



## For Investors: The Basics of a Municipal Bond Issuer's Audited Financial Reports

When considering the purchase or sale of a municipal bond, there are many important factors an investor should consider. One such factor is the issuer's financial condition and performance. The audited financial report is a source of information about an issuer's finances, financial position and operating results prepared by an independent party such as a certified public accounting firm or a state auditor.

The audited annual financial report provides a snapshot of a municipal bond issuer's financial and operating condition at a specified point in time. A municipal bond issuer's annual audited financial report offers a roadmap to understanding the financial health and financial risks that may impact the issuer's ability to pay principal and interest on its bonds. The audited annual financial report is typically provided in the issuer's official statement when the municipal securities are first issued. The financial statements are updated on an ongoing basis as a component of an issuer's continuing disclosure obligations throughout the life of the bonds. Some issuers prepare a comprehensive annual financial report (CAFR), which includes introductory, financial, and statistical information. The CAFR statistical section contains detail and contextual information about the issuer's financial condition.



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Investors should ask their broker, dealer or municipal securities dealer (collectively, “financial professional”) for guidance about an issuer’s finances when purchasing or selling municipal bonds. Financial professionals have obligations to their investor clients under the rules of the Municipal Securities Rulemaking Board (MSRB), including an obligation to disclose all material facts about a municipal bond at or prior to the time of the sale or purchase.<sup>1</sup>

Be an informed investor by understanding the basic components of an issuer’s financial reports. It is also helpful to know what questions to ask a financial professional when deciding whether to purchase a particular municipal bond. This document provides an overview of the basic components of an issuer’s financial reports to support investors in making an informed investment decision.

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## BASIC PRINCIPLES OF GOVERNMENTAL FINANCIAL REPORTING

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The Governmental Accounting Standards Board (GASB) is an independent organization that sets the accounting standards for U.S. state and local governments. Generally Accepted Accounting Principles (GAAP) are the commonly accepted accounting principles, standards and procedures for preparing financial statements. GAAP is a combination of authoritative standards (set by GASB) and commonly accepted ways of recording and reporting accounting information to provide useful information to investors and other users of financial reports. GAAP-based financial reports provide the public with information necessary to assess the accountability of an issuer, primarily by assessing the financial condition and results of operations, comparing actual financial results with the legally adopted budget and assisting in determining compliance with finance-related laws, rules and regulations.

### About the MSRB

The mission of the Municipal Securities Rulemaking Board (MSRB) is to protect investors, municipal entities, and the public interest by promoting a fair and efficient municipal securities market. As part of its mission to protect investors, the MSRB creates rules with specific obligations for municipal securities professionals which regulate their conduct with investors. The MSRB provides market transparency through its [Electronic Municipal Market Access \(EMMA®\)](#) website, the official source for municipal securities data and documents. Also, the MSRB serves as an objective resource on the municipal market and conducts extensive education and outreach to market stakeholders.

Many municipal bond issuers follow GAAP, however depending on state requirements, issuers may use alternative methods of financial reporting and accounting.<sup>2</sup> GAAP consists of basic financial statements and accrual basis of accounting (revenues reported when earned and expenses matched with related revenues or reported when the expense occurs). Accrual-basis information required to be reported under GAAP supports an issuer’s ability to assess its finances and determine whether it can afford to meet its commitments. Accrual-basis information provides accountability for longer-term obligations of an issuer such as pensions and other post-employment benefits.

## Financial Statements

Generally, issuers prepare two types of financial statements: a balance sheet (sometimes called, “statements of net assets”) and an operating statement (sometimes called, “statements of activities”). The balance sheet is the financial statement that presents what the issuer owns and what it owes (*i.e.*, fund balance or net assets). The balance sheet presents an issuer’s assets and resources it controls that enable it to provide services. Generally, these assets are “current,” meaning they are in the form of cash, short-term investments and short-term receivables. The balance sheet details the difference between assets and liabilities and fund balances. Liabilities are amounts owed by the issuer which are unavoidable obligations. Fund balance is the difference between assets and liabilities, that is, the amount that would be available if the assets were used to satisfy the liabilities. It is the balance of each fund.

Operating statements address management of revenues and expenditures in primary operating funds. The operating statement includes revenues and expenditures that are compared with the final revised budget and changes in fund balance. Basic financial statements for municipal governments consist of government-wide financial statements, fund financial

statements and notes to the financial statements. Financial data is grouped into funds which are primarily: 1) governmental funds; 2) proprietary funds; and 3) fiduciary funds.<sup>3</sup>

Revenues are shown by source or type, such as various taxes, fees and charges, and intergovernmental aid. There is not a definitive list of revenue categories, nor a required level of detail, which results in some variation from issuer to issuer. Expenditures generally are shown by function with the current operating expenditures presented apart from debt service and capital expenditures. Some issuers break the debt service expenditures into their principal and interest components.

Revenues and expenditures are not the only inflows and outflows of resources reported on the operating statement. Other financing sources and uses include the cash received when bonds are issued, as well as transfers between funds. Although these resource flows are not revenues or expenditures, generally they are shown to assist the reader of the statement in assessing ongoing revenues and expenditures versus the basic operations of the issuer.

 ***Ask your financial professional whether the bond issuer applies GAAP standards to its financial reporting and basis of accounting. If other standards and/or accounting methods are applied, ask your financial professional about any impact and/or other considerations that may be important to your investment decision.***

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## **BASIC COMPONENTS OF AN ISSUER'S AUDITED FINANCIAL STATEMENTS**

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A municipal bond issuer's audited financial statements include components such as: 1) the independent auditor's report; 2) management's discussion and analysis; 3) government-wide financial statements (the statement of net position and the statement of net activities); 4) for governmental funds, a balance sheet and a statement of revenue and expenditures; 5) for proprietary funds, a statement of net position and a statement of revenue, expenses and changes in net position; 6) notes to the financial statements; and 7) required supplemental information.

## **Independent Auditor's Statement**

An independent auditor's statement is found at the front of the audited financial report. It states an independent auditor's opinion with respect to whether the issuer's financial statements have been presented fairly and without any material misstatements (generally referred to as an "unqualified" opinion). This is also the section of the report where the auditor will indicate whether there are any modifications, such as the adoption of new accounting standards, any qualifications, such as the entity is not following GAAP, and/or any other significant matters that may be disclosed within the financial report (generally referred to as a "qualified" opinion).

## **Management's Discussion and Analysis**

Management's discussion and analysis (also referred to as the "M D & A") usually consists of a narrative summary of the issuer's finances and provides the issuer's view of the underlying reasons for any significant changes in its financial position from year to year. The M D & A may be useful for providing insights into key financial events and trends that the issuer sees as challenges or attributes of its financial health and performance.

 ***Ask your financial professional to discuss any potential credit impacts related to information provided in this section.***

## **Government-Wide Financial Statements**

Government-wide financial statements include all governmental and business-type activities. The information is presented in two statements — the statement of net position and the statement of activities. The first two statements in the audited financial report reflect financial government-wide operations of the issuer, and typically include columns to display all governmental activities which use governmental funds separate from the business-type activities which use proprietary funds. Any separate legal entities for which the issuer is financially accountable (usually called component units), are reported in a third column.

The statement of net position and the statement of activities typically present a picture of the issuer's long-term financial health. These statements generally reflect the annual cost of providing governmental

services and whether the issuer's sources of funds have fully funded the cost of those services. These statements reflect the overall financial health of the issuer, as they present the annual costs to the issuer of providing relevant services and the sources of funding to meet those expenses.

**i** *To evaluate the long-term financial health of an issuer, ask your financial professional about the total net position for governmental activities. Are there any future funding concerns that the issuer is likely to face? Have capital outlays kept up with depreciation over the last five years? Is the issuer taking adequate steps to sufficiently maintain, invest in or replace its core infrastructure?*

### Governmental Fund Statements

Governmental fund statements reflect a shorter-term focus and measure how the issuer spent funds it received. Issuers typically develop their annual budgets at the fund level. The fund balance generally measures how much money an issuer has available for future budgets. Separate activities are accounted for in separate funds to reflect how specific revenue is spent. Typically, the "General Fund" is the largest governmental fund and accounts for most activities that are not required to be accounted for in other funds (such as monies that are legally restricted like grants) or business activities such as water and sewer.

**i** *Ask your financial professional about the amount of the unrestricted fund balance as a percentage of annual expenditures in the general fund. Are there deficits in any of the funds? How significant are the deficits? Is there any explanation provided in the financial statements as to what possible underlying reasons may be for the deficits?*

### Proprietary Funds

There are two types of proprietary funds — enterprise funds and internal service funds. Enterprise funds are for business-type activities, where the issuer is providing a good or a service in exchange for fees, and the fees are generally intended to cover the full costs of the service. Some examples of such types of goods or services include water, sewer, electricity, or parking, among others.

Internal service funds typically are created to account for activity that will be charged internally to other funds of the issuer. Generally internal service funds are self-supporting, and a positive net position indicates that customers have paid the full cost of the services.

### Notes to Financial Statements

GAAP requires a comprehensive set of note disclosures to be included with the financial statement that provide details about financial information to investors and others. Common types of information that may be found in the note disclosures include:

- Significant accounting policies (though GAAP is standard, overall accounting and reporting policies can be unique from entity to entity);
- Compliance issues (legal compliance related to the budget, bonds, investment policies and the like);
- Deposit and investment detail (reporting requirements related to types of deposits and investments, the management of risk, insurance and collateral);
- Fixed-asset information (types of assets owned, i.e., land, buildings, equipment, their original cost, accumulated depreciation, additions to assets during the year and those taken out of use);
- Information on outstanding long-term debt (includes disclosure of the outstanding debt issues, interest rates, repayment terms, the amount of principal and interest due each year for five years and in five-year increments until maturity); and
- Pension plan information (the nature of the plan the entity participates in and the annual costs, or if it sponsors its own plan, the assets and liabilities as well as the funding requirements).

Read the notes to the financial statements carefully for any significant changes and disclosures related to the financial performance or policies of the issuer, as well as any noncompliance with legal, regulatory and other policy requirements. Reviewing the notes may also be helpful in highlighting any financial trends and events concerning the issuer's management of its financial operations.

**i** *Reviewing the notes to the financial statements may highlight issues for further investigation and consultation with your financial professional.*

## Required Supplemental Information

GAAP also requires certain supplemental information in an audited financial report. Supplemental information is designed to provide operational, economic, or historical context for the financial statements or notes to the financial statements. One type of supplemental information is a budgetary comparison schedule that would include the general fund and major special revenue funds, reflecting the issuer's original budget and the last amended budget as compared to actual financial results. Typically, expenditures indicate whether the issuer manages its revenues and expenses as projected, and the budgeting process reflects successful planning on an annual basis.

 ***Ask your financial professional about any significant amounts that are either over — or under — budget, as it is important to understand the reasons behind such variances, and what impact, if any, they may have on the issuer's ability to meet its financial obligations going forward. For any significant variations or trends, are there any explanations provided in the financial statements?***

Other information to consider includes the history of the issuer's funding levels for pensions and other post-employment benefits. It is important to understand that an issuer's net pension liability and pension contribution schedules generally reflect the overall health of the issuer's pension plan.

Ideally, they will show funding levels over time. The contribution schedule should provide the investor with an understanding of whether the annual required contribution is increasing or decreasing over time, whether the issuer has made a full contribution and whether the funding ratio is increasing or decreasing.

 ***Ask your financial professional about trends reflected in this supplemental schedule; generally, look for a positive trend, where the asset balance is increasing or moderating to reduce the issuer's liability levels over time and increase the funding percentage. Are pension and other post-employment benefits well-funded, and if not, is the funding level at a minimum increasing?***

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## HOW TO ACCESS AN ISSUER'S FINANCIAL REPORTS

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MSRB's Electronic Municipal Market Access (EMMA®) system is the designated repository for financial information from municipal bond issuers and makes it publicly available, free of charge at [emma.msrb.org](https://emma.msrb.org). On EMMA, you can find financial reports either searching by issuer or by the specific municipal security:

<https://emma.msrb.org/IssuerHomePage/Map>

<https://emma.msrb.org/Search/Search.aspx>

Issuers of most municipal securities sign a continuing disclosure agreement that lays out the contractual obligations of each party in offering to provide investors with updated information that may affect the repayment of the bond. The issuer commits to providing disclosure and updated financial information, including a copy of its annual audited financial report to the MSRB within a certain specified amount of time after the end of its fiscal year (typically within 180 days). Underwriters are required to confirm that issuers have signed these agreements to ensure compliance with SEC Rule 15c2-12, which establishes the kinds of information that must be submitted to EMMA®.

## Endnotes

- <sup>1</sup> Securities and Exchange Commission (SEC) Rule 15c2-12 requires dealers, when underwriting certain types of municipal securities, to ensure that the state or local government issuing the bonds enters into an agreement to provide certain information to the Municipal Securities Rulemaking Board (MSRB) about the securities on an ongoing basis. Such continuing disclosure agreements normally require annual financial information such as audited financial report.

MSRB Rule G-47: Time-of-Trade Disclosure requires each broker, dealer or municipal securities dealer to disclose all material information known about a municipal bond orally or in writing, at or prior to the time of trade when conducting a sale to a customer or purchase from a customer of a municipal bond, whether unsolicited or recommended, and whether in a primary offering or secondary market transaction and reasonably accessible to the market. Information is considered to be material if there is a substantial likelihood that the information would be considered important or significant by a reasonable investor in making an investment decision. The required time-of-trade disclosures under MSRB Rule G-47 include providing material information about an issuer's failure to make continuing disclosure filings required under its continuing disclosure agreements.
- <sup>2</sup> Other types of accounting that may be used by issuers subject to state requirements includes regulatory basis of accounting, other comprehensive basis of accounting (OCBOA), and cash basis of accounting. Regulatory basis of accounting, also known as statutory basis of accounting, is a basis of accounting in which the state regulator (the state or a state agency) establishes the financial reporting provisions and standards separate from GAAP. Other comprehensive basis of accounting is a system of methods of accounting other than GAAP, including cash basis, modified cash basis and regulatory basis of accounting. Cash Basis of Accounting method records transactions at the time cash is received or paid.
- <sup>3</sup> Governmental funds are used for accounting for general operations such as administrative activities and providing services, and report only one year of the issuer's financial assets and liabilities. Proprietary funds account for governmental activities that are more like a business (such as for a water department charging rates to cover annual operations and longer-term capital investment), they net income, which reflects a longer-term perspective on financial and non-financial assets, current and long-term liabilities. Fiduciary funds are used to account for funds held in the interest of a third party, such as pension funds, and are not assets owned by the issuer or reported in its government-wide financial statements.