

How Do Bond Rating and Bond Underwriting Companies Use Our Audit Reports?

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Topics of Discussion

- Umbaugh Overview
- Official Statement
- Bond Rating
- Bond Insurance
- Use of Audits
- Challenges with Audits
- Bond Sale
- Continuing Disclosure
- Conclusion



Umbaugh Overview

- Assist municipalities with issuing bonds to fund capital improvements
- Primary focus in Indiana and Michigan
 - Schools
 - Libraries
 - Cities
 - Towns
 - Counties
 - Townships



Umbaugh Overview (cont'd)

- Steps in marketing the bonds:
 - Prepare Preliminary Official Statement
 - Obtain a bond rating
 - Pre-qualify for bond insurance
 - Coordinate bond sale
 - Competitive
 - Negotiated
- Continuing Disclosure



Official Statement

- Preliminary Official Statement:
 - Disclosure document for marketing Bonds
 - Provides potential bond purchasers with information about the project, bond structure, security, legal opinion, etc.
 - Provides rating agencies and insurance companies with information on issuer's background, history, finances, etc.
 - Required (by SEC) for bond issues of \$1 million or greater




Official Statement (cont'd)

- Information gathered from the audit:
 - School Corporations:
 - Statement of Receipts, Disbursements, and Cash and Investment Balances – Governmental Funds
 - Typically show two or three most recent years available
 - Cities, Towns & Counties:
 - Statement of Assets and Fund Balances and Receipts, Disbursements, and Changes in Fund Balances – Cash and Investment Basis – Governmental Funds
 - Typically show two or three most recent years available




Official Statement (cont'd)

- Information gathered from the Audit (cont'd):
 - Pension Obligations (for cities, towns & counties)
 - 1925 Police Officers' and 1937 Firefighters' Pension Plan
 - Employer contribution amount
 - Net pension obligation amount
 - Employer percent of contribution




Official Statement (cont'd)

- Final Official Statement:
 - Finalize after bond sale
 - Contains final interest rates and reoffering prices
 - Includes bond rating and bond insurance information, if applicable
 - Distribute to bond purchaser within 7 days of sale



Bond Rating

- Three rating agencies: Standard & Poor's, Moody's and Fitch
- A rating is generally obtained for bond issues greater than \$4 or \$5 million
 - Typically just for bonds supported by property taxes, utility revenues or income taxes
- May request just a preliminary indicator rating
- Four basic analytical areas (Per Standard & Poor's):
 - Economic Base
 - Financial Indicators
 - Debt Factors
 - Management Factors
- "AA" Programmatic Rating for qualifying schools
 - Annual State Aid must be at least two times greater than combined annual debt service



Bond Rating (cont'd) Economic Base

- Economic base is critical in determining an issuer's rating
 - Demographics – age, education, skills, wealth, income levels
 - Tax base – size, structure, diversity
 - Employment base – composition, output, diversity
 - Employment patterns and labor force growth
- Incorporates local and national economic factors and trends



Bond Rating (cont'd) Financial Indicators

- Financial analysis includes accounting and reporting methods, revenue and expenditure structure and patterns, financial leverage and equity position, and budget and financial planning
 - Capacity to manage financial uncertainties
 - Fund balances and financial reports
 - Cash and investment balances and liquidity levels
 - Operating trend - revenues vs. expenditures
 - Diverse revenue sources



Bond Rating (cont'd) Debt Factors

- Debt analysis focuses on the pledged security, debt repayment structure, current debt service burden and future capital needs
 - Pledge of property taxes is very secure
 - Debt structure – term matches useful life of capital improvement
 - Outstanding debt of taxing unit and overlapping taxing units
 - Potential for future capital projects and/or debt issuance
 - Debt burden vs. ability to pay
 - Indicated by tax base, community's wealth and income, budget resources
 - Considered high if debt service payments are 15%-20% of combined operating and debt service expenditures



Bond Rating (cont'd) Management Factors

- Administration includes the ability to create and adhere to a long-range financial plan, management of finances and debt, preparation of an annual budget, maintaining fund balances and property tax administration
 - Ability to plan for changes and respond in a timely fashion
 - Background and experience of administration
 - Consideration of additional operating costs within budget
 - Revenue forecasting and financial strategies



Bond Insurance

- Generally request bond insurance on bond issues greater than \$4 to \$5 million
- Results in bond issue receiving a “AAA” rating, the highest bond rating offered, with insurance from:
 - FSA – S & P, Moody’s and Fitch
 - Assured Guaranty – S & P, Moody’s and Fitch
 - MBIA – S & P, Moody’s and Fitch
 - Ambac – S & P and Moody’s
- Insurance premium paid for by the issuer or from the underwriter’s discount



Bond Insurance (cont'd)

- Results in lower interest rates because debt is considered by the market to be more secure
 - Lower annual payments and tax impact
 - Lower overall interest costs
- Issues with receiving bond insurance:
 - Circuit Breaker Tax Credit (in Indiana)
 - Size of bond issue
 - Ending fund balances/finances
 - Construction risk
 - Concentration of large taxpayers/large users



Use of Audits

- Used as an indicator of the credit quality of the issuer
- Was a clean opinion given?
- Review major operating funds:
 - General, Transportation, Debt Service, etc.
- Look for financial trends from year to year
 - Review two to three year history of audits
 - Increasing, decreasing or stable ending fund balances
 - Did any expenditures or receipts change significantly



Use of Audits (cont'd)

- Look for healthy ending fund balances
 - Positive balances vs. cost overruns
- Inter-fund transfers
 - Why were transfers needed
 - Were they repaid as intended
- For School Corporations – review amount of State Aid
 - Two times coverage provides for “AA” programmatic rating



Use of Audits (cont'd)

- Notes to Financial Statements
 - Helps to further understand the numbers
 - Helps piece together the financial information
 - Detail on pensions, investments and debt
- Management’s Discussion and Analysis
 - Information about the community beyond the numbers
 - Budgetary pressures
 - Changes in assessed value, property tax levies, etc.
 - Description of capital improvement projects
- Statistical section, if available, provides longer trends



Challenges with Audits

- Timeliness of audit
 - Must be current to be effective
 - Within one or two years at most
 - Bond insurers may not provide insurance if recent audits are not available



Challenges with Audits (cont'd)

- Examination Report
 - Not a replacement for a full audit
 - Limited information
 - Lacking detailed Financial Statements, Management's Discussion and Analysis, and Supplementary Information
 - Lacking information that is helpful to rating agencies, bond insurers and underwriters for a thorough review



Bond Sale

- Competitive Bond Sale:
 - Competitive Bond sale may be required by State Statute
 - Typically sold upon 24 hours' notice
 - Underwriters provide bid morning of sale
 - Underwriters may perform internal credit analysis or rely upon bond rating and insurance, if applicable
 - Underwriter's clients may request audits for review
 - Bonds awarded to underwriter with lowest net interest cost
 - Based upon interest rates and underwriter's discount and/or premium



Bond Sale (cont'd)

- Competitive Bond Sale (cont'd):
- Advantages
 - Assurance that bonds are sold at the lowest interest rates
 - Provides incentive for each underwriter to submit most aggressive bid
 - Open, fair process
- Disadvantages
 - May have less flexibility
 - "Risk premium" built into bonds
 - Less control over allocation of bonds



Bond Sale (cont'd)

- Negotiated Bond Sale:
 - Negotiate interest rates and fees with one underwriter
 - Advantages
 - Greater incentive to engage in pre-sale marketing activities
 - Underwriters may perform internal credit analysis or rely upon bond rating and insurance, if applicable
 - Underwriter's clients may request audits for review
 - More flexibility concerning timing and bond structure
 - Can ensure that bonds are available to certain investors
 - Disadvantages
 - How is basis of underwriter selection determined?
 - Are you getting the best deal?



Continuing Disclosure

- Required for all bond issues greater than \$1 million that are traded in the secondary market
- Audited financial statements prepared by the Indiana State Board of Accounts must be filed within 60 days of receipt by the issuer
- Information is filed with:
 - Nationally Recognized Municipal Securities Information Repository ("NRMSIR")
 - State Information Repository, if any



Conclusion

- Audits are used by rating agencies, bond insurers and underwriters as part of their review of the credit quality of an issuer
- The greater the credit quality of the issuer, the more favorable the bond rating, insurance premium and interest rates received on the bonds
- Accuracy and timeliness of audits are important