

# Three Perspectives: How Audit Timeliness Impacts Government Bond Ratings

Financial transparency matters – not just because it’s a core Washington value, but because it has real-world effects on bond ratings. Don’t take just our word for it. Hear from a city finance director, a top bond underwriter to local governments and an SAO audit leader on the importance of working collaboratively to get audits done.

## How the city of North Bend had its bond rating reinstated

In January, S&P Global Ratings contacted the city of North Bend and indicated, due to the unavailability of an annual report for fiscal year 2022, the City was at risk of having its rating changed, suspended or withdrawn unless it submitted an audited annual report by March 2024.



By **Martin Chaw**, Finance Director, City of North Bend

Like many cities, staff turnover and a loss of critical knowledge within the City’s finance department precipitated the situation. Given this, there’s both bad and good news. The bad news: the City was unable to meet the March 2024 deadline, and in April, S&P formally withdrew the City’s credit rating. The good news: by June 2024, the City, in collaboration with the

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## Why timely financial audits matter for bond financing

D.A. Davidson & Co. serves as a bond underwriter or financial advisor to hundreds of Washington municipalities including cities, counties, school districts, fire districts, water and sewer districts, and other special districts.



By **Jim Nelson**, Managing Director, D.A. Davidson, Public Finance Department

Timely financial audits are required for bond financing purposes – but they are also required to maintain a rating during the life of the bond.

S&P Global Ratings recently underlined the importance of timely audits when it published an article on April 8, 2024, titled “Various Ratings Withdrawn on 91 U.S. Local Governments and Utility

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## Good communication and planning are keys to timely audits

In 2024, some Washington municipalities are experiencing actions on their bond ratings, such as having them placed in a “watch” status or subsequently withdrawn, due to a lack of financial transparency.



By **Kelly Collins**, Director of Local Audit, Office of the Washington State Auditor

Without the insights into a government’s finances provided by independent audits, unaudited financial reports and other documentation, rating agencies will hesitate to affirm a government’s creditworthiness.

The Office of the Washington State Auditor has been in regular communication with S&P Global Ratings, responding to inquiries regarding the

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Office of the Washington State Auditor, completed and submitted the missing audited annual financial report, met with S&P for a ratings review and, with the assistance of the City's bond underwriter, got the City's credit rating reinstated by S&P to the same level before withdrawal.

## How was the city of North Bend able to accomplish this so quickly?

**Approach #1: Keep the customer informed.** We frequently hear the adage, "the customer is king." While the City could not instantaneously produce an audited 2022 annual report for S&P, it was able to keep the customer – in this case, S&P – informed. This included regularly updating S&P staff with the audit status. Even after the City was unable to meet its March deadline and had its credit rating withdrawn, the City continued to communicate regularly with S&P staff.

*Lesson 1: Recognize that the top priority is transparency with the ratings agency. Plan to overcommunicate, even if the news may not be what the customer wants to hear.*

**Approach #2. Keep your partners informed.** The City's finance department contacted its bond counsel, bond underwriter and SAO to inform these partners of the situation. The finance department requested SAO perform an expedited review, which it was able to provide. SAO quickly mobilized a team.

The City established a collaborative working relationship with SAO. Once the audit started, City staff made the audit completion its highest priority. As suggested by the bond underwriter, the City deferred all investor communications to the underwriter. This not only allowed the City to focus on the audit, but also allowed the City and its partners to respond to investors with one consistent and coordinated voice.

*Lesson 2: Recognize the value of your partnerships. Leverage their expertise and resources. Don't hesitate to request an expedited review from SAO. Keep your partners informed along the way and work closely and collaboratively with each. Ensure to respond to SAO's requests for information promptly so auditors can*

*complete their work in a timely manner.*

### **Approach #3. Keep the City's leadership team informed.**

The City's finance department told the City's leadership team and elected officials about the situation and kept leadership regularly informed throughout the process. During these briefings, City staff explained to the leadership team how the City got to this point and kept them informed through regular updates.

*Lesson 3: Be clear and transparent with leadership, and don't sugarcoat. Reestablish and rebuild trust.*

### **Approach #4. Recognize that trust may have suffered. Reassure your stakeholders.**

The City's finance department knew this situation had harmed trust and belief in City management's integrity. Show the safeguards you put or are planning to put in place to ensure that you are addressing the immediate needs of the ratings agency and won't miss future deadlines for audited financial reports.

The finance department used a risk management framework, including assessing internal processes, identifying areas of risk, ensuring key staff are cross-trained and redundancies are established to mitigate or minimize risks where possible. Keep detailed notes and internal checklists with assigned staff roles and responsibilities. Be nimble and flexible so you are able to respond quickly to issues.

*Lesson 4: Reestablish trust and demonstrate leadership by being proactive and communicating regularly and often. Work collaboratively with SAO, your consulting partners and S&P staff. Establish a thoughtful and clear plan that accounts for risk and risk mitigation strategies. Regularly and transparently report on progress. Finally, be flexible. Recognize and anticipate that even the best plans don't always go as envisioned. Be prepared to respond nimbly to issues as they emerge.*



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Systems.” S&P included two cities and two water and sewer districts in Washington on that list, citing late financial audits as the reason.

“The withdrawals reflect our inability to obtain adequate and timely financial information necessary to maintain surveillance of the ratings in accordance with our applicable criteria and policies,” the S&P article said.

Having a rating withdrawn is potential negative press for a municipality. It has a negative impact on the bondholders, and if you are preparing to issue debt soon, the interest cost will likely be higher without a rating.

Overall, Washington municipalities achieve very good ratings because of the strength of their local economies, financial conditions and management practices. Examples include Central Whidbey Island Fire & Rescue, which achieved the first AAA rating for a Washington Fire District in 2017 based on strong financial policies, strong cash reserves, financial planning and forecasting. Lakehaven Water & Sewer District achieved a AAA rating in 2021 based on strong financial practices and financials and an updated Rate Study. And the City of Kenmore achieved a AAA rating in 2021 based on strong financial policies, financials and a strong economy.

S&P’s action reminds us of the importance of early planning for your future bond financing. Determine if your financial practices and policies need to be updated. Specify in your policy that you will be on a two-year audit cycle (if you are a smaller municipality) or an annual audit cycle (if you are a larger municipality). If you are within two years of bond financing, work with the Office of the Washington State Auditor to ensure you are up to date on your financial audit.

An S&P article published February 5, 2024, titled “How S&P Ratings Assesses Information Sufficiency and Timeliness for Washington Local Governments,” said S&P expects governments to have either a completed financial audit or unaudited financial information filed with the State Auditor’s Office within 365 days of the most recent fiscal year-end; and if the government

can provide only unaudited data, it should include a certification letter (if available), a summary report and supporting schedules including debt and pension disclosures.

For example: If you have a bond financing that is anticipated to close in August 2024, a financial audit covering fiscal year 2022 most likely will be sufficient for the rating analysts. If you have a bond financing that is anticipated to close in December 2024, S&P will most likely want a financial audit covering fiscal year 2023.

To best position your government for the rating process, we suggest these best practices:

- Proactively communicate with the State Auditor’s Office, bond underwriter or financial advisor, and bond attorney.
- Consider developing a financial forecast.
- Consider updating your capital improvement plan.
- Stay up to date on your annual continuing disclosure information that is uploaded to **EMMA MSRB** (<https://emma.msrb.org>). The information on **EMMA MSRB** is reviewed by investors, rating agencies and other interested parties.

If your rating is withdrawn due to a late financial audit, it can likely be reinstated (for a nominal rating fee, or the rating fee may be waived) when you have an updated financial audit. Another helpful suggestion to Washington local governments is to view your track record of financial disclosure as something worthy of good stewardship, because the municipal marketplace places a high value on financial transparency.

*Important Disclosures:*

*The information provided in this document is for informational and educational purposes only and does not constitute an offer to buy or sell any securities or services.*



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status of audits for municipalities and special purpose governments. Many of those governments had delays in preparing annual financial reports and completing their financial audits because of staff turnover, retirements or vacancies in their key finance personnel. Regardless of cause, a resulting negative rating action shows how important it is to maintain good communication with auditors and plan early for your financial needs. These are critical to achieve and maintain a good credit rating, and to ensure timely access to the municipal bond market when you have capital needs.

### SAO can help you achieve the financial transparency credit agencies are looking for.

These agencies monitor municipalities and look for available financial information. S&P recently announced that governments issuing bonds are expected to produce a financial audit completed within 365 days of the most recent fiscal year-end. Between audits, credit rating agencies use unaudited financial information to assess the credit quality of rated governments. So, if your government files its annual financial information with our Office on time, as required by state law, the data is then presented in

our [Financial Intelligence Tool](#) on our website. Rating agencies use FIT to examine governments' unaudited financial information. Filing your annual report on time also helps facilitate timely audits.

### Keep lines of communication open even when an audit isn't active.

Local governments shouldn't assume auditors know the government's audit timeline requirements. Local governments should communicate with their auditors regularly, and at least annually for governments issuing bonds, to ensure auditors have a clear understanding of your audit requirements and timeline needs, as well as to discuss scheduling a financial audit to coincide with the completion of your financial statement preparation. If in doubt, call us. We want you to reach out and talk to your auditors.

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Washington State Auditor's Office  
Insurance Building, P.O. Box 40021  
Olympia, WA 98504-0021

<http://sao.wa.gov>



“Our vision is to increase **trust** in government. We are the public's window into how tax money is spent.”

– Pat McCarthy, State Auditor



Office of the Washington State Auditor

Pat McCarthy