary transfers for general overhead. Water and sewer, sanitation, and storm water all make transfers, but parking and golf don't.

Defining and documenting the basis for allocating general overhead costs to the business-type activities would provide the City Commission and management with better information about the costs of providing services and the extent to which revenues covered those costs.

General support level

The level of general support for business-type activities shows no clear trend, remained close to zero throughout the period, and was below the median (figure 20). General support measures the extent to which taxes, rather than service charges, support business-type activities. A ratio of zero means that the business-type activities, taken as a whole, don't require support from general revenues or transfers. Business-type activities have low levels of support because they rely largely on charges for services to cover expenses.

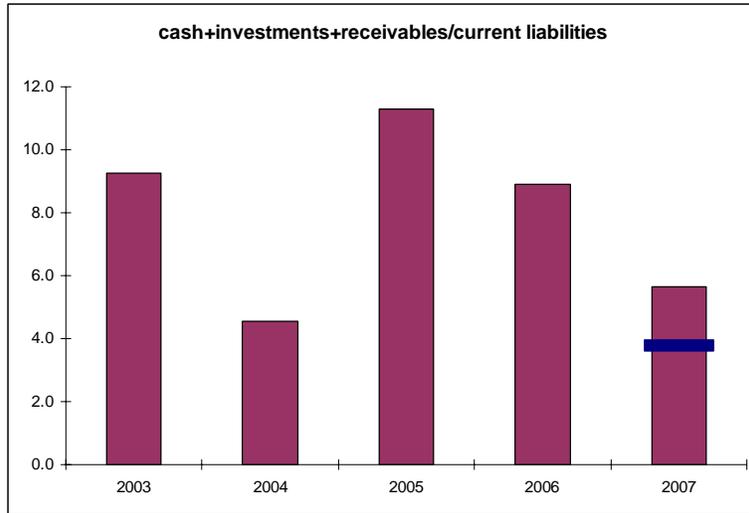
Figure 20 Business-type activities: general support ratio



Liquidity

The business-type liquidity measure showed a less favorable trend but remains above the median (figure 21). Liquidity measures access to resources to meet immediate needs. For this analysis, current liabilities include those long-term liabilities that are due within one year.

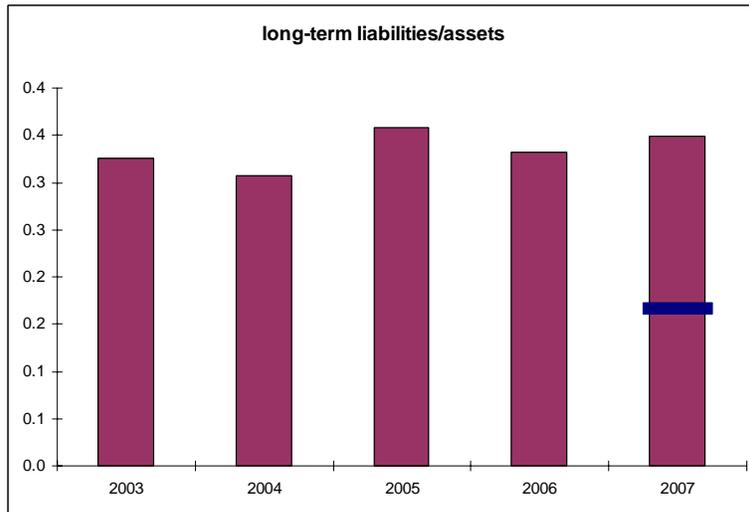
Figure 21 Business-type activities: liquidity ratio



Long-term liabilities

The business-type measure of long-term liabilities shows no clear trend and the level is above the median (figure 22). The ratio addresses debt burden. Compared to the median, Lawrence's business-type activities have higher debt burden.

Figure 22 Business-type activities: long-term liabilities ratio



Recommendations

The City Auditor recommends:

1. The City Manager should provide the City Commission with regular reports showing where the city stands in relation to the measures in the debt issuance guidelines.
2. The City Manager should document the method for allocating general overhead to the enterprise operations and the basis for interfund transfers related to that overhead.

The financial indicator analysis also suggests areas to consider for future audit work. The City Auditor will discuss these ideas with the City Manager as part of developing the proposed annual work program for 2009:

- Measure the quality and level of city services or test existing measures of the quality and level of city services. The 2008 audit work program approved by the City Commission includes a performance audit of the reliability of measures of pavement condition.
- Review fees for services. A performance audit could involve reviewing how the city sets, collects, uses, and reviews fees for services.
- Update the financial indicators analysis based on the 2008 Comprehensive Annual Financial Report.
- Analyze city expenditures in more detail. The 2008 audit work program approved by the City Commission includes performance audits related to street light payments and small purchases, both of which may address city expenditures.

Performance Audit: Financial Indicators

Scope, methods and objectives

Analyzing financial ratios provides the City Commission and city management with an assessment of Lawrence's financial condition. The analysis is intended to encourage discussion of the city's financial condition and to:

- identify significant existing or emerging financial problems
- put the city's financial condition in context of the five year period of 2003-2007 and through comparisons to medians of cities similar to Lawrence

The City Auditor reviewed several approaches to measuring and evaluating local government financial conditions; identified cities similar to Lawrence; collected information from comprehensive annual financial reports for Lawrence (2003-2007) and similar cities (most recent available year); calculated financial ratios; evaluated ratios for Lawrence by looking at the trends over time and comparing Lawrence to medians of the similar cities; and shared the evaluation with city staff. Most of the indicators in this performance audit are from work by Chaney, Mead, and Schermann.

The Planning and Development Services Department provided estimates for Lawrence population. Those estimates were used to calculate per capita debt, revenue, and expenditure trends. The trends were adjusted for inflation using *American City County Magazine's* municipal cost index and a base year of 2003.

The City Auditor conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require planning and performing the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. The City Auditor believes that the evidence obtained provides a reasonable basis for the findings and conclusions based on the audit objectives.

The City Auditor provided the City Manager with a draft of the report on August 4, 2008, and the City Manager's written response is included.

Comparable cities

To identify comparable cities, the City Auditor reviewed data from the U.S. Census Bureau American Community Survey for 2006. Data on 352 urban areas were used to identify those most similar to Lawrence on four measures:

- Population of the urban area
- Portion of residents under the age of 18
- Per capita income
- Median year of construction of housing

Figure 23 Cities similar to Lawrence

Urbanized Area	Population urbanized area	Percent under the age of 18	Per capita income	Median year housing built
Lawrence, KS	84,899	18.1	21,026	1978
Norman, OK	86,535	17.8	22,234	1977
Missoula, MT	73,659	18.1	20,150	1976
Bellingham, WA	94,988	17.9	23,653	1978
Athens-Clarke County, GA	120,444	18.5	18,809	1979
St. Cloud, MN	96,630	20	21,735	1979
Champaign, IL	127,577	17.3	21,306	1975
Johnson City, TN	102,652	19.8	19,835	1974
Chico, CA	98,804	20.6	21,946	1978
Grand Junction, CO	103,932	20.6	21,666	1979
Charlottesville, VA	86,630	18.1	25,180	1977

Source: U.S. Census Bureau, American Community Survey, 2006.

Urbanized Areas are central place(s) and adjacent territory with a general population density of at least 1,000 people per square mile of land area that together have a minimum population of at least 65,000 people.

The urbanized area of Leesburg-Eustis, Florida, fits the criteria used to identify places similar to Lawrence. However, because Leesburg and Eustis are two separate cities, with populations under 20,000, the urbanized area was considered significantly different from Lawrence and excluded from the comparison and the table.

Key Terms

City finances cover both governmental activities and business-type activities. **Governmental activities** include services like police and fire, public works, and administration. **Business-type activities** include services paid for largely by charges for service, such as trash collection and water and sewer utilities.

City **assets** are resources the city can use to provide services and operate the government. Among other things, assets include cash, investments, land, buildings, streets and water mains.

City **liabilities** are obligations the city has to turn over resources to other organizations or individuals. Liabilities include things like money the city has to pay to companies that provide services to the city and repayments for money the city borrowed.

Subtract liabilities from assets and the result is **net assets**. A portion of the city's assets may be used to meet ongoing obligations and this is referred to as **unrestricted net assets**.

The city collects taxes, such as sales taxes and property taxes, as **general revenues**. In addition to general revenues, **transfers** from other governmental activities can provide resources.

Source of Financial Data

Comprehensive annual financial reports from Lawrence and the similar cities provide the financial data used in this performance audit. Nearly all of the information comes from the government-wide financial statements. Those statements rely on "full accrual" accounting. That means that the financial statements include capital assets and long-term liabilities as well as current assets and liabilities. The government-wide financial statements report all revenues and costs of providing government services, not just those received or paid in the current year or soon after.

The government-wide financial statements are a relatively new requirement. Lawrence first prepared government-wide financial statements for 2003.

Performance Audit: Financial Indicators

Management's Response



DAVID L. CORLISS
CITY MANAGER

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MICHAEL DEVER
COMMISSIONERS
ROBERT CHESTNUT
DENNIS 'BOOBY' HIGHERBERGER
MIKE AMYX
SUE HACK

August 10, 2008

Mr. Michael Eglinski
City Auditor
City of Lawrence, Kansas
City Hall
Lawrence, Kansas 66044

Re: Performance Audit – Financial Indicators 2008

Dear Mr. Eglinski,

Thank you for the preparation and submission of the above referenced audit. City staff has reviewed the document and we agree with the audit recommendations.

We have begun the implementation of the first recommendation concerning the periodic review of the City's debt financial performance measurements. The City's fall debt issuance includes the following statistical measurements:

On September 1, 2008, the city will retire \$9,755,000 in general obligation bonds. With the planned issuance of \$3,740,000, the amount of outstanding general obligation bonds will be reduced by \$6,015,000. The table below compares the updated measures against the indicators from the City's debt issuance guidelines. After



We are committed to providing excellent city services that enhance the quality of life for the Lawrence community

the 2008 debt issuance, the City will continue to be below the maximums for all of the indicators stated in the guidelines.

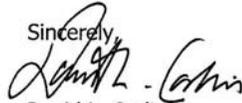
Measure	Guideline	Calculated
GO Bonds as a % of Appraised Value	2.20%	1.37%
Outstanding GO Bonds and Notes as a % of Statutory Debt Limit	60.00%	33.31%
Debt Service Payments from Bond and Interest as a % of Governmental Expenditures	15.00%	11.55%
GO Bonds Outstanding per Population	\$1,100	\$894.24
Overlapping GO Bonds Outstanding per Population	\$2,500	\$2,127.98
Mill Levy for Bond and Interest Fund	10.00	7.01

In addition to these measurements, staff believes it is appropriate to continue the financial measurements contained in the audit report. It is also appropriate to examine other possible financial measurement tools – the percentage growth/decline of delinquent special assessments would appear to be an appropriate measurement given the City’s financial history on this item.

City staff also supports the documentation and analysis of enterprise fund transfers and overhead allocations. We believe that a policy in this area would be appropriate and will develop a policy for consideration by the City Commission later this year.

We thank you for your work on this matter.

Sincerely,



David L. Corliss
City Manager

c: Mayor and City Commission