AUDITOR OF PUBLIC ACCOUNTS
LOCAL FISCAL DISTRESS MONITORING SUMMARY

The Virginia Acts of Assembly and Code of Virginia direct the Auditor of Public Accounts (Office) to establish a prioritized early warning system and annually monitor data and information from this system to identify potential fiscal distress within local governments across Virginia. During our first year of implementation in 2017, the Office used the Financial Assessment Model (FAM), which calculated an overall score for each locality based on the results of calculating ten financial ratios. We then evaluated the FAM score ratio results, along with consideration of other qualitative factors, to make our preliminary determination of the need to perform further follow up with a locality that appeared to show signs of potential fiscal distress.

During 2018, the Office changed the ratio methodology and overall approach to our fiscal distress monitoring model. The 2018 Local Government Fiscal Distress Monitoring Report provides more information about the Office's considerations when updating the methodology for our ratio model, along with expanded detail about the various enhancements made to each component of our early warning system model. Primarily, we determined the need to change our approach to how we analyze each locality's financial ratio results. We no longer use the methodology from the prior 2016 - 2017 model to calculate a ratio score or ranking when evaluating a locality's financial ratio results.

As part of the ratio analysis, we apply a methodology that analyzes each locality's ratio performance on an individual basis and does not compare the ratio results from one locality to another. The model calculates 12 financial ratios and assigns a points-based evaluation according to each ratio result. The Office uses a methodology to assign points for each ratio according to how the ratio performs in general at a level of strong, adequate, or weak. Overall, a higher number of points for each ratio, and in total for all ratios combined, indicate the locality is generally showing a weak or unfavorable performance in the ratio analysis. After analyzing each locality's points cumulatively for all ratios, the Office determines whether we need to perform further qualitative analysis on any locality with a high number of points based on our selected threshold of total points for all 12 financial ratios. We also review any trends showing significant increases in total points from year to year. Our selected threshold is based on professional judgment and will vary from year to year as we evaluate the performance of the ratios, along with any other external factors that may affect our analysis. Currently, we are applying a 45-point threshold as the indicator to apply our second qualitative review process. Appendix 1 gives additional information on the ratio weighting and points assigned for each ratio based on applicable levels of performance, along with detailed calculations and further descriptions for each ratio.

The second component of our model includes an additional assessment of demographic and other external, qualitative factors as part of our final evaluation to identify whether a locality should participate in our follow-up process. Appendix 3 discusses our Office's follow-up review and questionnaire process.

The qualitative evaluation focuses only on those localities we have identified in the ratio analysis as coming above our established threshold of total cumulative points for the 12 ratios. The qualitative analysis reviews trends in demographic factors, such as growth or decline in population, median household income, unemployment rate, poverty rate, and the assessed value of a locality's real estate and personal property. In addition, our qualitative analysis incorporates trends from other local government assessments performed by state entities to meet other monitoring objectives, such as the analyses from the Commission on Local Government and the Virginia Department of Education. Lastly, the qualitative analysis incorporates any external, economic, or other qualitative information that may come to our attention about a specific locality. Appendix 2 shows an example of the overall factors included in our qualitative analysis.

As part of our model, the Office then applies a qualitative evaluation, instead of a quantitative or numerical score, as the overall measure for making a preliminary determination of potential fiscal distress at a locality and the need to perform additional review. Based on the results of both the ratio and qualitative analyses, we classify each locality into either one of two categories: needs further follow-up through our financial assessment questionnaire and review process **or** does not need any further follow-up for the current monitoring process.

Financial Ratio Calculations **Appendix 1**

The following information describes the 12 financial ratios used in our ratio analysis to provide the specific ratio calculations, further interpretation from the Office related to the outcome of each ratio, and the weighting and points assignment for each ratio based on applicable levels of performance.

Ratio	Ratio Calculations	Ratio Description	Ratio Results Interpretation	Assignment of Points Based on Ratio Results
1	Cash and Cash Equivalents + Investments - Current Liabilities/ Charges for Services + General Revenues (*Government-wide Activity*)	This ratio measures the sufficiency of unrestricted reserves relative to the locality's normal revenue (non-grant revenue). By comparing the locality's unrestricted liquid assets (net of current liabilities) to its normal revenue, we can see the locality's ability to make up a revenue shortfall or utilize unrestricted reserves during an unforeseen situation.	• A higher ratio percentage suggests a locality is in a desirable position to make up a revenue shortfall or utilize unrestricted reserves during an unforeseen situation. • A lower ratio percentage suggests that a locality may not be in a desirable position to make up a revenue shortfall or utilize unrestricted reserves during an unforeseen situation. • A negative ratio percentage indicates that a locality does not have any unrestricted reserves.	Ratio is weighted at 10% • Ratio result is negative or less than 5%: 10 points • Ratio result is between 5% and 10%: 6.67 points • Ratio result is between 10% and 15%: 3.33 points • Ratio result is equal to or greater than 15%: 0 points
2	Cash and Cash Equivalents + Investments/ Total (Current and Noncurrent) Liabilities (*Government-wide Activity*)	This ratio measures the sufficiency of unrestricted reserves relative to the locality's total liabilities. By comparing the locality's unrestricted liquid assets to total liabilities, we can see its ability to pay total liabilities without needing additional revenue. *Note: This ratio removes the effect of the pension and other post-employment liabilities.*	• A higher ratio percentage suggests that a locality is in a desirable position to meet its obligations. • A lower ratio percentage suggests that a locality may not be in a desirable position to meet its obligations without obtaining additional revenues.	Ratio is weighted at 5% • Ratio result is less than 30%: 5 points • Ratio result is between 30% and 60%: 2.5 points • Ratio result is equal to or greater than 60%: 0 points
3	Net Position Unrestricted/ Total Expenses (*Government-wide Activity*)	This ratio measures the sufficiency of unrestricted reserves relative to the locality's expenses. By comparing the locality's unrestricted net position to its total expenses, we can see to what extent the locality can fund expenses from unrestricted reserves in the event of a revenue shortfall or unforeseen situation. *Note: This ratio removes the effect of the pension and other post-employment liabilities.*	• A higher ratio percentage suggests that a locality is in a desirable position to fund expenses from unrestricted reserves in the event of a revenue shortfall or unforeseen situation. • A lower ratio percentage suggests that a locality may not be in a desirable position to fund expenses from unrestricted reserves in the event of a revenue shortfall or unforeseen situation. • A negative ratio percentage indicates that a locality has a deficit unrestricted net position.	Ratio is weighted at 15% • Ratio result is negative or less than 5%: 15 points • Ratio result is between 5% and 10%: 10 points • Ratio result is between 10% and 15%: 5 points • Ratio result is equal to or greater than 15%: 0 points
4	Change in Net Position (Ending - Beginning)/ Net Position Beginning (*Government-wide Activity*)	This financial performance ratio shows the magnitude of how the locality's financial position improved or deteriorated as a result of resource flow. The percent change in net position provides the magnitude of how the beginning resource level changed as a result of resource flow during the fiscal year. *Note: This ratio removes the effect of the pension and other post-employment liabilities.*	The desirable change should be positive rather than negative. • A positive ratio percentage indicates that a locality's net position has improved from the prior year. • A negative ratio percentage indicates that a locality's net position has declined from the prior year. The higher the percentage decrease indicates a more negative downward trend.	Ratio is weighted at 10% • Ratio result is negative with a high decrease equal to or greater than (40)%: 10 points • Ratio result is negative with an intermediate decrease between (15)% and (40)%: 6.67 points • Ratio result is negative with a low decrease between (.01)% and (15)%: 3.33 points • Ratio result is positive or no change: 0 points
5	Total Tax Supported Debt/ FMV of Taxable Real Estate + Assessed Value of Tangible Personal Property + Assessed Value of Public Service Corporations (*Government-wide Activity*)	This ratio reviews a locality's total debt burden by measuring total direct, tax supported debt outstanding for governmental and business-type activities to the locality's fair market value (FMV) of total taxable real estate, plus the assessed values of tangible personal property and public service corporations. We obtain valuation data for the cities and counties from Table 6.2 and Table 6.4 of the Virginia Department of Taxation's Annual Report, as of the most recent tax year. Town data is not published in this annual report; therefore, it is obtained from the town's audited annual financial report, if available.	The Office uses a standard methodology in measuring this ratio comparable to how other professionals examine trends for this ratio, such as the Virginia Resources Authority, International City/County Management Association (ICMA), bond rating agencies, and other state's fiscal monitoring systems. An increase in long-term debt as a percentage of real property valuation can indicate that a locality's ability to repay its obligations is trending negatively. The Office uses the following trends when evaluating this ratio: • A ratio percentage less than 3% indicates strong performance. • A ratio percentage between 3% and 6% indicates adequate performance. • A ratio percentage equal to or greater than 6% indicates weaker performance.	Ratio is weighted at 10% • Ratio result is greater than 6%: 10 points • Ratio result is between 3% and 6%: 5 points • Ratio result is less than 3%: 0 points

Financial Ratio Calculations   Appendix 1

Ratio	Ratio Calculations	Ratio Description	Ratio Results Interpretation	Assignment of Points Based on Ratio Results
6	Unassigned + Assigned Fund Balances (+ other Committed reserves where applicable)/ Total Expenses (*General Fund Activity*)	This ratio measures the sufficiency of unrestricted reserves, plus any applicable reserves specifically set aside, relative to the locality's operating expenses. By comparing the locality's fund balance reserves to its operating expenses, we can see to what extent the locality can fund operating expenses from reserves in the event of a revenue shortfall or unforeseen situation.	• A higher ratio percentage suggests that a locality is in a desirable position to fund expenses from unrestricted reserves in the event of a revenue shortfall or unforeseen situation. • A lower ratio percentage suggests that a locality may not be in a desirable position to fund expenses from unrestricted reserves in the event of a revenue shortfall or unforeseen situation. • A negative ratio percentage indicates that a locality has a deficit unassigned fund balance in its general fund.	Ratio is weighted at 15% • Ratio result is negative or less than 5%: 15 points • Ratio result is between 5% and 10%: 10 points • Ratio result is between 10% and 15%: 5 points • Ratio result is equal to or greater than 15%: 0 points
7	Total Fund Balance/ Total Revenues (*General Fund Activity*)	This ratio measures the sufficiency of reserves relative to the locality's general fund revenue. By comparing the locality's reserves to its revenue, we can see to what extent the locality can make up revenue shortfalls with reserves.	• A higher ratio percentage suggests that a locality is in a desirable position to have sufficient reserves in the event of a revenue shortfall. • A lower ratio percentage suggests that a locality may not be in a desirable position to have sufficient reserves in the event of a revenue shortfall.	Ratio is weighted at 10% • Ratio result is negative or less than 5%: 10 points • Ratio result is between 5% and 10%: 5 points • Ratio result is equal to or greater than 10%: 0 points
8	Total Revenues/ Total Expenses (*General Fund Activity*)	This ratio, known as the Service Obligation or Operations Ratio, measures whether a locality's annual revenues were sufficient to pay for annual operations. This ratio does not account for Other Financing Sources, such as Transfers In.	This ratio has a natural benchmark of 100% or higher. A ratio result under 100% means that total operating expenses exceeded total operating revenues in the general fund.	Ratio is weighted at 10% • Ratio result is less than 60%: 10 points • Ratio result is between 60% and 100%: 5 points • Ratio result is equal to or greater than 100%: 0 points
9	Debt Service Principal and Interest Expenses/ Total Revenues (available to pay the debt service) *(General Fund Activity and Debt Service Fund Activity, if applicable)*	This ratio measures total debt service expenses divided by total revenues, primarily from the general fund. It also includes any other applicable governmental funds since some localities account for debt service in separate debt service fund or capital project fund outside of the general fund. This ratio identifies the percent of the locality's budget that is used or needed for repayment of debt. An increasing trend of debt service expenses to total revenues may mean the percentage of budget dedicated to debt payments is increasing; and therefore, less revenue will be available for asset repair/ replacement or meeting current service demands. As debt service increases, it adds to a locality's obligations and reduces the locality's expenditure flexibility.	• A higher ratio percentage suggests that a locality is an unfavorable position since the locality spends more of its current budget on debt repayment. • A lower ratio percentage suggests that a locality is in a more desirable, favorable position since the locality is spending less of its current budget on debt repayment.	Ratio is weighted at 10% • Ratio result is equal to or greater than 20%: 10 points • Ratio result is between 10% and 20%: 5 points • Ratio result is equal to or less than 10%: 0 points
10	Change in General Fund Unassigned Fund Balance (Current Year Ending - Prior Year Ending/ Prior Year Ending) (*General Fund Activity*)	This ratio identifies changes (increases or decreases) in unassigned fund balances from the prior year to the current year and is useful in identifying a locality whose unassigned fund balance is deteriorating over time, and how rapidly it may be decreasing.	• A positive change indicates a more favorable position since this indicates that unrestricted fund balance is growing. • A negative change could indicate an unfavorable position, particularly over a period of years, as this could indicate the locality is using fund balance reserves due to a fiscal distress situation.	Ratio is weighted at 10% • Ratio result is negative with a high decrease equal to or greater than (30)%: 10 points • Ratio result is negative with an intermediate decrease between (15)% and (30)%: 6.67 points • Ratio result is negative with a low decrease between (.01)% and (15)%: 3.33 points • Ratio result is positive or no change: 0 points

Ratio	Ratio Calculations	Ratio Description	Ratio Results Interpretation	Assignment of Points Based on Ratio Results
11	Intergovernmental Operating Revenues/ Total Revenues (*General Fund Activity*)	This ratio looks at a locality's reliance on revenues coming from other governmental revenues, such as grants and aid coming from federal and state. A key factor is also to determine the locality's vulnerability to reductions of such revenues. The external source may withdraw the funds and leave the locality with the dilemma of cutting programs or having to pay for them with general fund resources.	• A higher ratio percentage indicates that the locality has a higher dependence on revenues coming from other sources outside of the locality's own local revenues and may suggest that a locality is an unfavorable position. • A lower ratio percentage indicates that the locality has a lower dependence on revenues coming from other sources outside of the locality's own local revenues and may suggest that a locality is in a more favorable position.	Ratio is weighted at 10% • Ratio result is equal to or greater than 50%: 10 points • Ratio result is between 25% and 50%: 5 points • Ratio result is less than 25%: 0 points
12	Proprietary Fund Statements- Enterprise Fund Activity: Change in Net Position - Net Fund Transfers To (From)/ Expenses	This ratio is known as the "Business Type Activity Self Sufficiency" ratio, which measures the percent of business-type enterprise fund(s) expenses that were covered by enterprise fund(s) non-transfer revenues. If a locality has an enterprise fund that is not self-sufficient and not self-supporting but continues to rely on general fund transfers to support the enterprise fund, this could be a sign of distress. While this ratio shows coverage in total for all enterprise funds (as applicable), an important factor to consider is whether any transfers or loans were required for individual enterprise funds. *Note: This ratio is calculated only for localities that have enterprise funds.*	• A ratio result of 100% or greater indicates that enterprise fund activities as a whole were successful in recovering the full costs of service through charges for services or other revenues. • A ratio result of less than 100% indicates that the enterprise fund activities had to borrow from the past (by spending down assets or fund balance), borrow from the future (by increasing liabilities), or be subsidized by governmental funds through transfers, such as transfers from the general fund.	Ratio is weighted at 10% • Ratio result is between 1% and 50%: 10 points • Ratio result is between 50% and 100%: 5 points • Ratio result is equal to or greater than 100%: 0 points

The Office's model includes a second component, which involves an additional assessment of demographic and other external, qualitative factors as part of our final evaluation to identify whether a locality should participate in our follow-up process. The qualitative evaluation focuses only on those localities we have identified in the ratio analysis as exceeding our established threshold of total points for all 12 financial ratios. The following information provides a summary of the primary factors the Office evaluates as part of our demographic and qualitative analysis.

Population growth or decline based on the most recent count from the U.S. Census Bureau, compared to a three-year trend of local population estimates published by the University of Virginia Weldon Cooper Center

Three-year trend of local unemployment rate compared to the national and Virginia averages, as published by the Virginia Employment Commission and U.S. Bureau of Labor Statistics

Three-year trend of local median household income compared to the national and Virginia averages, as published by the U.S. Census Bureau

Three-year trend of local poverty rate compared to the national and Virginia averages, as published by the U.S. Census Bureau

Three-year trend in assessed value of the locality's tax base for the total value of real estate, tangible personal property, and public service corporations, as published annually by the Virginia Department of Taxation

Three-year trend in the locality's fiscal stress ranking and class designations, as published by the Commission on Local Government

Three-year trend of the locality's percent of actual local expenditures above the Required Local Effort and Required Local Match, and the Composite Index of Local Ability to Pay, as published by the Virginia Department of Education

Other external, economic, or qualitative factors through analysis of audited financial reports and monitoring external sources, such as information from state and local officials, local governing body meetings, or media

Follow-Up Review and Assessment Questionnaire Process — Appendix 3

The ratio and qualitative analyses are used as a starting point to make a preliminary determination of the need for our Office to perform further follow-up with a locality that appears to show signs of potential fiscal distress. Through a financial assessment questionnaire and further discussions with locality officials, our follow-up review focuses on gaining a better understanding of several key financial and other factors affecting a locality's situation, as shown in the figure below. The financial assessment questionnaire is a key component of our follow-up process, as it is designed to examine the qualitative and external factors unique to each locality that are not easily measured in a financial ratio, along with understanding policy and procedural aspects that may contribute to a locality's results in the ratio and qualitative analyses. The Office has included the financial assessment questionnaire on our website for any locality to use as an internal self-assessment tool.

Budget Process

- Does the locality have a structurally balanced budget?
- Has the locality utilized any significant transfers during the year to balance the budget?
- What is the locality's budget monitoring and reporting process?
- Are there any other external factors that have affected the locality's budget?

Debt and Borrowing

- Was the locality delinquent with any of its debt service payments, or noncompliant with any debt covenants?
- Has there been a recent change in the locality's bond rating by any of the bond rating agencies?
- Does the locality have any significant interfund borrowings between its general fund and other funds, such as an enterprise fund?
- Did the locality obtain any tax or revenue anticipation notes, or any other type of short-term financing during the year?

Expenses and Payables

- Does the locality have any payments in arrears to vendors or any joint participating authorities?
- Does management utilize any accounts payable aging analysis tools or reporting to periodically review liabilities and maximize cash flow?
- Was the locality delinquent in paying employee wages or other benefits, payroll taxes, retirement contributions, health insurance premiums, or workers compensation?

Revenue and Receivables

- Did the locality have any one-time, significant revenue items during the year?
- Has the locality experienced any significant revenue shortfall in a specific local revenue source?
- Is the locality experiencing any significant issues with collecting receivables?
- Does management utilize any accounts receivable aging analysis tools or reporting techniques to periodically review collections and overdue, delinquent accounts?

Reporting and Other Areas

- Has the locality experienced any vacancies in key management or finance related positions?
- Has the locality experienced any major issues with implementing new systems or technology?
- Has the local governing body adopted financial management policies to provide a framework for sound decision-making and long-term stability?
- Did the locality's independent auditor report any audit findings that may indicate fiscal stress?
- If the locality has continued to have an untimely audit and late reporting submissions, how are the governing body and management ensuring that action is taken to correct this in future?

The primary objective of our follow-up process is to determine if a locality is experiencing a situation of fiscal distress that warrants further assistance or intervention from the Commonwealth. The legislature has tasked our Office with developing an annual monitoring system that focuses on looking for early warning signs to determine if a locality is in fiscal distress and make a conclusion of whether a locality needs state assistance or intervention to further assess, help stabilize, or remediate the situation. Accordingly, our annual monitoring and follow-up review process is not designed to evaluate or give an opinion on a locality's fiscal health. The governing body and management at each locality have the responsibility for assessing and monitoring the fiscal health and stability of their locality.

If the Office's follow-up process indicates that a locality does not appear to be in a situation of fiscal distress, our review and discussions with a locality focus on obtaining an understanding of the specific issues and factors that may have contributed to the results in our ratio and qualitative analyses. Additionally, the follow-up process assists our Office in further understanding the policies and plans the locality has in place to continue to move forward and improve its financial position. Alternatively, if our follow-up process does identify a locality that is demonstrating signs of fiscal distress, our review focuses on obtaining an understanding of the extent of underlying issues causing the distress, the locality's response to the situation, and any policies or plans the locality should implement to move forward and improve its financial position. After completion of the follow-up review with a locality, our process involves further evaluation of a locality's specific situation of fiscal distress to determine if state assistance is needed. If necessary, the Office then formally notifies, in writing, the Governor, Money Committees, and the locality's governing body, about the specific issues or actions that may require state assistance or intervention. At that point, the legislation specifies that the Governor's office, in consultation with the Money Committees, will administer the process of deciding whether further consideration or action by the Commonwealth for assistance may be appropriate to help address the locality's fiscal distress.