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## FISCAL IMPACT REPORT

ORIGINAL DATE 2/18/09

SPONSOR Sapien LAST UPDATED \_\_\_\_\_ HB \_\_\_\_\_

SHORT TITLE Political Subdivision Financial Reporting SB 574

ANALYST Archuleta

### ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY08	FY09	FY10	3 Year Total Cost	Recurring or Non-Rec	Fund Affected
<b>Total</b>		Unknown	Unknown	Unknown		Various Local

(Parenthesis ( ) Indicate Expenditure Decreases)

Duplicates Senate Bill 336 - Tiered Reporting for State Entities

### SOURCES OF INFORMATION

LFC Files

#### Responses Received From

Office of the State Auditor (OSA)

Department of Finance and Administration (DFA)

Environment Department (NMED)

New Mexico Municipal League (NMML)

### SUMMARY

#### Synopsis of Bill

Senate Bill 574 establishes a tiered system of financial reporting under the Audit Act for incorporated municipalities, mutual domestic water associations, land grants and special districts that is based on the annual operating budget revenues of those municipalities, associations, land grants and special districts. Special districts are enumerated in Chapter 73 NMSA 1978 and include drainage districts, irrigation districts, conservancy districts, soil and water conservation districts, watershed districts and acequias. Senate Bill 574 applies to incorporated municipalities, mutual domestic water associations, land grants and special districts in the tiered system by creating a new definition under the Audit Act for a “local public body.”

### FISCAL IMPLICATIONS

Under the tiered system, the amount of a particular local public body’s annual operating budget revenue determines the type of financial reporting, if any, that applies to that entity. The operating budget revenue thresholds established by the bill are calculated using the cash basis of accounting. Under the cash basis of accounting, revenues and related assets are recognized when

received rather than when earned, and expenditures are recorded when paid rather than when the expenditure is incurred. Federal grants, private grants, and appropriations made to local public bodies for capital outlay projects are not calculated as part of the local public body's operating budget revenues. The bill also requires the Local Government Division of the Department of Finance and Administration (LGD of DFA) to inform the State Auditor of the compliance or failure of a local public body with DFA's budget certification rules.

For all government agencies covered by the Audit Act, the current practice of the State Auditor is to get a government agency caught up with an audit if there are years in which the agency did not conduct an audit. Therefore, the bill provides a waiver to certain local public bodies that have not complied with the Audit Act between January 1, 2006 and June 30, 2009, unless the local public body is required to receive a full financial and compliance audit under the new requirements.

The bill establishes the following tiered system:

1) If the annual operating budget revenue of local public body is less than \$50,000 and the local public body does not directly expend capital outlay appropriations, that local public body is required to comply only with the applicable provisions of Section 6-6-3 NMSA 1978, which include the budget certification requirements of the Local Government Division of the Department of Finance and Administration;

2) If the annual operating budget revenue of the local public body is less than \$50,000 and the entity directly expends capital outlay funds, the local public body is required to submit a financial report according to a specific set of agreed-upon procedures that are:

- a) Focused solely on the capital outlay funds directly expended;
- b) Economically feasible for the affected local public body; and
- c) Determined by the State Auditor after consultation with the affected local public body;

3) If the annual operating budget revenue of the local public body is \$50,000 or more but is less than \$250,000 and the entity does not expend capital outlay funds, the local public body is required to submit a financial report that includes a schedule of cash basis comparison and that is consistent with agreed-upon procedures for financial reporting that are:

- a) Economically feasible for the affected local public body; and
- b) Determined by the State Auditor after consultation with the affected local public body;

4) If the annual operating budget revenue of the local public body is \$50,000 or more but is less than \$250,000 and the entity does expend capital outlay funds, the local public body is required to submit a financial report that includes a schedule of cash basis comparison and a test sample of expended capital outlay funds that is consistent with agreed-upon procedures for financial reporting that are:

- a) Focused solely on the capital outlay funds directly expended;
- b) Economically feasible for the affected local public body; and
- c) Determined by the State Auditor after consultation with the affected local public body;

4) If the annual operating budget revenue of the local public body is \$250,000 or more but is less than \$500,000, the local public body is required to submit a compilation of the entity's financial statements and a report that is consistent with agreed-upon procedures for financial reporting that are:

- a) Economically feasible for the affected local public body; and
- b) Determined by the State Auditor after consultation with the affected local public body;

5) If the annual operating budget revenue of the local public body is \$500,000 or more, the local public body is required to submit a financial and compliance audit.

According to OSA, the exact fiscal impact to its operating budget is unknown. The OSA expects to incur additional administrative costs in implementing the tiered system with regard to rulemaking and outreach efforts. Currently, there are number of local public bodies (as defined by the legislation) that are not in compliance with the Audit Act.

Senate Bill 574 would have a significant impact on the operating budgets of incorporated municipalities, mutual domestic water associations, land grants and special districts that fall within the operating budget revenue thresholds of the tiered system. An annual audit of the smallest government entity can cost between \$5,000 and \$20,000 or more. The tiered system is designed to relieve that burden while created financial reporting alternatives at a lower cost.

### **SIGNIFICANT ISSUES**

According to OSA, many small, rural local public bodies encounter difficulties when attempting to procure the audit services of CPAs. Currently, only CPA firms who meet the eligibility requirements set forth by the State Auditor may respond to New Mexico government agency requests for price quotes or requests for proposals for audit services. According to 2.2.2 NMAC, *Requirements for Contracting and Conducting Audits of Agencies*, commonly known as the State Audit Rule, CPA firms must submit and complete a firm profile packet to be eligible for audit engagements pursuant to the Audit Act. Only those CPA firms that are approved by the State Auditor may provide government agencies bids for audit services. There are approximately 65 firms on the State Auditor's approved list of firms for fiscal year 2008. Upon implementation of the legislation, the State Auditor intends to allow any CPA who is licensed by the State to conduct agreed-upon procedures and compilation engagements under the tiered system, excluding financial and compliance audits. Allowing any CPA who is licensed by the State to conduct agreed-upon procedures and compilation engagements enhances the probability that a local public body will be able to procure those services.

### **PERFORMANCE IMPLICATIONS**

According to OSA, Senate Bill 574 will enable the agency to more effectively track and provide information to the Legislature, the public, and other interested parties regarding the financial information of local public bodies. Currently, the financial information of many local public bodies is unavailable because certain entities cannot afford an annual audit, have never had an annual audit conducted, or cannot procure an auditor. Furthermore, the agreed-upon procedures requirements that apply to capital outlay funds will assist in providing greater accountability with regard to the receipt and expenditure of capital outlay.

## **ADMINISTRATIVE IMPLICATIONS**

During the first year of implementation of the legislation, OSA will have considerable administrative duties to ensure proper implementation of the tiered system. The Office of the State Auditor (OSA) will have to promulgate rules to establish the agreed-upon procedures that apply to local public bodies under the tiered system. OSA will also have to develop a consultation process and carefully tailor the rules to local public bodies while considering what is economically feasible for local public bodies.

## **TECHNICAL ISSUES**

According to OSA, the Audit Act, Chapter 12, Article 6 NMSA 1978, requires all state agencies, entities, instrumentalities and political subdivisions of the state to conduct an annual audit or their financial affairs. The costs of the audits are required to be borne by the agency audited. Unfortunately, in applying its requirements, the Audit Act does not contemplate the distinctive nature of New Mexico's rural government entities or the financial capacities of those entities. By including "any political subdivision of the state" that "receives or expends public money" in the definition of "agency," the legislature encompassed New Mexico's smaller government entities often located in rural areas. For example, many rural government entities in New Mexico generate revenues or money for projects from membership fees or grants. Community land grants, which gained political subdivision status in 2004, have no taxing authority and therefore have no guaranteed revenue streams that can be leverage or pledged for funding projects. The revenues of community land grants typically come from permit fees for grazing and natural resource extraction, heir membership dues and lease agreements for the common lands. Annual operating budgets for these land grants range from \$0 to \$80,000. Acequias, which are community irrigation systems that are political subdivisions, operate by requiring members to pay into the system in the form of dues or labor. There are currently over 1,000 acequias in New Mexico and the budget of the largest acequia is approximately \$10,000. Finally, soil and water conservation districts and watershed districts generate revenues from sources such as grant funding or mil levies. Those funds are largely used for conservation programs in their districts.

## **OTHER SUBSTANTIVE ISSUES**

According to OSA, New Mexico's annual audit requirement is one of the most stringent and far-reaching in the nation and unfairly applies the same auditing requirements to all government entities. In general, many other states have adopted certain thresholds and criteria that determine and prioritize the type of government entity subject to state financial reporting requirements. A model that is common among many states is a system that utilizes the amount of public funds received by a government entity to determine the type of financial reporting that applies to that entity. This bill adopts a comparable model to address the differing financial realities between the government agencies broadly covered by the Audit Act.

The outcome is that many of New Mexico's rural government entities have struggled or failed to comply with the annual audit requirement. In both cases, New Mexico's rural government entities and the communities they serve suffer adverse financial impacts. Without maintaining current audits under the law, these entities jeopardize their abilities to secure much needed funds for their communities. Certifications of their budgets as required by state law may be withheld and access to state capital outlay dollars may be compromised.

**WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL**

Without appropriate application of financial reporting requirements, many of New Mexico's rural government entities will continue to struggle or fail to comply with the annual audit requirement. The result is that New Mexico's rural government entities and the communities they serve suffer adverse financial impacts. Without maintaining current audits under the law, these entities jeopardize their abilities to secure much needed funds for their communities. Certifications of their budgets as required by state law may be withheld and access to state capital outlay dollars may be compromised. These rural government entities want to maintain accountability for the use of public funds, but not at the cost of damaging the sustainability of their communities.

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