

Tax Supported Special Report

GASB 34: A New Look and New Tools for Municipal Credit Analysis

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■ Summary

The Governmental Accounting Standards Board (GASB), which makes the rules of accounting for local government units, adopted a major revision to the ways that governments will have to account for their financial operations in the form of GASB Statement No. 34 (GASB 34). This new standard has been a long time coming, and it is expected to be an even longer time before it becomes widely used and adopted in local government financial reporting. Large governments with annual revenues exceeding \$100 million are scheduled to implement the new rules for fiscal years ending after June 15, 2002; small units with annual revenue below \$10 million are slated for years ending after June 15, 2004. In addition, governments have an additional four years beyond the deadlines to include infrastructure assets retroactively. Therefore, users may not begin to see the full application across all levels of government until 2006 or 2007. This is a good thing since there still appears to be a great deal of confusion as to what the new rules will create, and even less agreement as to how the new information will be used.

For traditional users like credit analysts and rating agencies, which focus on annual short-term operations and cash flow, GASB 34 will still provide nearly the same information on governmental funds in the familiar format of fund accounting and the modified accrual basis of accounting. There will be some changes in the format of the presentation of the funds, with more emphasis on details for major operating funds and provisions to consolidate minor funds to streamline reporting. In discussions with industry analysts, there is widespread consensus that the new format rules will not create problems for municipal credit analysts in most cases. As long as issuers continue to report revenue, expenditure, and balance sheet details on their general funds, debt service funds, and those special revenue funds that account for tax-supported expenditures and nondiscretionary spending programs that require the financial support of local government, credit analysts' needs will be met.

Requirements for management discussion and analysis of transactions, events, and conditions are an extension to the information already provided by many of the largest state and local governments in transmittal letters that precede the accounting statements. This type of section is a prerequisite for governments that wish to receive the Government Finance Officers Association (GFOA) Certificate of Achievement in Financial Reporting. The widespread adoption of this practice will improve the information flow for smaller local governments that do not provide this analysis now and is clearly welcomed and applauded by financial analysts as a major improvement in the quality of financial reports.

GASB 34 also encourages issuers to provide highlights of events that are special, extraordinary, unusual, or nonrecurring in nature. Since these types of developments are a major part of an analyst’s job, this information represents a significant improvement to what is currently required under former accounting dictates.

In the dialogue that has occurred to date, there does not appear to be great controversy over GASB 34’s pronouncements in the aforementioned areas. Clearly, the controversy and confusion relate to GASB 34’s new requirements for consolidated statements and accounting for the creation and amortization of general fixed assets that have been built with taxes or tax-supported debt. The cost that may be involved in compiling and reporting this information is also an issue for jurisdictions. Fixed-asset accounting and depreciation have long been established and required for enterprise operations, which have been described as the government’s “business-like” operations that are paid for by charges to users of those systems and departments. The other assets of local government, variously described as general fixed assets and infrastructure, have long been an area of concern for financial analysts, policy makers, and taxpayers alike.

The term “crumbling infrastructure” is perhaps an overused phrase, but it captures the reason why there is a need for a better accounting for governmental capital assets. Without an orderly means of accounting for the “wear and tear” and maintenance of governmental infrastructure, industry analysts and investors will never be able to accurately estimate the degree to which infrastructure is indeed crumbling and whether communities are successful in protecting tax-supported investment in the infrastructure. This report focuses on this section of GASB 34 requirements and how Fitch, as a rating agency, will use and interpret the new financial information that will be provided by GASB 34.

■ Why Is GASB 34 Important to Credit Analysis?

Although the financial community did not specifically ask for all the detailed proscriptions of GASB 34’s infrastructure requirements, in the past, municipal credit analysts have been very vocal proponents of improved information on the condition of governmental infrastructure. The reasons for their concern can be summarized in four points:

- The size and condition of a government’s infrastructure is clearly related to an issuer’s debt, a major factor in credit analysis.

- Failure to maintain infrastructure adds costs to the general fund and can ultimately lead to on higher debt than is necessary.
- Failure to maintain infrastructure is poor financial management, causing past investment to be wasted.
- Failure to maintain the infrastructure may create a drag on the local economy and can encourage population and corporate flight while discouraging new private investment or reinvestment.

The problem for analysts, elected officials, and budgetmakers is the same — aside from losing one’s car in a crater-sized pothole, how can it be determined when infrastructure is falling into disrepair? Simply put, what a bond rater or municipal credit analyst wants to know is whether or not the debt issuer will face higher debt and the possibility of lagging economic development because of decaying infrastructure. If infrastructure is not being maintained, it is also important to try to gauge the degree of disrepair in that jurisdiction. The new fixed-asset information in GASB 34 attempts to supply the tools to help make those determinations.

■ Modified Approach Meets Needs of Analysts

There are two methods that issuers can use to comply with the new infrastructure requirements of GASB 34 — the depreciation method and the modified approach to reporting infrastructure. For credit analysts, the most straightforward method may well be the alternative modified approach to reporting infrastructure. Under this method, governments will still need to inventory their infrastructure assets, but depreciation need not be calculated. In its place, a government must establish and assess the physical condition of its fixed assets, using a description of the criteria that it uses to measure and report asset condition. The unit must then perform follow-up assessments at least once every three years, as well as state the condition level at which the government intends to maintain its assets. Finally, the unit must present the annual dollar amount spent on asset maintenance, with a five-year history of such annual expenses for comparison. This data would be required information in the required supplemental information (RSI) section of the financial statements.

This method may be the most effective for analyst needs, because it answers the basic question of whether assets are being maintained or allowed to deteriorate. However, its implementation by issuers is not as simple, because it requires a system to track

and the recurring expenditure of resources to perform asset inspections and assessments. GASB realized this concern by granting an additional four years for most governments to include infrastructure assets under GASB 34 rules. At this time, little information is available about the cost and difficulty of this type program compared to the valuation and depreciation of fixed assets contemplated in the fixed-asset accounting requirements of GASB 34.

The depreciation method, while being more objective, still creates analytical problems for Fitch analysts. First, the raw data are not likely to demonstrate the current condition of a jurisdiction's capital assets. Second, because this data will be new, there will be a shortage of information for comparison purposes during the phase-in years. Finally, it appears that there could be wide variation in the estimated lives of capital facilities from one jurisdiction to another. As GASB 34 takes hold, the information is expected to become more standardized and, therefore, more useful in Fitch's credit analyses.

■ **General Fixed Asset Reporting and Depreciation: A Whole New World**

GASB 34's requirements for fixed-asset accounting builds on earlier pronouncements established in the late 1970s, which were considered controversial at that time. In that era, issuers that did not report the cost or value of their buildings and capital assets in the general fixed-asset account group were subject to a qualified opinion from their auditors. Many units at that time (and some even now) had inadequate or missing documentation for capital plant. Issuers complained about the added costs of creating and maintaining these accounts, and there were serious questions about the value of listing this information. In retrospect, many of those arguments were probably correct, because there was little use in just knowing the recorded cost of facilities. Even reporting the replacement value of facilities had little or no value without knowing the current condition of those assets and their remaining useful lives.

GASB 34's requirements for general fixed-asset reporting and accounting for its depreciation or cost of maintenance attempts to provide the missing link. By requiring depreciation, GASB incorporates a calculation of the expensing of fixed assets or, more simply, attempts to calculate the normal wear and tear of fixed assets over the estimated useful life of the facilities. These calculations of gross and net fixed assets will mirror those rules already used for

enterprise fund accounting employed by municipal utility and airport systems and will only be found in the newly mandated governmentwide financial statements that will precede the traditional fund accounting statements.

■ **Other New Governmentwide Financial Statement Information**

The new governmentwide financial statements will include several schedules detailing balance sheet items and income/expense statements. The statements will try to present the operational results of the entire government entity in one place, which was not possible under the old fund accounting format. Much of the information that will be found in the new statements is already available but in the old, eight-column format of governmental funds, enterprise funds, fiduciary funds, and the fixed-asset and long-term debt groups of accounts.

The GASB believes the new statements are a groundbreaking innovation, enabling users to assess the financial condition of the entity as a whole. It is arguable that a user could roughly assess the improvement or deterioration of an entity's entire finances by analyzing the eight-column fund statements, with the notable exception of accounting for general fixed asset wear and tear. Other innovations will be in the new statements. One potentially useful piece of information will be a breakout of government cost centers and the extent to which those costs are recovered by related user fees and intergovernmental grants or supported by taxes. Fitch analysts believe that the cost recovery breakouts will provide some help in the analysis of a government's nontax revenue-raising flexibility. The most important new information that is expected to have the greatest effect on the debt rating process will be the presentation of general purpose fixed assets and measures that show the use and maintenance of a government's fixed assets and infrastructure network.

■ **How is Fitch Likely to Use the New Accounting Information?**

In GASB's literature describing the changes, the board emphasizes that the new statements will allow the user to better gauge whether an entity's financial condition has improved or deteriorated on the whole. In the assignment of ratings on debt that is paid from various dedicated revenue of the government entity, Fitch will likely continue to emphasize the use of the fund statements, which detail the sources of income and nature of expenses incurred that surround the

repayment of debt. The health of unit finances as a whole has always had broad implications for debt ratings across the spectrum of tax-supported and revenue bond ratings, and the new statements will contribute to this analysis. However, Fitch analysts believe that most rating changes, upward or downward, will likely be the result of the relevant funds, governmental or enterprise, that account for the day-to-day operations and actual payment of debt service expenses.

Deterioration of a unit's finances on the whole, as envisioned in the new statements, could be represented by negative positions in the statement of net assets or by deterioration or reductions in an entity's net asset position (similar to the drawdowns of fund balance surpluses in a unit's general fund in a given year).

For issuers that may report negative net asset positions in their initial submissions of financial statements under the new accounting rules, Fitch does not expect a significant number of rating changes to occur as a result. That is because the likely causes of such a negative net asset position, such as accrued vacation time or compensated absences, are already disclosed under current generally accepted accounting principles (GAAP) rules in the long-term debt group of accounts and are currently factored into Fitch's analyses. Another major contributor to a negative net asset position would likely be deficit bonds issued to fund annual budget expenditures (for which there would be no corresponding asset to offset the debt). Likewise, this debt should already have been factored into issuers' tax-supported debt ratings.

The last major contributor to a negative net asset position would result from poor capital asset management. Generally, as long as an issuer retires its debt at a rate equal to or faster than the depreciation of the asset and does not abuse the use of capitalized interest from bond proceeds, fixed-asset management should not result in negative net asset positions in the governmentwide statements. Theoretically, if an issuer depreciates its assets at a rate identical to its debt amortization, the net asset position should not be affected by fixed-asset management; depreciation and debt reduction would neutralize the effect on the balance sheet. It is currently unclear whether the modified approach to infrastructure reporting will help or harm an issuer's net asset position in the new governmentwide statements.

The initial net fixed asset balance sheet positions will not enable analysts to determine the adequacy or condition of a debt issuer's infrastructure because no reference point is provided. In that respect, analysts will be in no better or worse position than now. However, the initial net fixed-asset positions will provide an important reference point for future analysis, much like a tide marker. Until a trend of several tide markers is witnessed, it is difficult to determine whether the tide is rising or falling or when high tide has been reached or ebb tide has occurred.

For future rating analysis, the trend of net fixed assets will be the primary indicator of whether an issuer is maintaining its infrastructure relative to its growth rates or whether it is slipping behind and allowing the infrastructure to decay. Under any circumstance, it would appear that a downward trend in an issuer's net capital assets would indicate that infrastructure deterioration may be under way. In this scenario, a government is allowing the wear and tear of infrastructure to occur faster than it is paying off associated debt and is spending little or no annual revenue to defray the wear and tear.

In the scenario where net capital assets trends are stable, this may indicate that the government is allowing infrastructure deterioration to occur if it is showing signs of growth and expansion. In this case, new assets may be funded with new debt and pay-as-you-go capital expenditures, but wear and tear on existing infrastructure offsets the net new assets. Therefore, for growing cities, a stable trend of net fixed assets may be a warning sign that a city is not keeping up with its new facility demands while maintaining its replacement requirements.

■ **New Ratios for Infrastructure: Will They Have Any Meaning?**

As analysts and observers study the new information that will be generated from the new GASB 34 requirements, there may be much discussion about new ratios that will be added to analysts' lexicons. Ratios like per capita fixed assets, per capita net assets, and debt to net fixed assets are several that have been mentioned in other discussions of GASB 34. Of these ratios, the ratio of debt to fixed assets net of depreciation is likely to have the most stand-alone value for analysts in the absence of a multiyear trend that tracks these ratios. This is because issuers with lower ratios of debt to net fixed assets are likely those that supplement their capital expansion and maintenance programs with significant amounts of

pay-as-you-go appropriations or intergovernmental aid. Retiring debt at a faster than average pace can also contribute to lower debt-to-asset ratios. In other words, these issuers are making substantial “down payments” from annual revenue to supplement their borrowing programs. Fitch has stated that issuers with substantial pay-as-you-go capital funding are demonstrating one of the most valuable practices that can lead to stronger debt ratings.

Ratios like per capita fixed assets and per capita net assets, without any trends, are virtually meaningless because of the wide disparity in services and capital facility needs by the varied levels of government from state to state and, for that matter, within a state. A typical example of the incomparability of these ratios would show relatively low ratios for Chicago, which has other governments responsible for parks, wastewater, schools, health care, and criminal justice functions, compared to New York City, which has all typical local government functions provided under the umbrella of one city government.

Furthermore, statements of net capital assets will not identify whether infrastructure is adequate or inadequate or whether it is in good condition or disrepair. Therefore, the most important ratios are those indicators that show change over time, improvement, or deterioration. Among those indicators likely to be of most use to Fitch analysts are the following:

- Trends in depreciation versus net addition to capital assets.
- Declining net capital assets.
- Change in net assets.
- Comparison of needed to actual maintenance preservation spending.
- Trend in percentage of lane miles or bridges in “good or better” condition.
- Debt to net capital assets.

■ **Benefits of GASB 34 to Debt Rating**

In Fitch’s 1999 landmark review of default experience, lower than expected rates of default on traditional types of local government debt were noted. In 2000, Fitch noted that several secular trends and developments have occurred that have led to an increase in the safety of municipal bonds; one of those trends has been the advancement and standardization of modern accounting practices. GASB 34 continues the evolution of financial reporting for governments. The new guidelines will provide a comprehensive view of a government’s

overall economic resources and long-term requirements. They also account for the wear and tear and expense of capital assets over their useful lives. As issuers implement these standards, it is reasonable to assume that the new information will make its way into the budgeting process, encouraging officials to include provision for the regular maintenance and upkeep of infrastructure and buildings. Increased emphasis on the net cost of service will better enable policymakers to balance taxation against appropriate user charges for various municipal services. Analysts appreciate the fact that fund statements will continue to be reported, allowing analysis to be performed on both general governmental operations and those enterprise and other programs that support dedicated revenue bond debt service.

■ **Analytical Challenges of GASB 34**

The multiyear phase-in of GASB 34’s fixed-asset accounting requirements is understandable given the magnitude of change and complexity surrounding this major revision in accounting principles. However, the phase-in, including the four-year extensions granted for reporting infrastructure assets retroactively, hampers analysts’ ability to perform comparisons since there will not be a relatively complete universe of financial reporting fully implementing GASB 34 until 2007. Resistance by issuers to conform could also lengthen the timeline. In addition, as noted earlier, the information in the first year will be relatively meaningless until benchmarks for reference and capital maintenance trends have been established for a few years. Therefore, broad-scale, meaningful analysis of the new data may not occur until the end of the decade.

The new depreciated fixed-asset information is only found in the governmentwide statements, but annual operating budgets are likely to continue following the fund formats that have been adopted over many years. This incongruence may hinder or slow the integration of fixed-asset depreciation into the budgetary process for allocating resources for expenditures.

Although the new governmentwide financial statements will give users another point of view, the aggregation of funds and calculation of net assets will not give a complete depiction of what resources are available given fund structure, legal considerations, and special tax dedications. Statutes, charters, and often bond covenants can act to limit a government’s ability to move resources to where they may be most needed. Budget makers and legislators will also need to understand that positive net assets on the

governmentwide statements are not the same as available surplus in the budgetary model based on the flow of currently available resources.

The potential exists for the blurring of data for analysis due to provisions that allow consolidation of so-called “minor funds” into a catch-all fund report. For minor funds whose primary purpose is to report debt service transactions, their consolidation may present analytic challenges or at the least additional phone calls to ferret out the needed data to complete the issuer’s credit analysis.

Finally, analysts will need to contend with the problem posed by issuers that finance capital construction with debt but entrust ownership of the assets with other governments on whose behalf the debt was issued and the infrastructure constructed. Currently, counties in North Carolina face potential red ink on governmentwide statements because of large issuances of school debt where facilities built are reported on school district financial statements. This anomaly may also occur frequently at the state level where state debt is issued to reimburse local government facility construction.

■ Fitch Observations as GASB 34 Evolves

Fitch believes that the fixed-asset reporting requirements of GASB 34 will have long-term benefits for the safety of traditional municipal bonds. Issuers are now focusing on how to implement these new standards. The next logical step is figuring out how the new information will be factored into the annual or biennial budgetary process of raising tax and fee revenue and allocating their expenditures for government services, programs, and capital construction. GASB 34 could potentially increase pay-as-you-go capital construction as issuers try to “beef-up” their capital maintenance programs. Of note, issuers that are early implementers of GASB

34’s fixed-asset reporting will receive additional management credit in Fitch rating analyses as part of a continued focus on positive management practices.

GASB 34 may also help the capital formation process by improving the information used in creating multiyear capital improvement programs over time. As a broader cross-section of issuers implement the new rules, Fitch is likely to increase its reliance on the new data supplied under GASB 34. At that point, failure of issuer compliance may assume the aura of a qualified opinion on management controls, thereby making that issuer an “outlier” in the landscape of public financial management. Issuers can look good to rating agencies by rapidly retiring debt and creating pay-as-you-go depreciation reserves, both of which would improve an issuer’s financial position under GASB 34. Issuers that “short-change” capital maintenance will likely reveal stagnant or declining net asset positions. In extreme cases where infrastructure has deteriorated, this could lead to higher than average debt, increasing debt to net capital asset ratios, and/or slower than average debt amortization, factors that tend to contribute to lower ratings.

Given the complexity of the issues that can affect net asset positions on the governmentwide statements and the long timeframe before most jurisdictions are required to fully implement GASB 34, Fitch is likely to take a cautious position before considering any rating changes based on the new information under GASB 34. There will be much dialogue between debt issuers and Fitch rating analysts to understand better the meaning of the new data and how it shows the overall financial condition of state and local governments. As data become available from jurisdictions that implement GASB 34, analysts will be in a better position to make comparisons and judgements on the condition and repair of local governments’ infrastructure and capital maintenance efforts.

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