

# **DO THE EXISTING FINANCIAL REPORTING AND AUDITOR REPORTING STANDARDS ADEQUATELY PROTECT THE PUBLIC INTEREST? A CASE STUDY**

## *Abstract*

*In 2003, Garden City was unable to meet its contractual debt obligations on approximately \$26 million in debt. The authors examined Garden City financial reporting as of June 30, 2003 and 2004 to determine if the publicly available financial reports adequately disclosed the imminent possibility of bankruptcy. Information about the long-term debt was properly displayed in the Statement of Net Assets and disclosed in Note 10 to the financial statements. There was no mention of the possibility of bankruptcy in the MD&A either year, nor was it prominently mentioned in the letter of transmittal. The auditor's did not include an explanatory paragraph highlighting the debt, nor did they issue a 'substantial doubt about the ability to continue to exist as a going concern' report. This paper examines existing accounting and auditing standards to determine their adequacy to protect the public interest.*

## **INTRODUCTION**

Are users of governmental financial statements well served by existing financial reporting and auditing standards? To examine this question, consider the case of Garden City.<sup>1</sup> In December, 2004 Garden City found itself unable to make the principal payments on over \$26 million in long-term debt which, after several refinancings, finally came due in December of that year. At that time, a newspaper article reported that “(t)wo weeks ago, the banks gave the City another six months to work out a solution, still a far from promising situation, given that municipal credit agencies are threatening to lower the city’s rating to junk status.” [Sterngold, 12/12/04] As of November, 2005, no principal payments had been made on the past due debt nor had any restructuring arrangements been proposed by the debt holders. While no principal payments have been made on the debt since 1999, interest payments have been made regularly. As the City struggled under a heavy debt load, its citizens seem to have been unaware of the

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<sup>1</sup> The names of the City, its participating banks, its auditors, and other parties have been disguised.

financial woes until November, 2004 when the City approved the hiring of bankruptcy attorneys. The seriousness of the financial situation was not evident in the June 30, 2003 financial statements because, at that time, the debt was still classified as long-term debt<sup>2</sup>. Although the debt was appropriately reclassified in the June 30, 2004 financial statements as ‘current portion of long term debt,’ the auditors did not include an explanatory paragraph in the audit opinion highlighting the fact that the City had approximately \$4 million in General Fund ‘cash and investments’ and over \$26 million in ‘current portion of long-term debt.’

This paper will address how well the accounting standards issued by the Governmental Accounting Standards Board (GASB) and the audit reporting standards issued by the American Institute of Certified Public Accountants (AICPA) served financial statement users. The GASB issues governmental accounting standards designed to provide users of governmental financial reports with adequate information to satisfy a variety of needs. The AICPA issues auditing standards intended to protect the public interest. This paper will not address the additional audit standards issued by the Government Accountability Office (Government Audit Standards), those issued by the U.S. Office of Management and Budget (OMB Circular A-133), or the auditing requirements of the Single Audit Act.

This paper presents information from the Comprehensive Annual Financial Report (CAFR) for Garden City (prepared using GASB Statement No. 34) to demonstrate that while the new reporting model does indeed provide better information for users of

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<sup>2</sup> Note 10 to the June 30, 2003 financial statements said “The Certificates of participation are both due in its entirety in December 2004. The city is currently working on restructuring these certificates of participation.” Existing standards permit currently maturing debt to be classified as long-term if the entity has both the intent and the ability to convert that debt into long-term debt within 12 months from the financial statement date.

governmental financial statements, it still does not easily convey necessary information to users of financial statements. This paper also presents information from and about Garden City's audit report to demonstrate that existing auditing standards also did not serve the public well.

Background information on the objectives of governmental external financial reporting, existing external financial reporting requirements (promulgated by GASB), and existing audit reporting standards (promulgated by the AICPA), is presented to provide a basis on which to evaluate the adequacy of existing accounting and auditing standards to provide relevant information and to protect the public interest.

## **APPLICABLE AUTHORITATIVE LITERATURE**

### Objectives of Governmental External Financial Reporting

- The objectives of external financial reporting by state and local governmental entities were established by the GASB in its 1987 Concepts Statement No. 1, "Objectives of Financial Reporting," (CS1). "Financial reporting helps fulfill government's duty to be publicly accountable. Financial reporting also *helps to satisfy the needs of users* [italics provided for emphasis] who have limited authority, ability, or resources to obtain information and who therefore rely on the reports as an important source of information." [CS1, par. 3] The GASB recognized that financial reporting is a means of communicating financial information to users but that some financial-related information is best communicated by financial reporting outside the financial statements.

The GASB Concepts Statement goes on to say that financial reporting by state and local governments is used in making economic, social, and political decisions and in assessing accountability primarily by:

- Comparing actual financial results with the legally adopted budget
- *Assessing financial condition and results of operations* [italics provided for emphasis]
- Assisting in determining compliance with finance-related laws, rules, and regulations

- Assisting in evaluating efficiency and effectiveness

GASB believes that financial reports are used to assess a government's financial condition (meaning its financial position and its ability to continue to provide services and meet its obligations as they come due). They believe that it is important for users to be able to evaluate the government's ability to continue to provide resources for long-term debt services. Further, GASB believes that taxpayers use financial reports to evaluate the likelihood of tax or service fee increases. Without saying it specifically, GASB implies that citizens use financial reports to evaluate the likelihood of governments being able to continue to provide the goods and services currently being provided.

#### Governmental Accounting Reporting Model

In 1999, the GASB adopted a new reporting model for state and local governments to address perceived shortcomings in existing generally accepted accounting principals (GAAP). One of the perceived shortcomings was the reporting of long-term debt in governmental funds. While proprietary funds were required to recognize long-term debt in the funds, governmental funds were not permitted to do so. Although information about general long-term debt was available in the notes to the financial statements in the General Long-Term Debt Account Group (GLTDAG), the amounts of long-term debt (debt that would not use current financial resources) were not included in the governmental fund financial statements. Many believed that failure to incorporate long-term debt in the financial statements of the governmental funds was misleading to users of financial statements.

The new reporting model, GASB Statement No. 34, “Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments,” (Statement No.34) required governments to prepare basic financial statements that contained two sets of financial statements and one set of *Notes to the financial statements* that provide information that is essential to a user’s understanding of the basic financial statements. The basic financial statements should include—

- *government-wide financial statements* prepared using the flow of economic resources measurement focus and the accrual basis of accounting, and
- *fund financial statements*—a series of statements that focus on information about the government’s major governmental and enterprise funds, including its blended component units. Fund financial statements should also report information about a government’s fiduciary funds and component units that are fiduciary in nature. Governmental fund financial statements use the flow of current financial resources measurement focus and the modified accrual basis of accounting. Proprietary and fiduciary funds use the flow of economic resources measurement focus and the accrual basis of accounting.

#### Auditor’s Reporting Responsibility

“The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles.” [AU 110.01] With the exception of certain subsequent events and concerns or doubts about the ability of the entity to continue to operate as a going concern, it is assumed that the auditor’s opinion covers only transactions and events included in the financial statements as of and for the period ended on the balance sheet date.

“The auditor has a responsibility to evaluate whether there is substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited....” [AU

341.02] The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred period to the completion of fieldwork. In a discussion of conditions that *might* indicate there could be substantial doubt about the entity's ability to continue as a going concern, the standard mentions default on loans and restructuring of debt.

If, after considering the identified conditions, the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, he should consider management's plans for dealing with the adverse effects of the conditions and events. When, after considering the conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the auditor report should include an explanatory paragraph (following the opinion paragraph) worded as follows. [AU 341.13]

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the company has (identify the condition or event) that raises substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Omission of appropriate note disclosure about the conditions or events which cause the auditor to have substantial doubt about the ability of the entity to continue as a going concern are a departure from GAAP sufficient to cause the auditor to issue either a qualified or adverse opinion.

The AICPA Reporting Standards [AU 508] itemize eight specific circumstances that may require an explanatory paragraph in an otherwise unqualified opinion. One of

these specific circumstances is substantial doubt about the ability of the entity to continue as a going concern. In addition to the eight specific circumstances, the standard says that the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements. This explanatory paragraph should be included simply to highlight or direct attention to disclosures within the financial statements; it cannot provide information that should be, but is not, included in the body or notes to the financial statements.

## **CASE STUDY**

### History of Garden City's financial woes

In October, 2005, an article appeared in a national newspaper asking the question—"Will bank officials accept Garden City's offer to eventually repay over \$26 million in debt that was due one year ago or will they force Garden City down the path of bankruptcy?" For the past six years, Garden City had made annual interest payments on its \$26 million debt, but only twice has the City made any type of principal payment.

The \$26 million debt is the result of two programs begun in 1993—a city-backed insurance company (Municipal Mutual Insurance Company) and a first-time home-buyers program. Garden City borrowed money (\$14.9 million, of which the insurance company received \$10 million) to finance Municipal Mutual Insurance Company in exchange for an agreement that the insurance activity would repay the debt out of profits earned. Profits to repay the bonds never materialized and refinancing of the debt since 1993 has nearly doubled the amount owed. To finance the first-time home-buyers program, the City originally borrowed \$2 million, which has been refinanced and now amounts to \$6.5 million. Eventually both programs failed and left Garden City owing

\$6.5 million to an American-based bank and \$20.1 to a Japanese-based bank. The refinancing notes were originally due December 15, 2004, but since that date Garden City has regularly received three-month or six-month extensions, allowing it to avoid bankruptcy. The \$20.1 debt is secured with city property, including the community center, pool and parks. The \$6.5 million debt is secured with city property including a fire station and the police headquarters.

### Garden City's Reporting Issues

Garden City's government-wide Statement of Net Assets as of June 30, 2004<sup>3</sup>, reported \$27.1 million as the current-portion of long term debt while the June 30, 2003 Statement of Net Assets correctly displayed the entire amount of the debt as long-term debt due in more than one year. The reporting of this debt in both the June 30, 2004 and 2003 financial statements appears to be in accordance with GAAP. The General Fund Balance Sheets as of June 30, 2004 and 2003 (the fund that will ultimately bear the responsibility for liquidating the liability) did not report the current portion of the liability. Because GAAP does not require the fund to report long-term debt until it is matured, it was appropriate to omit the debt from the 6/30/03 General Fund Balance Sheet<sup>4</sup> but it may not have been appropriate to omit it from the 6/30/04 Balance Sheet<sup>5</sup>.

Prior to the effective date of Statement No. 34, the only financial statements available to users were fund financial statements. The new reporting model did require financial statement presentation of the impending financial crisis while the former

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<sup>3</sup> This is the latest date for which published financial statements were available at the time this project was undertaken.

<sup>4</sup> Although Garden City had the intent to restructure the debt, we now know, with the advantage of hindsight, that it was unable to do so.

<sup>5</sup> Garden City does not maintain a Debt Service Fund.

reporting model would have reported this valuable information only in the notes to the financial statements or in the GLTDAG prior to 6/30/04.

At the time the auditor's report was issued, December 10, 2004, one could argue that, at a minimum, an explanatory paragraph in the auditor's report would have been appropriate since the certificates of participation at both Smith and Union Banks were due in May, 2005, and it would be difficult to believe that repayment was going to be possible. However, since the City successfully negotiated an extension of the due date until December 15, 2005, one might argue that the impending financial distress was beyond the one-year requirement for an auditor to consider the ability of an entity to continue to exist as a going concern.

***Going Concern*** "Continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going concern assumption relates to the entity's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, externally forced revisions of its operations, or similar actions." [AU 341.01] The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited...." [AU 341.02] Is this notion of going concern in the private section applicable in the public sector? Traditionally, the primary focus of the AICPA audit reporting standards has been on for-profit entities. The notion of bankruptcy and the resulting possible inability to continue as a going concern might be an appropriate notion when the underlying entity on

which the auditor is reporting is a for-profit entity. However, when the underlying entity on which the auditor is reporting is a local government, perhaps there should be a different factor or factors which drive a modification of the auditor's report.

While the ability of Garden City to continue to exist as a going concern (as defined by the AICPA) may not be an issue (municipalities rarely cease to exist), the ability of the City to continue to provide services to the citizens may be significantly curtailed by its creditors. It could be argued that since management believed they would be able to negotiate a revised repayment schedule with both banks, a going concern explanatory paragraph was not needed. However, since the auditors were aware of the ongoing problems related to the inability of the City to service its debt, it would seem that the appropriate action by the auditors would have been to include an explanatory paragraph highlighting the potential curtailment of City services due to a drain on resources caused by the maturity of over \$26 million in long-term debt.

#### **CONCLUSION/RECOMMENDATIONS**

Garden City, or other governmental entities in similar financial conditions, might be able to avoid bankruptcy because of their status as a municipal corporation. If creditors demand payment, municipalities can file Chapter 9 bankruptcy which would not serve the creditors well because funding for essential municipal services would have first priority. So, creditors will have reasons to work with the debtor government to restructure debt to insure they recoup at least some of the investment they made in the municipality. However, to continue servicing the debt (principal and interest payments), even minimally, Garden City must either increase taxes or decrease services. This situation gives rise to the question—Should financial reporting and the associated audit report, as a

matter of public policy, make citizens aware of situations which could lead to increased taxes and/or decreased services?<sup>6</sup>

### Financial Reporting

The improvements in financial reporting anticipated from implementation of GASB Statement No. 34 appear to have occurred. A knowledgeable person could have read the financial statements and become aware of the deteriorating financial condition of Garden City. Bond raters, arguably more knowledgeable than ordinary citizens, were definitely aware of the deteriorating financial condition and reflected their assessment of the situation in the ratings given to the bonds of Garden City.

However, it would be helpful to users of financial statements to have information on the history of troubled debt. In this particular case study, the authors were able to obtain financial statements for June 30, 2003, from the internet and financial statements for June 30, 2004 directly from the City. Prior years' financial statements were not readily available. The majority of citizens would not have the knowledge or skills to obtain and interpret multiple year financial statements. If governmental accounting standards required entities to give the history of troubled debt in the notes to the financial statements, it should make the financial reporting more transparent. The troubled debt will not only impact the government, and its citizens, directly but also it will impact other borrowing by increasing the interest rate the government has to pay. Existing troubled debt may also preclude the government from being able to borrow funds to provide necessary services to its citizens.

### Audit Reporting

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<sup>6</sup> An additional question might be raised—Should states limit the ability of local governments to issue revenue bonds without voter approval? This question is beyond the scope of this paper.

In this case, audit reporting did not seem to serve the citizens of Garden City well. Because citizens have an expectation of certain levels of services being provided by their local governments, the focus should be on any circumstances which could affect the ability of the government to continue to deliver services. Since both the GAO and the OMB have audit standards to which independent auditors must adhere, it would seem that the appropriate place to address the audit reporting issues would be in either or both of those standards.<sup>7</sup>

We believe auditing standards should require that auditors assess the ability of the entity to continue to deliver the current level of services without increasing taxes. If the auditors have substantial doubt about the entity's ability to continue to deliver service, auditors should be required to modify their report.

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<sup>7</sup> Since PCAOB has not yet expressed an interest in addressing issues specifically related to governmental accounting and auditing, the authors did not include that organization here.

## REFERENCES

American Institute of Certified Public Accountants (AICPA). 1972. *Codification of Auditing Standards and Procedures*. Statement on Auditing Standards No. 1 [AU 110]. New York, NY: AICPA.

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Sterngold, James. San Francisco Chronicle, 12/12/04

## Selected Disclosures from the Garden City 2005-2006 Proposed Budget

Included in the 2005-2006 Proposed Budget is the following information relative to Debt Service Funds

Under current state statutes, a city's general obligation bonded debt issuances are subject to legal limitation based upon 15% of total assessed value of real and personal property. As of June 30, 2000 (sic), the City did not have net general obligation bonded debt subject to such limitation. As of June 30, 2005, the City had \$36,180,000 of outstanding certificates and bonded debt. Due to the financial burden placed upon the City by the principal and interest payments of these issues, the City entered into an agreement with Smith Bank in 1999 to defer the principal payments for the Municipal Mutual Insurance Company and the First-Time Home Buyers Program until Fiscal Year 2004-2005. Payments on principal and interest are made monthly and semi-annually based on a variable interest rate through August 2031 *with a significant portion of the principal indebtedness due in Fiscal Year 2004-2005.* [italics provided for emphasis] Currently, the City is in negotiations with the banks on restructuring of these obligations with the lines of credit on extension during the negotiation period.

The proposed budget includes a schedule of long-term debt which contains the following information related to the Municipal Mutual Insurance Company and First-Time Home Buyers Project.

Municipal Mutual Insurance Company	Outstanding Principal Balance \$20,140,000
Fiscal year 2005-2006 General Fund Obligation	
Principal	\$460,000
Interest	\$262,507
Total	\$722,507

General Fund obligation for Fiscal years 2005-06 is approximately \$722,507. Due to ongoing debt restructuring negotiation with the banks taking place in Fiscal Year 2004-2005 and 2005-2006, the General Fund obligation is based on current interest rates and scheduled principal payments. Refunding issued December 1999 in the amount of \$20,800,000 will mature July 1, 2025. Secured by a letter of credit with the Smith Bank, which is confirmed by a letter of credit between the Credit Bank and the Day Bank. The letter of credits are currently on extension pending resolution of the debt restructure negotiation

First-Time Home Buyers Project	Outstanding Principal Balance	\$6,135,000
Fiscal year 2005-2006 General Fund Obligation		
Principal	\$140,000	
Interest	\$200,005	
Total	\$340,005	

General Fund obligation for Fiscal years 2005-06 is approximately \$340,005 net of estimated loan repayments. Due to ongoing debt restructuring negotiation with the banks taking place in Fiscal Year 2004-2005 and 2005-2006, the General Fund obligation is based on current interest rates and scheduled principal payments. Refunding issued December 1999 in the amount of \$6,550,000 will mature March 1, 2025, and secured by a letter of credit with the Union Bank. The letter of credits are currently on extension pending resolution of the debt restructure negotiation.

It is important to note that the budget presentation is not audited, nor is any other form of assurance provided by a third party.

## Selected Disclosures from the 6/30/04 Garden City Comprehensive Annual Financial Report (CAFR)

Auditors issued an unqualified opinion with no explanatory paragraph(s) on the 6/30/04 CAFR for Garden City. The opinion is dated 12/10/04

The MD&A contained no mention of the impending financial crisis related to the long-term debt related to the Municipal Mutual Insurance Company or the First-Time Home Buyers Project.

The MD&A Financial Highlights section contained the following information.

- Assets exceeded liability by \$19,242,719 (net assets). Unrestricted net assets were (\$18,759,296) at June 30, 2004
- As of the close of the current fiscal year, Garden City's governmental funds reported combined ending fund balances of \$9,914,972 .... Approximately \$8,372,190 of this total amount is *available for spending* at the government's discretion (*unreserved fund balance*)

The governmental activities column of the Statement of Net Assets showed \$14.8 million in cash and investments and \$35.8 million in current liabilities and current portion of long-term liabilities. The governmental activities column also showed negative unrestricted net assets of \$17.7 million (which represents a \$1.6 million improvement from 6/30/03).

The Balance Sheet of the General Fund showed only \$.4 million in cash with the balance of the \$14.8 million of governmental activity cash in the special revenue and nonmajor funds. General Fund liabilities are \$5.1 million and the General Fund unreserved fund balance is \$2.5 million (a \$1.7 million improvement from 6/30/03).

**Note 10—Long-Term Debt** included the following information relative to Changes in Long-term liabilities: amount Due within one year \$26,940,000

It also contained the following information relative to the Certificates of Participation for the Municipal Mutual Insurance Company and First-time HomeBuyers

1999 Public Improvement Corporation—First Time home Buyers

Date Issued—December 1999; Final Maturity—May 2005; Outstanding \$6,135,000

1999 Financing Agency—Municipal Mutual Insurance Company

Date Issued—December 1999; Final Maturity—May 2005; Outstanding \$20,140,000

In addition this note showed annual debt service requirements for 2005 of \$27.9 million (\$27.1 principal and \$.8 interest)

**Note10 also includes the following information**

The series A and B bonds related to the MMIC and First-time Homebuyers Programs have maturity dates of March 31, 2025 and July 1, 2025. Payment of interest and principal on the bonds have been supported by letters of Credit that were due to expire on 12/31/2004. Smith Bank and Union Bank have extended the Letters of Credit expiration dates to May 31, 2005. Per the official statement of the Series A and B bonds, expiration of the line of credit agreement does not constitute an event of default.

Additionally, default does not allow remedies involving acceleration of payments and any remedies are also restricted by those laws governing public agencies and preserving the public welfare an interest.

The City fully anticipates an agreement resulting in the restructuring of the current debt arrangement with Smith Bank and Union Bank on or before May 31, 2005. The City does not anticipate any drastic operation changes apart from those already made that have resulted in the City progressing from a negative general fund balance of over five million dollars in fiscal year 1998 to its current position general fund balances of over three million dollars in fiscal year 2004.

## Selected Disclosures from the 6/30/03 Garden City Comprehensive Annual Financial Report (CAFR)

Auditors issued an unqualified opinion with no explanatory paragraph(s) on the 6/30/03 CAFR for Garden City. The opinion is dated 12/05/03

The governmental activities column of the Statement of Net Assets showed \$14.1 million in cash and investments and only \$8.1 million in current liabilities and current portion of long-term liabilities. The governmental activities column also showed negative unrestricted net assets of \$19.3 million

The Balance Sheet of the General Fund showed \$1.8 million in cash with the balance of the \$14.1 million of governmental activity cash in other funds. General Fund liabilities are \$4.9 million and the General Fund unreserved fund balance is \$1.8 million.

**Note 11—Long-Term Debt** contained the following information relative to Changes in Long-term liabilities in governmental activities--\$630,000 due within one year

Total bonded indebtedness Balance at June 30, 2003 \$40.6 million.

It also contained the following information relative to the Certificates of Participation for the Municipal Mutual Insurance Company and First-time HomeBuyers

1999 Public Improvement Corporation—First Time home Buyers

Date Issued—December 1999; Final Maturity—May 2005; Outstanding \$6,135,000

1999 Financing Agency—Municipal Mutual Insurance Company

Date Issued—December 1999; Final Maturity—May 2005; Outstanding \$20,140,000

In addition this note showed annual debt service requirements for 2005 of \$27.9 million (\$27.1 principal and \$.8 interest)

**Note10 also includes the following information**

The certificates of participation are both due in its entirety in December 2004. The City is currently working on restructuring these certificates of participation.