Fixed Income Insight
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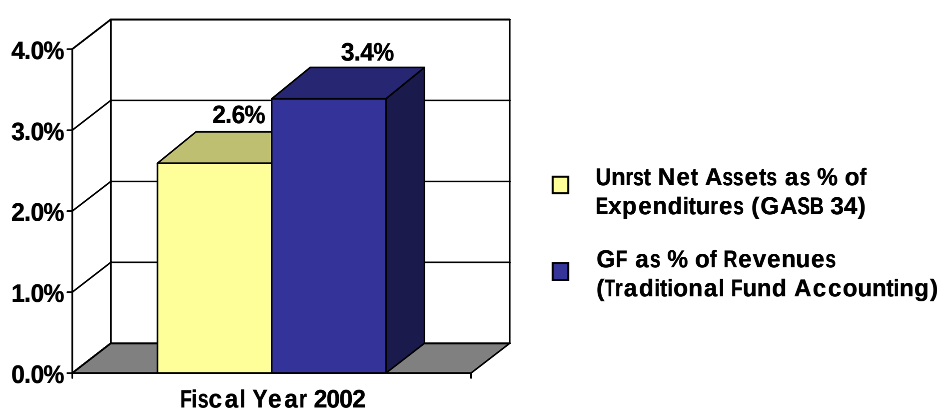
Bottom Line for States in FY02:
Not Markedly Changed by New GASB 34 Accounting

For the very first time, states are reporting their FY 2002 entity-wide annual financial results using new GASB 34 accounting standards in addition to traditional governmental accounting. Finally approved after years of debate among governmental officials, accounting experts and investor groups, the Governmental Accounting Standards Board approved and implemented the new rules to attempt to make governmental reports more like corporate reporting. Some of the most important changes involved consolidating the traditional governmental accounts such as the general fund, special revenue, capital and debt service accounts to provide a more comprehensive look at governmental resources. In addition, the main account, referred to as "governmental activities" uses accrual accounting to incorporate infrastructure assets, depreciation and indebtedness to help determine a "net worth" value for the governmental body. Previously, states focused almost entirely on the general fund which presents accounts on a modified accrual basis.

Comparing the 46 states with financials available in the Merritt Research state database produces a similar conclusion by using either GASB 34 or general fund accounting. However, there are major differences in the degree and in a handful of cases whether the state shows a surplus or a deficit. The four states not included in the analysis were: New York, New Mexico, Rhode Island and Vermont.

Prior to implementation, many critics of the new rules anticipated that a more negative picture would result from the GASB 34 approach, particularly when infrastructure assets and liabilities were factored into the equation. However, comparing outcome of the two methods during the first year of use shows generally similar direction for states as a whole. For example, using the traditional simple ratio showing the health of a government unit, the median general fund balance to revenues was 3.4%. Under the new rules, the best reflection of financial standing applies unrestricted governmental activities net assets to governmental activities expenses. By this measure, the new governmental activities ratio median stands at 2.6% of governmental expenses vs. the 3.4% general fund balance ratio (see chart below). Likewise, the percentage of states reporting negative bottom lines was similar under the new and old benchmarks. Thirty seven percent showed deficits under the new GASB rules and 33% using the traditional general fund approach.

General Fund vs. Governmental Activities
2002 Bottom Line Analysis



Guiding Portfolio Strategies

McDONNELL INVESTMENT MANAGEMENT, LLC

Many governments worried that the new accounting rules would produce much more negative results when infrastructure and long term liabilities were added to the equation, but the reality didn't support that concern. Although 25 states recorded GASB 34 bottom line results that were inferior to their General Fund position, 21 states had better looking financials under the new rules. Usually, better looking financial positions are related to the inclusion under the GASB rules of monies that may be accessible especially for cash flow but not usually considered available for discretionary appropriation without special approved legislation.

In the extreme, in nine states the application of the new GASB 34 rules produced opposite bottom line positions. **Alaska** shows up extremely strong under the new rules when substantial set aside reserves from oil-derived tax revenues are included in the full governmental activities account (101% surplus of governmental activities expenditures) but poorly when just the general fund is used (-18.9% of revenues). In **Florida**, GASB 34 results appear much more negative than a general fund focus due mostly to the way the state finances its schools and some of its roads. Essentially, Florida borrows for the projects by pledging its full faith and credit and then hands over ownership to the local school districts and local governments. The state's financial report says, "If these bonds were removed, the adjusted unrestricted net assets for governmental activities would be $1.1 billion." Other states with contradictory positions included **Hawaii, Maine, New Hampshire, New Jersey, Ohio, Texas** and **West Virginia**.

In other situations, like **California, Illinois** and **Connecticut**, each of these states recorded deficits regardless of the accounting approach; however, the scale of their deficits was far larger when focusing on the more comprehensive governmental activities numbers. Almost 75% of the huge GASB 34 deficit in California was related to restricted net assets being deducted from the bottom line similar to the situation in Florida where the state secures the bonds and the school assets are owned by the local governments. In Illinois, the large GASB 34 deficit reflects in part a portion of its seriously under-funded pension obligation, an important long term fiscal liability. Connecticut's negative unrestricted net asset position is due primarily to its "reliance on issuing of bonds for operating purposes." A close examination of a deficit, for whatever reason, ultimately will determine whether the negative condition poses a near or long term risk.

By traditional standards, **Oregon's** general fund deficit ranked as the worst in FY 2002 with a general fund balance deficit to revenues of 26.4%. Meanwhile the state's GASB 34 unrestricted net assets position was negative, but only by a meager negative six-tenths of a percent of expenditures. Oregon's general fund provided a narrower base of assets and felt the weight of temporary cash flow borrowing.

(continued on next page)

The five best and worst financial positions using each approach follow:

General Fund Balance as Percent of Revenues (Traditional Approach)		Unrestricted Net Assets as Percent of Governmental Activities Expenditures (GASB 34 Approach)	
The Best of 2002:			
1. Delaware	19.8	1. Alaska	101.4
2. Idaho	17.9	2. Washington	33.7
3. North Dakota	15.0	3. South Dakota	28.4
4. South Dakota	13.8	4. Wyoming	23.8
5. Oklahoma	13.7	5. Kansas	21.0
The Worst of 2002:			
1. Oregon	-26.4	1. Connecticut	-55.1
2. Alaska	-18.9	2. Illinois	-52.7
3. Illinois	-15.1	3. Massachusetts	-52.7
4. Wisconsin	-11.4	4. New Jersey	-24.0
5. California	-9.4	5. Florida	-23.9

Rankings do not include: Hawaii, New Mexico, New York, Rhode Island and Vermont whose financial reports have not yet been received.

In Summary

We believe that the more comprehensive economic approach to governmental accounting presented by GASB 34 provides investors with a better indication of the total resources and burdens of a governmental entity. For years, governments have drawn upon their total cash flow of their governmental accounts beyond the general fund. The new statements help investors gauge their cash flow potential. In addition, debt and liabilities that are incurred without having the benefit of offsetting productive assets uses up borrowing power that may well be needed to maintain the state's infrastructure or for use during times of hardship.

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Credit Name	Fiscal Year End	Unrestricted Net Assets	Unrst Net Assets (Gov)/Tot Exp %	Unreserved General Fund Balance	Unres Gen Fund Bal/Total Rev %
Alabama	9/30/02	596,303	4.7	147,941	13.52
Michigan	9/30/02	338,575	0.9	114,500	0.53
Texas	8/31/02	2,065,296	4.1	-369,352	-0.77
Alaska	6/30/02	5,469,850	101.4	-701,741	-18.91
Arkansas	6/30/02	1,381,014	17.9	895,644	10.54
Arizona	6/30/02	402,119	2.7	560,478	4.81
California	6/30/02	-19,417,429	-14.9	-5,987,214	-9.36
Colorado	6/30/02	843,080	8.5	164,291	1.96
Delaware	6/30/02	676,829	16.7	580,248	19.83
Florida	6/30/02	-10,289,643	-23.9	2,001,519	10.32
Georgia	6/30/02	4,238,321	18.2	658,853	2.67
Hawaii	6/30/02	-85,382	-1.6	348,777	10.76
Iowa	6/30/02	532,098	5.3	316,767	3.25
Idaho	6/30/02	388,008	9.1	324,274	17.95
Illinois	6/30/02	-21,991,559	-52.7	-3,458,270	-15.08
Indiana	6/30/02	2,970,923	16.2	738,880	10.06
Kansas	6/30/02	1,583,141	21.0	60,595	1.49
Kentucky	6/30/02	-1,576,870	-11.5	-36,033	-0.55
Louisiana	6/30/02	-2,881,310	-18.0	-33,953	-0.58
Massachusetts	6/30/02	-15,721,092	-52.7	1,407,669	11.41
Maryland	6/30/02	466,288	2.6	265,468	1.87
Maine	6/30/02	5,887	0.1	-136,169	-5.92
Minnesota	6/30/02	2,364,102	12.1	539,173	4.43
Missouri	6/30/02	271,688	1.6	620,712	4.76
Mississippi	6/30/02	747,945	7.6	1,169,275	12.50
Montana	6/30/02	140,044	4.9	81,316	7.16
North Carolina	6/30/02	-1,615,102	-6.3	-576,318	-2.65
North Dakota	6/30/02	318,778	16.5	114,717	14.97
Nebraska	6/30/02	349,311	6.6	80,612	3.46
New Hampshire	6/30/02	330,009	9.1	-37,869	-1.63
New Jersey	6/30/02	-8,272,288	-24.0	1,240,338	5.65
Nevada	6/30/02	-31,969	-0.7	-167,296	-5.45
Ohio	6/30/02	-3,065,421	-8.6	319,421	1.56
Oklahoma	6/30/02	1,279,298	13.0	1,312,107	13.71
Oregon	6/30/02	-70,371	-0.6	-1,178,320	-26.44
Pennsylvania	6/30/02	868,340	2.3	2,107,232	6.37
South Carolina	6/30/02	-879,188	-7.0	-207,562	-3.60
South Dakota	6/30/02	648,416	28.4	96,354	13.81
Tennessee	6/30/02	70,408	0.5	195,941	1.74
Utah	6/30/02	224,828	3.5	146,551	4.41
Virginia	6/30/02	-134,225	-0.7	-749,102	-7.08
Washington	6/30/02	7,736,660	33.7	1,246,527	7.84
Wisconsin	6/30/02	-3,582,988	-19.2	-1,877,328	-11.41
West Virginia	6/30/02	-549,510	-7.8	251,520	4.46
Wyoming	6/30/02	441,852	23.8	40,730	3.79
Connecticut	6/30/02	-8,196,738	-55.1	-944,022	-8.04