Faster, Cheaper, Better: Demands for Financial Reporting from State Governments

By Nancy Kopp

Financial reporting and auditing professionals ensure that the public has a clear view of the health and viability of state governments. They are keepers of the public trust. Today, however, these professionals face more demands than ever and have fewer resources than ever to support their important efforts. Cumbersome, and often burdensome, processes and financial limitations are now colliding with a multi-faceted push for financial reporting that is faster, cheaper and better. Can states sustain current efforts, and even go beyond, pushing the limits of their capacity to provide speed, economy and quality?

Setting the Stage

Faster comprehensive annual financial reports, faster annual single audits of federal grant funds, quarterly financial statements, quarterly grant reporting, more transparent reporting of state government pension plans, interim financial reporting—these items are just part of a growing list of reporting demands presenting real challenges to state government financial management and audit professionals.

One can hardly open a newspaper, go online or even watch the local evening news these days without confronting a headline about state government financial woes. The Great Recession has affected just about everyone, but it has been particularly hard on state governments. States are strapped for cash, and in most cases, tax revenues have decreased dramatically, exacerbating the problem. A recent study by the National Association of State Budget Officers reports that state sales tax, personal income tax and corporate income tax—which make up about 80 percent of state general fund revenue—all declined in the 2009 and 2010 fiscal years.[1] Even now, after economists have officially declared the recession over, state tax revenues have risen slowly, if at all.

The American Recovery and Reinvestment Act of 2009 helped, but the majority of its funding to state governments is set to expire in 2011 and 2012. Even though it provided much-needed aid to states, the Recovery Act came with significant accountability requirements. Among other things, states were required for the first time to report federal grant expenditures on a quarterly basis. Many said this feat could not be accomplished. However, through the efforts of dedicated government accountability professionals across the country, quarterly grant reporting became a reality beginning in September 2009.

Satisfaction with this accomplishment, however, was short-lived, as the demands continued to increase.

Recent reports by the U.S. Government Accountability Office have concluded there is a need for faster reporting of single audits (the organization-wide audit of any entity expending $500,000 or more of federal assistance), particularly reporting of internal control deficiencies.[2] To accomplish faster single audits, states must complete comprehensive annual financial reports in a more timely fashion. While state governments historically have been vastly more transparent than the private sector, there also have been recent calls for increased transparency and greater control over the promulgation of state and local government accounting standards. As if these issues were not daunting enough, Congress recently showed unprecedented interest in the pension plans of state and local governments, demonstrating that the federal government desires to exert its influence in areas it perceives as weak.

The clamor for faster and more transparent financial reporting from state governments is louder than ever.

What's At Stake?

States have plenty at stake in this regard. First, citizens have a right to financial information from their governments. Citizens must be confident that government is being run in an efficient, effective and financially stable manner. A loss of confidence in government by its citizens is hard to regain.

Second, investors must have adequate and timely financial information upon which to base their investment decisions. If investor demands are not met, governments run the risk of not being able to sell bonds. Given the current financial stresses upon states, any decrease in bond sales would be devastating and would likely result in the stoppage of key infrastructure projects (e.g., road improvements, new school buildings, etc.).

Third, bond raters need timely, reliable and easily accessible financial information upon which to base their decisions. Without providing such information, governments run the risk that bond raters will downgrade their bonds. This is not a desirable outcome under any circumstance, but especially in the current economic environment.

The Government Financial Reporting Environment and Obstacles to Faster Reporting

Government is Different

Critics argue that state government year-end financial reporting is hardly timely. While comprehensive annual financial reports are audited and presumably accurate, critics say they are not very useful for making timely investment or management decisions. When compared to large, multi-national private sector corporations, where audited financial statements are available within 60 to 90 days, states lag far behind.

Generally, states strive to issue their comprehensive annual financial reports (CAFRs) within six months—or 180 days—after the end of the fiscal year. As Table A reveals, states have been very consistent in their completion dates. On average, states fall short of meeting the six-month target.

Time has passed and technology has evolved, yet improving the completion time for state comprehensive annual financial reports has remained elusive. Perhaps the most significant reason is that government accounting and reporting requirements are fundamentally different from those for companies in the private sector. In fact, the differences are so profound that two separate accounting standards-setting boards are needed: the Financial Accounting Standards Board for the private sector and the Governmental Accounting Standards Board for state and local governments. Among the key differences are:

- *Collecting data from component units and agencies.* To complete the comprehensive annual financial reports, state finance officials are dependent upon data from a number of entities referred to as "component units" (e.g., public colleges and universities). Not only does each state have multiple component units, the component units in turn have their own component units (e.g., foundations at a public university). The flow of information from each of these levels to the preparers of the comprehensive annual financial report is not always as expedient as desired or as timely as may be technically required. In a recent survey, state comptrollers indicated that even if all other obstacles to completing a faster comprehensive annual financial report were addressed, difficulties with getting data from component units would preclude success. In addition, obtaining financial information from a myriad of state agencies also contributes to delays in completing the annual report. In many cases, state agencies operate in a decentralized environment that differs vastly from the private sector.
- *Dual perspective reporting model.* In its landmark Statement No. 34,[3] the Governmental Accounting Standards Board prescribed a dual

Table A: Comprehensive Annual Financial Report (CAFR) Completion Dates

	FY 05	*FY 06*	*FY 07*	*FY 08*	*FY 09*
Average number of days for states to complete the CAFR	208	204	205	204	206

Source: National Association of State Comptrollers, November 2010.

perspective reporting model for state and local government financial statements resulting in two different sets of financial statements. One set examines the government from a government-wide, or enterprise perspective. Here, activities are measured on a full accrual basis of accounting. The second set contains the fund statements, where activities are measured using a modified accrual basis of accounting. Differences between the two sets of financial statements must then be reconciled, adding further complexity to the overall process. Then, there is a statement that compares actual financial results to the approved budget. All told, preparers of state financial statements must use at least three different bases of accounting to compile the comprehensive annual financial reports. Of course, auditors similarly have to audit these different bases of accounting. The audit is further complicated by auditing standards that require opinion units, which results in the auditor having to issue multiple opinions. Simply stated, the rules in government accounting and auditing are much different than those in the private sector. These differences contribute significantly to the delays in preparing and auditing the comprehensive annual financial reports.

States are also faced with other obstacles to faster reporting. These include:

- *Funding/staffing for accounting and auditing.* According to a recent report from National Association of State Budget Officers,[4] in the 2010 fiscal year, 25 states used layoffs and 22 used furloughs to help reduce or eliminate budget gaps. The 2011 fiscal year looks similar, with 24 states using layoffs and 16 using furloughs. Some National Association of State Auditors, Comptrollers and Treasurers members recently reported 25 to 30 percent reductions of their professional staff at a time when the workload was increased dramatically during the implementation of the Recovery Act. Clearly, these resource reductions compound the problem and reduce the ability of states to produce faster financial information. Undoubtedly, reduced funding and staffing is having an impact on states. Some suggest the current workload in this environment is not sustainable. Unfortunately, reduced staff levels will likely remain an obstacle to faster financial reporting, at least in the near term, until the overall economy recovers and state tax revenue rates return to normal.
- *Outdated accounting systems that need to be upgraded or replaced.* The status of accounting systems in the states varies widely. While some states have purchased and implemented new, robust enterprise resource planning systems, others continue to operate on aging legacy systems. New, updated systems clearly will be needed at some point in the future for many states. However, funding constraints make major system purchases a long shot in the short-term.

Year-end reporting is not the only government financial reporting issue receiving attention.

The U.S. Securities and Exchange Commission is conducting field hearings to examine various issues pertaining to the municipal market. Not only is the SEC concerned about the lack of timely financial statements, it also would like to see more reporting of financial information on an interim basis. Publicly traded companies that must register with the SEC are required to file quarterly financial statements. While the SEC has indicated it does not believe the same requirement should be applied to municipal issuers, it is clear the SEC would like to see reporting of financial information on a more frequent basis than annual.

It is important to note the distinction between financial information and financial statements. Clearly, producing GAAP-based financial statements on a quarterly basis would be very problematic for states for the same reasons it is difficult for states to produce faster annual financial statements.

Are There Solutions?

There are no easy solutions, that is for sure. However, there may be some areas where progress can be achieved. The National Association of State Auditors, Comptrollers and Treasurers is examining how improvements can be made for both year-end annual financial reporting and interim reporting.

In the fall of 2010, the association developed a Faster Financial Reporting Work Group to examine the issue of timely financial reporting and to make recommendations on how to improve the timeliness. The work group conducted a survey to find the top barriers for states to faster financial reporting. Each identified barrier is being examined and evaluated. While the group is still in the midst of its work, no idea is being left off the table. Ideas such as changing fiscal year-ends of either the state or its component units, passing legislation to require faster comprehensive annual financial reports, using estimates to a much greater degree, interim auditing and re-examining materiality levels are all items receiving close scrutiny.

In 2003, NASACT convened a group of interested state government and bond market stakeholders to examine the issue of interim reporting. The goal was to develop a template of items governments could make available on an interim basis. The group identified the following four specific items as a recommended minimum set of financial information to be provided to investors and the general public at least quarterly:

1. Budget-to-actual operations, showing major categories of revenues and expenditures, for the general fund and major governmental and enterprise funds, year-to-date and an explanation of the major variances.
2. Cash receipts and cash disbursements in the general fund and major governmental and enterprise funds, year-to-date, compared to the previous fiscal year.
3. Balances and changes in long-term and short-term debt, year-to-date.
4. Significant events (e.g., loss of a major employer or taxpayer, a natural disaster, change in the tax laws that would have a substantial effect on its financial condition, etc.).

It seems these items, and perhaps others, are still relevant today and would address most major concerns about the lack of timely financial information. States generally do have a variety of financial information that could be of significant benefit to citizens and investors.

NASACT's Government Accounting Standards and Market Oversight Committee is re-examining the recommended disclosures and reaching out to relevant parties for input. Posting financial information of this nature on government websites in an easy-to-find "investor's section" appears to be one area where financially feasible improvements could be made.

Additionally, states are working to find innovative ways to fund underfunded pension systems, which have suddenly been thrust into the spotlight and fallen out of favor with the general public. While recently proposed federal legislation regarding reporting for public pensions may be well intentioned, it is misguided. The promulgation of generally accepted accounting principles for state and local governments is the responsibility of the states. The states have delegated this task to GASB and not to the federal government. States are addressing pension management and reporting in meaningful ways. State and local pension systems collectively have pre-funded nearly four-fifths of their future pension liabilities, and have done so in an undeniably challenging economic environment. In fact, GAO has found that public pensions as a whole are financially secure and positioned to meet their long-term obligations, and public pension stakeholders and decision makers continue to seek meaningful ways to improve funding and reporting.

Conclusion

In its most recent *Fiscal Survey of the States*,[5] the National Association of State Budget Officers found the 2010 fiscal year presented "the most difficult challenge for states' financial management since The Great Depression." States will likely face these and other challenges in 2011. However, it is during the most challenging times that leaders rise to the occasion.

Citizens can be optimistic that in 2011 states will find a way to balance the challenges they face, including increased desires for faster financial reporting, with the limited resources available to them. As the top state fiscal officers, NASACT members will continue working to develop solutions to meet the increasing demands being placed upon them. Achieving faster, cheaper and better financial reporting will not be easy; however, states have faced, and overcome, so-called impossible challenges before.

Notes

[1] *Fiscal Survey of the States*, National Association of State Budget Officers, Fall 2010.

[2] *Recovery Act: As Initial Implementation Unfolds in States and Localities, Continued Attention to Accountability Issues Is Essential*, GAO-09-631T, U.S. Government Accountability Office, April 2009.

[3] *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, Governmental Accounting Standards Board, June 1999.

[4] *Fiscal Survey of the States*, National Association of State Budget Officers, Fall 2010.

[5] Ibid.

About the Author

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