

Advisory Alert: Turnaround “apps” for the public sector - the Finance platform

Introduction

This is the fourth of a series of articles covering our strategic framework for executing turnarounds in the public sector. Our framework is based on 4 turnaround platforms or “apps” that cover the following key areas:

- Strategy
- Operations
- Finance
- Leadership

Our [last article](#) covered the **Operations** app. On this piece, we will be focusing on the **Finance** platform.

The finance platform

Today, governmental organizations are suffering from two types of financial distress that are common among private sector enterprises: expenses greater than revenues and excessive future commitments.

A structural imbalance between revenues and expenditures in the general fund is the government equivalent of unprofitable operations in the private sector. As elected officials became euphoric over the increase in revenue in good economic times, they undertook an expansion of services along with generous increases in compensation and benefits for employees. Providing more parks and summer programs for children, building beautiful performing arts centers, adding police and firefighters, and refurbishing government offices are all worthy

expenditures when cash is available. So is saving for a rainy day and paying off debt. The latter received short shrift in many instrumentalities in past years, so that when economic disaster hit, there was no cushion. Even those instrumentalities that had the foresight and discipline to save did not expect the impact of the current recession to last as long as it has. Now the government is faced with a cost base that exceeds its revenue potential at least in the near and medium terms.



Many governmental instrumentalities have statutory requirements for a balanced budget, which should prohibit the behavior outlined above. But the requirements are generally not well defined, and as a result, certain instrumentalities have found ways to fund current operating losses with long-term debt.



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In short, when there is little motivation to balance operating revenues and expenses, and capital markets encourage borrowing, public officials may postpone or avoid making difficult decisions.

Finance app #1:

Long-term financial planning

Distressed businesses often lack long-term financial plans. The discipline to look three to five years into the future forces management to incorporate strategic plans and create goals that serve the interests of their shareholders. Government is no different.

The US Government Finance Officers Association wrote about building a financially resilient government through long-term financial planning and referenced Jamais Cascio, a senior fellow at the Institute for Ethics and Emerging Technologies, who identifies the following eight essential characteristics of any resilient system:

- diversity – Avoid a single point of failure or reliance on a single solution
- redundancy – Have more than one path of escape
- decentralization – Centralized systems look strong until they fail catastrophically
- transparency – Share plans and preparations, and listen when flaws are pointed out
- collaboration – Work together to become stronger
- falling gracefully – Failure happens
- flexibility – Be ready to change when plans fail; do not count on stability
- Foresight – Think and prepare

This approach is a tool that instrumentalities can use as they undertake strategic planning in concert with long-term financial planning. The following characteristics are particularly

resonant when looking at public sector turnaround activities.

Transparency – A challenge with public finance is the lack of transparency and readily understandable financial reporting. Even sophisticated readers of financial information struggle to make heads or tails out of the reports generated by our government units. The timeliness of the information is often lacking —some reports appear many months after the actual results. Prospective financial information is even more challenging than the historical. Governments should institute clear and consistent information based on generally accepted accounting principles.

Foresight – The very concept of long-term planning begs government leaders to think beyond the election cycle and anticipate economic challenges and crises. Developing contingency plans and establishing real, tangible cash reserves are important.

Finance app #2:

Cash flow planning

Jim Gentry, professor emeritus of finance at the University of Illinois at Urbana-Champaign, once said that liquidity is like beer at a fraternity party: when you are out of liquidity, the party is over.

Understanding liquidity in the context of government operations is important to ensuring that essential activities can occur without interruption. Some government units make an attempt at cash flow forecasting, but limit its use to evaluating the need for short-term borrowing – revenue and tax anticipation notes in particular. However, the private sector uses cash forecasts as a “dashboard” to monitor performance, even if the business is not distressed, via a tool called the “13-week rolling cash forecast”.

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Successful businesses evaluate their forecasts against actual results to understand whether variances were based on timing or permanent differences. This discipline of evaluation creates a continuous feedback loop that enhances management's ability to forecast and minimize variance. How can this be applied in the public sector?

For most governments, 13 weeks is an insufficient time frame. Biannual tax payments, large lag periods associated with federal or state funding, and union contracts with annual lump-sum payments require a longer forecasting horizon. Ideally, a rolling 12-month forecast is better. Governments need to develop a heightened sense of importance around working capital management. In the private sector, businesses have long known that it is important to balance accounts receivable collections with accounts payable expenditures. Ideally, businesses want to collect their receivables as quickly as possible and pay their bills at the latest date acceptable.



Many public sector organizations existed for years without ever having to worry about having enough cash in the bank account to pay bills. This scenario has changed as cities and states have begun to spend more than they take in, making cash flow forecasting more important. Neglecting working capital management exacerbates cash flow problems and diminishes the fun at the party.

In our next article we will talk about turnaround “apps” for governments in the **Leadership platform**.

Call us to make an appointment with one of our experienced advisors. We will be glad to assist you.

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