

File No. 4-610

The attached report entitled “Timing of Municipal Bond Financial Audits Leaves Room for Improvement,” was provided by Richard Ciccarone, President and Chief Executive Officer of Merritt Research Services, LLC (Merritt) on October 17<sup>th</sup>, 2011<sup>1</sup> as a follow up to the meeting of Mr. Ciccarone with Commissioner Elisse B. Walter, members of her office and Commission staff on April 27, 2011, and his related submission of Merritt’s first annual study on the timing of municipal bond audits (see Memorandum to File No. 4-610 dated May 26, 2011 re: Meeting with Richard Ciccarone, Merritt Research Services, LLC (Merritt)).

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An earlier version of the report was submitted by Mr. Ciccarone on October 5<sup>th</sup>, 2011, but that version was superseded by the attached corrected version.

## Timing of Municipal Bond Financial Audits Leaves Room for Improvement

### *Second annual study examines timing of municipal bond audits*

Financial audits for issuers of municipal bonds continue to significantly lag the turnaround time for audits of companies in the private sector, according to Merritt Research Services, LLC, which recently completed its second annual audit timing study.

Merritt Research Services, a municipal bond credit database and research company, found little change in the results from this year's audit timing study compared to last year's study.

Based on medians for 16 municipal credit sectors, it took an average of 141.3 days from the end of the 2010 fiscal year to the time the audit report was completed, compared to an average turnaround time of 141.6 days for fiscal 2009.

Merritt examined the 2010 audits for 6,673 municipal bond issuers, representing nearly all municipal credit sectors. This year's study was expanded to include substantially more audits for the most recent audit period in its analysis this year than last year.

In addition, a broader base of borrowers was added for the historical period 2007 to 2009 to assess the trend in financial reporting times. In total, more than 25,500 audits were tallied in this year's study. Still, the results were little changed from last year's findings. Over the four-year period from 2007 to 2010, the average audit time across all credit sectors was 141.7 days after the close of the fiscal year.

General obligation bond borrowers backed by governmental entities such as states, cities and counties have consistently lagged municipal enterprise entities that use revenue bonds to complete their reports over the past four years. According to the study, states and territories are the slowest reporting credit sector in the market, while public power wholesale electric borrowers are the fastest.

Being a small municipal borrower does not seem to inherently handicap an issuer's ability to get its audits signed in a timely manner. In fact, size did not appear to be a determinant in how fast an audit could be completed. Many smaller entities were among the fastest to have their audits completed, while others were among the slowest. The four fastest audit times in 2010 were all linked to relatively small entities. Pulaski Electric Division, Tennessee, for example, was able to complete its audit within only 16 days of the close of its fiscal year. Titus County Fresh Water Supply District #1 in Mount Pleasant, Texas had its audit signed in 22 days, while two school districts, Newaygo Public Schools, Michigan and Maple Shade School District, New Jersey, both completed their audits in 23 days.

Many large municipal bond issuers also were able to have their audits signed within the 60-day window required by the Securities & Exchange Commission (SEC) for large, public corporate borrowers. A sample of those entities included Sacramento Power Authority (49 days), Indiana Municipal Power Agency (56 days), Port Authority of New York & New Jersey (56 days), Syracuse University (29 days), Mayo Clinic (48 days) and Santa Barbara County, California (55 days).

Governmental issuers, such as states, cities and counties, appear to find it more problematic than other municipal credits when it came to audit times. Very few of these entities would currently pass a 90-day audit test – no less the 120-day guideline set by the Municipal Securities Rulemaking Board (MSRB). However, the State of New York and New York City, two obvious complex credits, were able to make the 120-day audit time guideline for the past two years (the State of New York for the last four years, and New York City in three of the last four years).

While there was some suggestion in the numbers that credit quality might be correlated with faster or slower audit times, Merritt did not do a complete analysis of this relationship to make a conclusive determination. A number of slower reporting credits appeared to have weaker financial situations or held lower ratings from the bond rating agencies. By the same token, a large number of AA or Aa2 rated borrowers took 250 days to complete their audits.

A summary of the results of the study is included in this report.

## **Background**

In September 2010, Merritt Research Services, LLC released its first report quantifying the time it took for a municipal bond audit to be completed after the close of the fiscal year. The study, which examined more than 14,000 audits over a three-year period (2007 to 2009) for more than 4,600 different municipal entities, found that the average time for an audit document to be signed after the close of the fiscal year was about five months.

The analysis further found huge variations in the time it took to complete the audit by sector and by individual borrowers. In some of the more extreme cases, municipal entities took more than one year for the audit to be officially released and made available to the public. On the other hand, corporations which borrow in the securities markets are required to file their annual audit reports (10-K) within 60-90 days from the close of the business year depending, in part, on the size of the companies.

## Sector Highlights for the 2010 Audit Period

*Note: The fastest and slowest issuers listed in each sector are based on the number of days from the end of the 2010 fiscal year to the completion of the audit.*

- **Public power (wholesale electric) utility** borrowers continue outpace all other municipal borrowing credit sectors when it comes to completing their annual audited financial reports and making them available to investors and the public. For the second consecutive year, an analysis conducted by Merritt Research Services revealed a 90-day median for the completion of an audit for an entity in the public power sector, compared to an average of 141.3 days for 2010 audits across all sectors.
  - Fastest: Bonneville Power Administration, Pacific Northwest (28 days)
  - Slowest: Southeast Alaska Power Agency, Alaska (194 days)
- The median time for **hospital and healthcare system** audits lagged last year's performance by two days; however, the median turnaround time for the sector (110 days) was still second best of all municipal credit sectors. The annual median time for hospital audits has ranged from 105 in 2007 to 110 in 2010. About 29% of all hospital audits were completed within 90 days.
  - Fastest: Oak Valley Hospital District, Oakdale, California (40 days)
  - Slowest: Sacred Heart HealthCare System, Allentown, Pennsylvania (370 days)
- **Private higher education institutions** produced the third-best record for audit time completion for the second year in a row. The sector median was 112 days, just below the speed for hospitals. Fifteen percent of all private colleges completed their audits within 90 days of the end of their fiscal year.
  - Fastest: Syracuse University, New York (29 days)
  - Slowest: Bard College, New York (274 days)
- **States** were the slowest credit sector in the municipal bond market to sign their audits for the fourth year in a row. In 2010, the median state and territory audit time was 178 days, which was four days better than 2009 but still worst in the class. No state completed its audit with 90 days. Hawaii and the Virgin Islands reports for 2010 have not yet been received.
  - Fastest: New York (114 days)
  - Slowest: Illinois (365 days)

- **Counties and cities** were the second and third slowest credit sector for audit times, with median times of 167 and 172 days, respectively. Both median times were slightly better than their similar finish last year when their 2009 audits were completed in 168 and 175 days, correspondingly. Only 2.5% of cities and counties were able to complete their audits in 90 days.
  - Fastest city: Perinton Town, New York (53 days)
  - Slowest city: San Diego, California (427 days)
  
  - Fastest county: Cumberland County, Maine (55 days)
  - Slowest county: Santa Cruz County, Arizona (401 days)

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Merritt Research Services, LLC  
October 1, 2011

*About Merritt Research Services, LLC:*

*Merritt Research Services, LLC (MRS) is an independent municipal bond data and research provider, focused on credit information related to municipal bonds.*

*Headquartered in Hiawatha, Iowa, Merritt Research Services was originally founded in 1985 as a part of Van Kampen Merritt Inc. The company first began to collect municipal bond audits for its initial database software product called The Merritt System, which was launched in 1986. Ten years later, The Merritt System partnered with Investortools, Inc. to primarily release its data through Creditscope. In 2001, Merritt Research Services, LLC was spun off from the Van Kampen Funds to become an independent municipal data research company.*

Appendix: Statistical Summary of Audit Timing by Credit Sector

Sector	Audit Timing	Audit Timing	Audit Timing	Total Number of Audits
	<u>Median</u>	<u>Range*</u>	<u>Average</u>	
	FY 2010	FY 2010	2007-10	2007-10
Airports	145	47 – 393	152.5	499
Cities	167	53 – 427	167.5	2,625
Counties	172	55 – 401	174.0	1,454
Dedicated Tax	161	58 – 401	156.9	502
Hospitals and Healthcare Systems	110	40 – 370	107.5	4,542
Land Districts	155	49 – 314	153.0	519
Other Revenues	138	37 – 427	140.3	910
Private Higher Education	112	29 – 274	108.8	1,776
Public Higher Education	138	46 – 378	139.3	1,512
Retail Electric Utilities	133	16 – 394	134.3	2,019
School Districts	142	23 – 392	143.3	4,462
Special Districts	148	49 – 227	151.0	184
States and Territories	178	114 – 365	179.3	213
Tollways	119	53 – 237	113.0	182
Water and Sewer Systems	153	22 – 427	155.0	3,704
Wholesale Electric Utilities	90	28 – 194	91.0	492
Total		16 – 427		25,595
AVERAGE (all sectors)	141.3		141.7	
MEDIAN (all sectors)	143.5		147.1	
* Note: Range includes turnaround time for audits received as of report date. The range does not account for credits that have yet to complete their audits.				