Chapter 9

Disclosure and Financial Reporting

Information disclosure about issuers is a necessary condition for the effective operation of a securities market. Information—consistent, complete, timely, and comparable—is essential for judging the risks and rewards of investments. While information does not always answer all the questions (and bad information can give the wrong answers), an absence of information makes it difficult even to know what questions to ask.

Emerging and transitioning economies face particular difficulty with disclosure. Many countries are undergoing dramatic changes in their fiscal structure just as the structure and regulation of financial markets are changing as well. Direct guarantees by the sovereign are being replaced by newly minted local own-source revenue and transfer systems, as well as more specific pledges of assets and revenues. Some countries, such as South Africa, rely heavily on revenues pledged on commercial public utility operations. Other countries, for a variety of reasons, may choose to restrict long-term debt to self-supporting commercial operations.[1]

The ability of subnational governments to generate resources to support themselves or to generate surpluses for general revenue purposes depends on efficient technical and managerial operations. Even where governments rely primarily on transfer payments, information on trends in transfer payments compared with local expenses becomes vital to determining relative credit quality. Without uniform, regular, and reliable reporting, comparing and tracking the performance of subnational governments become impossible tasks, and market decisions are based more on faith than fact.

Regulating Disclosure

Disclosure can be required by the central government, by securities market regulation, or as a byproduct of market operations, through contracts and market practice and convention. Disclosures to securities markets originate with the borrowers themselves, the subnational governments. Borrowers may be assisted by the central or provincial government authorities in accumulating information, but the borrowing government is responsible for disclosures as the party financially responsible for timely and full payment of debt service. A closely related concept is that the party that controls decisions to honor obligations and thus has the relevant information is the one responsible for providing the information.[2]

In securities markets, disclosure is aimed at helping investors make informed investment decisions. An often overlooked but practical by-product of securities disclosure is that the performance, condition, and prospects of borrowers become publicly available information. These economic and financial factors are of material interest to many others in the market besides investors. Also, the concept of disclosure reaches beyond investor "protection" (that is, avoidance of fraudulent behavior) to encompass support for the rational allocation of resources on the ability to evaluate rewards versus risks, whatever their levels.[3]

Generally, formal disclosure requirements are met when the issuer sends published reports to the marketplace. In the bond markets, there are usually two phases in the process. First, the would-be borrower issues a document in conjunction with the initial sale that describes the transaction and provides pertinent information about itself, the security pledged, and the use of the bond proceeds, which is variously called an *official statemen*t or a *prospectus*. Second, after the sale, the borrower provides a stream of continuing information with respect to itself and the obligation, a process called *continuing disclosure*. The timing and scope of reporting information are important, and technology is changing the reporting process (see box 9.1). Another class of recipients of the information analyze it and convey their opinion to investors. The most important of these are the rating agencies, which, as is discussed in the next chapter, often act as a surrogate for disclosure to individual investors. Disclosure documents can be available from a central depository, using information received on a recurring or event-driven basis.[4]

The broad policy objective of developing a thriving securities market argues for balancing the need to protect investors with the need to ease access for certain classes of borrowers. Often, standards are lower for smaller issuers or for lower risk securities.[5] The content of disclosure statements can be dictated by the regulator's detailed list of required documents and schedules or by a flexible standard that relies on the issuer and its agents to provide information that investors need in reaching an investment decision. In practice, the two approaches are usually combined. Regulators provide a list of generic types of required information, leaving the particulars to the issuers. Since the scope and detail of meaningful disclosure can vary markedly, the trend has been to rely on market forces and self-regulatory bodies to specify the details of disclosure.

Box 9.1. Disclosure over the Internet

Electronic transmission of information over the Internet is changing the processes of bond sales and information disclosure in the securities markets. Although electronic transmission of data has been possible for many years, it was not until the use of the Internet became widespread that issuers were willing to move their bond sales to the Internet, taking bids in real time. An early experimenter was the city of Pittsburgh, which held its first Internet competitive bond auction in early 1997. That year, several large municipal bond issuers permitted bidders to file bids conventionally, in sealed envelopes, or over the Internet just prior to the close of auction.

In 1998 municipal issuers began to publish preliminary official statements over the Internet. Again Pittsburgh led the way. Investors could contact the city for a printed copy if they wished. While the city had previously printed 750 copies of the official statement at a cost of $15,000, once it began posting the statements on the Internet, it received only four requests for hard copies. Many issuers have started to post their budgets and financial statements on the Web.

The economies of posting bond disclosure over the Web are considerable for both bond sales and information disclosure. The access to a large number of investors and underwriters at low cost promotes improved disclosure. Just as exchanges in many emerging market economies are leap-frogging the stages of securities market development in many developed

(*Box continues on the following page*.)

Box 9.1. (*continued*)

countries, so too are new information technologies swiftly changing the flow of information in the markets.

In a related use of the Internet, subnational governments in Romania can access a Web site that provides a self-diagnostic program that allows them to compare their financial ratios with those of other governments. Administered by the Romanian Bankers Institute and funded by the U.S. Agency for International Development, the Web site also contains model loan and bond documents, a collection of state laws relating to local borrowing, and a listing of consultants and financial institutions interested in municipal finance.

Source: Authors.

Accounting Standards and Financial Disclosure

Uniform accounting standards for subnational government financial statements are critical to disclosure. In many countries accounting systems are under review with an eye toward improving their timeliness, transparency, and conceptual consistency.[6] International bodies are also working toward cross-country comparability. Strong accounting practices are central to improved financial management. The adoption of accounting standards has been expedited where the standards have been required for borrowers wishing to sell bonds or take out loans.[7]

Accounting standards vary greatly among countries and between the private and public sectors (see box 9.2). Most governments come from an orientation of controlling expenditures and revenues, stressing the legality of their actions and reporting on their conformance with legislation. This has led to the use of cash accounting techniques and has obscured the economic purpose or life of the expenditures. The biggest concerns with cash accounting techniques are their focus on short-term financial assets and liabilities and the ability to alter the results by accelerating receipts or delaying payments. It is not unheard of for governments to simply put the "bill in the drawer" or to delay making a payroll until the next fiscal year.[8] It is the case, however, that much credit analysis focuses on cash flows, particularly those flows related to the availability of cash to pay debt service in full and on time.[9]

When the government borrower is involved in an enterprise activity, it often uses accrual accounting techniques that conform to those used in the private sector. This has a sound economic rationale for determining the worth and period income performance of an activity. However, credit analysis typically requires conversion to a cash basis to ensure that adequate cash will be available when needed to meet debt service requirements.[10]

No accounting system is foolproof, and all are susceptible to misunderstanding and manipulation.[11] What matters most is whether the principles are being observed (that is, the accounts correctly kept in accordance with the chart of accounts and their definitions) and whether someone is systematically checking the books. An example of the importance of the consistent application of accounting principles in understanding what is going on is shown in box 9.3.

Another important issue is the frequency and independence of audits. Most subnational governments rely on audits performed by auditors from higher levels of government. The auditors typically check for compliance with program requirements rather than assess financial condition or assign costs to activities. Independent audits, which are sometimes required, may be difficult to implement because of a dearth of audit skills in the private sector or prohibitive costs for small borrowers (see Hungary case study, chapter 29). In some countries government financial records are not publicly available, and bank secrecy laws impede public disclosure of some portions of the financial statement. The very unavailability of such financial data is a warning flag that financial risk cannot be assessed and that political and legal risks are particularly important.

In addition to financial statements, appropriate disclosure may require information about the operations and characteristics of the service provided and the market served.[12] For example, investors in an enterprise-based security that looks to cash available after operating expenditures to repay debt want to know about the operating characteristics of the enterprise and the market it serves in order to judge how efficiently it is being operated and whether there are any concerns about such issues as the strength of demand, supplies, labor relations, environmental matters, and lawsuits. The list of items worthy of disclosure can be long, and the particulars will be dictated by the nature of the operation and the security pledged.[13] Thus, an

Box 9.2. Accounting for Accounting Differences

Differences in accounting and financial recordkeeping can make it hard to analyze the performance of governments and their enterprises. In some countries uniformity in these practices in the private sector arose from the tax systems and securities laws requirements. Because most subnational governments do not pay taxes on their activities and do not list their securities on stock exchanges, the pressure for prompt reporting and uniform accounting has been lacking.

Disclosure of information is meant to support analysis of the risk and reward relationship. Appraising "economic" risk—the risk that the borrower will be able to pay interest and principal as promised—depends on knowledge of its financial performance (operating statement) and condition (balance sheet). Since most problems involving "willingness to pay" are provoked by fiscal stress, strong financial reporting practices support assessment of this risk as well.

From a disclosure standpoint, the immediate objectives are getting financial data on a comparable basis; measuring the availability of dependable, recurring revenue streams to make debt service payments; and measuring liquid reserves available to continue meeting debt service requirements should the recurring revenues be interrupted. With proper reporting, other items, such as the strength and stability of the underlying economy, other indebtedness, and the mix and costs of inputs used by the borrower, also are disclosed or can be calculated from the financial statements and their footnotes.

Source: Authors.

important initial disclosure will be the intention or contractual commitment of the issuer to provide information on a recurring basis in the future.

Disclosure requirements do not mandate that every investor be able to read every document and understand every nuance of every deal. When disclosure requirements are particularly stringent, securities regulators may

Box 9.3 Why Did Czech Municipal Debt Grow So Fast?

It is not clear why the outstanding debt of municipalities in the Czech Republic grew so rapidly during the 1990s. There was no evident correspondence between the reported accounting flows of the revenues and expenditures of municipalities and their accumulation of debt. While the accounting reports indicated that the municipalities' fiscal balances were reasonably stable during the 1990s (that is, with rather small deficits alternating with small surpluses), the aggregate amount of municipal outstanding debt continued to rise rapidly.

This apparent discrepancy is thought to reflect a lack of uniformity in accounting practices that led to an inability to know what was actually going on. The evident inconsistency could have resulted from the following causes: differing interpretations by municipalities of accounting procedures and terminologies, including treating loan receipts as revenues; off-budget financial operations, including the treatment of grants from the state budget; and extrabudgetary funds that were inappropriately recorded as revenue by some municipalities. The Czech problem was not unique, as the accounting and financial reporting systems used by subnational governments during the transition often have been artifacts of the old unitary state system, which were not designed to measure their fiscal performance or condition.

Source: Czech Republic case study, chapter 28.

decide to promote reliance on private advisory and information services to examine disclosures and make informed judgments for which they are paid by investors. These opinions are published and become a "baseline" of the assessment process. An example of such services is provided by the credit rating agencies, which post ratings on issuers and issues and keep them under surveillance while the debt is outstanding. However, even if regulators are not doing the substantive reviews and forming opinions about the adequacy of disclosure, they need to institute meaningful safeguards to ensure that those who do (such as financial advisers, rating agencies, and other information providers) are professionally qualified, behave ethically, are not manipulating the market, and are free of conflicts of interest. Chapter 10 turns to the subject of credit analysis and credit ratings.

Notes

1. In the Philippines, bond issues by local governments are restricted to self-supporting projects. However, absent any definition of the term *self-supporting*, the restriction is not very effective.

2. A guarantee by a third party (such as the national government) has sometimes been seen as a reason to require less disclosure on the part of the actual borrower. That concept has been rejected in U.S. practice, where a guarantee (or insurance) does not obviate the need for full disclosure by the borrower. In South Africa and elsewhere the custom has been to relax requirements when the national government is the guarantor.

3. This is not just an academic distinction but goes to the heart of market regulation. If the primary purpose is to avoid fraud and investor loss, the emphasis should be on screening out high-risk securities that regulators feel might cause loss to the investors. This substitutes a bureaucratic decision for that of the marketplace. The other approach, and the one stressed in the U.S. philosophy, is to require full disclosure, and then to let the market decide on the appropriate rate of return to offset the level of risk, no matter what its magnitude.

4. In the United States this role is played in the municipal market by a limited number of officially sanctioned (but privately owned) repositories as well as a central repository operated by the Municipal Securities Rulemaking Board.

5. Traditionally, government securities have belonged to this lower risk disclosure class, although that tradition has been eroded in the United States and elsewhere and the exceptions are less likely.

6. One team of investigators reviewing the Latin American markets stress the problem of financial information: "The first problem is the quality of municipal or subnational management and accounting, which is often poor and incomplete " (Freire, Huertas, and Darche 1998).

7. International Federation of Accounting (IFAC) *Guideline for Governmental Financial Reporting*. The IFAC is attempting to develop widespread adoption of generally accepted accounting standards.

8. Credit analysts are concerned about cash flows, and not all cash accounting is considered bad. For example, state and local governments in Mexico are on a conservative system that accrues expenditures but treats revenues on a cash basis. This treatment is viewed favorably by rating agencies since it understates revenues while fully accounting for costs as they are incurred (interview with Jane Eddy, Standard & Poor's, March 25, 2002).

9. It is customary for credit analysts to restate accounting reports on a cash basis to assess the availability of cash to meet debt service payments. Revenue bond contract indentures are expressed in terms of minimums of available current revenues after meeting expenses (cash outlays) in relationship to debt service needs.

10. Asset valuation techniques differ among countries. Those that use a historical basis can greatly understate the replacement value of plant and equipment in periods of high inflation. For example, water utilities with much of their investment in underground piping and reservoirs may have major assets that have expected useful lives of 40 to 100 years. Utilities that use current market values for assets will appear to be much less leveraged (ratio of debt to total assets) than those that do not. However, their current depreciation charges are likely to be higher, which makes them appear less profitable.

11. A recent study of earnings management by local governments in Sweden and elsewhere found that use of the accrual system let governments manipulate reported earnings (deficits and surpluses) by altering depreciation rates, asset write-downs, and pension costs. The statistical analysis found that governments that were exposed to high levels of scrutiny by public groups and capital markets were less inclined to manage earnings (Stalebrink 2002).

12. The word *appropriate* is used because once beyond a simple general government balance sheet pledge (and likely even in that case), the information needed to assess risk will be specific to the local government. For example, a government that relies heavily on utility revenues will find its ability to pay debt heavily influenced by the operations of those utilities. If the raw material or labor costs are rising rapidly or users are not paying their bills, timely debt service payments may be endangered.

13. The list of items to consider can be found in various trade and professional publications. A good starting point for generic items is the Government Finance Officers Association's *Disclosure Guidelines for State and Local Government Securities* (GFOA 1991).