Fixed Income Insight
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Tracking Merritt Data - States
Just in Time Recovery for States - FY 2003 Audits Reflect Weak Bottom Line and Liquidity Conditions in Many States

After two serious years of fiscal decline in 2001 and 2002, fresh audited state government financial reports show many states with severely wounded balance sheets. With 75% of the states having recently reported their fiscal year 2003 audited statements to Merritt Research Services, LLC, it looks as though the recent uptick in tax revenues could not have come at a more appropriate time.

Slightly more than half of the 38 states that have reported their 2003 audits are showing negative unrestricted net asset-to-expenditure ratios compared to only about a third for all the states counted last year. The net asset-to-expenditure ratio reflects the total "net worth" of a state. This calculation was made possible last year when the states first implemented the new GASB 34 accounting rules. The net worth assessment takes a "business style" look at all governmental activities accounts and determines a bottom line reflecting a combined liquidity position, infrastructure assets, current liabilities, and long term debt.

Among the 38 states reporting their FY 2003 numbers, the states with the weakest net worth positions relative to their total annual spending included: Connecticut (-62.6%), California (-30.7), Massachusetts (-30.3) and Wisconsin (-25.2). Of these, all but Massachusetts posted weaker positions than in the previous year. Illinois, which also recorded one of the weakest net worth position states in 2002 (-52.7%), has not yet reported its FY 03 audit. Oil rich Alaska and Wyoming, as well as Microsoft's home state of Washington, recorded the best net worth positions for the recently ended fiscal year (64.4%, 31.9% and 32.4%, respectively).

The deterioration of state financial condition in FY 2003 was far more than just a negative position on paper. Weakened financials were heavily reflected in razor thin cash positions in many states. Days Cash on Hand (using all governmental activities accounts), based on the end date of the fiscal year, showed less than 10 days of reserves in Florida, New Jersey, North Dakota and Connecticut. The median days of governmental activities cash on hand for the 38 states reporting so far is 38.8 days compared to the national median of 39.2 for FY 2002.

Traditional governmental accounting standards placed the focus almost entirely on the general fund balance position relative to revenues. Using this benchmark approach, states covered in this report showed up a little better, but not enough to change the negative bottom line trend. The numbers reflecting the FY 2003 median unrestricted general fund balance as a percentage of revenues (about 2.5%) are coming in below last year and less than half of the level for all states in 2001.

Fortunately, most states have recently been receiving just enough of a boost in tax revenue to help stabilize them. As long as economic conditions do not take a sudden turn for the worse, the process of stabilizing most state coffers should follow.

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Guiding Portfolio Strategies

McDONNELL INVESTMENT MANAGEMENT, LLC

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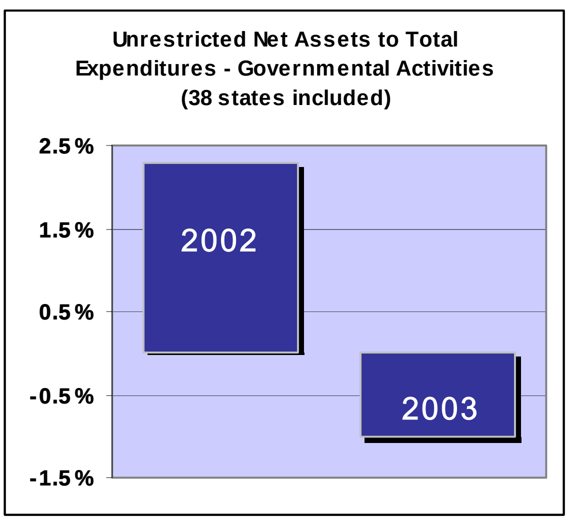
Notable State Finance Trend Highlights for Fiscal Year 2003:
(Thirty eight states are included in the early sample. A high percentage represents larger states. California is not included.)

- **Unrestricted Net Assets (Governmental Activities)** as a % expenditures shows depletion of reserves. The medians are:
  - 2.3% in FY 2002
  - -1.0% in FY 2003
- **Days Cash on Hand (Governmental Activities)** is down indicating a continued draw down in reserves. A high percentage of the states that reported their fiscal year 2003 numbers had less than 30 days cash on hand. The medians are:
  - 39.2 days in FY 2002
  - 38.8 days in FY 2003
- **Cash Flow for Governmental Activities Accounts** relative to long term debt is up strongly. The medians are:
  - 6.8% in FY 2002
  - 13.9% in FY 2003
- **Current Debt Service to Total Governmental Expenditures** is up slightly despite low interest rates reflecting an overall increase in indebtedness. The medians are:
  - 2.20 in FY 2002
  - 2.14 in FY 2003
- **LT Debt (Gov) to Net Fixed Assets (Gov)** is up slightly indicating an increasing reliance on debt to finance capital plant. The medians are:
  - .20 in FY 2002
  - .22 in FY 2003



Source: Merritt Research Services LLC

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