12 HABITS OF HIGHLY SUCCESSFUL FINANCE OFFICERS

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Through Fitch Ratings’ landmark municipal bond default study and subsequent analysis of 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, New York’s fiscal crisis in the late 1990s. Finally, the inappropriately speculative investment strategy and lack of internal controls of Orange County, California, 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 certain 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. New York City (since its financial crisis in the 1970s) and Detroit have also employed management practices that have resulted in enhanced credit quality.

Fitch has concluded that 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 decisions can cause rating downgrades to be below investment grade and, on rare occasions, bankruptcy or missed debt service payments. In addition, Fitch views disclosure as an important indicator of management quality. 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 and inadequate accounting methods can magnify and lengthen fiscal stress, if not actually contribute to the fiscal problems. Superior disclosure and accounting practices help issuers to avoid financial stress before it occurs.

The following financial management practices in the government sector are viewed most positively by Fitch in its credit analysis: fund balance reserve policy/working capital reserves to address unexpected revenue shortfalls or expenditures; debt affordability reviews and policies that cover all debt, including off-balance sheet financings, such as certificates of participation or lease debt; managing asset-liability mix, with regard to maturity and fixed/adjustable rate matching; superior debt disclosure practices, beyond the minimum legal requirements; pay-as-you-go capital funding policies that preserve financial flexibility; rapid debt retirement policies; conservative multiyear financial forecasting; monthly or quarterly financial reporting and monitoring that provide timely warnings of variances from budget; contingency planning policies; use of nonrecurring revenue only for one-time or discretionary spending that will not entail future spending pressure; and five-year capital improvement plans that integrate operating costs of new facilities.

By contrast, the following are viewed as poor financial management practices: cash basis accounting; qualified audit opinions of material weakness; deficit financing for two of the 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 financing growing significantly faster than annual spending; debt restructuring that defers more than 35% of current debt service; reliance on nonrecurring revenue for more than 15% of recurring expenses; an aggressive investment policy for operating funds; a pension contribution deferral in the
current budget year; a budgetary impasse beyond legal completion date; a lack of a capital improvement plan; and an excess inter-fund borrowing with no capacity to repay in the near future.

Historically, credit rating analysts have given only limited weight to best practices when assessing a government’s credit. Our concerns have always been that when economic conditions worsen, 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, policies and practices that have been ‘institutionalized’ by order, resolution, or ordinance have proven resilient. 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, shore up investor confidence, and assure 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.

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 above 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.