Being transparent about the true cost of doing business—another essential step in achieving fiscal health—means these costs must no longer be hidden **but clearly identified and made transparent to the organization and the citizens who provide for their funding.**

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IT'S ALL IN THE QUESTIONS PART 2

The Manager's Role in Achieving Fiscal Health

The current fiscal reality for most if not all local governments is challenging and bleak, to say the least. Declining revenues, slower if not stagnant growth, and depleted reserves are factors forcing the local government manager to become more involved as a partner with the finance officer in order to identify the symptoms and causes of the organization's fiscal distress. Working together this way, they can use the diagnostic analysis performed to correctly prescribe and apply the most appropriate and effective treatments.

By asking a series of basic diagnostic questions, the manager is able to gain a better understanding of the organization's fiscal health. It isn't enough, however, to simply pose the questions to the finance officer. It's also necessary to follow up with another question: Can you show me? Without documented and demonstrated analysis supporting the answer, the manager may be relying on inaccurate assumptions or unsubstantiated conclusions that don't treat the real symptoms.

The September issue of *PM* presented the first three questions that managers should be asking their financial officers:

QUESTION 1: Are we truly spending within our means?

QUESTION 2: Are we maintaining required reserves, and are they adequate and appropriate?

QUESTION 3: Do we understand our variances–especially budget versus actual?

This article continues the discussion and suggests the additional questions that need to be asked and analyzed to accurately and successfully assess the state of the organization's fiscal health.

Figure 1 outlines a diagnostic approach that helps an organization achieve fiscal health, the first step leading to long-term financial sustainability. By asking the right questions in five areas and then asking for basic diagnostic tests to be performed, the manager can obtain answers that help isolate the potential cause(s) of the fiscal issues and then focus on more in-depth analysis to identify and apply the most appropriate and effective treatments.

QUESTION 4: Are we being transparent about the true cost of doing business?

Within every entity, whether a Fortune 500 company or a local government, are elements commonly referred to as overhead or hidden costs. Being transparent about the true cost of doing business—another essential step in achieving fiscal health—means these costs must no longer be hidden but clearly identified and made transparent to the organization and the citizens who provide for their funding.

Transparency is simply about understanding and trust. The services provided by such internal functions as human resources, finance, legal, information technology, facilities, and fleet are critical to the success of the organization. Thus, the costs associated with these services should not be unexpected. If these internal or indirect costs are not connected with the various services being provided directly to citizens, it is unclear what any particular service truly costs, and a lack of transparency about the true cost of doing business is created.

Establishing fees for services without accounting for all costs, both direct and indirect, may unfairly use tax dollars to fund services that are expected to partially or fully pay for themselves. Failing to allocate indirect costs to other funds that benefit from the services provided by the overhead departments unnecessarily and unfairly burdens the general fund, affecting its financial sustainability.

FIGURE 1.
Assessing fiscal health

But transparency involves not only understanding but also trust—trust that these costs are appropriate and that the end users of those overhead services see clearly what drives those costs. Involving end users in discussions about changes they can make that may reduce costs not only establishes an atmosphere of trust but also drives further efficiencies and operational changes that benefit the organization. After trust is established, these previously hidden costs can be equitably associated with those operational areas that receive the benefit.

In raising this fourth question, the manager will realize these fiscal health objectives:

- Allocating appropriate internal and indirect costs so that the burden is shared by the programs (and other accounting funds) that demand and use those services.
- Ensuring that fees for services where some level of cost recovery is expected are capturing both direct and indirect costs associated with the service.
- Identifying opportunities to establish internal service funds for those departments that exist primarily to provide services to internal customers.

In determining the answer to the question of whether the local government is being transparent about the true cost of doing business, these more specific questions will help ensure a more complete and transparent understanding:

1. Do we have any internal service funds? If so, what services are accounted for in those funds, and how are the internal charges established and distributed?

- Assess that appropriate demand metrics are evaluated when determining rates to be charged to the internal customers of these internal services.
- Verify that internal customers perceive that costs are transparent and that they have the ability to influence those costs by altering their own demands.

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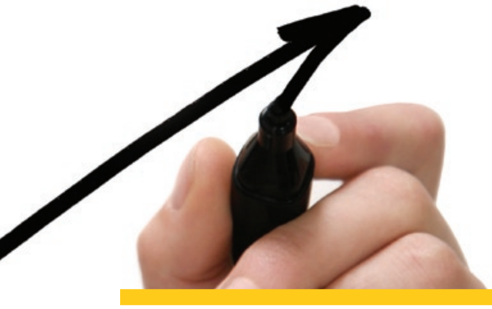


It is only by incorporating every planning tool available that decisionmakers can objectively understand **the long-term effects their decisions have on the overall fiscal health of the organization.**

2. Do we prepare any type of cost allocation plan (for example, the cost plan or full cost allocation plan described in OMB A–87, "Cost Principles for State, Local, and Indian Tribal Governments")? If so, how is this plan incorporated into the budget process?

- Gain an understanding of the allocation methodologies incorporated in the cost plan.
- Validate that fees charged to offset the cost of providing services are calculated using both direct and indirect costs.
- Determine whether indirect or overhead costs accounted for in the general fund could more appropriately be charged to another fund, thus relieving the burden on the general fund.

As the manager assesses the responses and looks over the accompanying diagnostic analysis, it becomes more apparent that these elements of fiscal health are present:

- Implement internal service funds, where appropriate, to align cost and level of service with customer demand.
- Use a cost-allocation plan to appropriately establish the means by which costs associated with all overhead and administrative programs can be allocated between departments and between accounting funds.
- Ensure that fees charged to offset the cost of providing a service recapture an appropriate level of both direct and indirect costs.
- Relieve the burden of indirect costs charged to the general fund by more appropriately charging them against the funds that benefit from the internal services provided.

QUESTION 5: How are we incorporating economic analysis and long-term planning into decision making?
In "Excelling in Times of Fiscal Distress," an October 1, 2008, article posted on Governing.com, ICMA Executive Director Bob O'Neill observes, "Most of us can articulate the early-warning signs that preceded the current economic downturn: Global forces that dramatically changed the local, state and federal playing fields. Skyrocketing fuel costs. A failing housing market. . . . Property tax limitations. Yet, many of us failed to correctly interpret these early-warning signs in relation to their impact on our government organizations."

Among the causes behind the failure that O'Neill recognized is the lack of attention given to the visible warning signs and their potential impacts. An even more significant cause of local government's distress occurs when, despite accurate interpretations of economic indicators and despite forecasts made with reasonable accuracy, decisionmakers make decisions without the context of how economic conditions impact their assumptions about the future.

Effects of the economy on expenditures and revenue sources are not the only influences many local governments fail to interpret or appropriately incorporate into their planning. Many entities devise elaborate and precise long-term plans to help focus on the achievement of organizational objectives.

These plans include key capital projects like infrastructure improvements, technology enhancements, citizen surveying, the development of comprehensive plans, or other strategic initiatives. Unfortunately, these plans often remain isolated (and unnoticed) within individual departments and are never appropriately synchronized with the big-picture scenarios decisionmakers depend on.

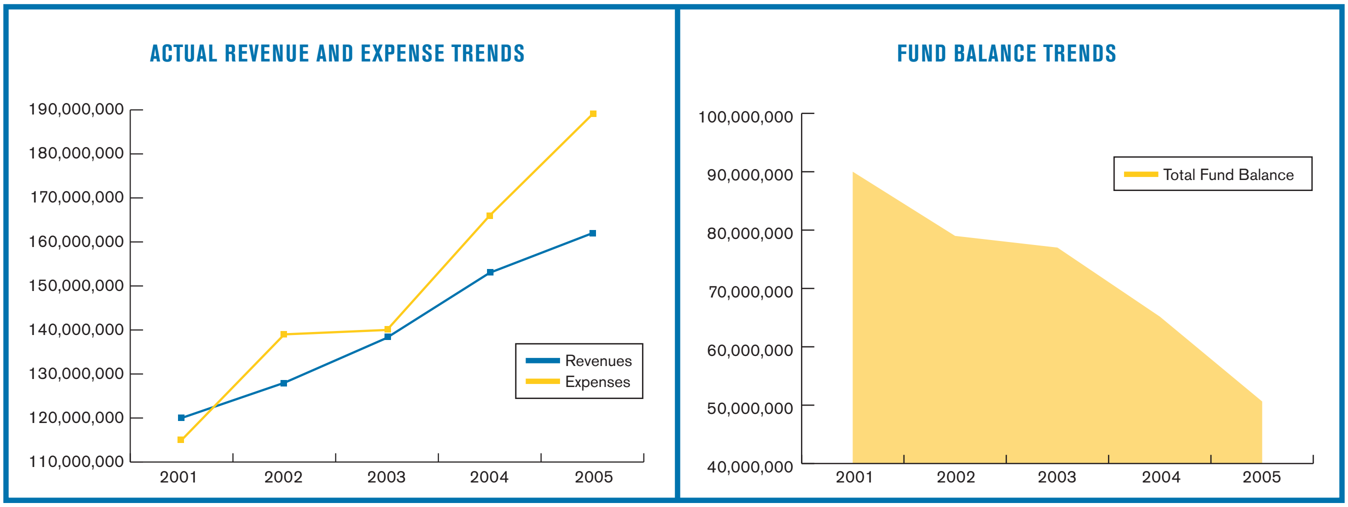
It is only by incorporating every planning tool available that decisionmakers can objectively understand the long-term effects their decisions have on the organization and, more important, the impact of those decisions on the entity's overall fiscal health. Championing the merits of scenario planning in the context of upholding an organization's stated objectives, Peter Schwartz postulates in *The Art of Long View* that "you can tell you have good scenarios when they are both plausible and surprising; when they have the power to break old stereotypes; and when the makers assume ownership of them and put them to work. Scenario making is intensely participatory or it fails."

Incorporating all long-term plans that are relevant to the objectives the organization is trying to achieve will ensure that these decisions are made in a more informed and strategic context.

In posing this fifth question, the manager can achieve the final objectives of fiscal health and bring it all together to frame decision making:

- Account for the impact of external economic influences.
- Incorporate and consolidate long-term plans into long-term forecasts.
- Assimilate all elements of fiscal health into scenario planning to ensure that decisions are made while upholding the objectives of fiscal health.

FIGURE 2. Ongoing fiscal health versus one-time fiscal health (general funds 2001–2005)



When asking how the local government is incorporating economic analysis and long-term planning into decision making, a manager should specifically ask these questions and see the diagnostic analysis that supports the answer:

1. Does our five-year forecast incorporate other long-term plans our organization has developed? If yes, what plans are included, and how are they incorporated into our forecasts?

- Verify that the all capital improvement plans, comprehensive plans, and other long-range plans are incorporated into the budget process.
- Verify that all plans are included in long-term forecasts.

2. What is our approach to planning for one-time or other capital-related initiatives? What information do we include or exclude? How is this information used in our budget process and our financial forecasts? Is the plan complete, with no monsters under the bed (in other words, capital needs or initiatives that are not planned completely but could have a serious impact on our available resources)?

- Determine that all ongoing operating costs associated with the completion of a project are fully and accurately identified.
- Verify that funding sources are identified for each project or initiative (both ongoing and one-time).

3. What tools does our organization use to communicate financial information to our elected decisionmakers?

- Understand the tools used to communicate critical financial information.
- Assess whether these tools are easily interpreted by those unfamiliar with government finance.
- Validate that these tools are more graphic than statistical in nature, convey information at a high level, and aren't number intensive.

When the manager has assessed the responses and looked over the accompanying diagnostic tools and analysis, it will be more apparent if these elements of fiscal health are present:

- Identify all long-term plans maintained by every department within the organization and ensure that they are incorporated in decision making.
- Prepare a comprehensive capital improvement plan that spans a period of at least five years and includes all potentially significant one-time expenditures as well as any associated ongoing operating costs.
- Develop a simple, graphic communication tool that is used consistently to provide decisionmakers with financial information at a summarized level.

Figure 3 demonstrates a scenario-planning model that many organizations are implementing to aid in the decision-making process. Note the separation of ongoing fiscal health in the graph on the left and one-time fiscal health on the right. Also note that the model demonstrates the organization's ability to uphold the objectives of fiscal health by tracking the effects of every decision made.

Wrap Up

William Osler, an early-twentieth-century doctor who was known as the father of modern medicine, transformed the medical profession by showing that proper diagnosis is the key to treating disease. Practitioners began recognizing that readily identifiable symptoms presented evidence of the cause of disease, and this marked a paradigm shift away from less evidence-based treatment methods like bloodletting and administering leeches and untested potions.

This same paradigm shift must also be embraced by local government managers in order to effectively address current fiscal problems—entities must first diagnose and then treat.

Often government leaders are confronted with a problem to solve but feel pressured to deal with it immediately. There is an urgency to rush to treatment, especially given today's fiscal environment, just to demonstrate timely response, ease the anxiety, or move on to the next major issue. In this rush to apply a treatment, little time is allotted to actually diagnosing the root causes that need to be addressed.

Would it be acceptable for our own doctor to prescribe treatment before analyzing our symptoms? Without a thorough examination, across-the-board budget cuts or a shortened workweek put in place to achieve a balanced budget would be as effective as non-evidence-based treatments like bloodletting or potions.

The causes of an organization's fiscal disease require a more thorough, robust, rigorous analysis if we are to improve our approach to finding effective and sustainable solutions.

The good news is that many organizations already have what is needed to make this transformation: it's simply a matter of asking the right questions to uncover the root causes that need to be treated. Our finance directors, our financial analysts, our auditors, our clerks, our department heads are the physicians on staff who can reveal the symptoms and the hidden causes to treat, but the manager needs to know the right questions to ask.

In most cases, the medical records and data about vital signs are already at our fingertips—the finance director has the comprehensive annual financial report and the department heads understand the variances in their spending and in their program revenues. By asking the right questions, assessing the documented analysis, and then partnering with the finance officer to accurately diagnose the causes, identify the treatment options, and apply the appropriate treatment, the local government manager can lead the organization down the path toward fiscal health.

In *The Principles and Practice of Medicine,* Osler identified and summarized most diseases and their causes, documented the method of diagnosing these conditions, and then recommended treatment options. This work became the bible for medical professionals of his time, and it is still considered essential reading in today's medical schools.

The road to fiscal health does not require medical training, but it does require a focus on spending within our means, identifying and maintaining reserves, understanding our variances, being transparent about the true cost of doing business, and ultimately guiding decision making with economic analysis and long-term planning.

Osler said "observe, record, tabulate, communicate. Use your five senses. Learn to see, learn to hear, learn to feel, learn to smell, and know that by practice alone you can become expert." Fiscal health is within every organization's grasp. The only question left is: Will you be able to achieve it? PM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