

Focus on Credit Quality Puts Sharper Spotlight on Municipal Bond Audit Times

Cities, counties and states continued to complete annual audits nearly six months after the close of their fiscal year, although the pace in each of these categories showed a slight improvement in 2012 compared to the prior year. Audits for all other major municipal bond credit sectors, including issuers of revenue bonds, were completed in a somewhat timelier manner than issuers of general obligation bonds, although the incremental improvement for these issuers in 2012 compared to the year before was insignificant.

In its third annual study of audit completion times, Merritt Research Services examined over 8,000 audit reports provided by municipal bond issuers. To gauge historical trends, Merritt compared this year's audit completion times to results for over 40,000 audits completed between 2007 and 2011. The findings indicate that, on the whole, municipal bond audits continue to substantially lag the completion time for issuers of corporate bonds. As in the past, this year's study continued to reveal a significant variance among municipal bond sectors when it comes to audit completion times. Furthermore, within each sector, many issuers completed their audits much faster than the sector median, while others took longer. Many issuers were notable exceptions to the norm on both ends of the timeliness spectrum.

To calculate audit timing, Merritt examined all audits entered into its database as of August 30, 2013 to identify the date on the signature on the audit letter and the date of the fiscal year end. The span between those two dates resulted in the "Audit Time" used as the measure for this study. It should be noted that, in many cases, an audit may not be made publicly available for days, or even weeks, after the audit letter is signed if governing board approval is required prior to its release.

The approximately 8,000 2012 fiscal year audits collected for this study represent roughly 88 percent of the total audits eventually collected for the 2011 fiscal year. While Merritt continues to collect and add to the database additional audits for the 2012 fiscal year, the median sector and overall audit times are not expected to change materially due to the large universe collected for the study, and based on patterns from prior years' studies.

While relatively slow audit times among municipal issuers has been a longstanding complaint in the municipal bond market, the concern is being echoed in even wider circles due to the increased attention on local government financial problems and Chapter 9 bankruptcy filings. Change may be on the horizon in light of recent comments made and actions taken by the Securities and Exchange Commission (SEC). Although the Tower Amendment, enacted by the U.S. Congress in the late 1970s still prevents direct regulation of state and local borrowers, the SEC has the power to oversee dealer requirements setting forth underwriting standards that pertain to documentation. Moreover, the SEC can enforce its 10-b5 anti-fraud provision for documents used in

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connection with sales. The SEC has been increasing its oversight of this provision; earlier this year, the SEC charged the City of Harrisburg, Pennsylvania with securities fraud for misleading public statements, implying that its financial information was outdated and incomplete. The underlying message implied that municipal borrowers that provided late information could be held in violation of SEC rules, subject to penalties.

While the SEC announcement came late in the game for municipal entities preparing their 2012 audits, the SEC's finding in the case of Harrisburg might be considered 'a shot across the bow' for municipal issuers with a tendency to take their time in releasing secondary market disclosure materials. Whether or not municipal borrowers will heed the warning and hasten the completion of their audits in 2013 and 2014 remains to be seen.

Filing annual audit reports within 60 to 90 days after the close of the fiscal year is standard for corporate bond issuers, depending on the SEC definition of the company's size. While this requirement does not apply to municipal bond issuers, the SEC has encouraged a 120-day standard for municipal issuers to complete and file annual audited financial statements.

No regulatory or standards board for municipal bond issuers has set forth a requirement determining a specific time frame between the end of an entity's fiscal year and the filing of its annual audit. The Municipal Securities Rulemaking Board (MSRB), which administers the Electronic Municipal Market Access (EMMA) database of municipal disclosure documents, does not have the authority to mandate when or how municipal issuers file their financial information. The Government Finance Officers Association (GFOA) rewards entities that file financial documents within six months of the fiscal year end with its 'Certificate of Achievement for Excellence in Financial Reporting.' The Government Accounting Standards Board (GASB), which establishes financial reporting standards for governmental bodies, uses the six-month parameter as its unofficial minimum guideline.

Specific findings of this year's Merritt Audit study:

- **States and Territories:** Among the credit sectors included in this year's study, governmental bodies that issue general obligation (GO) bonds are generally the slowest to turn in their audits. States and Territories, which have more complicated governmental structures and financial ledgers, took the longest amount of time to complete their audits, continuing the trend evidenced over the past six years. The median audit time for states was 174 days in 2012, a notable 8-day improvement over the prior year, but still a long way from the SEC recommendation of 120 days after the close of the fiscal year.

In this category, only Utah (111 days), New York (114 days) and the District of Columbia (120 days) were able to meet this guideline. On the other end of the scale, New Mexico (426 days) finished its annual report (which was reviewed by accounting firm, but not audited) last among the states, followed by South Carolina (342 days) and Illinois (335 days). The territories of Puerto Rico and the Virgin Islands had not reported their audits for 2012 at the time of the study. (Puerto Rico subsequently issued its annual audit the week of September 16, 2013). In 2011, their audits took 302 and 637 days, respectively, to be signed and then released for review.

- **Cities and Counties:** The median audit time for Cities and Counties was slightly shorter than for States and Territories, but still well above the median across all sectors. Of the 1,029 City audits recorded as of August 30, 2013, the median audit time was 171 days. The median audit time for Counties, based on 678 county audits, was one day longer, at 172 days. Issuers of dedicated tax bonds, such as sales tax-backed bonds, were also relatively slow, with a median audit time of 167 days, in large part due to the fact that their audited numbers are most frequently incorporated into the audits for States, Cities and Counties.

Among Cities, Salisbury, Massachusetts completed its audit in the shortest amount of time (54 days), followed by Moore, Oklahoma (63 days), and Haslet, Texas (69 days). On the other hand, Baltimore took the longest time (415 days) between the close of its fiscal year and the completion of its audit in 2012, followed by Utica, New York (404 days), Rialto, California and Scotts Valley, California (tied at 403 days).

Among Counties, Kendall County, Illinois had the shortest audit time (41 days) in 2012, while Newton County, Georgia took the longest (362 days) to complete its audit.

- **Fastest Reporting Municipal Credit Sectors:** Three revenue bond sectors – **Wholesale Electric Power, Hospitals, and Private Higher Education**, which have traditionally ranked among the fastest to complete their audits – continued the trend in 2012. While the median audit times in each of these sectors fell short of the corporate 60-to 90-day standard, the median times for all three are within the SEC's 120-day recommendation for municipal bond issuers.

The **Wholesale Electric Public Power** credit sector, which included 155 audits as of August 30, 2013, took honors for the sixth straight year for having the shortest median audit time of 95 days.

Hospitals were the second-fastest sector, with a median audit time of 109 days in 2012, and a six-year average of 109 days. Of the 1,096 audits from independent and system-run hospitals, Oak Valley Hospital District, California completed its audit in the shortest amount of time (41 days) in 2012, while West Penn Allegheny Health System in Pittsburgh, Pennsylvania took the longest amount of time (380 days) in the sector.

Among **Private Higher Education** borrowers, the 113-day median for the 528 colleges and universities in the sector was led by the perennial winner, Syracuse University, which completed its audit within 30 days of the close of its fiscal year. Alaska Pacific University took the longest amount of time (291 days) in this category.

Interesting Patterns and Observations:

- *Size was not a consistent factor in determining the length of time it took for an issuer to complete its annual audit after the close of its fiscal year.*

In the **School District** sector, the overall median audit time in 2012 was 144 days, which was faster than Cities and Counties. Many small and large population school districts had audit times on both the short and long ends of the audit time spectrum. Rapid River Public Schools, Michigan, with a district population of 2,789, was among the smallest school districts in the study. Using a Generally Accepted Accounting Principles (GAAP) compliant audit, Rapid River Public Schools completed its 2012 audit within a mere 18 days after the close of its fiscal year. Remarkably, Rapid River has completed its annual audit in less than 60 days in each of the last six years. On the other hand, Dougherty County School System in Albany, Georgia, with a district population of 94,788, also used GAAP accounting standards, but took 415 days (over 400 days) to complete its audit.

In fact, size did not appear to be a factor in any of the other municipal credit sectors. Both Baltimore, Maryland (population: 620,216) and Scotts Valley, California (population: 11,625) were among the slowest **Cities** to complete their audits. Salisbury, Massachusetts (population: 8,372) was the fastest city to complete its audit (54 days). Among Cities with a population over 100,000 residents, Schaumburg, Illinois completed its audit within 70 days. New York

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City, which has one of the most complicated city audits in the nation, was signed by its auditor in 118 days, just as it has done in every year since 2008.

- *Credit quality, while not a determining factor in audit time, did reveal some patterns in some sectors.*

In a closer examination of the 20 fastest and slowest issuers to complete their audits, Merritt looked for a correlation between financial trends and audit times in several credit sectors. In the **Cities** sector, indicators of financial strength were generally more evident among issuers with the shorter audit times, while weaker financial indicators were more prevalent among the issuers with longer audit times. Similar observations were made in the **Counties, Hospitals and Airports** sectors, and, to some extent, among **States** when the 10 fastest and slowest issuers were considered.

- *There is some evidence that once a distressed situation is fairly advanced, audits take much more time.*

Cities like Stockton and San Bernardino, California completed their audits in 506 and 517 days, respectively. Neither had completed its audit for 2012 at the time of the study.

Richard A. Ciccarone
President & Chief Executive Officer
Merritt Research Services, LLC
(319) 861-5489

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Background on Merritt Research Services, LLC

Merritt Research Services, LLC is an independent municipal bond data and research provider focused on credit information related to municipal bonds. Founded originally in 1985 as a part of Van Kampen Merritt Inc., it first began to collect municipal bond audits for its initial database software product called The Merritt System, which was launched in 1986. Ten years later, The Merritt System partnered with Investortools, Inc. to primarily release its data through CreditScope. In 2001, Merritt Research Services LLC was spun off from the Van Kampen Funds to become an independent municipal data research company. Today, Merritt Research, headquartered in Hiawatha, Iowa, collects municipal bond audits on over 8,000 municipal bond credits.

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2013 MERRITT RESEARCH SERVICES AUDIT TIMING STUDY - Appendix A
Fastest and Slowest Issuers by Municipal Credit Sector (FY 2012)

| | <u>Fastest</u> | | <u># Days after FYE</u> | | <u>Slowest</u> | | <u># Days after FYE</u> |
|--------------------------|--|----|---------------------------------|--|----------------|-----|---------------------------------|
| Airports | 1 Port Authority of New York & New Jersey | NY | 56 | 1 Virgin Islands Port Authority | VI | 281 | |
| | 2 Tampa International Airport | FL | 57 | 2 Fresno Yosemite International Airport | CA | 273 | |
| | 3 Huntsville International Airport | AL | 62 | 3 Manchester - Boston Regional Airport | NH | 270 | |
| | 3 Chesapeake Regional Airport | VA | 62 | | | | |
| Cities | 1 Salisbury | MA | 54 | 1 Baltimore | MD | 415 | |
| | 2 Moore | OK | 63 | 2 Utica | NY | 404 | |
| | 3 Haslet | TX | 69 | 3 Rialto | CA | 403 | |
| | | | | 3 Scotts Valley | CA | 403 | |
| | <i>Not yet reported:</i> | | | | | | |
| | <i>Harrisburg</i> | PA | (496 days in FY 2011) | | | | |
| | <i>Stockton</i> | CA | (506 days in FY 2011) | | | | |
| | <i>San Bernardino</i> | CA | (517 days in FY 2011) | | | | |
| Counties | 1 Kendall County | IL | 41 | 1 Newton County | GA | 362 | |
| | 2 Somerset County | ME | 54 | 2 Orangeburg County | SC | 342 | |
| | 3 Manatee County | FL | 58 | 3 Bulloch County | GA | 341 | |
| Dedicated Tax | 1 Wisconsin Center District Dedicated Tax Revenue B WI | | 67 | 1 Build Illinois Bonds | IL | 335 | |
| | 2 New York Convention Center Development Corpora NY | | 69 | 2 Puerto Rico Federal Excise Taxes | PR | 306 | |
| | 3 New York Local Government Assistance Corporatio NY | | 79 | 3 St. Johns County Sales Tax | FL | 270 | |
| | 3 Sarasota County Communications Services Tax Seri FL | | 79 | | | | |
| Hospitals | 1 Oak Valley Hospital District | CA | 41 | 1 West Penn Allegheny Health System Inc & Subs | PA | 380 | |
| | 2 Seminole Hospital District of Gaines County | TX | 43 | 2 Plumas District Hospital | CA | 374 | |
| | 3 Children's Hospital Central California | CA | 45 | 3 Regina Medical Center | MN | 313 | |
| | 3 King's Daughters Medical Center | KY | 45 | | | | |
| | 3 Mayo Clinic | MN | 45 | | | | |
| Private Higher Ed | 1 Syracuse University | NY | 30 | 1 Alaska Pacific University | AK | 291 | |
| | 2 St Thomas University Inc | FL | 54 | 2 Merrimack College | MA | 272 | |
| | 3 Stillman College | AL | 55 | 3 Xavier University of Louisiana | LA | 271 | |

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|---------------------------------|--|-----------|---------------------------------|---|----------------|-----|---------------------------------|
| Public Higher Ed | 1 University of South Alabama | AL | 46 | 1 University of Puerto Rico | PR | 418 | |
| | 2 Victoria County Junior College District | TX | 49 | 2 Christopher Newport University | VA | 341 | |
| | 3 Macomb Community College | MI | 59 | 3 George Mason University | VA | 312 | |
| Retail Electric | 1 Floresville Electric Light & Power System | TX | 31 | 1 Altus Municipal Authority Fund | OK | 367 | |
| | 2 Fillmore Electric Fund | UT | 32 | 2 Freeport Village Electric Fund | NY | 364 | |
| | 2 Benton County Electric System | TN | 32 | 3 Burbank Water & Power - Electric Fund | CA | 361 | |
| School Districts | 1 Rapid River Public Schools | MI | 18 | 1 Dougherty County School System | GA | 415 | |
| | 2 Andover Regional School District | NJ | 30 | 2 Youngstown City School District | OH | 388 | |
| | 3 Harbor Springs Public School | MI | 32 | 3 Barrow County Board of Education | GA | 361 | |
| | 3 Warren Woods Public Schools | MI | 32 | | | | |
| Special Districts | 1 Minooka Fire Protection District | IL | 42 | 1 Pike County Public Library | KY | 349 | |
| | 2 Sand Creek Metro District | CO | 63 | 2 Chicago Park District | IL | 217 | |
| | 3 Grossmont Healthcare District | CA | 74 | 3 Eagle Bend Metro District #2 | CO | 206 | |
| States & Territories | 1 Utah | UT | 111 | 1 New Mexico (reviewed, not audited) | NM | 426 | |
| | 2 New York | NY | 114 | 2 South Carolina | SC | 342 | |
| | 3 District of Columbia | DC | 120 | 3 Illinois | IL | 335 | |
| | <i>Not yet reported:</i> | | | | | | |
| | <i>Puerto Rico</i> | <i>PR</i> | <i>(302 days in FY 2011)</i> | | | | |
| | <i>Virgin Islands</i> | <i>VI</i> | <i>(637 days in FY 2011)</i> | | | | |
| Tollways | 1 Mackinac Bridge Authority | MI | 50 | 1 Delaware River Port Authority | NJ | 207 | |
| | 2 Buffalo & Fort Erie Public Bridge Authority | NY | 53 | 2 Cape May County Bridge Commission | NJ | 194 | |
| | 3 Kansas Turnpike Authority | KS | 58 | 3 Illinois State Toll Highway Authority | IL | 193 | |
| Water/Sewer | 1 Titus County Fresh Water Supply District #1 | TX | 26 | 1 Baltimore Water & Wastewater | MD | 415 | |
| | 2 Harrisonburg-Rockingham Regional Sewer Authority | VA | 31 | 2 Turlock Water & Sewer | CA | 384 | |

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|---------------------------|---|-------------------------------|----------------|--|
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| | 3 Rogers Water Utilities - Sewer Department | AR | 33 | 3 Amador Water Agency |
| | | | | 3 Mountain Park Master Conservancy District |
| Wholesale Electric | 1 Bonneville Power Administration | OR | 26 | 1 West Texas Municipal Power Agency |
| | 2 San Miguel Electric Cooperative Inc | TX | 39 | 2 Sam Rayburn Municipal Power Agency - RPSA Fur TX |
| | 2 Associated Electric Cooperative Inc | MO | 39 | 3 Lafayette Public Power Authority |

Note: Data reflects audit count as of August 30, 2013

Source: Merritt Research Services, LLC