

# **PERSPECTIVES ON ANALYTICAL PROCEDURES: THE VIEWPOINTS OF STATE AND LOCAL GOVERNMENT FINANCIAL MANAGERS**

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## **ABSTRACT**

Financial statement indicators (ratios) and common-size data are available and used for decision making in the private sector. They are not readily available in the state and local government sector. This study indicates that financial managers in state and local government believe the use of these analytical procedures would provide a better means of understanding and explaining a government's financial condition.

## **INTRODUCTION**

The basic financial statements for state and local governments, when prepared in accordance with generally accepted accounting principles (GAAP) and audited in accordance with generally accepted governmental auditing standards (GAGAS), provide information to assess the governments' financial condition, operating results, and its ability to meet its obligations. Financial statement analysis is used by internal and external users. Government financial managers (internal) use this analysis to assess performance and plan for subsequent operating activities for future years. Taxpayers and creditor/investors (external) use this traditional analysis to also evaluate the organizations' financial condition and management's performance. Both internal and external financial statement users incorporate their analysis into the decision making process that entails the allocation of scarce economic resources.

The decision making process is uniquely developed within each organization according to its structure and dynamics. As such, various analytical procedures are used in the analysis of the basic financial statements. Bond rating companies evaluate an organization's financial statements as part of the process for rating prospective bond issues or reassessing the risk of currently outstanding corporate and/or government bonds. Stockholders evaluate corporate financial statements to assess their individual investment return and risk. Taxpayers and bond investors should assess the financial statements of their government to determine organizational performance and financial condition.

Both business and government organizations issue bonds and compete in the open economy for investor dollars. Because GAAP requirements provide that like economic events are measured and reported similarly, it appears that the financial statements by business and government can be and should be evaluated using similar analytical tools. To evaluate the financial condition of the company, analysts calculate appropriate financial ratios and compare them to like companies or the broader composite ratios of other companies in the same industry. A prudent investor/creditor would most likely use comparable tools to evaluate the options available for the placement of capital. Industry ratios are readily available in the business sector and greatly facilitate the decision making process of the investor/creditor group as to the allocation choice of scarce economic resources. Industry averages in

the state and local government (SLG) arena are principally non-existent.

There were three purposes of this study:

- 1) to determine the current use of selected analytical procedures by state and local government financial managers,
- 2) to assess the perspectives of state and local government financial managers about selected analytical procedures, and
- 3) to assess the perspectives of state and local government financial managers as to the need for comprehensive industry standards.

## **METHODOLOGY**

### **Scope of the Study**

The scope of the research was limited to financial managers from Alabama state agencies and local governments. The process was designed to determine the perspectives of state and local government financial managers about selected analytical procedures and to determine their current use of selected analytical procedures. Analysis was limited to the overall government and used the government wide financial statements required by GASB Statement No. 34.

### **Analytical Procedures**

The study used two types of analytical procedures commonly applied to analysis of business financial statements: (1) comparative statements in both dollar amounts and percentages (common-size) and (2) financial performance indicators (ratios) to assess the financial condition. The review of the literature provided several financial ratios that could be used to measure the financial condition of a state government. The authors' selected the most common measures available for evaluating the components of financial condition: liquidity, leverage, and ability to provide basic services.

### **Study Process**

The two authors designed and conducted this study as presenters at a continuing professional education (CPE) conference sponsored by the Government Finance Officers Association of Alabama. Four hours of the 2½ day program was provided for this study. The topic and delivery style was printed in the conference marketing brochure. All participants who paid to attend this CPE conference knew that they could select to be participants in a study group concerned with governmental financial statement analysis. Fifty-five of the registrants elected to participate in this concurrent session.

The participants were provided comparative statements in both dollar amounts and percentages prepared by the authors from actual statements issued by a selected medium sized city. The actual city was referred to as Sample City in the study financial statements. The questions/tasks given the participants included:

- Efficacy of the financial statement ratios for use in assessing financial condition and management performance. The three selected ratios were calculated by the participants from the comparative financial statements of Sample City.
- Identification of financial condition trends from four years of common-sized financial

statements of Sample City. The common-sized statements were prepared by the authors/facilitators from Sample City financial statements.

- Efficacy of common-size statements for use in analyzing financial condition and management performance.
- Efficacy of these ratios and common-sized statements when compared with an industry data base.
- Current use of any analytical procedures including those given above.

The survey responses were compiled in an excel spreadsheet for purposes of calculating and analyzing the results of this study.

## **FINDINGS AND CONCLUSIONS**

**Efficacy of Financial Statement Ratios:** All groups agreed that the liquidity ratio and the leverage ratio provided a more in depth understanding of the Sample City's financial position. They did not agree when using the continuing services ratio. The primary criticism of the continuing services ratio was it was too simplistic to reflect all the factors that would actually impact a government's ability to continue to provide services in the future.

**Identification of Financial Condition Trends:** The participants reached consensus that the common-size statements provided a quick identification of key trends regarding financial condition components and operating activity.

**Efficacy of Common-Size Statements and Ratios for Industry Comparisons:** The groups overwhelmingly agreed that industry ratios and common-size financial statements would be very helpful in analyzing and explaining the government's financial performance. Their concern was that the political process would not allow for the presentation of common-size statements that may show the entity with any negative results. The group did support the concept completely if politics were not a factor.

Industry averages and common-size data, available in the private sector, are not readily available in the state and local government arena. The participants believe that such industry ratios are important but will only be realized if the investment community and the professional accounting and public administration organizations insist on this happening. The consensus of the participants was that in order to advance public sector financial accountability, there will need to be a financial data base for the state and local government sector (industry).