

STATE ADMINISTRATION
JANUARY 30, 1981
RM 436

The meeting of the House State Administration Committee was called to order by Chairman Jerry Feda at 8:00 a.m. on January 30, 1981. Representatives Azzara and O'Connell were absent and Representative Hanson was excused.

Chairman Feda opened the hearing on House Bill 314.

HOUSE BILL 314-SPONSOR, Representative Bud Gould, introduced this bill to the committee. House Bill 314 creates the Taxpayers' Lobbyist Disclosure Act of 1981 that prohibits a municipality from paying public funds to a lobbying organization unless authorized by a majority vote of the municipalities' electorate at a general election. A municipality may not increase its payments to the organization by more than 3% annually unless the increase is authorized by the city's voters during another general election.

PROPOSERS

There were no proposers to House Bill 314.

OPPOSERS

DAN MIEZNER, Montana League of Cities and Towns, arose in opposition to HB 314. Mr. Miezner explained the dues structure of the league to the committee. He said that 16 cents goes to the general fund, 2 cents per capita for the legislative fund (for travel expenses etc.) and 2 cents per capita goes to the budget fund. He said the dues are a minimum of \$100 and a maximum of \$9,000 based on population. He said that the league also does codification work and charges 10% of the cost. He said that the league is a public organization and anyone can come in and get information on the complete operation.

Chairman Feda opened the hearing to questions by the committee.

Representative Spilker asked Representative Gould if he thought the cities might drop out of the league and get their own people to lobby if this bill passed, therefore, costing the taxpayers more money.

Representative Gould said if the league is as good as Mr. Miezner says it is, why would they do that?

Representative Gould closed the hearing on House Bill 314.

HOUSE BILL 329-SPONSOR, Representative Kanduch, introduced HB 329 which revises the procedure for obtaining an economic impact statement requested by the Administrative Code Committee. It requires that the Committee must approve or object to an impact statement filed by the agency or disagree with the agency on the question of whether it is impossible to formulate an impact statement. If the Committee and the agency agree on a revised impact statement to replace a statement objected to by the Committee, the revised statement must be filed with the Secretary of State. If an agreement is not reached, the Committee shall notify the Governor who shall file with the Secretary of State and the Committee, a statement containing the impact statement and the Committee's objection. A copy of Representative Kanduch's testimony is attached and is EXHIBIT 1 of the minutes.

PROPONENTS

JOHN BRAUNBECK, Energy Service Co., spoke in favor of HB 329. He said that the consideration for economic entity has been lacking for some time.

GEORGE JOHNSTON, ASARCO, stated that he was in support of this bill and thought it would bring better relations between the Administrative Code Committee and the Governor's office. He said the Governor should welcome this bill.

DONALD JOHANSON, representing himself, stated that "there has to be an effective means of requiring at least some substantive content within the body of, and addressing the true impacts, both social and economic of any such proposal. We have little to lose and much to gain in this bill."

JANELLE FALLAN, Montana Chamber of Commerce, arose and stated their support for House Bill 329.

GARY LANGLEY, Western Engineering Trade Assoc. (WETA), stated they supported HB 329 because it requires more discipline of State Regulatory Agencies.

BILL HAND, Montana Mining Assoc. with office in Helena, stated that the economic impact statement should be part of the rule making process.

OPPONENTS

There were no opponents to House Bill 329.

Representative Kanduch closed the hearing on House Bill 329.

HOUSE BILL 372-SPONSOR, Representative Sales, introduced this bill requested by the Public Employees' Retirement Board. This bill provides a method for reviewing disability retirement benefits for six retirement systems. The board is authorized to: determine whether a member is disabled, require a recipient of a disability allowance to undergo medical examinations, cancel the allowance if a recipient refuses to submit to an examination or if he is no longer incapacitated, and reduce the allowance if a recipient is gainfully employed.

PROPOSERS

LARRY NACHSHEIM, P.E.R.S., gave written testimony in support of House Bill 372. A copy of his testimony is attached and is EXHIBIT 2 of the minutes.

OPPOSERS

WALT MILLER, Montana Highway Patrol, arose in opposition to HB 372. He said they had no problem with sections 4 and 5 of the bill but were strongly opposed to section 6. This section would limit the amount of income a recipient could earn without reduction of benefits. Mr. Miller said that they have members who receive benefits at the minimum rate (\$300) who earned \$275 dollars a year back then. If they were limited to making half that amount before having benefits reduced that would put their income at around \$450 a month and no one can live on that.

JIM DeBOER, Montana Assoc. State Game Wardens, opposed the bill for basically the same reasons as Mr. Miller. He said if this bill passes it would encourage disabled retirees' to become dishonest. They probably would not report their income if it meant losing benefits. He recommended that sections 3, 6, 9, 12, and 15, all dealing with disability allowance reduced by earnings, be removed from the bill.

JOHN SCULLY, representing the Sheriff and Peace Officers Assoc., concurred with other testimony and stated that in these fields which are highly skilled and risky positions it would be a mistake to withdraw disability retirement benefits. Mr. Scully also said that when

it states that the department may require a disabled police officer to return to work if he is able, it does not say whether that job is in the same field he was trained in. He could be put into a position he is not qualified for. Mr. Scully said that a disabled person should not be penalized for wanting to go back to work.

TOM SCHNEIDER, M.P.E.A., said there is a question as to who would be responsible to pay the medical examination fees if the board did not agree with the determination of the doctor. In section 2, it does not say who will pay the examination so one could assume it would be the patient. They may refuse to have the exam if they cannot afford it and then be subject to loss of benefits.

JACK WILLIAMS, Montana Police Assoc., concurred with other testimony. He said in this time of inflation it would not be fair to restrict them in their earnings.

GENE KIZER, Chief of Police, Billings, said he was concerned about young officers who have families. This would place a burden on him concerning the future of his family.

GORDEN HAGE, disabled, retired Highway Patrolman, stated that he was in opposition to this bill for all the reasons mentioned and stated that if this bill did pass there should be a cost-of-living adjustment built into the bill.

Chairman Feda opened the hearing to questions from the committee.

Representative Sales closed the hearing on House Bill 372.

HOUSE BILL 341-SPONSOR, Representative Bardanouve, introduced this bill at the request of the Department of Administration. This bill amends the Treasury Fund Structure Act by renaming and defining the funds within the state treasury. It also removes the sunset provision that was scheduled to eliminate the six university funds on June 30, 1981. Furthermore, the bill requires the Department to prepare legislation for the next session to amend all references affected by the proposed changes. Representative Bardanouve quoted facts from a booklet entitled "Analysis of Treasury Fund Structure Bill". A copy is attached and is EXHIBIT 3 of the minutes. Also attached is a informational guideline sheet for HB 341 which is EXHIBIT 4 of the minutes.

PROPOSERS HB 341

MORRIS BRUSETT, Department of Administration, stated that GAAP came about because New York City defaulted on some bonds a few years ago. He explained the accounting guidelines (known as generally accepted accounting principles (GAAP)). In 1980, the National Council on Governmental Accounting, which is the accounting standards setting body for states, issued GAAP which included a revised fund structure. He passed out a sheet that illustrated the differences between the present fund structure, established in 1963, and this new structure known as GAAP. A copy is attached and is EXHIBIT 5 of the minutes.

DAVE LEWIS, Department of Budget and Program Planning, testified in support of HB 341. He said that it is very important to establish a nationally accepted form of accounting with consistent and comprehensive information.

JIM GILLET, Acting Legislative Auditor, stated that this bill would provide that if the state was not in accordance with GAAP the public would be informed.

JACK NOBLE, Deputy Commissioner for Management and Fiscal Affairs, in behalf of the Commissioner of Higher Education and the Presidents of the six campuses of the Montana University Systems, presented testimony in support of House Bill 341. A copy of his written statement is attached and is EXHIBIT 6 of the minutes.

OPPOSERS

There were no opposers to House Bill 341.

Chairman Feda opened the hearing to questions from the committee.

Following brief discussion, Representative Bardanoue closed the hearing on House Bill 341. He said that there would not be a large fiscal impact but some additional software would be required costing approximately \$20,000.

HOUSE BILL 390-SPONSOR, Representative Winslow, stated that this bill permits a county governing body to designate any public building other than a jail or hospital as a polling place without cost to the county if no structural changes are necessary for the building to be used as a polling place. He said these buildings are provided and built by taxpayer dollars and should be available for the public to use as polling places. He said that in Yellowstone county one town had a problem because the school would not allow them to use the building and they ended up voting in a store that was willing to open to the public.

PROPOSERS

There were no proposers to HB 390.

OPPOSERS

There were no opposers to HB 390.

Chairman Feda opened for questions by the committee.

Representative Holiday said that in her district several jails are used as polling places.

Representative Winslow said jails and hospitals could be amended out of the bill.

EXECUTIVE SESSION

Representatives Azzara, O'Connell, Hanson and Kanduch were absent for executive session.

HOUSE BILL 314

DO NOT PASS

Representative Mueller moved that HB 314 DO NOT PASS. The motion was seconded by Representative Kropp. Following discussion, question being called and a vote taken. Motion carried 13 - 1. Representative Pistoria voted NO. Representative McBride abstained because she did not hear the testimony.

HOUSE BILL 341

DO PASS

Representative Mueller moved a DO PASS on HB 341. Representative Briggs seconded the motion. A vote was taken and carried unanimously.

EXECUTIVE SESSION (cont.)

HOUSE BILL 372

SUB-COMMITTEE

There was detailed discussion concerning sections 3, 6, 9, 12 and 16 of HB 372 which deal with disability allowance reduced by earnings.

Representative Spilker said that there should be some type of safeguard in the bill to prevent retirees' from taking advantage of the system.

The idea of a built in cost-of-living adjustment was discussed.

The committee as a whole seemed to agree that a disabled retiree should not be penalized for working.

Chairman Feda said that the bill would be put into a sub-committee and possibly some amendments could be worked out. He appointed Representatives Phillips, Ryan and Kennerly to the committee.

HOUSE BILL 390

DO PASS AS AMENDED

Representative Kropp made a motion to amend HB 390 to strike "except a jail or hospital" out of the title and on page 2 line 4 of the bill. A vote was taken and carried unanimously.

Representative Kropp moved a DO PASS AS AMENDED. The motion was seconded by Representative Mueller. A vote was taken and carried unanimously.

HOUSE BILL 291

DO NOT PASS

Representative Dussault was excused at this time.

Representative Smith moved a DO NOT PASS. The motion was seconded by Representative Phillips.

Representative Spilker said that there should be some protection for the state concerning how much money can be given out. Discussion followed.

A vote was taken on the motion and carried 13 - 1.
Representative Sales voted NO.

EXECUTIVE SESSION (cont.)

Representative Spilker said that the committee moved too fast on the action of HB 291. She said she felt the counties should be able to decide how to spend their money but there has to be some protection for the state.

Representative Mueller made a motion to reconsider the committee action on HB 291. A vote was taken and failed.

Representatives Spilker and Mueller said that they wanted to be recorded as opposing the DO NOT PASS motion.

The vote DO NOT PASS was changed from 13 - 1 to 11 - 3. Representatives Sales, Spilker and Mueller voting No.

Representative Sales, after studying the bill, made a motion that the committee introduce the bill requested by the Department of Community Affairs as a committee bill. A vote was taken and carried unanimously.

A motion was made and seconded to adjourn at 10:15 a.m.

Respectfully submitted,



G. C. "JERRY" FEDA, Chairman

Cathy Martin-Secretary

HOUSE BILL 329

By Kanduch, et al

The present law authorizes the Administrative Code Committee to obtain from any agency of state government a statement describing the economic impact of a rule or rule change proposed by the agency.

Unfortunately, the law giving this authority contains no requirements on the adequacy of this economic impact statement. All that is specified is that the statement, whatever it is, be published. Thus, under the present law, a request to the Department of Health for a statement on the economic impact of new air standards, could be simply answered, "No impact.", and this would be sufficient.

My bill imposes a mild degree of discipline on the agency providing the statement.

First, it gives the Administrative Code Committee the right to either accept or reject the statement. This, of course is absolutely essential.

If this statement is rejected as being inadequate, the Code Committee and the agency can get together within 20 days to see if they can't work out their differences.

If an agreement on the adequacy of the statement is reached everything is fine. But, if a disagreement continues, then the Code Committee may notify the Governor and he must provide the economic impact statement.

I am sure the practical effect of this bill will be to induce the agency to do what the law requires -- prepare an economic impact statement. I am also sure that this bill will not impose any serious burdens upon the Governor.

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EXHIBIT 2

Larry Macklin
PERD 1/30/81

H.B. 372

This bill is proposed primarily to provide a method for reviewing disability retirement benefits for the Judges', Highway Patrolmen's, Sheriffs', Game Wardens' and Municipal Police Officers' Retirement Systems.

The language found in H.B. 372, which is repeated several times, once for each of these systems, is basically the same language that is found in the Public Employees' Retirement Act. As part of this review, there is a salary limitation, based on the salary that the employee was receiving at the time they were disabled.

The Legislative Auditor has recommended that the Board review all disability retirement benefits. In the audit of the Retirement Division disability recipients were checked against the Employment Security Division records. They found one individual receiving a salary of \$26,000/year while receiving a 1/2-pay disability allowance. Another individual was receiving disability benefits in two retirement systems.

The purpose of this bill is not to deny disability retirement benefits or abrogate future retirement rights but rather to provide a method for a determination of continuing eligibility for a recipient of a disability retirement allowance. It also provides for reemployment upon recovery from a disability.

The salary limitation is not to discourage an individual from attempting to become employed but rather to encourage reemployment, if possible, by reducing or suspending the allowance during the period of gainful employment and allowing the resumption of the allowance if gainful employment cannot be continued.

Some recognition has been given to unique situations in the various retirement systems such as the Judges Retirement System, which is entirely elected officials. Quite obviously this system cannot have a provision whereby the individual returns to his previous employment. The same recognition is provided for elected officials under the Sheriffs' Retirement System.

The Highway Patrolmen's Retirement System has a provision that the benefits may not be cancelled until a vacancy occurs on the Highway Patrol for an individual whose disability benefits is subject to cancellation.

In the Municipal Police Officers' Retirement System the cities may request additional medical or psychological review for any retired officer the Board may determine no longer disabled and eligible for active police status.

③ AB 341

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EXHIBIT 3

ANALYSIS OF
TREASURY FUND STRUCTURE BILL

Prepared by
Department of Administration
Morris L. Brusett, Director

GAAP DEFINED

Generally Accepted Accounting Principles (GAAP) are accounting and reporting practices that derive authority from their general acceptance by the accounting profession. They have evolved from the experience and thinking of the profession, as represented by the American Institute of Certified Public Accountants (AICPA) and the National Council on Governmental Accounting (NCGA). Governmental Accounting, Auditing and Financial Reporting (GAAFR) was published in 1968 as the official pronouncement of the NCGA. It has gained widespread acceptance and acknowledgement as the primary authoritative statement on the application of GAAP to state and local governments. In March 1979, the NCGA issued Statement 1, GAAFR which restated the principles of 1968 GAAFR. This pronouncement has been endorsed by the AICPA in Statement of Position No. 80-2 Accounting and Financial Reporting by Governmental Units:

"...Since the (AICPA Industry Audit) Guide recognizes GAAFR, it is necessary to amend the guide to recognize Statement 1 as an authoritative modification of GAAFR... Accordingly, statements presented in accordance with Statement 1 are in conformity with generally accepted accounting principles..."

IMPORTANCE OF ADHERING TO GAAP

A. Montana must report in accordance with GAAP or be prepared to experience an adverse effect on the state rating for the sale of bonds. Standard and Poor, a private rating company, issued a Policy Statement in 1980 (Reference Exhibit 1) which states:

"All financial statements submitted to S&P, either in connection with a rating request for a bond sale or for a review, are expected to be prepared in accordance with Generally Accepted Accounting Principles (GAAP)... These statements should be independently audited, ...The audit should include the auditor's opinion, as well as comprehensive disclosure notes covering such items as ... any departures from GAAP which materially impact results,...In the absence of financial reports prepared in accordance with the aforementioned guidelines, S&P will specifically reflect such absence in its rating process as a *negative factor* and where the report is not timely or is substantially deficient in terms of reporting, *will not rate at all.*" (emphasis added)

An excerpt from The Daily Bond Buyer on May 7, 1980 (Exhibit 2) warns:

"Municipal bond issuers seeking ratings from Standard & Poor's Corp. should submit financial statements prepared in accordance with generally accepted accounting principles (GAAP), according to a new S&P's policy statement."

From Standard & Poor's *Perspective*, November 1980 (Exhibit 3), comes the following:

"This fall, S&P asked the research firm of Goldstein/Krall Marketing Resources Inc. to do a market survey on municipal accounting. Interviews were conducted among 200 underwriters, dealers, dealer banks, and institutional investors. Results show the market may already be imposing penalties in the form of higher interest costs where accounting and financial reporting are substandard. To assess the size of the penalty, S&P looked to one of its units which regularly prices about \$20 billion of tax-exempt bonds for investment trusts. Based on views obtained there, plus contact with underwriters and market makers who set interest costs on new issues, research shows penalties may average 0.125 to 0.25 percentage point."

During Fiscal Year 1980 Montana issued bonds for \$19,130,000. A penalty of 0.125 to 0.25 percentage points on the issue would amount to \$24,000 to \$48,000 in interest costs for one year or \$480,000 to \$960,000 over the average life of the bonds. It has been suggested that Montana enjoys the benefit of a Aaa rating on the bond market even though our rating by Standard & Poor is Aa. If this is the case, reporting in accordance with GAAP would protect that favorable interest rate.

Also from Standard & Poor's *Perspective*, November 1980:

"Of those polled by Goldstein/Krall on generally accepted accounting principles (GAAP) and the municipal bond market:

- Fifty-four percent (54%) said they think the marketplace now imposes interest rate penalties on issuers who don't conform to accounting and reporting standards. Seventy-six percent (76%) of them think the penalties will increase in the future.

- Seventy-eight percent (78%) said they think issuers who ignore GAAP will have a harder time selling general obligation bonds in the future."

The effect of Standard & Poor's Policy Statement on ratings has been felt by at least one large city and several states:

San Francisco

"Earlier this year, San Francisco's bond rating was withdrawn because of the lack of timely financial reporting." Standard & Poor's *Perspective*, November 1980.

Maryland

"Maryland, one of the first states to adopt GAAP, began in 1975. Last year, the project was operational. Did anyone notice? Officials in Annapolis say the bond market did. Last January, Maryland and a state with cash-basis accounting each sold more than \$100 million of AAA-rated bonds on consecutive days. Maryland's interest rate was 0.15 percentage point lower, equal to a \$600,000 saving, in part reflecting conversion to GAAP, said Maryland's Comptroller Louis V. Goldstein. The saving paid the cost of the new accounting system, plus independent audits for 1979 and 1980, according to a report to the legislature." Standard & Poor's *Perspective*, 1980(Exhibit 3)

From a News Release, Comptroller of the Treasury, Annapolis, Maryland, January 23, 1980 (Exhibit 4):

"The disclosure statement circulated in connection with this bond sale was the first issued by any state that contained the opinion of an independent nationally recognized firm of certified public accountants which has performed an audit of the State's financial records."

Massachusetts

The Wall Street Journal, May 21, 1980 (Exhibit 5) reported the effects of not complying with the standards specified by the rating agency.

"Taking a sharp swipe at Massachusetts' financial reporting standards and its financial condition, Standard & Poor's Corp. lowered its rating of the state's general obligation bonds to double-A-minus from double-A...S&P made good on its threat of two weeks ago to penalize bond ratings of state and local governments that fail to comply with more stringent accounting standards favored by the rating agency."

Oregon

The correlation between a reduced credit rating by national rating firms and higher interest costs on bonds issued was noted in the Oregon Stateman Journal, July 30, 1980 (Exhibit 6):

"The bonds carry a half-percent higher interest rate than tax-exempt municipal bonds issued nationally the past two months...Its credit rating has been reduced by national rating firms."

Nevada

The First Boston Corporation, Municipal Research Department, reporting on Debt Issuance Policies, Procedures, Performance and Recommendations reports that Nevada's 1977 bond rating improved favorably from A1 to Aa as a result of better financial reporting, which was the only change from the 1975 review. (Exhibit 7)

The effect of a lower rating on the bond market is becoming more noticable on the interest costs a state must pay for bond issues. Noncompliance with the required audited financial statements prepared in accordance with generally accepted accounting principles results in a higher rate of interest on bonds.

B. Federal reporting requirements for all grants and federal revenue sharing to state and local governments are specified in the Office of Management and Budget, Circular A-102, "Uniform Administrative Requirements for Grants-in-Aid to State and Local Governments." Attachment P (Exhibit 8)

"Audits will include, at a minimum, an examination...to determine whether:

a. There is effective control over and proper accounting for revenues, expenditures, assets, and liabilities.

b. The financial statements are presented fairly in accordance with generally accepted accounting principles.

The auditors comments on the financial statements should...Express an opinion as to whether the financial statements are fairly presented in accordance with generally accepted accounting principles."

Montana will receive adverse or qualified opinions year after year on the audit required for federal grants and revenue sharing, if the financial statements are not prepared in accordance with generally accepted accounting principles.

C. The recent financial failure of various municipal governments were not anticipated because the accounting and reporting principles in use were not adequate to disclose to taxpayers, managers, and legislators the impending failure. This problem has been addressed by the restated principles in Statement 1 and if generally accepted accounting principles are utilized, potential financial failures will be more readily disclosed, allowing time for corrective action.

TREASURY FUND STRUCTURE

To be in accordance with GAAP, Montana must now pass legislation to change its fund structure. Statement 1, NCGA designates the types of funds that should be used by state and local governments (Exhibit 9).

Discrepancies between the present SBAS fund structure definitions and Statement 1 definitions present the following problems:

1. Montana currently has nine funds. Statement 1 has eight (seven that apply to Montana).
2. Current definitions prevent relating a specific existing fund to a specific Statement 1 fund. Agency or department financial statements are now prepared by examining the use of each accounting entity and combining those related under the Statement 1 definition. It is not possible to prepare GAAP financial statements for all Montana without performing this analysis statewide.
3. Activity in an existing fund may properly belong in two Statement 1 funds. The following chart shows the overlap (i.e., the various locations where Montana's fund activity may fit into Statement 1's fund structure).

<u>Current Montana Funds</u>	<u>GAAP Funds</u>						<u>Trust and Agency</u>
	<u>General</u>	<u>Special Revenue</u>	<u>Debt Service</u>	<u>Capital Projects</u>	<u>Enterprise</u>	<u>Internal Service</u>	
-General	O						
-Earmarked	O	O					
-Sinking			O				
-Federal and Private Revenue	O	O					
-Federal and Private Grant Clearance	O	O					O
-Bond Proceeds			O				
-Revolving					O	O	
-Trust and Legacy							O
-Agency							O

To alleviate the stated problems the method of recording and reporting needs to be updated. The definitions of Montana's fund structure need to be changed to comply with GAAP. The names of Montana's funds should be changed to properly reflect the restructuring of the funds.

A description of the required changes follows:

<u>MCA Section</u>	<u>Change</u>
17-2-101.	Updates the language to conform to modern usage.
17-2-102.	Paragraphs 1 through 7 incorporate the wording of the recognized definitions for each fund in general government. This language is taken directly from Statement 1. Paragraphs 8 through 13 reflect the established fund structure for the university system. Paragraphs 14 and 15 incorporate the wording of the recognized definitions for each account group taken from Statement 1.
17-2-103.	Paragraph 3, the university accounting sunset provision is deleted.
17-2-107.	Incorporates new references to the existing statute.

Problems of the new Treasury Fund Structure to be overcome are loss of historical base, identification of federal funds, and cost.

1. Historical Base - Montana's budgets and financial reports contain comparisons between years. These comparisons are one of the tools used in budgeting and judging expenditure patterns. Some of the benefits of direct fund by fund comparisons will be attainable through the use of a matrix by the Office of Budget and Program Planning. Agency comparisons will be possible; fund comparisons will be more difficult.
2. Identification of Federal Funds - The Office of Budget and Program Planning has been assured by the Department of Administration that the structure can retain the federal fund identification, or it can be obtained by use of revenue object.

3. The direct cost of the change is estimated to be \$20,000. When looking at this consider the alternatives.
 - A. Reformatting existing SBAS is an annual recurring cost. It includes the necessary costs of ensuring consistency between years and agencies.
 - B. Maintaining two systems is costly and dual nomenclature becomes very cumbersome. A legislature that has to work with SBAS figures and also reports and financial statements prepared according to GAAP is compounding its problems.

MUNICIPAL ACCOUNTING AND FINANCIAL REPORTING

Standard & Poor's Policy Statement

An integral part of Standard & Poor's municipal rating process is the timely receipt and analysis of financial statements certified by independent certified public accountants, or appropriate state or local auditing agencies. With the 1979 Restatement of Governmental Accounting and Financial Reporting by the National Council on Governmental Accounting (NCGA), GAAFR for municipal purposes is recognized as GAAP, generally accepted accounting principles.

With the need for improved, timely and standardized financial accounting and reporting becoming increasingly evident to many of the participants in the municipal marketplace, including issuers, analysts, underwriters and investors, as well as the Congress and state legislatures, it is appropriate that S&P state its position on this subject.

Although S&P does not and cannot perform an audit function, S&P can and must take into account in its rating process the type and quality of reporting and accounting standards being used by the issuers under review.

All financial statements submitted to S&P, either in connection with a rating request for a bond sale or for a review, are expected to be prepared in accordance with Generally Accepted Accounting Principles (GAAP). Where legal requirements for recording transactions differ from GAAP, the accounting system employed should make provision for both, but in the preparation of general financial statements, GAAP must take precedence.

These statements should be independently audited, either by a certified public accounting firm, or by a qualified independent State or local agency, on a timely basis, i.e. no later than six months after the fiscal year-end. The audit should include the auditor's opinion, as well as comprehensive disclosure notes covering such items as a summary of significant accounting policies (fund accounting, encumbrances, reserves, investments, etc.), any departures from GAAP which materially impact results, status of pension plans, lease obligations if applicable, contingent liabilities (such as vacation and sick leave), and any pending litigation. Also, although not part of the audit itself, the auditor's management letter is an extremely useful document in that it may point out any weaknesses or deficiencies in financial and/or management controls. If such a management letter exists, it should be furnished to S&P; if none exists, a written statement to that effect should be furnished to S&P.

The standards of accounting employed refer to the point in time when revenues, expenditures/expenses, transfers and the relative assets and liabilities are recognized in the accounts and reported in the financial statements. They relate specifically to the timing of the measurements being made on either the cash or accrual method. Under the cash basis of accounting, revenues and transfers in are not recorded until cash is received, and expenditures or expenses and transfers out are recorded only when cash is disbursed.

Under the accrual basis of accounting, most transactions are recorded when they occur, regardless of when cash is received or disbursed. Items not practicably measurable until cash is received or disbursed are accounted for at that time in both commercial and governmental accounting, as may be items whose measurements would be approximately the same under either basis or which are immaterial.

The accrual basis is the superior method of accounting for the economic resources of any organization. It results in accounting measurements based on the substance of transactions and events, rather than merely when cash is received or disbursed, and thus enhances their relevance, objectivity, timeliness, completeness, and comparability. With this in mind, the use of the accrual basis to the fullest extent practicable in the government environment is preferred. The accrual basis is necessarily applied somewhat differently in the enterprise funds than in the general governmental funds where the modified accrual basis is used. However, the cash basis of accounting is not appropriate. The modified accrual basis has been extensively defined in the GAAFR Restatement with the above standards.

In the absence of financial reports prepared in accordance with the aforementioned guidelines, S&P will specifically reflect such absence in its rating process as a negative factor and where the report is not timely or is substantially deficient in terms of reporting, will not rate at all. Each issuer is expected to immediately furnish to S&P any material changes in, or additions to, any information contained in the aforementioned documents.

Where cash basis accounting is modified to account for liabilities and/or encumbrances, such modification will be considered by S&P and may serve to lessen the negative impact upon the financial reporting considerations in the rating process.

For additional information on how this policy may be implemented please contact Hyman Grossman (212) 248-2197 or Frank S. Rizzo (212) 248-2471, Vice Presidents of Municipal Bond Ratings.

November 26, 1980

Byron Klapper
Director
Special Fixed Income Research
(212) 248-2484

S&P's Requests Bond Issuers To Utilize GAAP Method

Municipal bond issuers seeking ratings from Standard & Poor's Corp. should submit financial statements prepared in accordance with generally accepted accounting principles (GAAP), according to a new S&P's policy statement.

Financial data that does not conform to the guidelines will be considered "a negative factor" in the bond rating process, S&P's said. States, cities or other government units will not be rated at all "where the report is not timely or is substantially deficient in terms of reporting," it added.

Among other S&P's guidelines:

- Financial statements should be independently audited, either by a certified public accounting firm or by a qualified state or local agency.

- Audits should be completed no later than six months after the end of the fiscal year.

- Audits should include the auditor's opinion, disclosure notes covering such items as a summary of significant accounting policies — fund accounting, encumbrances, reserves, investments, etc. — any departures from GAAP that have a material impact on results, status of pension plans, lease obligations if applicable, contingent liabilities such as vacation and sick leave, and any pending litigation.

- If an auditor's management letter exists, it should be furnished to S&P's. If none exists, a written statement to that effect should be furnished instead.

Under the 1979 Restatement of Governmental Accounting and Financial Reporting, GAAFR for municipal purposes is recognized as GAAP.

S&P's also said it prefers accrual accounting based on when transactions occur, rather than cash accounting, recorded when cash is received or spent.

"The accrual basis is the superior method of accounting for the economic resources of any organization," S&P's said. "It results in accounting measurements based on the substance of transactions and events ... and thus enhances their relevance, objectivity, timeliness, completeness and comparability."

S&P's said the cash basis of accounting is not appropriate, but added that if it is modified to account for liabilities and/or encumbrances, "such modification will be considered ... and may serve to lessen the negative impact upon the financial reporting considerations in the rating process."



Standard & Poor's

PERSPECTIVE

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WHO'S WATCHING THE BOOKS?

"The most critical deficiency in existing municipal securities practices is in the area of municipal accounting and financial reporting." From the Securities & Exchange Commission report on the City of New York, February 5, 1979.

Five years have passed since budgetary gimmicks led the nation's largest city to the brink of bankruptcy. Yet governmental accounting is still undergoing major structural change. Concepts and standards are under debate. Special interest groups vie for authority to make the rules. States and cities, worried over the specter of federal controls, attempt to police themselves, creating the perception of progress. Much still needs to be done. Says the SEC: "The market for municipal securities provides investors only limited protection compared with corporate, government or other types of issuers."

In the regulated corporate market, accounting must meet stringent standards. The unregulated market for municipal bonds has no effective way to enforce uniform rules of financial reporting. Investor protection depends on voluntary practices of states and each state makes its own rules.

While corporate bond investors may reasonably compare finances of one company with another, municipal accounting often leaves buyers in a quandary. Investors have become wary of general obligation bonds backed solely by a government's taxing power, while showing a preference for revenue bonds, with proven cash flows and more "business like" accounting. See chart on page 3.

In another development, the market may be penalizing issuers for deficiencies in financial reporting. Poor accounting may be costing taxpayers many millions of dollars in higher interest costs, according to research recently undertaken by Standard & Poor's.

Accounting Reforms

Recent attempts to improve accounting have produced results. Investors have access to more information. Financials include items previously omitted, like pension and sick leave liabilities and tax refunds owed but unpaid. Reports begin to reflect generally accepted accounting principles (GAAP) allowing comparison of bond issuers. Data is more reliable with the emergence of independent audits.

Efforts to improve the municipal market's credibility have drawn a dozen groups into a power play for ultimate rule-making supremacy. Driving them is the prospect of a take-over by Washington. Several bills linger in Congress for a federal agency to set reporting standards—which is anathema to state and local governments.

Equally abhorrent to some of them is a project to develop governmental accounting concepts by the Financial Accounting Standards Board, which makes rules for corporations and non-business entities. Many fear this could lead to domination by the FASB which allegedly lacks experience in the public sector.

As a compromise, a Governmental Accounting Standards Board has been proposed. This non-federal body would set standards and seek compliance under the aegis of state and local governments, the accounting profession, municipal securities dealers, and users of financial statements.

There is no shortage of existing accounting rules. The industry bible is Governmental Accounting, Auditing and Financial Reporting (GAAFR), written by the National Council of Governmental Accounting and published by the Municipal Finance Officers Association. Statement No. 1 restated GAAFR last year. An implementation of it soon will be released by MFOA. There's also the industry audit guide by the American Institute of Certified Public Accountants, pronouncements by FASB, state legal codes and academic texts.

S&P's Accounting Policy

A bond rating implies the existence of adequate information to make a credit judgment. While S&P does not and cannot perform an audit function, the quality of financial reporting and accounting has long been considered in analyzing applications for bond ratings.

S&P has rejected applications and lowered or withdrawn ratings where reporting was inadequate. Last spring, that practice was formalized with publication of an S&P statement on municipal accounting and financial reporting. (See back page.) Accounting is one of many factors to be evaluated in the rating process on a case-by-case basis. The policy requests that financials:

- Conform to generally accepted accounting principles
- Be independently audited within six months of the fiscal year end
- Be stated on a modified accrual, rather than cash basis, so that revenues are reported when they become measurable and available to pay expenses
- Contain an auditor's opinion and disclosure notes, and cite any variance from GAAP which impact the results.

A cash-basis system shows revenues and expenditures only when cash is received or spent. Since many transactions may go unreported until payments are made, a cash system may not accurately represent a government's true financial condition.

Earlier this year, San Francisco's bond rating was withdrawn because of the lack of timely financial reporting. Bonds may be downgraded because of poor accounting plus deteriorating fiscal or economic factors, as with Massachusetts last May, and Toledo, Ohio, in June. Elsewhere, reporting weaknesses may be cited while bond ratings are maintained, as with New York State and Puerto Rico this year. Both say they are converting to GAAP.

As each issuer applies for a bond rating, compliance with S&P's accounting policy is evaluated and entered into a data bank. Ultimately, a substantial body of information will be available through this source.

S&P currently has a project team studying the question of whether S&P should simply withdraw from the business of rating issuers that utilize cash-basis accounting.

Market Penalties

This fall, S&P asked the research firm of Goldstein/Krall Marketing Resources Inc. to do a market survey on municipal accounting. Interviews were conducted among 200

underwriters, dealers, dealer banks, and institutional investors. Results show the market may already be imposing penalties in the form of higher interest costs where accounting and financial reporting are substandard.

To assess the size of the penalty, S&P looked to one of its units which regularly prices about \$20 billion of tax-exempt bonds for investment trusts. Based on views obtained there, plus contact with underwriters and market makers who set interest costs on new issues, research shows penalties may average 0.125 to 0.25 percentage point.

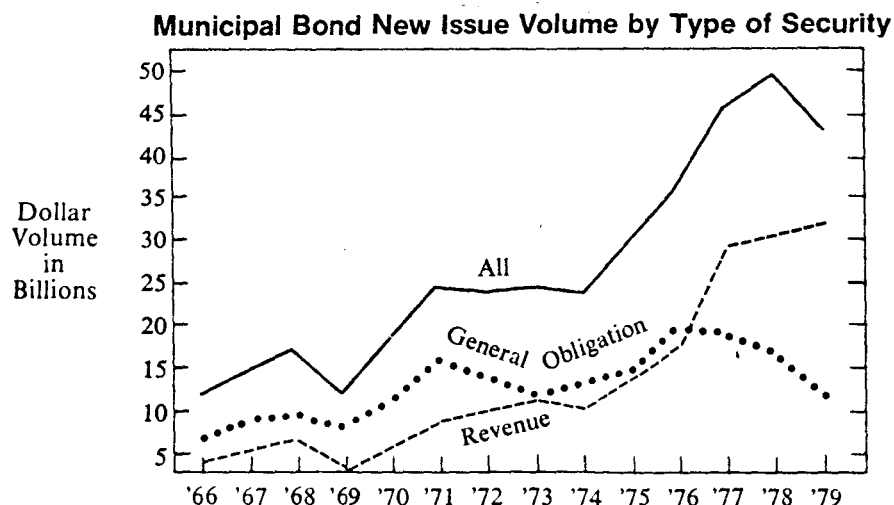
On a typical \$100 million issue of bonds with a 10-year average life, that equals a penalty of \$1,250,000 to \$2,500,000 over the issue's average life. The market for new general obligation bonds totals about \$12 billion annually. Based on estimates that half of them don't comply with GAAP, taxpayers could be penalized from \$75 million to \$150 million over a 10-year average life of the bonds. This penalty would be repeated annually as more new bonds are issued in future years.

Of those polled by Goldstein/Krall on generally accepted accounting principles (GAAP) and the municipal bond market:

- Fifty-four percent (54%) said they think the marketplace now imposes interest rate penalties on issuers who don't conform to accounting and reporting standards. Seventy-six percent (76%) of them think the penalties will increase in the future
- Seventy-eight percent (78%) said they think issuers who ignore GAAP will have a harder time selling general obligation bonds in the future
- Sixty-five percent (65%) said they think the market feels less comfortable now with general obligation bonds than five years ago
- Ninety-five percent (95%) said in their opinion municipal accounting standards are important. Eighty-nine percent (89%) said they feel accounting practices as a bond rating consideration is "desirable."

The research also found critics among those interviewed. Among sample comments:

- Municipal issuers may not decide to change accounting procedures for the sole purpose of getting an S&P rating
- The accounting profession is trying to impose corporate standards on governments
- It is not S&P's responsibility to make rules but to analyze what is given to them
- So long as municipalities can get bids on bonds, they won't do more than they have to.



General obligation bonds have declined in recent years as a percent of total tax-exempt issues. Source: Public Securities Association.

States Move to GAAP

Many states are taking the initiative in moving to GAAP. New York State Comptroller Edward V. Regan in a September memo to Governor Hugh Carey, said activities of his office are "moving the State from an archaic checkbook, or cash basis, for running government to a system conforming with generally accepted accounting principles." The conversion is expected to take several years.

Similarly, Puerto Rico has begun to convert a cash system to modified accrual as a more accurate measure of its fiscal condition. Under its timetable, the Commonwealth will have in place:

- A computerized general ledger by fiscal 1981
- An accounts payable and encumbrance system by fiscal 1982
- Procedures to account for fixed assets by fiscal 1983
- Final implementation of its central government accounting system by fiscal 1984.

Maryland, one of the first states to adopt GAAP, began in 1975. Last year, the project was operational. Did anyone notice? Officials in Annapolis say the bond market did. Last January, Maryland and a state with cash-basis accounting each sold more than \$100 million of AAA-rated bonds on consecutive days. Maryland's interest rate was 0.15 percentage point lower, equal to a \$600,000 saving, in part reflecting conversion to GAAP, said Maryland's Comptroller Louis V. Goldstein. The saving paid the cost of the new accounting system, plus independent audits for 1979 and 1980, according to a report to the legislature.

Under GAAP, Maryland's financials now show all revenues when measurable and available instead of when cash is received, and all expenditures when the liability is incurred rather than when the payment is made. Also reported are contractual obligations incurred, and all other liabilities which exist at the close of the fiscal year. Omission of any of these could cloud the state's true fiscal condition. Under the cash-basis system used prior to 1979, for example, about \$150 million of unpaid liabilities or uncollected receivables may have gone unreported.

New York City

Events have a way of coming full circle. New York City, where it all started, now wants back into the bond market. Mayor Edward Koch told a Wall Street group last month: "New York has eliminated all budgetary and accounting abuses that characterized its practices prior to 1975."

Recently, the City unveiled its integrated financial management system. Called IFMS, it centralizes budgeting, accounting, purchasing, and payroll in a single database computer network. "It's among the most sophisticated financial control systems of any government entity in the United States," says the mayor. From IFMS comes detailed monthly reports tracking \$13.5 billion of annual revenues and expenditures within 30 days of the close of each month.

Previously considered unauditable, the city is now audited by a "Big Eight" accounting firm. That data is being examined by S&P as part of a request by the city to have its suspended rating reviewed relative to New York City's proposed re-entry into the bond market.

Independent Audits

If New York City can bring order out of its chaos, can any governmental unit credibly claim an inability to comply with accounting and auditing standards?

An indicator of local government compliance is the U.S. Comptroller General's report to Congress last May. To qualify for \$25,000 or more under federal revenue sharing, 11,000 governments are asked for independent audits every three years. (Congress may amend that to annually.) Of the total reports submitted 63% met audit requirements, 26% partially complied, and about 11% were unacceptable.

At the state level the Council of State Governments is developing accounting practices for states under a National Science Foundation grant. Its survey of 50 states shows most of them audit agencies and departments. Few audit the entire state. That's as though General Motors Corp. had its divisions audited but not the parent company. Among states polled only 20 said they did annual audits. Others said audits were done every two, three or four-years, or were vague as to frequency and scope.

The credibility of an audit depends on the auditor's independence. Questions arise when audits are performed by the person who also keeps accounting records or who serves at the will of a governor or mayor. An auditor is considered independent if he:

- Is elected to a term of office
- Is appointed by a chief executive but reports to the legislature or city council which confirms the appointment
- Is named by the legislature or city council to whom he reports
- Is a state official auditing local government
- Is an outside auditor who is a certified public accountant.

Opinion and Comment

"General obligation bonds are suffering from an erosion in confidence—a credibility gap," said Brenton W. Harries, president of S&P, at a meeting of state auditors, comptrollers and treasurers. Can the trend be reversed?

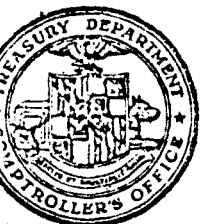
There's been a structural change in the municipal bond market and in the way investors look at debt backed by an issuer's "full faith and credit." Investors believed what they read in a state constitution that general obligation meant the issuer would raise taxes in whatever amount necessary in the event of default. With such assurances, there was little interest in financial statements, full disclosure, or independent audits. The experience of New York City and Cleveland shattered those illusions.

A general obligation pledge is not a key to unlock a city's assets. Nor can investors rely on interpretations of passages in a state constitution, which through legal maneuvers may be put aside under a state's police powers to protect the health, welfare, and safety of its citizens. The antidote to moratoriums is fiscal discipline scrutinized under full disclosure, standardized accounting and timely auditing. From what we see at S&P, the message is getting across. But it is a slow, agonizing process, muddled in politics, legalities, and the desire of states to reject any tampering with sovereign rights and powers.

Because of their considerable political clout, governments may be able to forestall a federal legislative solution to this problem. However, they cannot defeat the forces at work in the financial markets. Investors have too many other bond issues to choose from, and may continue to penalize general obligation issuers using archaic accounting systems. "This decade will require accounting and financial reporting be brought up to snuff," said Mr. Harries. "Cash-basis accounting may well be the dinosaur of the 1980s."

LOUIS L. GOLDSTEIN
COMPTROLLER

STATE OF MARYLAND



News from

COMPTROLLER OF THE TREASURY

ANNAPOLIS, MARYLAND 21401

FOR IMMEDIATE RELEASE
JANUARY 23, 1980

A-9

MARYLAND BOND ISSUE BRINGS LOW INTEREST BID OF 6.19%

The Maryland Board of Public Works, consisting of Governor Harry Hughes, State Comptroller Louis L. Goldstein, and State Treasurer William S. James today sold \$117,310,000 in Triple A rated general obligation bonds for an exceptionally low interest bid of 6.191332%. The low bid was submitted by First Boston Corporation and Associates. Maryland National Bank is the local bank.

A total of 3 bids were submitted at the sale, the first general obligation bond sale held by the State of Maryland since June, 1978.

"This kind of an interest rate is very favorable in light of the current high prime interest rates," Mr. Goldstein said. "It is further evidence of the confidence in Maryland's economy and financial management. The disclosure statement circulated in connection with this bond sale was the first issued by any state that contained the opinion of an independent nationally recognized firm of certified public accountants which has performed an audit of the State's financial records. This factor, combined with Maryland's program to control the amount of bonds being issued and the pension reform helped us to retain the Triple A rating."

Mr. Goldstein observed that the cost of the two years of audits which are being performed by the independent CPA firm was more than recovered in the spread between the interest costs of the 3 bids submitted, and bids submitted to other AAA states.

The Comptroller noted that the other two Triple A rated states which have sold bonds since January 1, 1980 will have to pay substantially higher interest rates. Illinois received a low interest bid of 6.61% and Minnesota received a 6.34% bid.

Governor Hughes remarked that he was elated with the interest rate and noted the importance of the cooperation of the General Assembly in holding down bond authorizations.

Of the \$117,310,000, a total of \$44,000,000 will be used for general state construction, \$48,210,000 for public school construction, and \$25,100,000 for other purposes.

A low interest rate is important because it helps to keep the state property tax rate low. All revenue from the state property tax is used to help pay the principal and interest costs of Maryland's general obligation bonds.

#

CONTACT: Marvin A. Bond

Public Information Office

269-3885

Standard & Poor's Hits Massachusetts' Financial Reporting

* * *

Agency Lowers Bond Ratings,
Says Accounting Standards
Are 'Among the Poorest'

May 21, 1940

By a WALL STREET JOURNAL Staff Reporter

NEW YORK—Taking a sharp swipe at Massachusetts' financial reporting standards and its financial condition, Standard & Poor's Corp. lowered its rating of the state's general obligation bonds to double-A-minus from double-A.

Labeling Massachusetts' financial reporting as "among the poorest" of the states it rates, S&P made good on its threat of two weeks ago to penalize bond ratings of state and local governments that fail to comply with more stringent accounting standards favored by the rating agency.

The statement also cited the "deteriorating financial condition of the state and an economy which, while showing some improvement, still lags the nation and the region."

Massachusetts is scheduled to seek bids today on \$76 million of serial bonds maturing from 1981 to 2000.

Specifically, the statement said Massachusetts didn't meet S&P's policy guidelines on financial reporting which favor accrual accounting. Massachusetts employs a "modified cash" system of accounting.

This method permits Massachusetts to avoid showing on its books spending items for which funds currently aren't available "until funds become available to meet that liability." In addition, the timeliness of Massachusetts' financial reporting is "sub-standard," the rating agency said.

Also lowered to double-A-minus from double-A ratings were the bonds of six state-related agencies.

Outside studies on the Massachusetts economy that show the state will weather the recession handily "evidently aren't convincing to S&P," Robert R. McClain, undersecretary of finance and administration, said in Boston. "We don't think our economy is deteriorating," he said. "This state is going to end up in the black this year."

Mr. McClain said the question over accounting procedure is "an ongoing controversy." For example, he said, the state classifies unpaid taxes as money owed rather than income. He added that the state's "modified cash" system is "more conservative and it protects the taxpayer."

On S&P's comments that Massachusetts' reporting system is "among the poorest in the states it rates," Mr. McClain said, "I have asked which states they rate because we think we do a very good job of reporting."

OREGON STATESMAN - Journal 7-30-80

Bond costs rise half percent

A syndicate of Citibank and Bank of America, represented in Oregon by U.S. National Bank of Oregon, purchased \$40 million in bonds offered yesterday by the state Department of Environmental Quality.

Interest cost to the state will be 8.0432 percent over the 21-year life of the bonds. The interest is tax-exempt.

A syndicate including Chase Manhattan Bank, represented in Oregon by The Oregon Bank, submitted a lower bid — 8.0121 percent. But that offer was thrown out by bond counsel Howard Rankin because the bid form was improperly filled out, said Jim Swenson, a spokesman for DEQ.

The bonds carry a half-percent higher interest rate than tax-exempt municipal bonds issued nationally the past two months. The higher price was expected, said Diane Hopper, municipal bond division research analyst for the state treasurer.

She said Oregon bonds have declined in appeal, especially to eastern bond buying institutions, for three reasons: The state faces a \$204 million deficit. Its credit rating was been reduced by national rating firms. And the eastern perception is that Mount St. Helens' eruption had an adverse overall effect on the area.

Turn to BONDS, Page 13A.

Bonds . . .

Continued from Page 1A.

Swenson said bids submitted yesterday's were better than DEQ officials had expected. And he said it was gratifying that three major syndicates submitted bids. The third was Continental of Illinois, represented by First National Bank of Oregon, which bid 8.3547.

DEQ will use the \$40 million bond proceeds to purchase bonds sold by small Oregon municipalities for pollution control, landfills, sewage systems and other projects. The state buys the bonds at a lower interest cost than would be charged by a private investor or a bank, Swenson said.

DEQ also awards grants and loans from its available funds.

Outstanding pollution bonds are limited to \$160 million. The \$40 million sale yesterday brought the total to \$139 million.

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NEW YORK, N.Y. 10005

3. NEVADA

From A to A1

September 26, 1975

Debt factors were deemed most important in this up-grading. Debt service is consistently low, and borrowing is infrequent. Wealth indicators are high, although the wealth lacks diversification. Financial reports, however, have been poor.

From A1 to Aa

June 2, 1977

The only change over the 1975 review is improvement of financial reporting.

Financial Conditions and Practices

States that experienced downgradings in general obligations typically ran deficits in their operating budgets and/or experienced cash flow problems. The use, or overuse, of revenue anticipation financing was mentioned several times as a cause to downgrade. Secondly, the use of budgeting "gimickery" to delay hard political decisions was also mentioned more than once.

Most of the specific factors used to justify upgradings were ideosyncratic to the state. For example, Nevada, while an A1, improved its financial reporting and was upgraded to Aa. In the case of Louisiana, the upgrading was due to state constitutional changes. Other elements of upgrading were "economic expansion", or such "non-negatives" as "infrequent borrowing".

Monday
October 22, 1979

Part V

**Office of
Management and
Budget**

Circular A-102; Uniform Administrative
Requirements for Grants-in-Aid to State
and Local Governments

**OFFICE OF MANAGEMENT AND
BUDGET**

**Circular A-102, "Uniform
Administrative Requirements for
Grants-in-Aid to State and Local
Governments"**

AGENCY: Office of Management and
Budget.

ACTION: Final Policy.

SUMMARY: This notice revises OMB Circular A-102 by replacing paragraph 2h, Attachment G, with a new Attachment P entitled, "Audit Requirements." The revision originated from a Presidential initiative to streamline Federal aid, and is another part of OMB's system of guidance for federally assisted programs.

One area the President highlighted as having a substantial need for improvement was audit of federally assisted programs. He directed Federal departments and agencies to improve audit coordination, and to increase their reliance on audits made by State or local governments. This revision sets forth the audit requirements for State and local governments and Indian tribal governments receiving Federal assistance. It provides for independent audits of financial operations including compliance with certain provisions of Federal law and regulation. The requirements are established to insure that audits are made on an organization-wide basis rather than a grant-by-grant basis.

EFFECTIVE DATE: This revision becomes effective October 22, 1979.

FOR FURTHER INFORMATION CONTACT:

John J. Lordan, Chief, Financial Management Branch, Office of Management of Budget, Washington, D.C. 20503, (202) 395-6823.

SUPPLEMENTARY INFORMATION: On July 11, 1979, a notice was published in the *Federal Register* (44 FR 40624-25) to amend Circular A-102. Interested persons were invited to submit written comments by September 11, 1979. About fifty comments were received from Federal agencies, State and local governments, professional associations, and others. The comments were considered in developing these final regulations. Although almost all commenters agreed with the concept of a single audit, some raised questions or made suggestions for clarifying changes. The more significant comments received, and OMB's responses to them are discussed below.

Changes in Final Regulation

Set forth below are changes that have been adopted in the final regulations. The paragraphs are keyed to the proposed regulations published on July 11, 1979.

1. Paragraph 1 has been amended to make the Attachment applicable to Indian tribal governments. This paragraph was also changed to make it clear that one of the objectives of the audit was to determine if financial reports to the Federal Government contain accurate and reliable data.

2. Paragraph 2. The definition of "cognizant agency" was added to this paragraph, and is now used uniformly throughout the Attachment.

3. Paragraph 3 was amended to provide that contracts awarded by recipients for audit services shall include a reference to this Attachment. Also, the paragraph was further divided into two separate paragraphs for clarity.

4. Paragraph 5. A clause was added to make it clear that the auditor should make a determination that the financial statements are presented fairly and in accordance with generally accepted accounting principles.

5. Paragraph 7. The phrase "at scheduled intervals" was deleted for clarity.

6. Paragraph 8 was changed to make it clear that, in the event irregularities are found, management officials above the level of involvement should be notified.

7. Paragraph 9 was restructured and reworded to clarify its intent. Also, a change was made to make it clear that auditors need express a positive assurance only with respect to items tested.

8. Paragraph 10 was amended to require cognizant agencies to notify auditors in writing when the three-year retention period for workpapers needs to be extended.

9. Paragraph 13. A sentence was added to make it clear that auditors are responsible for distributing audit reports to their program officials.

10. Paragraph 14. Changes were made to make it clear that this paragraph covered only State and local governments and Indian tribal governments. Also, the recipient's responsibilities with respect to subrecipient audits are more clearly delineated.

**Suggested Changes Not Considered
Necessary**

Comment. Several commenters felt that there were conflicts between Attachment P and audit guidelines issued by the General Accounting Office.

Response. The GAO guidelines are currently being reviewed to assure consistence of policy.

Comment. Several commenters were concerned with the provisions of the Attachment requiring comments on the accuracy of financial reports. This requirement, they said, would require the examination of every transaction processed by a governmental entity.

Response. It was never intended that a hundred per cent examination would be routinely required. We believe this is clear from other provisions of the Attachment.

Comment. One commenter said it was not clear whether an auditor should automatically expand the scope of audit and secure additional data to support the disclosure of irregularities in the audit report.

Response. The Attachment does not provide for automatically expanding the scope of audit work. This is a matter that would have to be worked out between the auditor, the cognizant agency, and the recipient.

Comment. Several commenters recommended that the Attachment contain a definition of the term "independent."

Response. The Attachment incorporates by reference the *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions* published by the General Accounting Office. Chapter 3 of these standards discusses the standard of independence in some detail.

Comment. Several commenters said that additional audit costs would be incurred to achieve full compliance with the Circular. They suggested that the mechanism for funding these audits be addressed in the Attachment.

Response. Circular 74-4, "Cost principles for grants to State and local governments," establishes rules for determining allowable costs. This Circular provides that the cost of audits is allowable.

Comment. One commenter suggested that each grant application should contain a certification that arrangements will be made for the audits prescribed by the Circular. Failure to furnish an acceptable audit as determined by the cognizant agency could be a basis for denial of Federal funds.

Response. The grant application forms prescribed by Circular A-102 now contain an assurance that the applicant will comply with all the provisions of the Circular. We do not believe it is necessary to single out the audit requirements for a separate certification.

Comment. One commenter said the Attachment requires an audit every two years, and asked whether that meant

that only every other year's transactions should be audited.

Response. It is the intent of the Circular that audits cover the period since the previous audit. If this is a two-year period, the audit should cover both years.

James T. McIntyre, Jr.,
Director.

Circular A-102

Attachment P—Audit Requirements

1. This Attachment establishes audit requirements for State and local governments, and Indian tribal governments that receive Federal assistance. It provides for independent audits of financial operations, including compliance with certain provisions of Federal law and regulation. The requirements are established to insure that audits are made on an organization-wide basis, rather than on a grant-by-grant basis. Such audits are to determine whether (a) financial operations are conducted properly, (b) the financial statements are presented fairly, (c) the organization has complied with laws and regulations affecting the expenditure of Federal funds, (d) internal procedures have been established to meet the objectives of federally assisted programs, and (e) financial reports to the Federal Government contain accurate and reliable information. Except where specifically required by law, no additional requirements for audit will be imposed unless approved by the Office of Management and Budget.

2. Definitions: "Cognizant agency" means the Federal agency that is assigned audit responsibility for a particular recipient organization by the Office of Management and Budget.

"Recipient organization" means a State department, a local government, an Indian tribal government, or a subdivision of such entities, that receives Federal assistance. It does not include State and local institutions of higher education or hospitals, which are covered by Circular A-110.

3. State and local governments and Indian tribal governments shall use their own procedures to arrange for independent audits, and to prescribe the scope of audits, provided that the audits comply with the requirements set forth below. Where contracts are awarded for audit services, the contracts shall include a reference to this Attachment.

4. The provisions of this Attachment do not limit the authority of Federal agencies to make audits of recipient organizations. However, if independent audits arranged for by recipients meet the requirements prescribed below, all

Federal agencies shall rely on them, and any additional audit work shall build upon the work already done.

5. Audits shall be made in accordance with the General Accounting Office *Standards for Audit of Governmental Organizations, Programs, Activities & Functions*, the *Guidelines for Financial and Compliance Audits of Federally Assisted Programs*, any compliance supplements approved by OMB, and generally accepted auditing standards established by the American Institute of Certified Public Accountants.

6. Audits will include, at a minimum, an examination of the systems of internal control, systems established to ensure compliance with laws and regulations affecting the expenditure of Federal funds, financial transactions and accounts, and financial statements and reports of recipient organizations.

These examinations are to determine whether:

a. There is effective control over and proper accounting for revenues, expenditures, assets, and liabilities.

b. The financial statements are presented fairly in accordance with generally accepted accounting principles.

c. The Federal financial reports (including Financial Status Reports, Cash Reports, and claims for advances and reimbursements) contain accurate and reliable financial data; and are presented in accordance with the terms of applicable agreements, and in accordance with Attachment H of this Circular.

d. Federal funds are being expended in accordance with the terms of applicable agreements and those provisions of Federal law or regulations that could have a material effect on the financial statements or on the awards tested.

7. In order to accomplish the purposes set forth above, a representative number of charges to Federal awards shall be tested. The test shall be representative of (1) the universe of Federal awards received, and (2) all cost categories that materially affect the award. The test is to determine whether the charges:

a. Are necessary and reasonable for the proper administration of the program.

b. Conform to any limitations or exclusions in the award.

c. Were given consistent accounting treatment and applied uniformly to both federally assisted and other activities of the recipient.

d. Were net of applicable credits.

e. Did not include costs properly chargeable to other federally assisted programs.

f. Were properly recorded (i.e., correct amount, date) and supported by source documentation.

g. Were approved in advance, if subject to prior approval in accordance with Circular 74-4.

h. Were incurred in accordance with competitive purchasing procedures, if covered by Attachment O of this Circular.

i. Were allocated equitably to benefiting activities, including non-Federal activities.

8. Audits usually will be made annually, but not less frequently than every two years.

9. If the auditor becomes aware of irregularities in the recipient organization, the auditor shall promptly notify the cognizant agency and recipient management officials above the level of involvement. Irregularities include such matters as conflicts of interest, falsification of records or reports, and misappropriation of funds or other assets.

10. The audit report shall include:

a. Financial statements, including footnotes, of the recipient organization.

b. The auditors' comments on the financial statements which should:

(1) Identify the statements examined, and the period covered.

(2) Identify the various programs under which the organization received Federal funds, and the amount of the awards received.

(3) State that the audit was done in accordance with the standards in paragraph 5.

(4) Express an opinion as to whether the financial statements are fairly presented in accordance with generally accepted accounting principles. If an unqualified opinion cannot be expressed, state the nature of the qualification.

c. The auditors' comments on compliance and internal control which should:

(1) Include comments on weaknesses in and noncompliance with the systems of internal control, separately identifying material weaknesses.

(2) Identify the nature and impact of any noted instances of noncompliance with the terms of agreements and those provisions of Federal law or regulations that could have a material effect on the financial statements and reports.

(3) Contain an expression of positive assurance with respect to compliance with requirements for tested items, and negative assurance for untested items.

d. Comments on the accuracy and completeness of financial reports and claims for advances or reimbursement to Federal agencies.

e. Comments on corrective action taken or planned by the recipient.

11. Work papers and reports shall be retained for a minimum of three years from the date of the audit report unless the auditor is notified in writing by the cognizant agency of the need to extend the retention period. The audit workpapers shall be made available upon request to the cognizant agency or its designees and the General Accounting Office or its designees.

12. The Office of Management and Budget will work with Federal agencies and State and local governments to assure that recipient audits are made in accordance with the standards set forth in paragraph 5.

13. The Office of Management and Budget will designate cognizant agencies for major recipient organizations.

14. The cognizant agency shall have the following responsibilities:

a. Obtain or make quality assessment reviews of the work of non-Federal audit organizations, and provide the results to other interested audit agencies. (If a non-Federal audit organization is responsible for audits of recipients that have different cognizant audit agencies, a single quality assessment review should be arranged.)

b. Assure that all audit reports of recipients that affect federally assisted programs are received, reviewed, and distributed to appropriate Federal audit officials. These officials will be responsible for distributing audit reports to their program officials.

c. Whenever significant inadequacies in an audit are disclosed, the recipient organization will be advised and the auditor will be called upon to take corrective action. If corrective action is not taken, the cognizant agency shall notify the recipient organization and Federal awarding agencies of the facts and its recommendation. Major inadequacies or repetitive substandard performance of independent auditors shall be referred to appropriate professional bodies.

d. Assure that satisfactory audit coverage is provided in a timely manner and in accordance with the provisions of this attachment.

e. Provide technical advice and act as a liaison between Federal agencies, independent auditors, and recipient organizations.

f. Maintain a followup system on audit findings and investigative matters to assure that audit findings are resolved.

g. Inform other affected audit agencies of irregularities uncovered. The audit agencies, in turn, shall inform all appropriate officials in their agencies. State or local government law

enforcement and prosecuting authorities shall also be informed of irregularities within their jurisdiction.

15. Recipients shall require subrecipients that are State and local governments or Indian tribal governments to adopt the requirements in paragraph 1. through 11. above. The recipient shall ensure that the subrecipient audit reports are received as required, and shall submit the reports to the cognizant agency. The cognizant agency will have the responsibility for these reports described in paragraph 14.

[FR Doc. 79-32579 Filed 10-19-79; 8:45 am]

BILLING CODE 3110-01-M

Summary Statement Of The Principles

ACCOUNTING AND REPORTING CAPABILITIES

1. A governmental accounting system must make it possible both: (a) to present fairly and with full disclosure the financial position and results of financial operations of the funds and account groups of the governmental unit in conformity with generally accepted accounting principles; and (b) to determine and demonstrate compliance with finance-related legal and contractual provisions.

FUND ACCOUNTING SYSTEMS

2. Governmental accounting systems should be organized and operated on a fund basis. A fund is defined as a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.

TYPES OF FUNDS

3. The following types of funds should be used by state and local governments:

Governmental Funds

- (1) *The General Fund* — to account for all financial resources except those required to be accounted for in another fund.
- (2) *Special Revenue Funds* — to account for the proceeds of specific revenue sources (other than special assessments, expendable trusts, or for major capital projects) that are legally restricted to expenditure for specified purposes.
- (3) *Capital Projects Funds* — to account for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds, Special Assessment Funds, and Trust Funds).
- (4) *Debt Service Funds* — to account for the accumulation of resources for, and the payment of, general long-term debt principal and interest.

- (5) *Special Assessment Funds* — to account for the financing of public improvements or services deemed to benefit the properties against which special assessments are levied.

Proprietary Funds

- (6) *Enterprise Funds* — to account for operations (a) that are financed and operated in a manner similar to private business enterprises — where the intent of the governing body is that the costs (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges; or (b) where the governing body has decided that periodic determination of revenues earned, expenses incurred, and/or net income is appropriate for capital maintenance, public policy, management control, accountability, or other purposes.
- (7) *Internal Service Funds* — to account for the financing of goods or services provided by one department or agency to other departments or agencies of the governmental unit, or to other governmental units, on a cost-reimbursement basis.

Fiduciary Funds

- (8) *Trust and Agency Funds* — to account for assets held by a governmental unit in a trustee capacity or as an agent for individuals, private organizations, other governmental units, and/or other funds. These include (a) Expendable Trust Funds, (b) Nonexpendable Trust Funds, (c) Pension Trust Funds, and (d) Agency Funds.

NUMBER OF FUNDS

4. Governmental units should establish and maintain those funds required by law and sound financial administration. Only the minimum number of funds consistent with legal and operating requirements should be established, however, since unnecessary funds result in inflexibility, undue complexity, and inefficient financial administration.

HB 341

1. Page 1 Lines 22-24

-Merely provides better description of financial reporting.

2. Pages 2-5

-Deletes the present fund structure and inserts the new fund structure.
-This is the main thrust of the bill.

-The present fund structure was established in 1963 based on a Legislative Council Study with assistance from a university professor.

-In 1980, the National Council on Governmental Accounting, which is the accounting standards setting body for states, issued new accounting guidelines (known as generally accepted accounting principles(GAAP)) for states, which included a revised fund structure.

-A handout is provided to illustrate the differences.

-Montana must prepare its annual financial report in accordance with the revised fund structure (GAAP) or be prepared to experience an adverse effect on the state rating for the sale of bonds. Standard and Poor, a private rating company, issued a Policy Statement in 1980 which states:

All financial statements submitted to S&P, either in connection with a rating request for a bond sale or for a review, are expected to be prepared in accordance with GAAP...In the absence of financial reports prepared in accordance with the aforementioned guidelines, S&P will specifically reflect such absence in its rating process as a *negative factor* and where the report is not timely or is substantially deficient in terms of reporting, *will not rate at all.* (emphasis added)

Several states have already felt the effect of Standard and Poor's Policy Statement:

1. Maryland's interest rates on bonds sold was 0.15 percentage points lower than comparable bonds sold by another state in part reflecting conversion to GAAP. This resulted in a \$600,000 savings.

2. Massachusetts had its bond rating lowered because they did not comply with the more stringent accounting standards favored by the rating agency.

3. Oregon had to pay a higher interest rate after its credit rating was reduced.

4. Nevada's bond rating improved due to better financial reporting.

-It is estimated that a rating change from AA to AA- represents from 1/8 to 1/4 percentage points in interest paid. During fiscal year 1980 Montana issued bonds for \$19,130,000. A penalty of 0.125 to 0.25 percentage points on the issue would amount to \$24,000 to \$48,000 in interest costs for one year or \$480,000 to \$960,000 over the life of the bonds. Montana cannot afford a potential loss of that magnitude.

-A National Conference of State Legislatures (NCSL) task force issued a report to the NCSL Executive Committee on December 30, 1980 that states:

The NCSL Task Force on the Governmental Accounting Standards Board recommends to the NCSL Executive Committee that NCSL encourage state legislatures to review their states' adoption and use of generally accepted accounting principles, and uniform reporting standards. That in so far as practicable and reasonable for each state with regard to its own laws, we recommend that each state legislature move to strengthen and develop their state and local governmental accounting and reporting standards in conformance with the recommendations of the National Council on Governmental Accounting.

- An alternative to restructuring our present fund structure would be to use the current fund structure for internal reporting and budgetary purposes and reformat the data into the revised fund structure for external reporting purposes. However it would be a costly approach as the data would need to be reviewed and reformatted every year. Also, it may lead to confusion as internal and external reports would carry different titles and balances.
- Potential problems associated with the proposed restructuring include:
 - Loss of historical base - plans are to develop a matrix that make comparison possible.
 - Identification of federal funds - this information will be attainable through the structure of accounting entities or the use of revenue object codes.
 - Cost of approximately \$20,000 - the cost is minimal for such a major change. The other alternative of reformatting existing SBAS data for financial reporting would cost much more when audit costs are considered and would be an annual recurring cost.

3. Pages 8-12

- The next noteworthy change is on pages 8 and 9. This section establishes two account groups: the "fixed assets account group" and the "long-term debt account group".
- On page 10 the sunset provision on the university fund group is repealed. Four years ago when the university fund group was established by law accounting officials were unclear whether the university funds should be added (as was done) or submerged within the state regular fund structure. Authorities now agree the university funds should be added on to the regular fund structure. The sunset provision forced a review of the prior decision.
- Section 5 on pages 11 and 12 is a new section that requires the Department of Administration to review all laws affected by the change and submit to the 1983 legislature a bill to bring them in line with the new proposed fund structure.
- Finally Section 6 on page 12 provides for two effective dates.
 - Section 3 repealing the sunset provision and Section 5 requiring the interim review are effective immediately.
 - The other sections are effective July 1, 1983. This will permit the 1983 budget to be prepared based on the new fund structure.
- Another bill (HB 482) has been introduced to match the new fund structure to current budgetary authority.

CURRENT FUND STRUCTURE COMPARED TO
PROPOSED FUND STRUCTURE

Current Montana Funds	GAAP Funds						Trust and Agency
	<u>General</u>	<u>Special Revenue</u>	<u>Debt Service</u>	<u>Capital Projects</u>	<u>Enterprise</u>	<u>Internal Service</u>	
General	0						
Earmarked	0	0					
Sinking			0				
Federal and Private Revenue	0	0					
Federal and Private Grant Clearance	0	0					0
Bond Proceeds				0			
Revolving					0	0	
Trust and Legacy							0
Agency							0



6

THE MONTANA UNIVERSITY SYSTEM

33 SOUTH LAST CHANCE GULCH

HELENA, MONTANA 59620

(406) 449-3024

EXHIBIT 6

COMMISSIONER OF HIGHER EDUCATION

HOUSE BILL 341

TO: Members of House Administration Committee

FROM: Jack Noble *JN*
Deputy Commissioner for
Management and Fiscal Affairs

DATE: January 29, 1981

SUBJECT: Support the Passage of H.B. 341 - An Act to Rename and Define
Treasury Funds, etc.

Speaking on behalf of the Commissioner of Higher Education and the Presidents of the six campuses of the Montana University System, we support the passage of H.B. 341.

We have invested several hundred thousand dollars in the development of the centralized accounting system for the University System. The accounting programs that we currently use are based on the treasury Fund structure contained in 17-2-102. The University fund structure was created in statute in 1977. The Sunset Provision was put into law to assure that the appropriateness of the University fund structure was reviewed in 1981. The University fund structure is still consistent with generally accepted accounting principles for colleges and universities, thus, the Sunset Provision should be removed.

JN/llt

VISITORS' REGISTER

HOUSE

COMMITTEE

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SPONSOR

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VISITORS' REGISTER

HOUSE _____ COMMITTEE

WILL AS-3/4

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HOUSE

COMMITTEE

ALL

Date _____

SPONSOR

NAME	RESIDENCE	REPRESENTING	SUPPORT	OPPOS.
Gene Levin	Belmont	Police Chiefs		
Jim DeBus	Shepherd	Man. Assoc. State	James Wardens	
CD Avery	Helena	Legislative Auditor		
Jack Williams	Helena	Man. Chief of Police		X
Walt Miller	Helena	MDP		X
Clarence	Clarence	MDP		X
Dr. Smith	6224 1/2	Man. Hzn. to Pen. Of		X
Thomas Schunder	Helena	MDP		X
Larry Nachtsheim	Helena	PERD	X	

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VISITORS' REGISTER

HOUSE COMMITTEE

77

Date _____

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