



November 10, 2010

CHAIR
PETER HERZOG
Councilmember
City of Lake Forest

TO: Local Agency Formation Commission

VICE CHAIR
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Supervisor
2nd District

FROM: Executive Officer
Policy Analyst

CHERYL BROTHERS
Councilmember
City of Fountain Valley

SUBJECT: Proposed Process for the Development of the OC LAFCO
Financial Early Warning System

BILL CAMPBELL
Supervisor
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PURPOSE

The purpose of this report is to provide a proposed process for the development of the OC LAFCO Financial Early Warning System (*Attachment A*). The report includes discussion of financial indicators and an overview of “financial dashboards” as user-friendly methods of depicting the financial condition of local governments.

ARLENE SCHAFFER
Director
Costa Mesa
Sanitary District

BACKGROUND

At the January 2010 meeting, this Commission directed staff to return with information regarding LAFCO’s role, if any, in assessing financially stressed public agencies and LAFCO’s role in public agency bankruptcy. In April of this year, the Commission was presented with a report on LAFCO’s role in public agency bankruptcy, and in June staff presented a Best Practices update on the financial ability of local agencies to provide services. Finally, in August of 2010, the Commission requested the development of an early warning system as a method of assessing the financial condition of local governments in Orange County.

JOHN WITHERS
Director
Irvine Ranch Water District

SUSAN WILSON
Representative of
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ALTERNATE
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Representative of
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FINAL PRODUCT

The final product of the proposed financial early warning system will be a user friendly, publicly accessible, web-based financial dashboard capable of assessing the financial condition of local agencies. Similar to a car’s dashboard, the financial dashboard provides a visual, graphic depiction of an agency’s financial information as well as historical data so that trends may be followed in agency’s finances. Web-based dashboards have emerged from the private sector as management tools to assess the financial condition of corporations and are discussed in detail later in this report.

ALTERNATE
CHARLEY WILSON
Director
Santa Margarita
Water District

JOYCE CROTHWAITE
Executive Officer

The proposed financial early warning system would be annually updated with standardized data readily available from the audited financial statements of Orange County cities and special districts. Staff is proposing that the indicators used in the financial early warning system be vetted by local stakeholders and financial experts. The financial early warning system would also help fulfill the LAFCO municipal service review (MSR) mandate by providing a method of assessing the financial ability of agencies to provide services over time.

COMPONENTS OF THE FINANCIAL EARLY WARNING SYSTEM

There are two components of the financial early warning system that are presented as part of this initial report. First, the report describes the wide array of financial indicators already developed by both the public and private sectors. Secondly, financial dashboards are reviewed as a tool for presenting the financial condition of local agencies.

Sources of Indicators

Financial indicators are not a new method of analysis and have been studied at all levels of government and the private sector. This section explores sources of indicators used to develop the initial, comprehensive list in *Attachment B*.

The International City Manager's Association's (ICMA) Financial Trend Monitoring System (FTMS) provides one of the most complete sources of financial indicators. The ICMA system identifies factors that affect financial conditions that can be easily measured and analyzed. Two other methods of assessing the financial conditions of local governments that may be useful in the development of LAFCO's early warning system were developed through state offices in Florida and North Carolina.

The Florida State Auditor General has developed the Local Government Entity Financial Condition Assessment Procedures for analyzing trends to assess the financial health of local agencies.¹ Another potential resource is the *County and Municipal Fiscal Analysis Tool* developed through collaboration between the North Carolina State Treasurer's office and the University of North Carolina. The tool is presented as a web-based financial dashboard which is "a management tool that helps local governments in North Carolina analyze and communicate their financial condition."² This tool is presented later in this report as the recommended template for LAFCO's financial early warning system.

In addition, there are many local sources of indicators specific to California and Orange County. For example, each year the California State Controller compiles the *Cities Annual Report* which is a compilation of financial data for California's city governments. Orange County specific sources of indicators include the *Orange County Progress Report*, the *Orange County Community Indicators*, and the *Orange County Infrastructure Report Card*. All of

¹ For additional information visit the Florida State Auditor General's website:
http://www.myflorida.com/audgen/pages/fca_procedures.htm

² For additional information visit the North Carolina State Treasurer's website:
<http://www.nctreasurer.com/dsthome/StateAndLocalGov/lgcreport>

these reports provide varying levels of analysis using indicators ranging from the economy to the environment. While they provide important data specifically tailored to Orange County, none of them provide the level or type of detail anticipated in the proposed early warning system.

Financial Dashboard

It is easy to get lost in spreadsheets of financial data. Similarly, ratios and indicators provide valuable information, but it is difficult to see the forest from the trees. In order to provide a complete picture of an agency’s financial condition staff has explored the potential for a dashboard method of analysis as LAFCO’s early warning system.

There are many different displays of financial dashboard systems. The method recommended uses a web-based tool developed by the North Carolina State Treasurer’s office in conjunction with the University of North Carolina’s School of Government. The tool compares an agency with benchmarks and is annually updated. This method allows for agencies of similar characteristics (i.e. geographic size and terrain, population, levels and types of services) to be compared. The chart below has been taken from the website of the North Carolina State Treasurer’s office and depicts two municipalities with similar populations and service responsibilities.

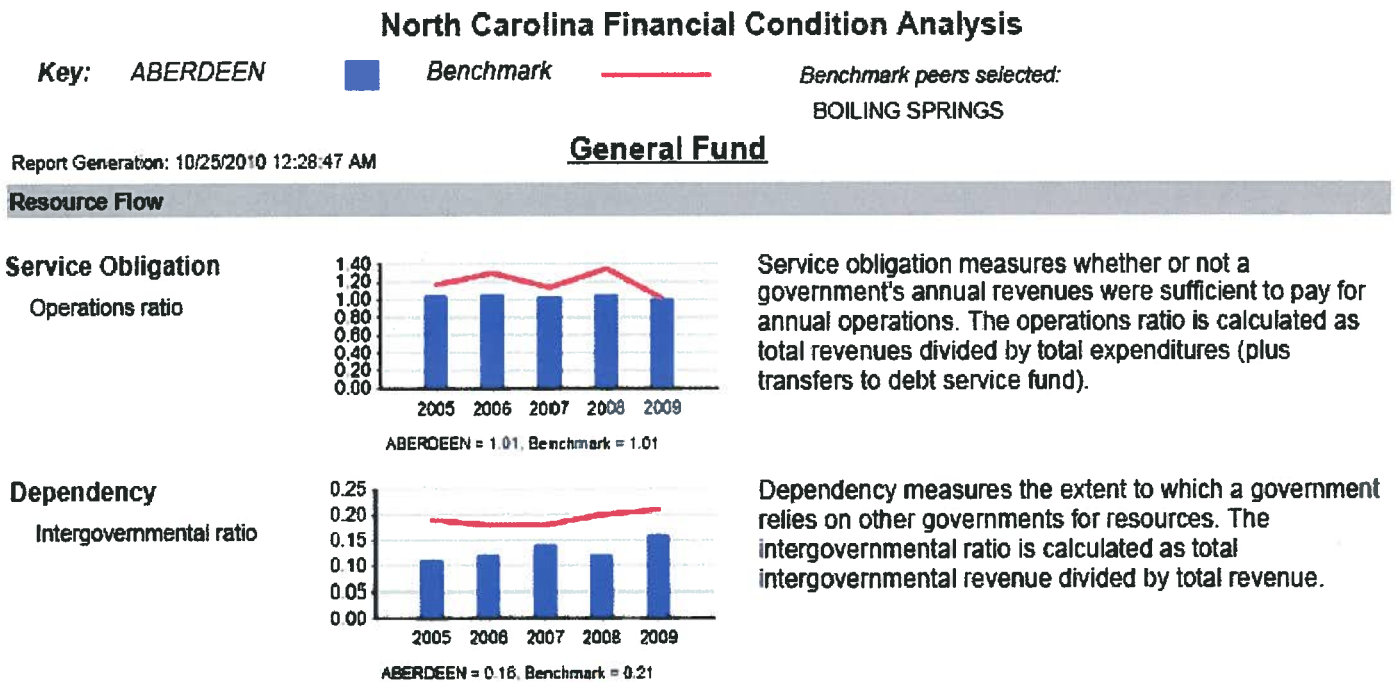


Figure 1: North Carolina Financial Condition Analysis

The analysis examines a series of financial ratios and provides comparison between the two municipalities selected. For example, Figure 1 depicts a comparison of the Operations Ratio for the City of Aberdeen (blue columns) and the City of Boiling Springs (red line). An operations ratio assess whether the government’s annual revenues were sufficient to pay

for annual operations. A ratio of one (1.0) would indicate that revenues equaled expenditures for operations. As depicted in Figure 1, the City of Aberdeen had a steady rate of 1.01 for the period of 2005 to 2009 while the City of Boiling Springs displayed more erratic indicators with revenues exceeding operating expenditures in 2006 and 2008. A downward warning trend cannot be determined without data for 2010, but could be “red flagged” as a community to watch in the future. A similar approach could be used for the LAFCO financial early warning system. In addition to the comparison of similar agencies, the Commission may also want to include the comparison to a county-wide average of each of the indicators selected.

PROPOSED PROCESS

The proposed process is provided in detail in *Attachment A* to this report. The initial efforts involve obtaining feedback on the proposed process from the entire Commission and the creation of a Commission Advisory Group to provide general oversight over the process during the next six months. Staff is recommending the Commission Advisory Group be comprised of three Commissioners. The group would provide assistance in vetting the comprehensive list of indicators (*Attachment B*), would add legitimacy to the process, and encourage participation by local stakeholders.

The next step would be the distribution of a survey to all affected agencies to determine the current use of financial indicators and to receive feedback on the proposed system. A specific question on the survey would ask about participation in a working group and a prototype study. The survey results of this question would be directed to the Commission Advisory Group which would recommend members of the working group and selection of the prototype study to the full Commission. The working group would consist of representatives from the cities, special districts, and the private sector. The Commission Advisory Group would participate in the working group meetings to direct preparation of and collect feedback on the prototype study.

Prior to the March 2011 LAFCO hearing, the prototype study would be vetted by an independent financial consultant to ensure completeness and objectivity. A case study of the City of Victorville might also be included in the prototype study as a method of assessing the capabilities of the early warning system and the strength of the indicators selected. San Bernardino LAFCO determined during the last sphere of influence update for the City of Victorville (September 2010) that the agency was experiencing fiscal stress and a case study could test the capability of the prototype study. The prototype study, with the Commission’s concurrence, could be expanded to all of the cities and special districts in Orange County. The timeline proposes the final expanded early warning system presentation to the Commission in May 2011. Staff anticipates the web-based financial early warning system being “live” on the LAFCO website in June of next year.

CONCLUSION

The proposed process (*Attachment A*) will develop a financial early warning system specific to Orange County that will be vetted and peer reviewed to allow opportunities for input from all of the local government stakeholders. Financial indicators and benchmarks cannot provide a complete picture of an agency's financial condition. Non-quantifiable factors such as internal management practices can greatly impact an agency's financial health. Given this limitation, the anticipated final product will focus on depicting the quantifiable factors of Orange County local governments while recognizing the unique political and economic climate of each agency.

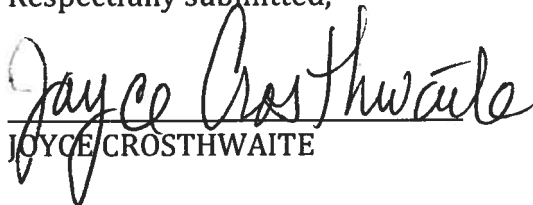
The process discussed above allows for the involvement of LAFCO Commissioners, financial experts, and local government stakeholders. This interactive approach is intended to allow for a thorough vetting of the indicators which will be specifically tailored to Orange County agencies.

RECOMMENDATIONS

Staff recommends that the Commission:

1. Approve the proposed process for the development of the financial early warning system as presented in *Attachment A* of this report.
2. Direct staff to initiate data requests from all of the cities and special districts in Orange County for audited financial statements for the past five (5) years.
3. Form a Commissioner Advisory Group consisting of three Commissioners.
4. Receive and file the initial report.

Respectfully submitted,


JOYCE CROSTHWAITE


BENJAMIN LEEBANDT

PROPOSED PROCESS

To ensure sufficient stakeholder involvement and time to analyze and vet the various financial indicators the following process and timeframe is recommended.

- 1) Initial report presented to Commission** *November 10, 2010*
The report provides an overview of the dashboard presentation of financial indicators and includes the proposed process.
- 2) Form Commissioner Advisory Group** *November 10, 2010*
*Advisory Group would consist of 3 Commissioners to provide input on the draft list of indicators presented in **Attachment B**; attend working group meetings and provide oversight.*
- 3) Distribute survey to cities & special districts** *November – January 2011*
This step would determine current utilization of financial indicators and also include interviews with willing participants in preparation for establishment of working group.
- 4) Prepare a draft list of indicators** *January 2011*
Based on the survey results a draft list of indicators will be prepared for vetting by the working group.
- 5) Working group meetings** *January – February 2011*
Representatives from the Commission, OCBC, Finance Officers, City Managers, and Special District General Managers
- 6) Prototype Study** *March 9, 2011*
Based on indicators chosen by working group a prototype of the final product will analyze a test group of agencies in Orange County.
- 7) Peer review of prototype study** *April 2011*
If approved by Commission in March the prototype system will be peer reviewed by independent consultant.
- 8) Working Group review of prototype system** *April 2011*
Working group will provide final review of peer review of the prototype study and system.
- 9) Presentation to Commission** *May 11, 2011*
- 10) Financial Dashboard system available for the public and local agencies on LAFCO website** *June 2011*

Attachment B

Category	Indicator	Formula	Warning Trend	Data availability
Revenues	(1) Revenues per Capita	Net operating revenues/population	Decreasing net operating revenues per capita	
	(2) Restricted Revenues	Restricted operating revenues/net operating revenues	Increasing amount of restricted operating revenues as a percentage of net operating revenues	
	(3) Intergovernmental Revenues	Intergovernmental operating revenues/gross operating revenues	Increasing amount of intergovernmental operating revenues as a percentage of gross operating revenues	
	(4) Elastic Revenues	Elastic operating revenues / net operating revenues	Decreasing amount of elastic operating revenues as a percentage of net operating revenues	
	(5) One Time Revenues	One-time operating revenues / net operating revenues	Increasing use of one-time operating revenues as a percentage of net operating revenues	
	(6) Tax Revenues	Tax revenues (constant dollars)	Decline in tax revenues	
	(7) Uncollected property taxes	Uncollected property taxes / net property tax levy	Increasing amount of uncollected property taxes as a percentage of net property tax levy	
	(8) User Charge Coverage	Revenues from fees and user charges/Expenditures for related services	Decreasing revenues from user charges as a percentage of total expenditures for related services	
	(9) Revenue shortfalls or surpluses	Revenue shortfalls or surpluses/net operating	Increase in revenue shortfalls or surpluses as a percentage of	

Expenditures		revenues	actual net operating revenues	
	(10) Expenditures per capita	Net operating expenditures/population	Increasing net operating expenditures per capita	
	(11) Operating expenses as a total of all expenses			
	(12) Expenditures by function	Operating expenditures for one function / total net operating expenditures	Increasing operating expenditures for one function as a percentage of total net operating expenditures	
	(13) Employees per capita	Number of municipal employees / population	Increasing number of municipal employees per capita	
	(14) Fixed costs	Fixed costs / net operating expenditures	Increasing fixed costs as a percentage of net operating expenditures	
	(15) Fringe benefits	Fringe benefit expenditures / salaries and wages	Increasing fringe benefit expenditures as a percentage of salaries and wages	
Operating Position	(16) Operating Deficit or Surplus	General fund operating deficit or surplus/net operating revenues	Increase in general fund operating deficit or surplus as a percentage of net operating revenues	
	(17) Enterprise Operating Position	Enterprise working capital or operating income in constant dollars	Reductions in working capital or recurring operating losses	
	(18) Fund balances	Unreserved fund balances / Net operating revenues	Declining unreserved fund balances as a percentage of net operating revenues	
	(19) Liquidity	Cash & short-term investments / Current	Decreasing amount of cash and short-term investments as a	

		liabilities	percentage of current liabilities	
Debt Structure	(20) Current liabilities	Current liabilities / net operating revenues	Increasing current liabilities at the end of the year as a percentage of net operating revenues	
	(21) Long-term debt	Net direct bonded long-term debt / assessed valuation, population, or personal income	Increasing net direct bonded long-term debt as a percentage of assessed valuation, population, or personal income	
	(22) Debt Service	Net direct debt service/net operating revenues	Increasing net direct debt service as a percentage of net operating revenues	
Unfunded liabilities	(23) Overlapping Debt	Long-term overlapping bonded debt / assessed valuation	Increasing long-term overlapping bonded debt as a percentage of assessed valuation	
	(24) Pension Obligations	Pension obligations/salaries and wages	Increasing pension obligations as a percentage of salaries and wages	
	(25) Pension assets	Pension plan assets / annual pension benefits paid	Decreasing value of pension plan assets as a percentage of benefits paid	
Capital Plant Indicators	(26) Post Employment Benefits	Total liability for post employment benefits/number of municipal employees	Increasing post employment benefits liability per municipal employee	
	(27) Maintenance effort	Expenditures for repair and maintenance of general fixed assets (constant dollars) / quantity of assets	Declining expenditures for maintenance of general fixed assets per unit of asset (constant dollars)	
	(28) Capital outlay	Capital outlay from	A three or more year decline in	

		operating funds / Net operating expenditures	capital outlay from operating funds as a percentage of net operating expenditures	
Community needs and resources indicators	(29) Population growth	Population over time	Rapid change in population	
	(30) Population density	Population / jurisdiction area in square miles	Decreasing population density	
	(31) Population under 18 & over 64	Population under 18 or over 64 /population	Increasing percentage of population under 18 or over 64	
	(32) Per Capita Income	Personal income (constant dollars) /population	Decline in the level of growth rate, or personal income per capita (constant dollars)	
	(33) Poverty households or public assistance recipients	Poverty households or public assistance recipients / households in thousands	Increasing proportion of poverty households or public assistance recipients	
	(34) Property Value	Change in property value (constant dollars) / property value in prior year (constant dollars)	Declining growth or drop in the market value or residential, commercial, or industrial property (constant dollars)	
	(35) Top five taxpayers	Total assessed value for top five taxpayers / total assessed valuation	High percentage or increasing percentage of overall assessed valuation owned by a few taxpayers	
	(36) Home ownership	Home ownership rate	Decreasing home ownership	
	(37) Vacancy rates	Vacancy rates	Increasing vacancy rates in residential, commercial, or industrial buildings	
(38) Crime rate	Crime rate	Increasing crime rate		
(39) Employment base	Employment and/or the number of jobs in the community	Increasing rate of local unemployment or a decline in the number of jobs in the		

	(40) Business activity	Retail sales (constant dollars) Number of business units Gross business receipts (constant dollars)	community Decline in business activity as measured by retail sales, number of business units, or gross business receipts (constant dollars where appropriate)	
Intergovernmental constraints	(41) Mandated activities	Expenditures for mandated activities / Net operating expenditures	Increasing percentage of expenditures for mandated activities	
	(42) Restrictions on fiscal powers	See trend worksheet	High level of external restrictions on fiscal powers	
Disaster Risk	(43) Disaster Risk	See trend worksheet	Lack of financial preparation for predictable natural disasters	