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Accountant's View of Municipal Bonds

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It is indeed a privilege and pleasure to publish this paper by Heloise Brown, CPA, of Houston, Texas. Heloise is Convention Chairman for the 1952 *Annual Meeting of AWSCPA/ASWA to be held in Houston, Texas on October* 3 *to* 5, 1952.

Heloise was National President of AWSCPA in the year 1947-1948. *She was recently elected President of the newly formed Houston Chapter of ASWA. Her previous contributions to "The Woman C. P. A." have always been warmly accepted. The readers of "The Woman C. P. A." will thoroughly enjoy this article.*

She was named Houston's Business Woman of the Year at the time that she served as president of AWSCPA. She is a charter member of the Harris County Citizen's Committee for the Hoover Report; Vice Chairman of the Houston Chapter of CPA's; a director of the Altrusa Club of Houston; and Co-Chairman of the Publicity Committee for the forthcoming American Institute of Accountants' convention in October 1952.

AN ACCOUNTANT'S VIEW OF MUNICIPAL BONDS

By HELOISE BROWN, CPA, Houston, Texas

For many years, the purchase of municipal bonds in the United States was almost entirely confined to financial institutions and relatively few individuals considered the purchase of municipal bonds for investment purposes. However, at the present time, it is estimated that almost 50 percent of the municipals now outstanding are owned by individuals. The reason for this popularity lies in the fact that the interest on income from municipal bonds is completely free from Federal income taxes. This freedom from taxation has given this type of bond a decided yield advantage over other income producing securities, and this advantage has progressively increased as income tax rates have been successively advanced.

Because of this growing need for municipals in an investment portfolio, accountants are now being called upon to analyze municipal credits more often than has been true in the past. It is therefore worthwhile to know what factors should be considered when selecting a municipal bond for investment purposes.

In speaking of a municipality, we generally think of it in terms of "a political subdivision of a state"—and the term municipal is interpreted to include, among other things, obligations of cities, counties, states and other political subdivisions. There are four basic types of municipal bonds. They are:

(1) GENERAL OBLIGATION BONDS: These are the primary bonds of municipalities. They represent the maximum of protection and are backed by the full taxing power of the community. Frequently general obligation bonds are named after the particular purpose of their issuance, yet are still protected by the full taxing power of the community. In this category might come school district bonds, water bonds, park bonds, etc.

(2) REVENUE BONDS: As the name implies, this type of municipal bond is secured by revenue—the earnings from specific projects or group of projects built or maintained by the municipality. Among the projects upon which revenue bonds are normally issued are toll roads and bridges, electric power plants, water works, subways, tunnels,

and in fact any specific municipal project that sustains itself by means of charges to the public.

(3) HOUSING AUTHORITY BONDS: Housing Bonds vary in type. Some are general obligations bonds; some have additional backing by the Federal Government; and some are self-supporting revenue bonds with sufficient rental income to defray all expenses, pay interest, and provide for amortization of the principal.

(4) SPECIAL ASSESSMENT BONDS: These bonds are secured by special levies on property which is immediately adjacent to specific local improvements. Included in this category would be properties benefiting materially from the extension of sewers, streets of sidewalks. Because of the localized source of revenue, special assessment bonds are normally less desirable to the investor than those payable from general taxation.

It might be well to mention here that there are several methods of obtaining statistical data on municipal issues. Any specific information that is desired may be obtained by direct correspondence with the municipality; the investment broker has statistical data on many of the municipalities that would be available to the accountant upon request; and at the present time there are three services available from which other data can be accumulated. From these sources, the accountant can obtain data on the history and economic background of the community, assessed valuations and tax rate, statement of bonded indebtedness and sinking funds, tax collection figures and percentages collected, receipts and disbursements, debt service requirements for a period of years, and schedule of bonded debt with details of each issue.

In making an analysis, the accountant should give a great deal of consideration to the historical background of a community. The attitude of the municipality toward debt in the past years, the character of its public officials, the condition of the local banks, are only a few of the characters affecting the credit of a municipal obligation. Whether the municipality under study had defaulted in past obligations is important. In case of a default, the investor should de termine the cause of the default. The worse possible cause would be bad faith wherein a municipality took advantage of a loophole to escape paying bonds which is was morally obligated to discharge. The manner in which a default was worked out will indicate the good faith of the municipality.

The average wealth of the community compared with that of similar communities is important. Other factors which should be considered are the population trend, geographical location of the municipality, and the industrial trend. A wise investor would seek an obligation of a community whose prosperity is not dependent on a single industry or industries whose activity is subject to wide fluctuation.

Before making any detailed analysis and comparisons, it might be well to review several terms that are peculiar to municipals:

TOTAL BONDED DEBT means the total long term debt represented by bond issues outstanding and includes bonds for whatever purpose so long as they are general obligations of the municipality.

In arriving at the NET BOND DEBT, the debt of self-supporting operations should be deducted. As the name implies, self-supporting debt takes care of itself without the levy of ad-valorem taxes. Sinking funds for all debt other than self-supporting debt should also be deducted in determining the NET BONDED DEBT figure. This is the debt for which taxes must be levied.

In addition to the direct debt against the municipality, we find what is called OVERLAPPING DEBT for which the same property is taxable. This would include a school district with bonds outstanding, a proportionate part of district or county debt—the debt of these units being payable from taxes levied against the same property which is paying taxes to the municipality. In making any type of analysis, it would be necessary to include the municipality's proportionate share of that overlapping debt.

The DIRECT LOCAL NET DEBT added to the OVERLAPPING DEBT gives the TOTAL DEBT BURDEN of the municipality.

A statistical examination of the total debt burden over a period of years will give an indication of the policy of the municipality and what the future may hold for it. If the debt is found to be progressively increasing over the years, the matter should be scrutinized further. It may be the result of certain developments or certain administrative policies prevalent in the municipality. A popular means of comparison is that of the current debt with what it was around 1930 or 1931. If a taxing unit weathered the depression at a time when many had trouble and the debt since then has decreased, it is in a rather good position to withstand any other financial adversity that might come along. However, if the debt has increased substantially since 1930 or 1931, and they experienced difficulty then in meeting their obligations, it might be wise to check further into the situation.

The relationship of total debt burden to population and estimated actual valuation should be studied and a comparison of these figures made with those of similar communities.

A comparison should be made of the relationship of annual debt service requirements to anticipated annual revenue. A municipality may be in serious difficulty if the total debt service requirements begin to run as high as 25% of the annual budget. Debt service requirements are a fixed charge. Take, for example, an annual budget of $2,000,000 wherein $1,000,000 or 50% is provided for debt service and 50% for operating expenses. If during the year collections decline 10%, that deficit of $200,000 is going to apply against the amount provided for operating expenses since the debt service must be paid. Thus if there is a 10% delinquency where there is a 50% debt service requirement, it will result in a 20% delinquency as far as operating expenses are concerned. If the debt service is only 20% of the total budget, a 10% delinquency would represent only about 12% of the operating budget, which may not necessarily be as serious.

The schedule of debt service requirements should show a declining trend to allow for new financing in future years. If the amount of principal which becomes due each year is the same, the total debt service is declining because as bonds are paid off the interest requirements are decreasing. If, in the debt schedule, there is one year with a very large maturity, the municipality probably will be forced to refund a portion of the maturity in that year to prevent raising the tax rate to abnormal proportions.

There is another type of municipal debt which is not usually included under bonded debt, but which may be a burden against the same property. That is floating debt. It is not unusual to have a normal amount of debt outstanding for what is know as current tax debt and the amount of debt outstanding will depend on the manner in which taxes are collected. In many cases. municipalities collect taxes only once a year and must operate for a portion of the year on borrowed money. The best means of examining floating debt is to compare the current floating debt with various periods in the past. A rising trend is cause for further examination. If the floating debt continually rises, it is possible that the municipality would be unable to pay the debt off in any one year and would have the embarrassment of refinancing the debt.

The security behind the bonds is of utmost importance. In analyzing any bond, there is the question of whether the bond is a general obligation of the municipality or whether it is payable from some special source of revenue. If they are not general obligations, the source of revenue should be examined very carefully to determine if it is adequate. In some instances there is a statutory limit as to the amount of tax that may be levied for debt service. Some municipalities have tax limitations provided by their charter; some tax limitations exclude debt service requirements but are applicable to operating expenses. Obviously those issues which are backed by the unlimited taxing power of the entire community are to be preferred over municipals which are dependent upon localized assessments or upon specific revenues.

Generally there is no priority of one issue over another with respect to the revenues from which they are payable and general obligations rank equally as to their claim upon ad-valorem taxes. In some cases, there is a priority of claim against tax collections as between local taxing units.

The next item to consider is the manner in which taxpayers have paid and are paying their taxes. During the early thirties many municipalities experienced difficulty in the collection of taxes, and the delinquency in some cases was as much as 30%. At the present time, the tax delinquency figures are low.

In analyzing revenue collections, it is important to see that a reserve has been set up in the annual budget against anticipated delinquency. It is also important that the municipality has adequate penalties for non-payment of taxes when due. Some individuals tend to let their real estate taxes go if the tax penaltiy is not sufficient to more than offset what they would have to pay for money at the bank. Where the law provides for the public sale of property on which taxes have not been paid, it is essential that this be done because such sales bring revenue to the municipality rather than unpaid tax notices. Such sales are also a great incentive for the taxpayer to pay up rather than to be sold out.

In examining a tax rate, it is important to see how it compares with what the municipality has successfully collected in the past. It is also necessary to take into consideration the basis on which property is assessed. For example, if the assessed valuation is only 20% of actual value, it probably will be necessary to have an apparently high tax rate in order to raise the needed funds.

It is important for purchasers of municipal bonds to always demand a legal opinion by qualified attorneys with the delivery of the bonds and this legal opinion should be kept with the bonds at all times. A municipal bond, without accompanying legal opinion, sells for several points lower than the general market. An opinion is obtained at the time of original issue and insures the investor that the bonds were issued in accordance with constitutional legislation; the debt limit of the municipality was not exceeded; that statutory authority was obtained; and that statutory requirements for proper procedure were carefully followed. In the case of limited tax bonds, the opinion does not go into detail as to what the limitations are but puts the buyer on notice that there are limitations. While it is not the duty of the accountant to pass on the merit of a legal opinion, it is something that he should be familiar with and if his client is a prospective purchaser of municipal bonds, the accountant should bring this point to his attention. Bond dealers won't accept bonds without legal opinion so why should the ultimate purchaser accept less.

The greatest advantage to the investor of municipal bonds is that the income is completely free from Federal income tax. Tax advantages are quickly apparent when the yield of tax-free municipals is compared with the net income of taxable securities. As investor in a $50,000 tax bracket owning a 3% corporate bond could more than double his net income by purchasing a tax exempt state or municipal bond yielding only 1.70%. And an individual in a $70,000 tax bracket would have to secure a yield of 12.24% from an investment whose income is subject to tax to equal the yield of 1.50% from a tax-free bond.

Another advantage of owning a municipal bond is the fact that cities seldom cease to exist. Compare this with the fact that more than a quarter of a million corporations have gone out of business since 1929. The owner of municipal bonds does not have to worry about obsolescence or decay. Fashions change, new inventions, new competition will radically affect the future of individual industries. But every new industry must pay taxes to the communities in which they operate.

Another safeguard is the debt limit which the various states set upon their municipalities in order to prevent any possibility of the abuse of borrowing and taxing power. And the fact that a legal opinion attesting to the legality of each new bond issue must be in existence in order for a municipal bond to be freely marketable adds further to the protection of municipals for investment purposes.

The accountant has a real opportunity to be of service to his client. When a client is considering an investment program—either for temporarily idle funds or of a long term nature—his accountant is the logical person to pass upon the merits of the program and his cooperation with the broker can be of material benefit to the client.

COAST-TO-COAST

By MARY C. TONNA, CPA, San Francisco, Calif.

ATLANTA

"Investments Under Current Economic Conditions" was the topic of Mr. J. W. Speas, Vice President and Trust Officer of the First National Bank, at the March meeting.

At the April meeting, Mr. Todd G. Cole, Comptroller of the Delta Air Lines, spoke on "Airline Accounting." Mr. Edward F. Porter showed a movie of Nassau.

New Members welcomed: Katherine A. Geldrich and Hattie P. Carroll.

Activities: Study club continuing with a spring series on "Banking"; Marie White and Kay Harsh talked to high school students on "Accounting as a Career" during "Career Day."

BUFFALO

Mr. B. E. Esperson spoke at the February meeting on "Interpretation of a Financial Statement by a Bank." Mr. Esperson is Assistant Vice-President of the Manufacturers & Traders Trust Company. At the March meeting, Mr. Norman S. Schlant, tax examiner, spoke on "New York State