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ASSESSMENT OF THE FINANCIAL CONDITION OF MUNICIPALITIES IN LITHUANIA

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Summary. The problem of analysis and assessment of municipality's financial condition is investigated in the publication. The paper's subject has both theoretical and practical relevance and, to the authors' knowledge, it is among the first works of Lithuanian authors to tackle this issue. The aim of the research conducted was to analyse and assess the financial condition of municipalities in Lithuania. The research was based on publicly available consolidated municipalities' financial statements prepared according to the public sector accounting standards. Next, the ratios of municipality's financial condition were developed, with due consideration given to the peculiarities of the public sector accounting standards in Lithuania, and with reference to scientific literature. The set of ratios developed allowed to investigate and assess the basic elements of municipality's financial condition: current and long-term liabilities management, asset management, revenue and expenditure management. Statistical scores of municipalities' financial condition were calculated using SPSS software. The findings indicate that municipalities in Lithuania have the financial ability to cover their financial liabilities and perform their functions, have the competence to manage their assets and possess financial independence. The results of this may be used as a benchmark for individual municipality to assess whether it is performing above or below the „industrial average". The method presented herein can be used to analyse the financial condition of municipalities in foreign countries that prepare financial statements on an accrual basis.

Key words: financial condition, ratio analysis, municipalities.
Słowa kluczowe: kondycja finansowa, analiza wskaźnikowa, gminy.

INTRODUCTION

The assessment of municipalities' performance has become a major issue worldwide since municipalities take on increasingly more responsibility in terms of providing essential services to taxpayers. Increasing decentralization in decision-making from central to local governments has made the measurement and evaluation of their financial performance critical (Cohen et al. 2011). Knowing the financial condition of local government is important because it is the main provider delivering services directly to the public (Ritonga et al. 2012). According to Cohen (2011) municipalities with poor financial performance are not able to offer quality municipal services to their residents. Fiscal health may not be the ultimate measure of success for local governments, but without a healthy financial condition, the level and quality of public services will suffer (Huang and Ho 2013). Sound financial condition of local government not only directly impacts the local community, but also plays an important role in the economy (Ritonga et al. 2012). The significance of the analysis of municipality's financial condition based on financial statements and other information is confirmed by the fact that regular and well-timed analysis helps identify strengths and weaknesses of municipalities' financial performance, highlights fiscal problems and provides information necessary for corrective actions. Thanks to such analysis one can check the appropriateness of decisions already taken and also substantiate current and future financial decisions.

The need and possibility to analyse the municipalities' financial condition in Lithuania is associated with the reform of public sector accounting and financial accountability. Countries that started the reforms of public sector accounting (Lithuania since 2005) had to switch from accounting on a cash basis to accounting based on an accrual basis , and thus had to begin preparing financial statements that: 1) would provide more precise information; 2) would enable analysis and assessment of the financial condition of public entities; 3) would enable to compare the results of the analysis with results achieved by other public entities; 4) would allow users of financial statements to make more efficient decisions concerning resource management.

The analysis of the works of foreign authors (McKinney 2004; Chaney 2005; Finkler 2005; Wang et al. 2007; Cohen 2008; Rivenbark et al. 2010; Ngwenya 2010; Maher and Deller 2011; Cohen et al. 2011; Cabaleiro et al. 2012; Ritonga et al. 2012; Trussel and Patrik 2012; Huang and Ho 2013; Kablan 2013) shows that there is no a single approach towards the analysis of municipality's financial condition. Various ratios, their combinations and methods of analysis that differ in terms of completeness of information used and number of ratios assessed are provided. There is no a single approach as to which and how many ratios of financial condition should be calculated. Most of the methods of financial condition analysis are idiosyncratic, that is specific to given country's public sector accounting system and are intended mainly for the analysis of municipalities' financial condition of that country.

Although after implementation of reform of public sector accounting in 2010, municipalities in Lithuania prepare financial reports that enable to analyse and compare the municipalities' financial condition, insufficient attention is paid to this issue in the works of Lithuanian authors. Definitely, there is a deficit of studies devoted to the calculation of financial condition ratios of Lithuanian municipalities and comparison of these ratios with the best ratios of other municipalities. So far no practical research on the financial condition of Lithuanian municipalities has been conducted.

The aim of the article is to assess the financial condition of municipalities in Lithuania.

To achieve that goal, the authors shall proceed as follows: 1) investigate the theoretical questions regarding assessment of municipalities' financial condition; 2) provide a set of relative financial ratios enabling complex analysis of financial condition of Lithuanian municipalities; 3) calculate financial ratios of municipalities in Lithuania; 4) determine statistical scores of financial ratios and provide general assessment of the municipalities' financial condition.

The research methods are: analysis of scientific literature, information grouping, comparison, specification and generalization, analysis of statistical data.

LITERATURE REVIEW

Research on municipalities' financial condition started only in 1980 and so it is a rather new field, much less explored than the issue of corporate financial condition, the research on which started twenty years ago (Ritonga et al. 2012). In general, until the 21st century the concept of financial condition analysis in academic practice referred mostly to the analysis of financial statements (balance, income statement, cash flow statement) of business entities. The problem of municipalities' financial condition analysis in literature was researched only fragmentarily, and more attention was paid to methods and types of analysis.

Due to global financial crisis, municipality's financial ability to meet obligations on behalf of residents decreased, resulting in increased focus on municipality's efficiency. It also initiated the reform of public sector accounting which encouraged academics to look into municipality's fiscal health, financial condition and financial stability. Nowadays researchers discuss the concept of municipality's financial condition (Rivenbark et al. 2010; Ritonga et al. 2012), number of ratios and methods used for the analysis (Cohen 2008; Ngwenya 2010), the need to assess municipality's financial condition with the use of indexes of financial condition and financial stability (Groves et al. 1981; Gomez et al. 2009; Cohen et al. 2011; Chen et al. 2012; Clark 2014). Another matter being discussed is the application of corporate finance analysis methods to assess the financial condition of public sector entities and its suitability (Hruza 2013; Cohen et al. 2011).

Although there are quite a few models that allow to assess and predict changes of the financial condition of businesses, they are rarely applied to the public sector (Cohen et al. 2011). There are two main reasons for this. Firstly, the majority of municipalities in Europe started publishing accrual accounting financial statements only a few years ago. Financial statements of municipalities in Lithuania are drawn up on accrual basis since 2010. Therefore, historical information that can be used to analyse municipality's liquidity, capital structure and other aspects is limited. The other reason is related to the differences in the interpretation of financial ratios in business and public sectors, e.g. ratios of profitability: ROA (return on assets), ROE (return on equity). Increased profitability may be interpreted not as an indication of efficiency but as a result of unjustified high taxes imposition (Cohen et al. 2011).

As noted by Finkler (2005), ratios suggested by various authors are only examples of performance analysis. Each ratio must be calculated in a way that accounts for a given situation. Therefore, municipality's financial condition analysis methods found in literature generally are intended for analysing the financial condition of municipalities in a particular country.

McKinney (2004) referring to Groves et al. (1981) presents a system of financial condition monitoring intended for the analysis of municipality's financial condition. It is based on internal (budget and financial statements) and external (economic and demographic) information which allows to calculate financial indicators intended for the monitoring of financial changes taking place in a given city or region. The system of financial condition monitoring includes twelve factors having the biggest impact on the financial condition. Each factor consists of a certain number of financial indicators (in total 36). As this monitoring system requires to be fed by a number of indicators and data, for small municipalities it is too challenging a tool to be used consistently or used at all. Unfortunately, it impedes the use of financial analysis as a regular instrument of financial management. Another more widely known method of municipality's financial condition is a test of 10 ratios created in 1993 by Brown. This method is intended for financial condition analysis of small municipalities in the USA. The strong point of this method is the comparison of ratios with the best (target) ratios (Rivenbark et al. 2010).

Analysis of financial ratios in foreign countries (USA, Australia, and Canada) is often included in a municipality's audit. For instance, U.S. states present the reports on the cities' financial condition every year. Absolute and relative financial ratios spanning over the period of several years are reflected in these reports; changes of the ratios are calculated, comparative analysis is made and conclusions about the present financial condition are presented. When looking through the audit reports it can be noted that similar sets of financial ratios are used in each of them. Methods and their modifications provided by Groves et al. (1981), Brown (1993) are generally used.

Although after implementation of the reform of public sector accounting in 2010, municipalities in Lithuania prepare financial reports allowing the analysis of financial condition, the content of municipality's financial condition analysis has not yet been regulated. Ratios that would allow to draw well-justified conclusions about municipality's financial condition have not been developed. Moreover, there is a lack of empirical studies on this subject. Although pursuant to Article 27 of the local self-government law of the Republic of Lithuania, the municipality's auditor (municipality's control and audit office) supervises whether municipality's assets are managed and used legally, efficiently and economically, how municipality's budget is kept and how other monetary resources are used, in contrast to the audit reports made abroad, Lithuanian auditors only assess the veracity of information provided in financial statements. Running through several audit reports made by municipal' auditors it can be observed that financial ratios are not calculated and municipalities' financial condition is not evaluated in these reports. More attention in the articles and practice of Lithuanian authors (Mackevicius 2010; Valuzis 2006; Narbutiene 2008) is paid to the issue of correct information presentation in financial reports, and not to the problems of financial condition assessment.

RESEARCH METHODOLOGY

The aim of the research is to analyse and evaluate the financial condition of municipalities in Lithuania.

Stages of research: 1) selection of assessment ratios; 2) calculation of financial condition assessment ratios for every municipality; 3) calculation of statistical indicators of financial condition (mean, maximum, minimum, standard deviation).

There is no unanimous stance in the subject literature which financial condition ratios should be calculated. There is also the issue of the number of financial ratios to be applied. According to the authors' opinion, when choosing financial condition assessment ratios it is necessary to take into consideration their ability to assess the main aspects of municipality's financial management: current and long-term liabilities management, current and long-term assets management, and revenue-expenditure management. 12 relative financial ratios that capture these aspects are presented in Table 1. They are divided into 4 groups of relative ratios: liquidity, debt, turnover, revenue-expenditure (Table 1).

Table 1. Ratios for assessment of municipality's financial condition

Ratio	Formula	Information source
Liquidity Ratios		
Current Liquidity Ratio	Current Assets / Current Liabilities	Statement of Financial Position
Quick Liquidity Ratio	(Current Assets–Inventories) / Current Liabilities	Statement of Financial Position
Debt Ratios		
Debt to Asset Ratio	Total Liabilities / Total Assets	Statement of Financial Position
Debt to Net Asset Ratio	Total Liabilities / Total Net Assets	Statement of Financial Position
Total Liability per Capita	Total Liabilities / Population	Statement of Financial Position Socioeconomics Ratios
Turnover Ratios		
Total Asset Turnover Ratio	Revenue / Total Assets	Statement of Financial Activities Statement of Financial Position
Long-term Asset Turnover Ratio	Revenue / Long-term Assets	Statement of Financial Activities Statement of Financial Position
Revenue-Expenditure Ratios		
Net Surplus (Deficit) to Revenue Ratio	Net Surplus (Deficit) / Revenue	Statement of Financial Activities
Revenue per Capita	Revenue / Population	Statement of Financial Activities Socioeconomics Ratios
Expenditure per Capita	Expenditure / Population	Statement of Financial Activities Socioeconomics Ratios
Revenue to Expenditure Ratio	Revenue / Expenditure	Statement of Financial Activities
Net Surplus (Deficit) per Capita	Net Surplus (Deficit) / Population	Statement of Financial Activities Socioeconomics Ratios

Source: authors' own compilation.

The purpose of liquidity ratios is to assess the municipality's ability to cover its short-term liabilities by current assets (current liquidity) and liquid current assets (quick liquidity). The debt ratios assess municipality's ability to effectively use borrowed funds. The turnover ratios show municipality's assets and long-term assets ability to generate revenue. When calculating revenue-expenditure ratios, the municipality's ability to generate revenue from performed operations is assessed. Calculations of presented ratios were based on available consolidated municipalities' financial statements for the years 2011–2012. Since not all municipalities present their financial statements to the public, it was possible to calculate financial ratios for only 49 out of 60 municipalities. Finally, using the calculations and SPSS software, statistical indicators of municipalities' financial condition were calculated, enabling thorough assessment of the financial condition of municipalities in Lithuania.

RESEARCH FINDINGS

Statistical indicators of Lithuanian municipalities' financial condition are presented in Table 2.

When analysing average values of liquidity ratios presented in Table 2, it may be observed that in 2011–2012 the municipality's ability to cover short-term liabilities by current assets and liquid short-term assets remained almost unchanged. Average value of current liquidity shows that in the period of 2011–2012 for covering 1 Litas of current liabilities municipalities had a bit more than 1 Litas in short-term assets. Slight decrease in average quick liquidity ratio (from 0.94 to 0.93) reflects municipality's reduced ability to cover current liabilities by liquid current assets. Comparing the values of this ratio with the limit value used in evaluation of business entities' financial condition, equal to 1, it may be observed that liquid current assets of only 23 municipalities out of 49 exceeded current liabilities.

The biggest problems in terms of liquidity in 2011 and 2012 were found in Druskininkai municipality where current liabilities exceeded the current assets more than twofold and more than five fold – liquid current assets. Trakai municipality showed the highest liquidity in 2011; its current assets almost twice exceeded current liabilities. In 2012 Kaišiadorys municipality had the most current and liquid current assets for paying short-term obligations. Although the recommended range of liquidity ratios is not provided in subject literature, high liquidity ratios might indicate excessive and inefficient use of municipality's current assets.

Table 2. Statistical indicators of Lithuanian municipalities' financial condition

Ratio	Mean		St. Deviation		Minimum		Maximum	
	2011	2012	2011	2012	2011	2012	2011	2012
Current Liquidity Ratio	1.028	1.028	0.402	0.442	0.224	0.438	1.975	2.402
Quick Liquidity Ratio	0.944	0.930	0.392	0.404	0.175	0.177	1.828	2.110
Debt to Asset Ratio	0.134	0.128	0.073	0.056	0.037	0.041	0.461	0.314
Debt to Net Asset Ratio	0.405	0.502	0.607	0.808	–0.749	–0.322	2.849	4.252
Total Liability per Capita	990.55	1046.5	552.00	574.03	297.38	180.65	3463.1	3412.4
Total Asset Turnover Ratio	0.534	0.519	0.217	0.203	0.171	0.156	1.357	1.241
Long-term Asset Turnover Ratio	0.589	0.567	0.284	0.254	0.176	0.16	1.761	1.575
Net Surplus (Deficit) to Revenue Ratio	0.178	–0.02	0.401	0.123	–0.849	–0.52	1.223	0.424
Revenue per Capita	3517.79	3555.18	1086.11	1081.55	2129.09	2178.74	9742.27	10128.88
Expenditure per Capita	3548.72	3790.94	1835.41	1187.60	1098.76	2758.32	13587.38	11020.80
Revenue to Expenditure Ratio	0.98	0.965	0.344	0.068	0.436	0.658	3.032	1.111
Net Surplus (Deficit) per Capita	630.79	–74.548	1536.7	439.33	–3794.8	–1303.2	4005.0	1651.8

Source: authors' own calculations on the basis of publicly available consolidated financial statements of municipalities of the Republic of Lithuania for the years 2011–2012.

Average values of debt to asset ratio presented in Table 2 point to fairly minor dependence on creditors. In 2012, only 12.8 percent (13.4 percent in 2011 respectively) of municipalities' assets was financed by borrowed funds. When analysing average values of debt to net asset calculated by deducting liabilities and financing from the assets, it may be noticed that in 2012 the ratio was a bit more than 50 ct of liabilities per 1 Litas of net assets (41 ct in 2011). Analysis of minimum and maximum values of debt to net asset ratio shows a particularly complicated situation in Skuodas district municipality. Negative values of debt to net asset ratio of this municipality (–0.75 in 2011 and –0.32 in 2012) resulted from negative net assets. It shows that liabilities and loans exceeded the municipality's assets by 1.33 times in 2011 and twice in 2012. Maximum value of this ratio (4.25) in 2012 is indicative of a very complicated situation in Kaunas district municipality. This resulted from extremely large loans that constituted almost 67 percent of assets in the said municipality. Vilnius city municipality had difficulty in meeting its liabilities with net assets in 2011, with almost 3 Litas of liabilities per 1 Litas of net assets. Average values of total liabilities per capita of municipalities had definitely increased over the analysed period. This increase in ratios was brought about by decline in population and increased liabilities in most municipalities. It indicates growth in the municipalities' debt burden. Minimum and maximum values of total liabilities per capita show significant variation of this ratio.

Calculated average values of turnover ratios show that assets and long-term, revenue generating assets were more efficiently used in 2011 with 0.53 Litas of income per 1 Litas of municipality's assets and 0.59 Litas of revenue per 1 Litas of municipality's long-term assets. Decreased revenue and increased assets had the biggest influence on the diminution of efficiency of the use of assets. The lowest efficiency of assets' management during the analysed period was in Birštonas municipality. In 2011, there was 0.17 Litas of income per 1 Litas of assets and almost 0.18 Litas of revenue per 1 Litas of municipality's long-term assets. After decrease in the municipality's revenue in 2012, the turnover of assets and long-term assets dropped by 9 percent. Revenue generating assets were most efficiently used in 2011 by Švenčionys district municipality and by Skuodas district municipality in 2012.

Revenue-expenditure ratios indicate a slightly worse financial condition of Lithuanian municipalities in 2012. Decreased revenue and increased expenditure (more than 5 percent on average) were the most responsible for the deteriorated financial condition of most municipalities. In 2012 only 13 out of 49 municipalities generated the surplus, while in 2011 financial results of only 27 municipalities were positive. Average values of revenue--expenditure ratios lower than 1 show that in majority of municipalities the income generated was not sufficient to cover the expenditure. Revenue from main activity exceeded expenditure only in 9 municipalities in 2011 (8 municipalities in 2012). Faster increase in expenditure and decreased revenue caused the growth of net deficit in 2012. 630.79 Litas of surplus in 2011 and 75 Litas of deficit in 2012 was the per capita average.

The practical significance of the research conducted is reflected in the application of the findings, as generalized information about average, maximum and minimum values of municipalities' financial condition ratios in Lithuania within the period analysed is provided. The results of this research may help municipalities identify weaknesses of their financial management and also guide them in the attempts to improve the existing financial situation. Financial condition ratios should be calculated and assessed every year, and such analysis should become part of municipality's financial management. Besides, in order to assess the factors influencing municipality's financial condition it is useful to perform the factor analysis, that is the one described as third stage.

Research limitation is related to data reliability. The results obtained are reliable provided that information presented in municipalities' financial statements is reliable. Reliable information is accurate, i.e. comprehensive, impartial and correct. Currently this is a practical problem of great relevance faced by majority of municipalities in Lithuania. Results of audits performed by municipality's auditors (municipality's control and audit offices) reveal mistakes in the drawing of financial statements which misrepresent information provided in financial reports. For instance, an excerpt from the audit's remarks on consolidated financial statements of Vilnius city municipality (VCM) of 2013 says: „[…] The consolidated financial statements of 2013 and the report on municipality's property managed by municipality by virtue of trust law, do not reflect the actual financial condition of VCM consolidated entities as of 31st December 2013 and do not reflect the results achieved, changes of net assets and cash flow in 2013 pursuant to the public sector accounting standards of the Republic of Lithuania". Imprecisely presented information triggers the necessity to correct accounting errors committed in previous accounting periods and to adjust the data provided in financial statements. The correction of fundamental errors may distort the results of financial analysis and decrease their reliability.

CONCLUSIONS

To implement the reform of the public sector accounting, since 2010 the municipalities in Lithuania are bound to prepare financial reports on accrual basis which provide more precise information and allow to analyse and compare the financial condition of municipalities, and enable users of financial reports to make more efficient decisions on the use and management of financial resources. After a generalization of financial condition analysis ratios mentioned by foreign authors and considering the peculiarities of public sector accountability in Lithuania, four groups of ratios for the analysis of municipality's financial condition consisting were designed covering the following aspects of municipality's financial management: management of current and long-term liabilities, assets management and, revenue-expenditure management. The purpose of the research performed was to calculate financial ratios, compute statistical indicators and present a general assessment of the financial condition of Lithuanian municipalities on the basis of publicly available consolidated municipalities' financial statements for the years 2011–2012.

The results of the research have shown that as many as thirty three municipalities faced liquidity problems in the period analysed. Available liquid current assets were not enough to meet their current liabilities. Although only ca. 13 percent of municipalities' assets came from borrowed funds, a growing debt burden for inhabitants was observed. This trend is conditioned by population decline and, in most municipalities, increase in liabilities. Calculated revenue--expenditure ratios showed that in most municipalities the income generated did not suffice to cover the expenditure. Revenue-expenditure ratio higher than 1 was observed in eight municipalities in 2012 (nine municipalities in 2011). Such situation resulted from rapid growth of expenditure and decreased revenue of municipalities.

The assessment of the financial condition of Lithuanian municipalities revealed their main problems with regard to financial management. The first problem is low liquidity indicating the municipalities' struggle to pay their short-term obligations. The second problem is too large expenditure that is not covered by municipality's revenue. The third problem is the growth of debt burden for inhabitants. When solving these problems municipalities must pay more attention to the management of liabilities (current and long-term) in order to decrease the debt burden for inhabitants and increase municipality's liquidity. It is also necessary to make decisions that would stimulate municipality's revenue and increase the efficiency of its expenditure management.

Although in other countries the analysis of municipalities' financial condition is an inherent part of their financial audit, the scope and content of this analysis is not regulated at the national level in Lithuania, and methodical recommendations for such analysis have not been provided. Development and application of one consistent assessment approach would be an important tool allowing the municipalities to assess their financial sustainability in order to foresee any potential financial distress.

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Streszczenie. Celem niniejszego artykułu jest analiza i ocena kondycji finansowej okręgów i rejonów na Litwie. Kwestia ta jest istotna zarówno z teoretycznego, jak i praktycznego punktu widzenia. Zgodnie z wiedzą autorów niniejsza publikacja jest jedną z pierwszych prac litewskich badaczy poświęconych tej tematyce. Analizę przeprowadzono na podstawie publicznie dostępnych, skonsolidowanych sprawozdań finansowych gmin, przygotowanych zgodnie ze standardami rachunkowości sektora publicznego. Zbiór wskaźników kondycji finansowej opracowano na podstawie literatury przedmiotu, uwzględniając osobliwości istniejące w rachunkowości sektora publicznego. Pozwala to na badanie i ocenę głównych elementów kondycji finansowej rejonów: zarządzania bieżącymi i długoterminowymi zobowiązaniami, zarządzania kapitałem, zarządzania przychodami i wydatkami. Oceny statystyczne kondycji finansowej gmin obliczono z wykorzystaniem oprogramowania SPSS. Przeprowadzone badania wykazały, że litewskie gminy posiadają zdolność pokrycia swoich zobowiązań finansowych oraz pełnienia wyznaczonych funkcji, a także kompetencje potrzebne do zarządzania własnością gminy oraz finansową niezależność. Wyniki przedstawionych badań mogą służyć jako punkt odniesienia dla innych gmin w celu oceny, czy działają powyżej czy poniżej średniego wskaźnika. Przedstawioną metodę stosować można na potrzeby analizy kondycji finansowej gmin w innych krajach stosujących zasadę memoriałową.