

OHIO AUDITOR OF STATE KEITH FABER



From: Auditor of State's Center for Audit Excellence

To: All IPA Firms

Subject: Moody's Investor Services

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We've recently been made aware of changes to the process used by Moody's to maintain ratings for issuers. In summary, Moody's Investors Service, effective 7/1/2018 (for fiscal years ending after 7/1/2017), requires audited financial statements submitted within 12 months of year end. In certain circumstances, Moody's may accept unaudited statements; however, if audited statements are not received within 18 months, they will consider withdrawing their bond rating of the entity. The audit requirement also applies to issuers with a biennial audit cycle, however, biennial issuers are required to provide unaudited financial statements during the "off-year." For example, if an issuer is expected to complete an audit for fiscal years ending June 30, 20XX and 20XY, the issuer will be required to provide sufficient unaudited information at the end of fiscal 20XX.

For additional details regarding this change, refer to the attached Moody's communication dated May 9, 2018.

If you have any questions, please contact a member of the Center for Audit Excellence.

SECTOR IN-DEPTH

9 May 2018

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Public finance - US

Update to local government insufficient information practice

We recently updated our insufficient information practice, which identifies local government issuers that fail to provide timely audited financial information. To maintain ratings, we require complete audits within 12 months of the fiscal year-end. In certain circumstances, we accept unaudited financial statements with the expectation that the complete audit is soon to come. In these cases, if we do not have a complete audit 18 months after the fiscal year-end, we will convene a rating committee to consider whether we can maintain the rating. This new practice is effective July 1, 2018 for fiscal years ending after July 1, 2017.

- » **What is insufficient information and why is it important?** Insufficient information is an analytical judgment that there is a lack of enough current data or third-party verified financial reporting to support a credit rating. We are required to review all of our ratings on an annual basis with updated financial information. As we do our annual reviews, we identify issuers for which we do not have updated third-party verified financial information. When a rating committee determines that we do not have sufficient, reliable and timely information to maintain a rating, we withdraw it.
- » **What is our new process?** If we do not receive the final audit within 12 months of the fiscal year-end, we require unaudited information that will be reviewed by a committee to determine its sufficiency. Under our new practice, if the final audit is not submitted within 18 months, regardless of the quality of unaudited statements provided, we will consider withdrawing the rating. The requirements for biennial issuers are slightly different.
- » **Ripple effects of insufficient information.** Many of our ratings are linked to other ratings in various manners. If we withdraw an issuer's rating, ratings that depend on the withdrawn rating (such as through a reference rating relationship) or to which the withdrawn rating is an input (such as pool financed ratings) will also be withdrawn in most cases.

What is insufficient information and why is it important?

Insufficient information is an analytical judgment that there is lack of enough current data or third-party verified financial reporting to support a credit rating. We regularly review our records to identify issuers that have not provided updated third-party verified financial information. We review all of our ratings on an annual basis with new financial information. In addition to our annual review requirements, many of our methodologies require timely reporting of financial data.¹

In our opinion, timely reporting of financial statements means publishing audited financial statements within 12 months after the end of the fiscal year (i.e., we require the audit for an issuer's fiscal year ending June 30, 2017 by June 30, 2018). It is important for us to receive audited information within one year of the fiscal year closing because local government issuers typically only report annual audited information. In contrast, corporate issuers, for example, provide quarterly statements allowing for more real-time reaction to changes in financial health.

If a local government's audit is not completed within 12 months of the end of the fiscal year, we accept unaudited financial statements as a stopgap measure until the final audit is completed. This is common for local governments in states such as Alabama, Georgia, and Washington where the state is required to conduct the audits. Our new practice, effective July 1, 2018, requires that we receive the final audit within 18 months after the fiscal year ends, regardless of the quality of unaudited statements provided 12 months after the fiscal year end. When these requirements are not met we will consider withdrawing the rating.

On average, of the relatively small number of issuers that provide sufficient and reliable unaudited information in lieu of an audit, 75% of that group provide the complete audit within 18 months of the fiscal year's end.

What is our new process?

We have updated our practice regarding the withdrawal of ratings when issuers have not provided third-party verified audited financial statements within one year of the fiscal year-end. Below is an example timeline and detailed description of the events that occur for an issuer with a September 30 fiscal year-end when we have not received a timely audit.

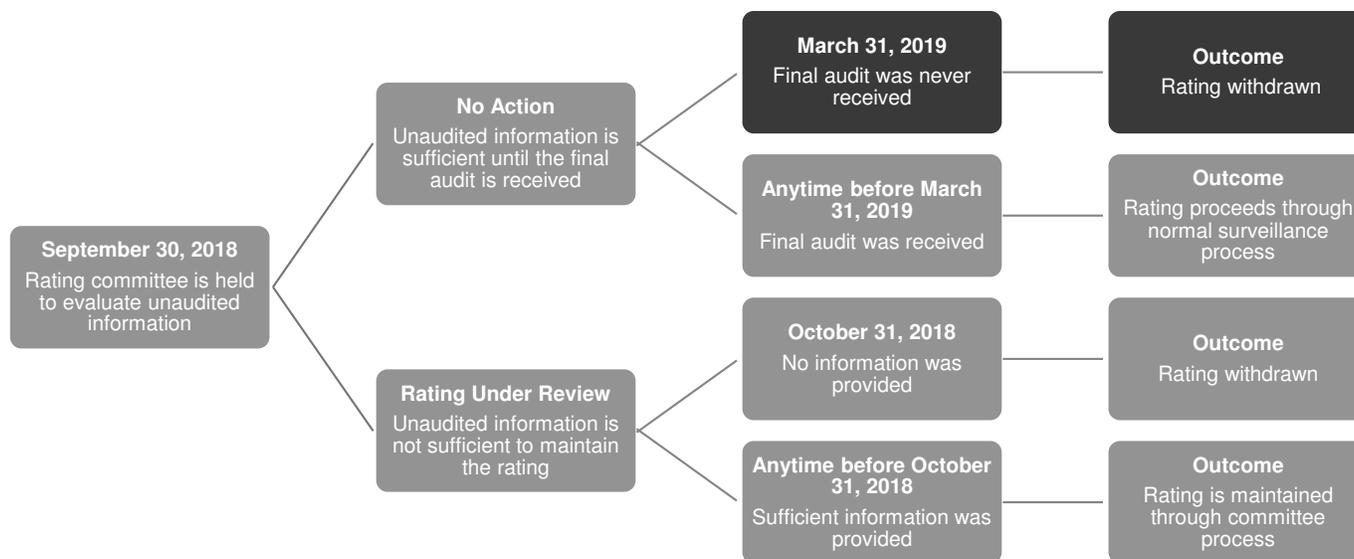


1. September 30, 2017: The issuer's fiscal year ends. This marks the start of our clock for receiving audits for fiscal year 2017.
2. June 15, 2018 (8.5 months after the fiscal year ends): The issuer receives an initial email 8.5 months after the fiscal year ends as a reminder to submit the fiscal 2017 audit. The email is sent by our data collection team.
3. July 15, 2018 (9.5 months after the fiscal year ends): The issuer receives a second reminder email 9.5 months after the fiscal year ends as a reminder to submit the fiscal 2017 audit if we still have not received the audit. If an issuer provides unaudited information, it will still receive reminder emails to provide the audited financial statements.
4. August 1, 2018 (10 months after the fiscal year ends): The issuer receives a final certified letter 10 months after the end of the fiscal year. This is the last communication our data collection team has with the issuer before rating analysts reach out to the issuer.
5. September 1, 2018 (11 months after the fiscal year ends): A local government analyst contacts the issuer to investigate the outstanding audit request. The assigned analyst will be the point of contact for the issuer through the rest of this process. The analyst will continue to check in with the issuer and issuer's financial adviser, auditor or state to check on the status of the audit.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

6. September 30, 2018 (12 months after the fiscal year ends): A full year after the fiscal year has ended, a rating committee will convene to evaluate all of the issuers that have not provided audited financial statements for fiscal year end 2017. The rating committee will review all of the unaudited statements provided and evaluate their sufficiency. With respect to each rating, the rating committee will either place the rating under review for withdrawal due to insufficient information or take no action. A press release will announce ratings placed under review for insufficient information.

The “decision tree” below shows the steps that take place after an issuer is either placed under review for withdrawal due to insufficient information or no action is taken.



No action taken

For issuers that provide sufficient unaudited interim financial information, there are two possible outcomes after we have decided to take no action:

- » Scenario 1: *The issuer provides sufficient interim financial statements but does not provide the full audit by March 31, 2019, six months after we took no action and 18 months after the fiscal year 2017 ended.* At this point, under our new practice, we will consider withdrawing the rating because the delay in receiving final audited information is too long.
- » Scenario 2: *The issuer provides final audited statements anytime before March 31, 2019.* Upon receipt of new financials we begin our standard surveillance process and the rating is not withdrawn for insufficient information.

Rating placed under review

For issuers that do not provide sufficient unaudited interim financial information and are placed under review on September 30, 2018, there are also two possible outcomes.

- » Scenario 1: *The issuer provides no sufficient information within 30 days and a second rating committee withdraws the rating 13 months after the fiscal year ends.*
- » Scenario 2: *The issuer provides sufficient information within 30 days and a full rating committee is convened to resolve the under review status.* The committee can take any rating action, including confirmation, upgrade, downgrade, assignment of an outlook, or no action. In cases in which unaudited information is provided during the review period, the rating may be withdrawn if a complete audit is not provided within 18 months of fiscal year-end.

Issuers on a biennial auditing cycle

The new process to assess insufficient information does not affect issuers that follow a biennial auditing cycle. Biennial issuers are required to provide sufficient interim financial statements during the "off-year." For example, if an issuer is expected to complete an audit for fiscal years ending June 30, 2018 and 2019, the issuer will be required to provide sufficient unaudited information at the end of fiscal 2018.

The issuer, however, is still required to provide a full, complete, two-year audit within 12 months of the biennial fiscal year-end. If the biennial issuer does not have a final two-year audit within 12 months of the fiscal year-end, it will be placed on review for possible withdrawal due to insufficient information. An auditing cycle longer than two years does not provide sufficient independent verification for us to maintain a rating.

In the same example, the issuer's fiscal 2018 and 2019 biennial audit will be due by June 30, 2020 for fiscal years 2018 and 2019. If the final audit is not complete at that time, the issuer will be placed under review on June 30, 2020 and will follow the same process as explained above. Unaudited information for fiscal 2018 and 2019 provided on June 30, 2020 does not lead to additional time for this biennial issuer.

Ripple effects of insufficient information

There are downstream effects on other ratings when an issuer does not provide timely audited statements. Downstream effects can include the withdrawal of related ratings and pool ratings when an issuer does not provide timely audited statements.

Issuer rating inputs

In September 2017, we began publishing issuer ratings that are used as inputs for other US public finance ratings. These issuer-level reference ratings provide the market with more transparency regarding how we arrive at the rating for securities that utilize the general obligation limited tax (GOLT) portion of the [US Local Government General Obligation Debt methodology](#) or are based on other methodologies that use general obligation (GO) ratings as inputs including: [Lease, Appropriation, Moral Obligation, and Comparable Debt of US State and Local Governments](#), [US Public Finance Special Tax](#), and the [US Municipal Utility Revenue Debt](#).²

When we assign an issuer-level reference rating, we have determined that there is a significant enough connection between the general government and the related debt that we need to have an issuer-level rating to rate the related debt. As such, we require information on the reference rating in order to maintain the "family of ratings." If we do not receive audits for the related issuer, we may withdraw both ratings due to insufficient information.

Pool program and pool financing ratings

Similar to reference ratings, we maintain ratings on many pool financings and programs. Pool ratings begin with evaluating the creditworthiness of the individual participants based on the security of participants' obligations to the pool (i.e., if the pool is a GO of its participants, we would base the pool rating on the GO ratings of the underlying participants). Because pool ratings are based on the individual pool participants' ratings, we require the same timely audited information from the pool participants as we do for standalone ratings, whether the participants' rating is public or used for our purposes internally. As explained above, we reserve the right to withdraw ratings on issuers that have not provided timely sufficient information. If we withdraw a rating on a single issuer and it is also part of a pool financing rating, we will also consider withdrawing the rating on the pool financing in some instances.

For example, Pool A has three participants, towns X, Y and Z and town Y does not provide its audit within the timeline described above. We could place the entire pool rating under review because without updated information about town Y, we cannot be confident that its current credit quality is the same as when the rating was first assigned. Further, if town Y does not provide sufficient information within the under review time frame, we could withdraw town Y's rating and the entire pool financing rating.

Moody's related publications

Sector In-Depth

- » [Plan to publish Issuer Ratings used as inputs for other US public finance ratings](#), July 31, 2017
- » [Moody's Framework for Monitoring US Municipal Ratings](#), May 17, 2017

Special Comment

- » [New Requirement for Audited Financial for Rating NY Local Governments](#), August 1, 2013

Sector Comment

- » [Minimum of Biennial Audits Required to Maintain Credit Rating](#), January 6, 2016

Moody's Investors Service Policies

- » [Policy for Withdrawal of Credit Ratings](#), August 7, 2017

Endnotes

- ¹ For more information on our rating surveillance process, please reference "[Moody's Framework for Monitoring US Municipal Ratings](#)."
- ² For more information regarding issuer input ratings, please reference "[Plan to publish Issuer Ratings used as inputs for other US public finance ratings](#)."

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