



## State Auditor's Office Progress Report: Local Government Financial Health

August 7, 2014

Report Number: 1012330

This report highlights signs of declining financial condition identified by audits since an initial report in November 2012. During this reporting period, we found 57 local government organizations showing indicators of declining financial condition, with 3.1 percent of audited governments showing indicators during audits of 2012 financial statements. Nearly a third of these local governments are concentrated in just three counties. Local governments continue to face a combination of rising costs and constrained revenues that could jeopardize their financial stability in the future. To help local governments proactively manage their financial health, the Local Government Performance Center within the State Auditor's Office is assembling new resources that can help local governments identify and respond to financial problems without waiting for an audit to detect them.



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## ***The mission of the Washington State Auditor's Office***

The State Auditor's Office holds state and local governments accountable for the use of public resources.

The results of our work are widely distributed through a variety of reports, which are available on our Web site and through our free, electronic subscription service.

We take our role as partners in accountability seriously. We provide training and technical assistance to governments and have an extensive quality assurance program.

For more information about the State Auditor's Office, visit [www.sao.wa.gov](http://www.sao.wa.gov).

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## ***State Auditor's Office contacts***

### **State Auditor Troy Kelley**

360-902-0360, [Troy.Kelley@sao.wa.gov](mailto:Troy.Kelley@sao.wa.gov)

### **Chuck Pfeil, CPA :: Director of State & Performance Audit**

360-902-0366, [Chuck.Pfeil@sao.wa.gov](mailto:Chuck.Pfeil@sao.wa.gov)

### **Sheri Sawyer :: Assistant Director, Local Government Performance Center**

360-725-5552, [Sheri.Sawyer@sao.wa.gov](mailto:Sheri.Sawyer@sao.wa.gov)

### **Daniel Masterson :: Project Manager, LGPC**

360-725-5637, [Daniel.Masterson@sao.wa.gov](mailto:Daniel.Masterson@sao.wa.gov)

### **Thomas Shapley :: Deputy Director of Communications**

360-902-0367, [Thomas.Shapley@sao.wa.gov](mailto:Thomas.Shapley@sao.wa.gov)

## ***To request public records***

### **Mary Leider :: Public Records Officer**

360-725-5617, [PublicRecords@sao.wa.gov](mailto:PublicRecords@sao.wa.gov)

# Local Government Financial Health Audit and Resource Summary

## Introduction

In the spring of 2014, the State Auditor's Office found signs that 57 local government organizations may have experienced declining financial condition, based on a summary of our audit results issued between October 2012 and May 2014.

A complete list of local governments that showed signs of declining financial condition is available in **Appendix A**. The results of what was found in the audits of these governments are examined in more detail on pages 7-9.

This report follows the one we released in November 2012, summarizing the signs of declining financial condition found during audits of local governments ranging from counties and cities to regional hospitals and fire districts. In that report, based on audits conducted between 2006 and 2012, we found that 88 governments had indicators of declining financial condition. The total number of governments in the last report is not comparable to the total in this report because of the different lengths of time examined. However, in **Figure 1** we can compare changes over time and across reports by looking at the prevalence of indicators during the periods the audits actually focused on.

The Local Government Performance Center within the State Auditor's Office is assembling new resources that can help local governments identify and respond to financial problems without waiting for an audit to detect them. These resources will include a new financial health assessment tool and financial management trainings, which are discussed in more detail on pages 5-6 of this report.

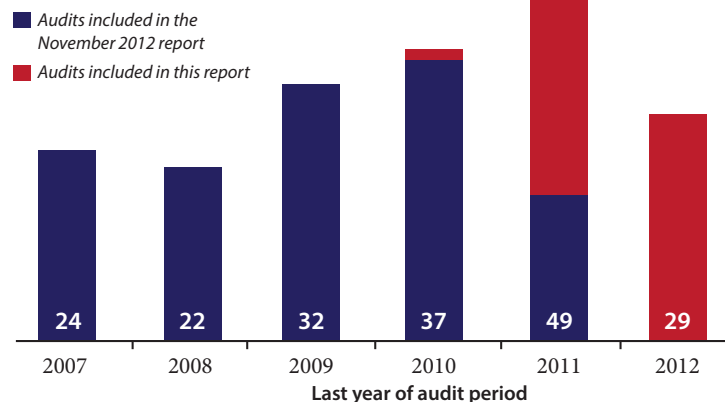
**Appendix B** defines the indicators used by auditors to identify declining financial condition. **Appendix C** describes the ratios planned for the upcoming first version of the financial health assessment tool and compares them with the indicators presented in this report. **Appendix D** provides a list of local government financial health resources, including those of the Local Government Performance Center.

## Local governments continue to struggle with financial challenges

Local governments continue to face the fiscally challenging combination of rising costs and constrained revenues that could jeopardize their financial stability long after the state and national economies fully recover.

Fiscal problems have persisted since November 2012, when we released the first audit summary to highlight local government declining financial condition. While **Figure 1** shows improvement from the worst periods of the recent recession, it is still a cause for concern. The percent of local governments with audits indicating declining financial condition fell to 3.1 percent for audits of 2012 finances. This percentage is down from 5.2 percent of governments audited in 2011.

**Figure 1. Number of local governments showing indicators of declining financial condition**



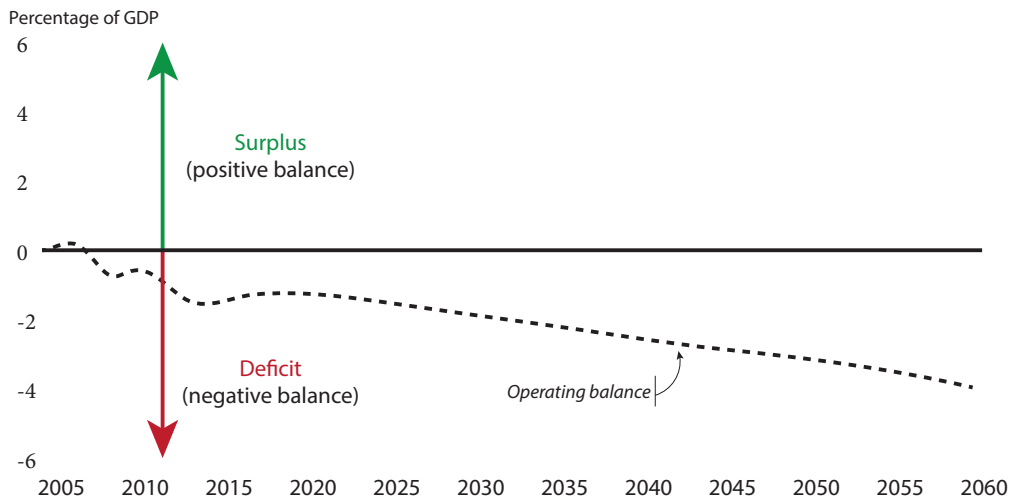
Source: Washington State Auditor's Office audits, as of May 31, 2014.  
Notes: Some governments show indicators in more than one year. The reports also include governments with indicators in 2006 and 2013 but which are not shown in this graph.

The problem of how to improve the fiscal health of governments, small and large, is not confined to Washington.

The federal Government Accountability Office (GAO) recently predicted that state and local governments will remain financially squeezed for decades to come unless policymakers and managers address persistent and complex policy issues. The trend line in the GAO's report (Figure 2) warns that state and local government revenues will shrink relative to expenditures, creating ever-larger operating deficits, until at least 2060.

## Identifying governments with declining financial condition

Figure 2. Projected state and local operating balance measure, as a percentage of Gross Domestic Product (GDP)



Note: GAO simulations are from 2011 to 2060, using many Congressional Budget Office projections and assumptions, particularly for the next 10 years. Simulations are based on current policy, updated April 2013.

As required by state law (RCW 43.09.260), the State Auditor's Office assesses the financial condition of every local government in the state at least once every three years as a part of each audit conducted. These independent audits play an essential role in identifying problems that put financial stability at risk, but they may not reveal a threat early enough to help prevent the organization from entering into financial distress.

The State Auditor's Office is committed to helping local government officials anticipate and respond to financial challenges as early as possible, in order to maximize their ability to provide the services that Washingtonians rely on and expect from local government. To assist local governments dealing with the challenges highlighted in the GAO's report, the State Auditor's Office has begun work on new analytical tools and specialized trainings. These resources are designed to help local government officials evaluate their governments' financial health and create their own strategy to improve financial sustainability.

## **The Local Government Performance Center: a resource for tools and training**

The Local Government Performance Center is working with local government officials, associations and other stakeholders to make our expertise in assessing financial condition more accessible. The Local Government Performance Center already offers an array of trainings and workshops, and an online library of more than 150 tools, templates and other materials. Soon it will add a financial health assessment tool, targeted training sessions, and resources focused specifically on financial health. The new resources are designed to help elected officials and staff understand their financial management responsibilities and enable them to more easily monitor their financial health. They align with the State Auditor's Office's strategic goals of helping governments work better, cost less, deliver higher value, and earn greater public trust.

### **New financial health assessment tool developed after consulting with local government leaders**

Last year, the Local Government Performance Center's Leadership and Technical Experts Advisory Group asked us to make financial health a priority. Their suggestions included objective assessments of financial condition between audits, guidance that would allow governments to monitor financial health risks, and technical assistance for local governments that needed to improve their financial health. These suggestions mirror some of the recommendations in a recent report by the State Budget Crisis Task Force.

In response, the Local Government Performance Center is developing an online financial health assessment tool that is dependable and easy to use, plus training and technical assistance.

### **Financial health assessment tool will help identify problems sooner and more easily**

We want to make it easier for local governments to regularly assess and monitor their own financial health, using financial information they already report annually to the State Auditor's Office. As this information is reported, audited, and refined, it creates a reliable and accurate historical financial database that can be used to analyze changes over time.

Initially, this data will power a new financial health assessment tool serving local governments that use a cash basis of accounting. The first version of the financial health assessment tool will:

- Provide local governments with a new tool to monitor and respond to the growing financial pressure they face
- Automatically calculate financial condition ratios used by auditors
- Display clear and easy-to-understand charts and summary analysis
- Use current and historical financial data already reported annually
- Allow governments to identify some potential threats to financial health up to three years before an audit (see **Figure 3** on the following page)

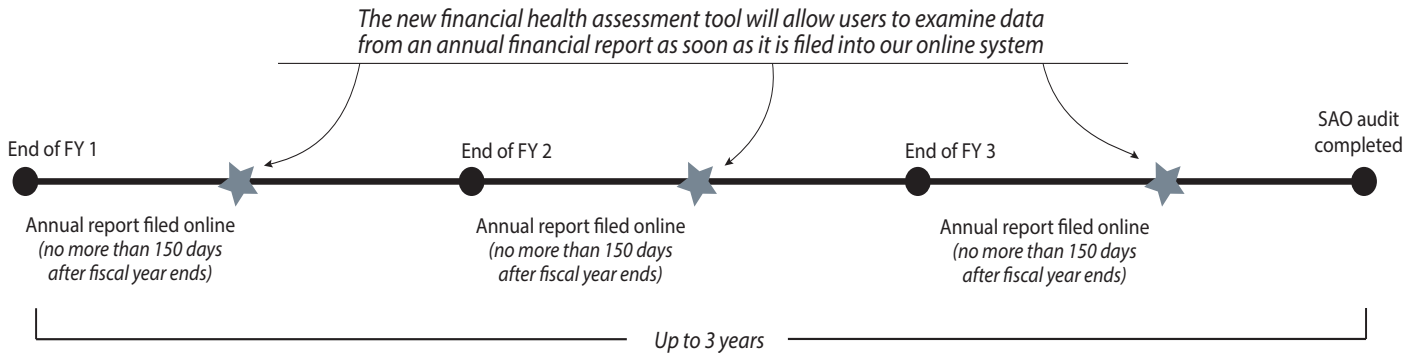
#### ***The first Financial Health Assessment Tool will show:***

- Cash balance sufficiency
- Operating margin
- Change in cash position
- Enterprise self-sufficiency (cities and counties only)
- Debt service load

The objectives for future versions of the tool include:

- Availability for local governments using Generally Accepted Accounting Principles (GAAP)
- More flexible analysis that can be tailored to the community's needs and decisions
- Additional data sources that will enable more contextual analysis
- A customizable and responsive online interface

We will continue to refine the tool based on feedback from elected and appointed local government leaders, outside experts, and other local government stakeholders.



Note: While some governments are audited annually and some every other year, many local governments are only audited once every three years.

## Financial management trainings

The Local Government Performance Center is also developing financial management trainings and video tutorials to help government officials effectively monitor their governments' finances. The trainings are focused on topics such as:

- The roles/responsibilities of an elected official
- Understanding financial reporting
- Safeguarding public resources by establishing effective internal controls
- Understanding the audit procedure
- Oversight of financial health

The financial management strategies covered in the trainings can help officials meet their goals and deliver necessary services to residents and stakeholders in their communities.

## Contact the Performance Center

This report and the tools, trainings and other resources provided through the Local Government Performance Center are intended to help local governments with a variety of financial management needs.

See **Appendix D** for additional information about Local Government Performance Center resources.

Visit us online at [www.sao.wa.gov/performancecenter](http://www.sao.wa.gov/performancecenter) for helpful tools and the latest information on upcoming trainings and events.

Want to host a workshop or request more information? Contact us at [performance@sao.wa.gov](mailto:performance@sao.wa.gov) or 360-725-5552.

## 2014 Update of financial condition audit concerns

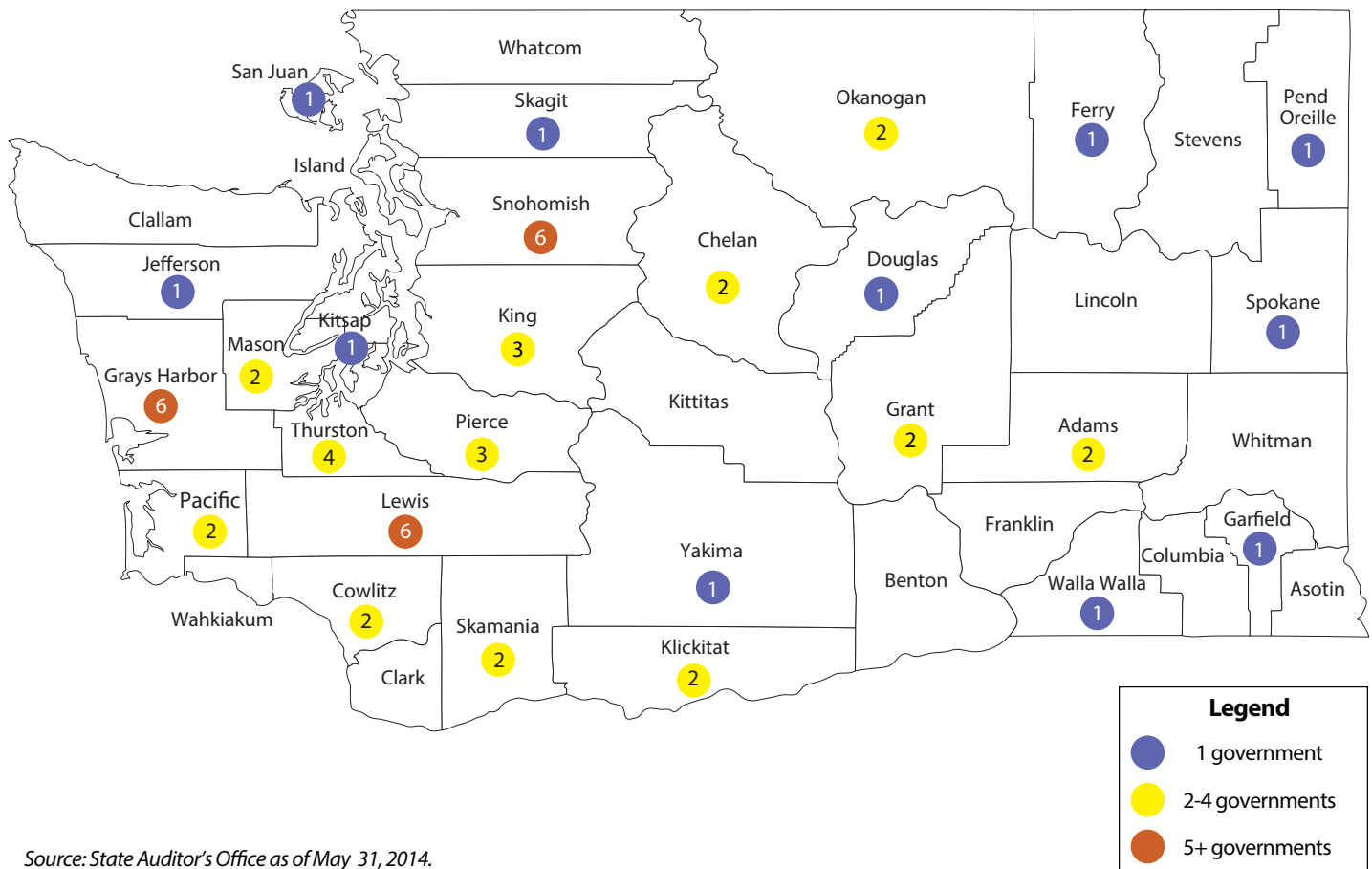
### Audits indicate continuing declining financial condition

While local governments may be under less pressure than during the worst years of the recent recession, many are still struggling. In the year and a half since our last report in November 2012, our auditors found indicators of declining financial condition for 57 local governments. Nearly a third of these local governments are concentrated in just three counties: Snohomish, Grays Harbor and Lewis counties. These results should be regarded only as an estimate of the number of local governments that could be experiencing declining financial condition. Because some local governments are audited only every three years, this number may understate the rate of declining financial condition among local governments. This number may also be overstated, because an indicator could reflect a government's intentional financial strategy or past problem that has since been resolved.

The map in Figure 4 shows the number of local governments with indicators by county.

**Figure 4. Number of local governments with indicators of declining financial condition by county**

*Our audits have found indicators of financial distress in 57 local governments since November 2012*

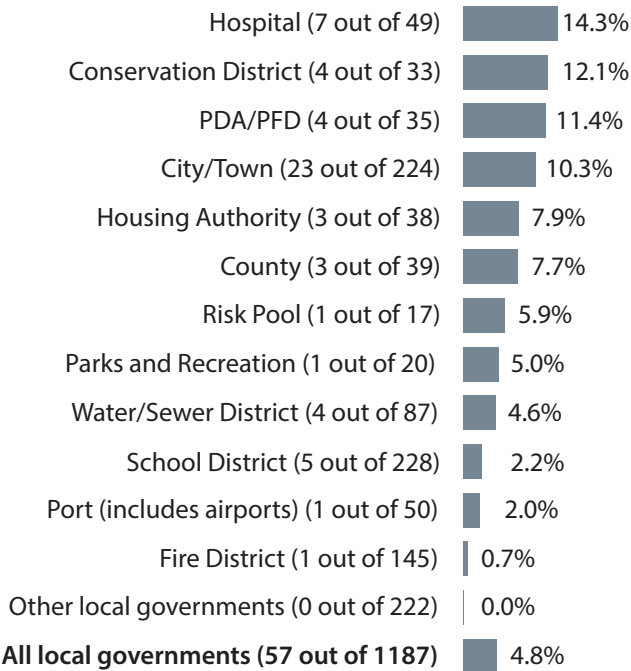


Source: State Auditor's Office as of May 31, 2014.

Forty percent of local governments with indicators of declining financial condition since our last report in November 2012 are towns and cities. But hospitals, conservation districts, and public development authorities/public facility districts had the highest incidence of indicators identified during their audits. **Figure 5** shows the incidence of indicators for each type of government.

**Figure 5. Some types of local governments have a higher incidence of indicators**

*Percentage shows the rate for each government type*



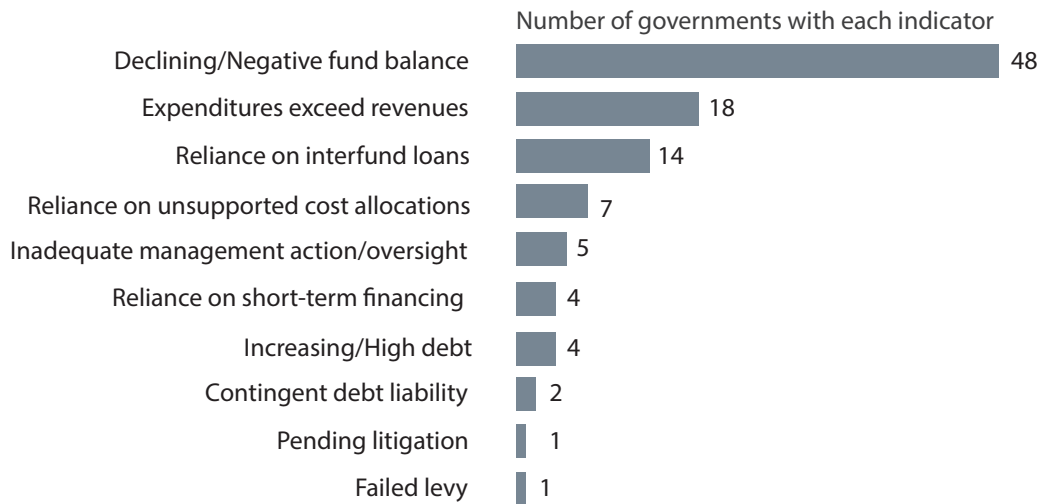
Source: State Auditor's Office audits of local government between 10/1/2012 and 5/31/2014.

Note: The rate shows the percentage of governments with indicators of declining financial condition out of all governments of the same type with audit reports issued between 10/1/2012 and 5/31/2014.



As **Figure 6** illustrates, our auditors found that the most common indicators of declining financial condition were declining or negative fund balances and expenditures that exceeded revenues.

**Figure 6. The most commonly found indicators of declining financial condition**



Source: State Auditor’s Office audits of local government between 10/1/1012 and 5/31/2014  
 Note: Governments may show more than one indicator of declining financial condition

However, as **Figure 7** shows, some government types were more likely to rely excessively on controversial revenue sources such as interfund loans, short-term financing and unsupported cost allocations.

**Figure 7. Most common indicators by type of government**

City/Town	County	Hospital	Conservation Districts	All others
1. Declining/Negative fund balance	1. Declining/Negative fund balance	1. (tied) Declining/Negative fund balance	1. Declining/Negative fund balance	1. Declining/Negative fund balance
2. Reliance on interfund loans	2. (tied) Reliance on interfund loans	1. (tied) Reliance on short-term financing	2. Reliance on interfund loans	2. Expenditures exceed revenue
3. (tied) Expenditures exceed revenue	2. (tied) Expenditures exceed revenue	2. Expenditures exceed revenue		3. Inadequate management action/oversight
3. (tied) Reliance on unsupported cost allocation	2. (tied) Reliance on unsupported cost allocation			

# Appendix A: List of Local Governments by County with Audit Indicators of Declining Financial Condition

This table lists local governments, by county, whose audits showed indicators of declining financial condition since our last report (10/1/2012 through 5/31/2014).

By County	Expenditures exceed revenues	Declining/Negative fund balance	Increasing/ High debt	Reliance on short-term financing	Reliance on unsupported cost allocations	Reliance on interfund loans	Failed levy	Inadequate management action / oversight	Contingent debt liability	Pending litigation
<b>Ending year(s) of the audit period(s) during which an indicator was found</b>										
<b>Adams</b>										
Adams Conservation District		2012								
East Adams Rural Hospital		2012								
<b>Chelan</b>										
City of Wenatchee		2011			2011				2011	
Greater Wenatchee Regional Events Center	2011									
<b>Cowlitz</b>										
Cowlitz Public Facilities District		2011								
Housing Auth. of the City of Kalama		2012								
<b>Douglas</b>										
Bridgeport School District No. 75		2013								
<b>Ferry</b>										
Joint City of Republic-Ferry County Housing Authority		2011								
<b>Garfield</b>										
City of Pomeroy		2011								
<b>Grant</b>										
Grant County PHD No. 2	2012	2012		2011, 2012						
Grant County PHD No. 5				2012						
<b>Grays Harbor</b>										
City of Oakville		2012								
City of Ocean Shores		2012	2012							
Grays Harbor Conservation District		2011								
Grays Harbor County		2011			2011	2011				
Grays Harbor Historical Seaport Authority	2011	2011								

By County	Expenditures exceed revenues	Declining/Negative fund balance	Increasing/High debt	Reliance on short-term financing	Reliance on unsupported cost allocations	Reliance on interfund loans	Failed levy	Inadequate management action / oversight	Contingent debt liability	Pending litigation
Lake Quinault School District No. 97		2012, 2013								
<b>Ending year(s) of the audit period(s) during which an indicator was found</b>										
<b>Jefferson</b>										
City of Port Townsend	2011	2011, 2012	2011							
<b>King</b>										
City of Des Moines		2012								
Vashon Maury Park & Recreation District	2012, 2013	2012, 2013	2013					2012		
Water and Sewer Risk Management Pool		2012								
<b>Kitsap</b>										
South Kitsap School District No. 402		2013								
<b>Klickitat</b>										
City of White Salmon		2011				2011,				
Lyle School District No. 406		2013				2013				
<b>Lewis</b>										
City of Morton		2011								
City of Mossyrock		2011			2011					
City of Toledo	2012	2012			2012					
City of Winlock		2011							2011	
Lewis County Water District No. 2	2013	2013								
Lewis County Water District No. 5	2011, 2013	2011, 2013	2011, 2013					2011, 2013		
<b>Mason</b>										
Mason County (Belfair Sewer Fund)	2012	2012								
Mason County Housing Authority		2012								
<b>Okanogan</b>										
Okanogan County PHD No. 3		2012		2012						
Okanogan-Douglas Dist. Hosp. No. 1				2012						
<b>Pacific</b>										
City of Long Beach		2011, 2012			2012					
Pacific County Public Healthcare Services District No. 3	2012	2012								

By County	Expenditures exceed revenues	Declining/Negative fund balance	Increasing/ High debt	Reliance on short-term financing	Reliance on unsupported cost allocations	Reliance on interfund loans	Failed levy	Inadequate management action / oversight	Contingent debt liability	Pending litigation
<b>Pend Oreille</b>										
Pend Oreille Conservation District		2011								
<b>Ending year(s) of the audit period(s) during which an indicator was found</b>										
<b>Pierce</b>										
City of Eatonville		2012								
City of Lakewood	2012	2011, 2012				2011				
City of Sumner						2011				
<b>San Juan</b>										
Fisherman Bay Sewer District		2011								
<b>Skagit</b>										
Bullerville Utility District	2010							2010		
<b>Skamania</b>										
City of North Bonneville		2011, 2012				2012				
Skamania County		2012								
<b>Snohomish</b>										
City of Arlington		2012								
City of Goldbar	2012	2012				2012	2012			2012
City of Granite Falls	2011	2011				2011				
City of Lynnwood					2011	2011 2012				
Edmonds Public Facility District	2011					2011				
Snohomish County PHD No. 1 (Valley General)	2011	2011, 2012								
<b>Spokane</b>										
Town of Spangle		2011			2011			2011		
<b>Thurston</b>										
City of Tenino	2011, 2012	2011, 2012				2011				
City of Tumwater						2011				
SE Thurston Fire Authority		2012								
Thurston County Conservation District		2011				2011				
<b>Walla Walla</b>										
Touchet School District No. 300		2013								
<b>Yakima</b>										
Yakima Air Terminal	2011							2011		

## Appendix B: Indicators of Declining Financial Condition

This table describes the indicators analyzed in both this report and the November 2012 audit summary.

Type of indicator	What it shows
<b>Expenditures exceeding revenues</b>	Operating expenditures exceed revenues in the General Fund.
<b>Declining or negative general fund balance</b>	A situation in which the General Fund has declined significantly over time or has a negative balance. The General Fund pays for services such as public safety, community planning, public health, etc. The ending balance identifies the amount of resources the government has available for these services.
<b>Increasing or high debt</b>	The use of other sources of long-term financing, such as issuing Bond Anticipation Notes or taking out bank loans, to cover general operating expenditures.
<b>Reliance on short-term financing</b>	Borrowing money from the County to pay for operations and to address cash-flow shortages. This is known as “registered warrants” and interest is charged on these funds, resulting in an additional expense to the local government.
<b>Reliance on unsupported cost allocations</b>	The costs of central services such as administration, human resources, payroll and purchasing can be allocated among government funds that benefit from the services. The government must adopt a fair and equitable method of distributing these shared costs among the funds. At times, these allocations are not properly supported, such as allocating more costs to funds with the most resources.
<b>Reliance on interfund loans</b>	When the General Fund does not have sufficient funds to cover general government operating expenses, the government loans money from a separate fund.
<b>Failed levy</b>	Some local governments receive funding from voter approved property taxes called levies. Typically, the levies fund maintenance and operations and apply for a year or two. Levy failures can have a major impact on financial condition.
<b>Inadequate management action or oversight</b>	Indications that elected officials are not aware of, engaged, or taking necessary actions to stabilize the financial condition, such as reducing expenditures through program or staff reductions or identifying new revenue sources.
<b>Contingent debt liability</b>	Local governments can accept responsibility for loans through contracts or agreements. These liabilities are contingent on certain events or circumstances occurring or not occurring.
<b>Pending litigation</b>	Litigation costs or pending legal judgments that risk depleting available fund reserves.

# Appendix C: Description of Financial Health Assessment Tool and Comparison with Audit Indicators

## Ratios in the new Financial Health Assessment Tool

The first version of the Financial Health Assessment Tool for cash basis local governments will include five ratios. This table shows descriptions of what each ratio measures and what it reveals to decision-makers.

Title of Ratio/ Tool	What does it measure?	What does it reveal?
<b>Operating margin</b>	This measure shows the margin between receipts and disbursements for total governmental funds. Figures exclude capital outlay and other financing sources and uses to focus on whether receipts were sufficient to cover spending on operations and debt service.	Whether governmental activities are sustainable.
<b>Cash balance sufficiency</b>	This measure is the number of days that the general fund could operate on its ending cash and investments balance. That is, it compares the general fund ending cash and investments balance to the average daily general fund cash expenditures (excluding capital outlay and other financing uses).	How well the government can deal with emergencies and unanticipated needs.
<b>Change in cash position</b>	This measure is the percent change in ending cash and investments compared to last year for all governmental funds combined. Unlike the Operating Margin, this figure includes the effects of capital outlays and other financing sources and uses.	Whether the cash position of governmental funds has improved or declined.
<b>Enterprise fund self-sufficiency</b>	This measure shows the percent of enterprise fund expenses that were covered by receipts. Other financial measures in our preliminary analysis focus on either the general fund or total governmental funds because enterprise funds are expected to recover their own costs through charges for services or other revenues.	Whether enterprise funds are self-supporting.
<b>Debt load</b>	This measure shows the percent of the total governmental fund revenues that are being used for debt service payments (principal and interest payments).	How much governmental fund revenue is used for debt payments.

## Comparison of report indicators and financial health assessment tool ratios

The ratios in the first financial health assessment tool will not provide a complete picture of financial condition. However, they will align with three of the indicators analyzed in our financial condition audit summary. This table shows how the tool's ratios relate to the indicators summarized in this report and the November 2012 audit summary.

Indicators identified during the audit process (relevant for all entities)	First financial health assessment tool ratios (relevant for cash-basis entities)
Expenditures exceeding revenues	Operating margin
Declining or negative general fund balance	Cash balance sufficiency Change in cash position Enterprise self-sufficiency (cities/towns and counties only)
Increasing or high debt	Debt service load
Reliance on short-term financing Reliance on unsupported cost allocations Reliance on interfund loans Failed levy Lack of adequate management action or oversight Contingent debt liability Pending litigation	No ratios (Assessed through management analysis of other considerations)

# Appendix D: Resources

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## References cited in this report

- **The Government Accountability Office (GAO) State and Local Governments' Fiscal Outlook** predicts that state and local tax revenues will shrink relative to gross domestic product while expenditures, especially health care costs, will continue to grow. According to GAO, without policy changes, state and local governments' budgets will be stressed in the near term and through at least 2060.  
<http://www.gao.gov/products/GAO-13-546SP>
- **Report on Reforming State Budgeting and Financial Reporting, State Budget Crisis Task Force**  
<http://www.statebudgetcrisis.org/wpcms/>

## Resources from the State Auditor's Office

- **Local Government Performance Center Financial Management Resources (in development)**
  - The Local Government Performance Center has developed three case studies highlighting promising approaches taken by cities to address budgeting challenges caused by the recession.
  - The Performance Center is providing technical assistance to local governments and training related to assessing and strengthening internal controls. It will also be providing training for elected officials related to financial management.
- **Resource on Cost Allocation** <http://portal.sao.wa.gov/PerformanceCenter/#/address?mid=6&rid=18492>
- **Financial Condition Self-Assessment Checklist** <http://portal.sao.wa.gov/PerformanceCenter/#/address?mid=6&rid=18477>

The State Auditor's Office's November, 2012 Audit Summary of Local Government Financial Condition  
<http://portal.sao.wa.gov/ReportSearch/Home/ViewReportFile?arn=1008675&isFinding=false&sp=false>

## Other Washington state resources

### *Washington State Treasurer's Office*

In 2010, the State Treasurer and the Department of Commerce reported on the financial health of Washington's cities and counties<sup>1</sup> for the Legislature:

<http://www.tre.wa.gov/documents/localGovtFiscalReport.pdf>

- The State Treasurer used ten financial condition indicators to assess the health of local governments. Some of these indicators are the same as those used by the Auditor's Office. The report also includes a scoring tool to assess how widespread the financial difficulties are. If governments identify four or more stress points, the report states the entity is financially stressed.

### *Association of Washington Cities*

Another tool for local governments is the "Red Flag Checklist: Communicating About Your City's Financial Condition" developed by the Association of Washington Cities. It developed this tool to help cities self-assess their financial condition and to serve as a tool to communicate with city leaders, the community and businesses. This tool applies to other types of local government. The document lists 15 financial indicators or "red flags" that indicate some level of financial concern or distress and a scoring system that can help cities or other local governments gauge their situation. The checklist is available at

[www.awcnet.org/Portals/0/Documents/publications/RedFlagChecklist.pdf](http://www.awcnet.org/Portals/0/Documents/publications/RedFlagChecklist.pdf)

## Examples from other states

- North Carolina State Treasurer Fiscal Analysis Tool  
<https://www.nctreasurer.com/slgl/Pages/Fiscal-Analysis-Tool.aspx>
- New York State Comptroller Local Government Fiscal Stress Monitoring System  
<http://osc.state.ny.us/localgov/fiscalmonitoring/index.htm>
- Oregon Secretary of State Financial Condition Review of Counties  
<http://sos.oregon.gov/Documents/audits/full/2012/2012-17.pdf>
- Colorado State Auditor Fiscal Health Analysis for Colorado Counties and Municipalities  
<http://www.leg.state.co.us/OSA/coauditor1.nsf/LocalGovPublic?OpenForm>
- California Local Government Finance Almanac  
<http://www.californiacityfinance.com/>

## Resources from other organizations

- Governmental Accounting Standards Board  
<http://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1176156742174>
- International City/County Management Association: Financial Management  
[http://icma.org/en/icma/knowledge\\_network/topics/kn/Topic/99/Financial\\_Management](http://icma.org/en/icma/knowledge_network/topics/kn/Topic/99/Financial_Management)
- Institute for Local Government (California League of Cities) <http://www.ca-ilg.org/>

### Government Finance Officers Association

The Government Finance Officers Association provides best practices and tools to help governments with financial management. The Fiscal First Aid resource provides guidance to help city officials diagnose their fiscal condition and treat the problems, as well as longer term tools and practices to help recover and remain financially healthy. The Association's resource is available at:

[http://www.gfoa.org/index.php?option=com\\_content&task=view&id=937&Itemid=416](http://www.gfoa.org/index.php?option=com_content&task=view&id=937&Itemid=416).

GFOA also maintains a broad list of additional best practices. Provided here are links to two key resource pages:

- Government Budgeting and Fiscal Policy:  
[http://www.gfoa.org/index.php?option=com\\_content&task=view&id=120&Itemid=134](http://www.gfoa.org/index.php?option=com_content&task=view&id=120&Itemid=134)
- Accounting, Auditing and Financial Reporting:  
[http://www.gfoa.org/index.php?option=com\\_content&task=view&id=119&Itemid=131](http://www.gfoa.org/index.php?option=com_content&task=view&id=119&Itemid=131)