

Criteria Report

The 12 Habits of Highly Successful Finance Officers

Management's and Disclosure's Impact on Municipal Credit Ratings

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November 21, 2002**■ Summary**

In 1999, Fitch Ratings undertook a study of defaults of municipal debt, which resulted in the revision of its rating criteria for many sectors of public finance. During that process, Fitch came to the conclusion that management practices were more important in predicting favorable credit performance than had been appreciated in the past. Fitch's public finance group identified several preferred management practices and said on record that issuers who incorporate several of these best practices could see a difference of one to three rating notches above the ratings of similar issuers that do not incorporate such practices. In the subsequent review of Fitch's entire portfolio of debt ratings that occurred through 2000, many ratings were revised under the new criteria. Fitch changed about 27% of its tax-supported debt ratings and about half its water and sewer ratings, mostly upgrades. Fitch estimates that about three-quarters of the rating changes were a result of the emphasized consideration of management practices.

This report, while directed primarily at local governments' tax-backed governmental operations, serves as an overview for the entire spectrum of governmental debt issuance, for both tax-supported and user fee-based enterprise operations. It discusses the management practices that Fitch believes are conducive to strong creditworthiness and those that are detrimental to financial soundness. In updating its view on management's effect on creditworthiness, Fitch incorporates an assessment of disclosure and debt affordability practices. For the future, Fitch is in the process of disseminating similar reports for other sectors of public finance, such as health care, transportation, and higher education. Fitch will continue to evaluate and identify best practices and disclosure techniques so that management can be appropriately and objectively evaluated in assigning ratings.

■ Background

Prior to Fitch's default study, rating agencies had always considered financial management practices when assigning bond ratings. Policies that call for contingency operating reserve funds, pay-as you-go capital spending, and multiyear budgeting were encouraged, although their rating value was left vague in rating agencies' guidelines. Likewise, receiving budgeting and financial reporting awards from organizations like the Government Finance Officers Association (GFOA) was generally lauded by rating agencies but given the same indistinct response in assigning ratings. Most rating adjustments for management reasons occurred on a case-by-case basis, rather than based on consistent benchmarks that define management practices' worth in an issuer's ultimate rating assignment.

In analyzing actual financial crises of the past 25 years, it is clear that management has had a significant impact on salvaging, as well as exacerbating, situations. In the 1970s, New York City had more than its share of economic problems, with declining population, employment, and property values. However, its financial crisis was precipitated by cash basis accounting, poor management decisions, lack of internal controls, overspending, and poor record keeping. The default by the Washington Public Power Supply System was as much a result of unrealistic projections as of a national shift from nuclear power generation to conservation as a means of addressing energy shortages. Reliance on nonrecurring revenues and liberal growth forecasts contributed to Nassau County, NY's fiscal crisis in the late 1990s. Finally, the inappropriately speculative investment strategy and lack of internal controls of Orange County, CA caused the huge investment losses that led to the county seeking bankruptcy protection. In most of these cases, questions were raised about whether adequate disclosure practices were employed. Market participants expressed concern that lack of disclosure was a major contributor to the meltdowns, allowing issuers to mask their financial problems until it became too late to mount effective strategies to reverse their fortunes.

On the positive side, fiscal discipline and strong management practices have significantly benefited credits. Baltimore has been faced with long-term economic erosion and urban flight as much as any city in the country. However, its budgets are consistently balanced, and its bond ratings have been kept in the upper end of the 'A' category by all three major rating agencies. The cities of Detroit and New York have also employed management practices that have resulted in enhanced credit quality.

In summary, management practices and policies can add stability to weak credits, maximizing their credit rating potential. Conversely, weak financial management can negatively affect even the strongest economies and local government structures. In extreme cases, poor management can cause rating downgrades to below investment grade and, on rare occasions, bankruptcy or missed debt service payments. The increased pressure for better disclosure by issuers from regulators and municipal analysts is understandable because of the correlation between substandard disclosure and severe fiscal stress and default events.

■ Best Practices and Disclosure Standards

Best practices that promote efficiency in government and solvency in public finance have been identified by the GFOA; The National Association of State Auditors, Comptrollers and Treasurers; the National Association of State Budget Officers; the National Association of Counties; and the International City/County Management Association. In 1997, a group called the National Advisory Council on State and Local Budgeting (NACSLB) was created by these and numerous other government organizations and business leaders. NACSLB published a report in 1998 on approximately 60 best practices in budgeting and financial management for state and local governments. Its recommendations constitute many of the financial management practices that Fitch recognizes as superior and considers in its credit rating process.

Not all NACSLB's best practices deal with financial management; many concern taxpayer communications or assessing programs and services. Fitch believes that if taxpayers understand the services governments provide, they may be less likely to propose restrictive initiatives or force dramatic political or management changes through the electoral process. Coral Springs, FL and Scottsdale, AZ are recognized leaders in the identification of taxpayer concerns, needs, and priorities.

The national debate about increased disclosure by issuers of municipal debt began after New York City's financial crisis in 1975. Many governments still used cash basis accounting to report their operations, and many series of bonds were sold with little more than a four-page notice of sale and bidding instructions. To its credit, New York City fashioned improvements to its financial management system and oversight mechanisms (these were required by the credit markets before market access would be granted to the beleaguered city), which led to the widespread acceptance of generally accepted accounting principles (GAAP) as the minimum standard of financial reporting disclosure for state and local governments. This trend toward increased GAAP use was an important factor in Fitch's conclusion in its 1999 default study that there has been an improvement in safety and stronger creditworthiness in the municipal market.

Although the municipal market still enjoys relative freedom from regulation by the Securities and

Exchange Commission, self-policing structures, like the Municipal Securities Rulemaking Board, exist to ensure that an active debate regarding disclosure practices continues. In recent years, the National Federation of Municipal Analysts (NFMA) led the charge for more detailed disclosure by local governments. This organization issued or drafted comprehensive disclosure guidelines for nine municipal finance sectors and developed secondary market disclosure forms for another eight areas.

Related to the quality and amount of disclosure by issuers is the concept of timeliness. Rule 15c2-12 of the Securities Exchange Act of 1934 is intended to ensure timely disclosure of material events or developments defined by the rule. Annual audited financial reports are generally available within six to nine months after a fiscal year's end, according to accepted practice; however, there is no formal standard for this written into regulation. Rating agencies have a certain amount of influence because the failure to receive an audited financial report can result in the withdrawal or loss of a bond issuer's rating. However, such an action does not help investors make informed decisions; rating withdrawals only result in an absence of information. Fitch believes a delay in reporting that exceeds six to nine months after the close of a fiscal year is excessive.

In recent years, there has been a fair amount of controversy regarding the adequacy and operation of the disclosure repositories. With the expansion of the internet and its widespread acceptance as a means to transfer information, even the smallest issuer has a cost-effective platform for the dissemination and publication of debt disclosure information.

Fitch's last report on management presented a list of positive financial management practices that Fitch felt had the most beneficial effect on creditworthiness. Several of these items touched on disclosure, such as an issuer's receipt of awards for excellence in financial reporting and budgeting. Fitch indicated it would more favorably view ratings for issuers that were already meeting the newer demands for fixed asset and depreciation reporting resulting from Governmental Accounting Standards Board Statement No. 34 (GASB 34). Now that many governments have to meet the fiscal years 2002 and 2003 implementation deadlines for GASB 34, this form of disclosure will increasingly become the accepted standard, rather than the exceptional practice of a few forward-minded issuers. Fitch is updating its list of favorable practices to address the

Best Financial Management Practices for Governmental Issuers

- Fund balance reserve policy/working capital reserves
- Multiyear financial forecasting
- Monthly or quarterly financial reporting and monitoring
- Contingency planning policies
- Policies regarding nonrecurring revenue
- Debt affordability reviews and policies
- Superior debt disclosure practices
- Pay-as-you-go capital funding policies
- Rapid debt retirement policies (greater than 65% in 10 years)
- Five-year capital improvement plan integrating operating costs of new facilities
- Financial reporting awards
- Budgeting awards

broader subject of disclosure, rather than focusing on fixed asset depreciation reporting. The box above lists those financial management practices in the government sector that Fitch believes are most positive in credit analysis.

Fund Balance Reserve Policy/Working Capital Reserves

Maintaining an operating reserve or rainy day fund is perhaps the most effective practice an issuer can use to enhance its credit rating. It is also the most frequently implemented practice, adopted by both large and small local government issuers. A financial reserve may be used to address unanticipated revenue shortfalls or unforeseen expenditures. This provides a first defense against deficit spending and helps maintain liquidity when budgeted drawdowns become inevitable. The appropriate size of such a reserve depends on the potential variability of the entity's revenues and expenses, as well as its working cash needs to handle seasonality of revenues or expenditures.

Governments can issue cash flow notes — tax anticipation notes or revenue anticipation notes — when revenue receipts and/or expenditure disbursements are uneven throughout the fiscal year or mismatched with one another. In such cases, short-term borrowings can be an effective means to even out lumpy or unbalanced cash flows. However, in several instances, governments have issued sizeable amounts of cash flow notes to compensate for unanticipated

year-end cash and fund balance deficits. A need for notes in situations of fiscal stress may indicate weakened credit quality and is a leading cause of downgrades. Issuers that can meet their seasonal cash flow needs from working cash on hand can avoid all the potential problems that issuing notes in finance shortfalls might create.

Multiyear Financial Forecasting

The practice of forecasting operating revenues and expenditures over several years has generally developed from issuers experiencing severe fiscal stress and coming under the oversight of financial control boards, such happened in New York City, Washington, D.C., and Philadelphia. However, in these cases, multiyear financial forecasting has had beneficial effects long after the financial crises passed. A multiyear plan enables executives and legislators to anticipate potential budget stress that may result from projected revenue and expense imbalances, allowing them to take corrective action long before budgetary gaps develop into crises. The multiyear plans of New York City and Philadelphia serve as good models for larger local governments. Multiyear planning for general fund operations can be effectively employed by smaller issuers (with less than 50,000 people) too, such as Radnor Township, PA, at relatively low cost.

Monthly or Quarterly Financial Reporting and Monitoring

Interim financial reporting and monitoring can block the progress of impending fiscal stress if the financial management system is calibrated properly. The best interim reports give details on the issuer's major tax and revenue sources, with variance analysis that shows the factors that are affecting revenue inflow. Likewise, interim reports that present spending for the current month, for the year to date, and in comparison with the budget are also beneficial. For an interim report to be most meaningful, its format and basis of reporting should be consistent with the adopted budget, the past year's GAAP results, or both. The quarterly city manager's report put out by Philadelphia is an example of excellent interim reporting; in addition to providing updates on service delivery and important management initiatives, the report gives quarterly results for general fund operations, adjusted to GAAP and comparable with the city's annual financial statements.

Contingency Planning Policies

When evaluating credits, municipal credit analysts do not like to see surprises, particularly negative ones. Demonstration by an issuer of foresight and planning against unforeseen events is viewed positively. Many future challenges can be anticipated. Each year, in several states, a number of voter initiatives are presented that propose revenue limits or reductions and can potentially change issuers' financial flexibility dramatically. Issuers should have meaningful contingency plans against the possibility of voter-ordered tax cuts. Likewise, issuers located in zones with frequent hurricanes should have reasonable contingency plans for dealing with the financial, economic, and social challenges posed by a storm's destruction. Finally, local governments should consider making contingency plans for their proposed or adopted budgets, in the event that budget assumptions prove erroneous. Simply put, officials should think about creating a plan B. Early planning and timely communication of contingency plans can greatly help maintain creditworthiness in the face of unusual events.

The City of Federal Way, WA is an example of an issuer that employs good contingency planning techniques. In Fitch's 2000 comprehensive review of ratings and management practices, Federal Way was the Fitch-rated issuer with the greatest number of best practices implemented and maintained.

Policies Regarding Nonrecurring Revenue

Overreliance on nonrecurring revenues, or "one shots," to pay ongoing and recurring expenses is a credit concern, since it frequently contributes to budgetary stress and fiscal structural imbalances. One shots can be sales of fixed assets (such as surplus school buildings or properties), budgetary savings from a debt refinancing, court settlements, or tax collection windfalls resulting from state or federal government changes.

From a credit perspective, nonrecurring revenues are best used for one-time or discretionary spending that will not entail spending pressures in future years. Such uses include funding a pension fund's unfunded liability or providing pay-as-you-go capital expenditures, in turn reducing that year's debt issuance by a similar amount.

Knoxville, TN, among several best practices it employs, has adopted prudent fiscal policies regarding the use of nonrecurring revenue. These policies paved the way for an upgrade of the city's rating to 'AA+' in August 2001.

Debt Affordability Reviews and Policies

Strong debt management practices are evidenced by comprehensive debt policy statements that discuss the types and methods of financing employed by an issuer. These should include an issuer's policies regarding off balance sheet financings, such as certificates of participation (COPs) or lease debt, as well as bond anticipation notes, tax and revenue anticipation notes, and variable-rate demand obligations (VRDOs). Conduit debt need not be included unless it draws on taxes and/or fees levied and collected by the issuer as part of traditional government operations. Policy statements should also set forth any self-imposed debt limitations, such as those based on personal income, property market value, or annual recurring revenue or spending. Debt affordability policies, like those of the State of Maryland, Howard County, VA, and many other counties in Virginia and Maryland, are viewed as most valuable in Fitch's debt management analysis.

Also related to debt affordability, an issuer should consider its overall exposure between invested assets and external debt issuance. Increasingly, government issuers are balancing short- and long-term investments with a mix of short- and long-term debt. Fitch recognizes that prudent use of VRDOs and other interest rate risk management tools can benefit the balance sheets and long-term financial health of a tax-exempt debt issuer. However, inappropriate or excessive use of such financial instruments may have the opposite impact. A debt issuer engaged in such practices is encouraged to do so in conjunction with a comprehensive asset-to-liability management policy that includes:

- Identification of debt and investment management products and counterparty ratings acceptable to the debt issuer.
- Expected benefits of selected financial products in light of potential interest rate volatility.
- Strategies for responding to projected and unprojected changes in short- and long-term interest rates.
- Sources of funds available for potential swap termination payments.
- Designation of individuals responsible for negotiating, monitoring, and reporting market conditions and their impact on variable- and fixed-rate debt, interest rate hedges, investments, and any financial products under consideration or already implemented.
- Frequency of marking to market and monitoring investments and other financial products.

The City of Orlando, FL is a leader in the field of asset-to-liability management.

Superior Debt Disclosure Practices

Superior disclosure practices go beyond the documentation required to successfully undertake a new issuance of bonds or notes. Risk managers, analysts, and institutional investors provide a market mechanism that sets disclosure standards for favorable market access. Thus, the true measure of an issuer's disclosure practices comes when it has no future debt plans and holders of its securities are dependent on secondary market disclosure to make informed decisions to buy, sell, or hold debt.

The ongoing requirements of Rule 15c2-12 under the Securities Exchange Act of 1934 are the minimum for disclosure and, in many cases, are limited to calling for audited financial statements and publication of negative developments after they occur. In such cases, an investor may receive important information after the fact, when an issuer is experiencing fiscal stress or in default.

Although many VRDOs are exempt from the continuing disclosure provisions of Rule 15c2-12, superior disclosure practices should incorporate a commitment to ongoing disclosure of material events relating to VRDOs. Such material events include conversion of interest rate modes, mandatory tenders, draws on liquidity or credit facilities, changes in liquidity or credit support providers, significant amendments of bond and bank documents, and termination of related swaps.

For annual financial reports, while GASB 34 sets minimum new disclosure requirements (such as the new management's discussion and analysis section), nothing prohibits an issuer from choosing to disclose additional information. Additional disclosure can be presented in notes to the annual financial statement or in a supplementary information section or statistical section. These sections can contain the data on demographic trends, tax assessments, and utility customers that is found in most comprehensive annual financial reports awarded the GFOA's Certificate of Achievement for Excellence in Financial Reporting. Some larger states and cities have implemented an annual disclosure statement as a companion to the audited report, which basically updates all the key information and statistics originally supplied in new bond issue offering statements. The annual disclosure statement, when

updated, can serve as a section of the new official statement for debt issued during the current fiscal year.

Some examples of superior disclosure that are not standard items in a financial report are:

- Delineation of financial management policies (such as the items listed in this report as best practices).
- Specific histories of pledged tax or revenue streams that back revenue bonds (which many times are obscured due to their inclusion in a larger, more general category such as local taxation).
- Charts depicting required and actual revenue bond coverage, calculated per the bond indenture formulas.
- Operating fund cash flows, broken out monthly, particularly for issuers that externally borrow for seasonal cash flow needs.
- Compliance with key indenture terms, such as covenants, reserve funds, and/or renewal and replacement funds.
- Use of short-term borrowings that occur within a fiscal year but are not reported because they are extinguished before the fiscal year-end audit reporting requirement.
- Use and performance of interest rate swaps, including marked-to-market value, occurrence of events of default or termination, and any termination payments made or received.
- Annual updates of operating data for enterprises, such as fees, customer trends, and service volume.
- Status of VRDOs, including the actual average interest rate paid during the previous year, current credit and/or liquidity support providers, and any plans to convert or swap debt to or from fixed or floating rate.

Fitch prefers that issuers regularly disclose all municipal debt and lease obligations — including general obligation bonds and debt supported by local tax or enterprise revenue sources. Fitch's tax-supported debt ratings take into account the level of all such debt relative to the size of the local tax base. Disclosure of whether any bonds are not fully supported on an annual basis by their intended source of payment (such as a sales tax or gas tax providing at least 1.0 times debt service coverage) is also needed in order for analysts and investors to consider all relevant credit pressures on the municipal entity.

In addition, disclosure of debt issued by off balance sheet entities, including shell leasing companies and

entities created to facilitate securitization of tobacco settlement revenues, is helpful, although the decision of whether to include such debt in tax-supported debt ratios will vary, based on, among other factors, the intended source of debt payment, the receipt of legal opinions clarifying the recourse of off balance sheet bondholders to government resources, and whether pledged revenues are owned by the rated municipality. *(For more information on tobacco-related off balance sheet entities, see Fitch Research on "Revised Treatment of Tobacco Bonds in Government Debt Ratings," dated March 1, 2001, available on Fitch's web site at www.fitchratings.com.)*

Issuers considering improvements to their ongoing disclosure practices can find suggestions and examples in several places. Two good sources are the guidelines promulgated by the GFOA for its Certificate of Achievement for Excellence in Financial Reporting Program and the secondary market disclosure guidelines adopted and published by the NFMA.

A leader in the use of the internet as a means of ongoing disclosure is the City of Philadelphia, which incorporates copies of its annual financial report, annual budget in brief, and five-year financial plan for tax-supported funds on its web site.

Pay-As-You-Go Capital Funding Policies

In terms of credit analysis, the benefits of pay-as-you-go capital funding are several and profound. First, significant funding of capital costs from annual budget appropriations helps keep an issuer's debt low, which is always a positive credit factor. Second, pay-as-you-go capital appropriations improve an issuer's financial flexibility in the event of a sudden revenue shortfall or emergency spending. A temporary shift away from pay-as-you-go funding for recurring expenditures is not automatically viewed as negative if the issuer historically has demonstrated a propensity to return to pay-as-you-go funding when possible. In future years, some issuers may choose to increase their pay-as-you-go appropriations in response to GASB 34 (depreciation of general assets). Such a move would have positive implications for a local government credit. Finally, contribution of capital pay-as-you-go appropriations for a project financed with COPs provides insight on the leased project's essentiality to the issuer. Providing a substantial downpayment from annual resources demonstrates the government's commitment to the project and encourages the issuer to keep annual rent payments current so as not to lose the contributed capital of the pay-as-you-go appropriation through a

COP default and the project being taken over by a receiver or trustee.

Chattanooga, TN is a leader in using pay-as-you-go contributions for capital projects, which has allowed the city to keep its debt burden manageable despite a major downtown redevelopment project over the past two years.

Rapid Debt Retirement Policies

One tenet in credit analysis is that the life of debt should not exceed the useful life of the asset or project being financed. However, useful life should not be the only benchmark considered when structuring the maturity of an issuer's debt. An issuer that frequently sells 30-year debt or continually extends the existing maturities of its debt through refinancing and restructuring may still manage to match debt to useful life. However, from a credit perspective, an issuer that pays off its debt rapidly (65% or more of principal in 10 years) will be analyzed more favorably than a similar issuer that retires only 50% of its debt over 10 years. Retiring less than 35% of tax-backed debt in 10 years is considered a weak fiscal practice.

Of further credit value, rapid debt retirement usually results in a declining debt service schedule, thereby providing additional financial flexibility and debt capacity for future years. Issuers that stretch out their debt through ascending debt service maturities or heavy use of capital appreciation bonds reduce their financial flexibility. Back-ended debt can raise concern, particularly if repayment is expected to come from future revenue growth that may not be realized.

Hamilton County, TN restricts the final maturities on its tax-supported debt to 15 years, resulting in a debt amortization rate of 89% over the next 10 years. This gives the county a great deal of flexibility for future debt issuance, and the declining debt service schedule that results incorporates budgetary flexibility to meet rising service costs in other areas.

Five-Year Capital Improvement Plan that Integrates Operating Costs of New Facilities

The practice of creating a multiyear capital improvement plan has reached such widescale acceptance that absence of a plan may be viewed as a credit negative. Plans of the more sophisticated and foresighted government managers not only project future debt issuance but include the incremental operating costs of newly built facilities. Generally,

five years is a good planning time frame, although for some communities, a longer range plan may be appropriate. Integrating future operating costs for capital construction in a capital plan implies that the issuer does multiyear forecasting for its operating fund. Doing both of these is viewed as cutting edge, contributing to more favorable rating consideration.

Since the early 1980s, New York City's four-year financial plan has incorporated not only the future debt costs for its capital plan, but the future capital plant operating costs in its four-year operating fund forecasts.

Financial Reporting and Budgeting Awards

Awards for excellence in financial reporting and budgeting are granted by the GFOA and, to school districts, by the Association of School Business Officials International (ASBO). Receipt of these awards does not imply financial strength; the City of Philadelphia continued to receive such awards in the early 1990s, when it was near bankruptcy. However, an issuer's achieving these awards gives investors and credit analysts increased confidence that the information disclosed in its financial reports and budgets is comprehensive and accurate.

Frequently, reporting items beyond those required by the GFOA and ASBO standards is helpful in fully describing an entity's financial operations. Additional items may include details of major operating fund transfers in and out and a breakdown of revenues categorized as taxes into specific components. Issuers that regularly disclose the management and internal control assessments received from their auditors are recognized as making the best efforts to present full and complete disclosure to rating agencies and other industry credit analysts.

Oak Ridge, TN has garnered the most GFOA awards over the 57 years of the GFOA's financial reporting award program and 18 years of its budget award program, with 57 (40 for its annual reports and 17 for its budgets). The cities of Boca Raton, FL, Eugene, OR, Fort Worth, TX, and San Antonio, TX and Montgomery County, OH are tied for the greatest number of GFOA budgeting awards, each with 18.

■ Accounting for Depreciation of General Governmental Fixed Assets

GASB 34 requires issuers to account for and report use and depreciation of capital assets not reported in utility enterprise funds. Initially, it seems local

governments that did not fund depreciation of such assets on a pay-as-you-go basis are likely to report annual operating deficits in the new governmentwide financial statements under the new accounting model, even if all other normal expenses are funded or exceeded by normally recurring revenues. Because of the newness of GASB 34, Fitch does not expect to downgrade issuers in the near term due to deficits resulting solely from new depreciation expenses for general infrastructure, provided that the normal revenue and expenditure balance in the general operating fund continues and the liquidity and financial position of the general fund is not compromised. However, as depreciation accounting becomes more standardized and accepted, Fitch and other municipal credit analysts will expect governments to account for infrastructure maintenance in compliance with GASB 34 requirements and to take actions to keep their infrastructures in good repair.

Orlando, FL reported its fiscal 1999 financial operations in accordance with the GASB 34 guidelines, several years before the deadline for cities of its size.

■ Best Practices and Their Impact on Debt Ratings

Historically, analysts have given only limited weight to best practices when assessing a government's credit. Their concern was always that when economic conditions turn tough, government financial managers may loosen their standards and policies, reverting to acts of fiscal or political expediency to maintain or increase services without raising taxes.

However, after reviewing the historical performance data, it is clear that most issuers that garnered executive and legislative support for best practices did not discard their policies when revenues fell short of budget. Furthermore, the discipline that these issuers adopted as part of long-range financial management improvements helped them during tough times. While some such issuers' fund balances were drawn down, they were rarely fully depleted. For some, pay-as-you-go financing was curtailed temporarily, but generally resumed when revenue collection improved. Also, self-imposed debt affordability restraints were generally not abandoned during recession. Rather, best practices provided such issuers with a steady set of guidelines to see them through troubled economic times, shored up investor confidence, and assured continued access to the debt markets. As such, Fitch believes it is appropriate to

explicitly give greater weight in the credit rating process to such standards.

Record bankruptcies in the corporate world, combined with past fiscal meltdowns in the state and local government sector, all serve to demonstrate that poor disclosure practices can magnify and lengthen fiscal stress, if not actually contribute to the fiscal problems. Superior disclosure practices help issuers to form capital and avoid financial stress before it occurs.

Assessing management can be very subjective; one analyst's view of what constitutes strong managers may substantially differ from another's. However, the management practices cited in this report are all tangible evidence of good management and, in one form or another, have been viewed positively by credit analysts in the public finance sector. Recognition of management practices, rather than merely managers, helps provide an objective means to assess this sector in credit analysis.

The best practices beneficial to an issuer's creditworthiness are weighted in the table below. Fitch's rating process assesses an issuer's achievement of these best practices, and the more of these practices an issuer uses, the more rating enhancement is possible. Those practices considered most valuable are labeled "very significant," on down to "significant" and "influential." Many of these practices have been used by managements of issuers that received 'AAA' ratings from Fitch in the past. In

Relative Values of Best Practices in Fitch's Public Finance Ratings

| Best Practice | Value* |
|--|------------------|
| Fund balance reserve policy/working capital reserves | Very Significant |
| Multiyear financial forecasting | Significant |
| Monthly or quarterly financial reporting and monitoring | Significant |
| Contingency planning policies | Influential |
| Policies regarding nonrecurring revenue | Influential |
| Debt affordability reviews and policies | Very Significant |
| Superior debt disclosure practices | Very Significant |
| Pay-as-you-go capital funding policies | Significant |
| Rapid debt retirement policies (greater than 65% in 10 years) | Significant |
| Five-year capital improvement plan integrating operating costs of new facilities | Influential |
| Financial reporting awards | Influential |
| Budgeting awards | Influential |

*Values in descending order of importance are: very significant, significant, and influential.

future reviews, these practices will be important criteria for new 'AAA' assignments.

■ Practices that Cause Concern

Listed in the box at right are some practices that raise analysts' concern about an issuer's fiscal future. Many are familiar or self-explanatory. In a future report, Fitch will examine these practices and other negative developments that have caused and will continue to produce negative concern and lower debt ratings.

■ Management Is Key to Ratings in the 21st Century

Management analysis, as well as new viewpoints on the analysis of local economies and special tax pledges, formed the cornerstone of Fitch's revised rating guidelines for tax-backed debt originally published in May 2000. The rash of bankruptcies of companies like Enron Corp. and WorldCom highlights the role that poor disclosure can play in distressed situations. Fitch feels that its approach to factoring in management and disclosure practices will serve as a standard for credit analysis in the age of the internet and rapidly expanding technology. As always, Fitch welcomes comment and debate from other interested parties, whether issuers, analysts, investors, or academics.

Worst Financial Management Practices for Governmental Issuers

- Cash basis accounting
- Qualified audit opinion of material weakness
- Deficit financing for two of past five years
- Slow debt retirement (less than 35% in 10 years)
- Unfunded accrued pension liability (funding ratio less than 60%)
- Tax and revenue anticipation note amount growing significantly faster than annual spending
- Debt restructuring that defers more than 35% of current debt service
- Overreliance on nonrecurring revenue (for more than 15% of recurring expenses)
- Aggressive investment policy for operating funds
- Pension contribution deferral in the current budget year
- Budgetary impasse beyond legal completion date
- Lack of capital improvement plan
- Excess interfund borrowing with no capacity to repay in near future

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