
Abstract

We examined the population of audited financial reports from all of Washington State’s 292 School Districts via the State Auditor’s Office. We found that 19 percent of school districts do not produce audited financial statements, and an additional 34 percent have problems ranging from relatively minor to severe. Of the remainder, 46 percent are generally compliant, yet only one percent of school districts produce disclosures that fully comply with generally accepted accounting standards (GAAP). This rate and quality of disclosures is significantly less and of lower quality than many other systems of financial reporting. The current reporting system appears to have significant flaws.

Background

Audited financial reports are an integral part of effective, ethical governance. Reports allow stakeholders to understand a government’s finances and the context in which those finances operate. Most local governments in Washington State produce yearly reports in accordance with RCW 43.09.230 that are relatively accessible. School districts in Washington State appear to be an exception, with many districts having out-of-date, problematic, or nonexistent audited financial reports. Why the discrepancy? This research seeks to describe this behavior and begin to explain why such behaviors are encountered in the current auditing environment. In sum, Washington State School Districts are difficult sources from which to gather information, and this raises questions whether this is an endemic problem. This indicates it is important to catalogue the extent of missing and incomplete audited financial reports in order to understand the Washington State school district environment.
The Eras of Financial Reporting Transparency in Public Systems

History reveals three broad stages of reporting public finances in America: an era of non-reporting, an era of simple reporting, and an era of accrual reporting. Each era exhibits a distinct level and format of reporting. These distinct levels and formats resemble the levels and formats at which Washington State School Districts are currently reporting.

Reporting quality is influenced by communication distance (Kossinets et al. 2008) and the bounded rationality of executives. Technology has strongly reduced the effect of communication distance (such as through the internet), and somewhat reduced the effect of executive bounded rationality (such as through improved management science). This is shown in the historical trend of increasingly detailed reporting that is communicated to leaders with greater expectations of interpretation.

The Non-Reporting Era (1644-1934)

For a large proportion of American history, public entities were not required to report any financial information at all. The important traits of this era were general nondisclosure, cash basis accounting and budgeting, and widespread corruption. These traits appear interrelated. Lack of disclosure to outside entities and lack of accrual-basis accounting and long-term budgeting make it significantly easier for individuals to take unethical actions. While there are examples of disclosure from this era, such as Baltimore and Ohio Railroad’s contractually-obligated disclosures, or E.S. Mills Public Accounts manual, these were not widely adopted (Previts 1998, Flesher 2003).

The lack of public oversight and general chaos not only meant that fraud was much easier to commit, but that even organizations working in good faith could severely harm themselves through poor planning or lack of awareness. Such uncertainty and exposure to liability were among the reasons various good governance groups such as the National Municipal League and the Citizens Union formed in the late 1800s (Roybark 2012). These organizations sought to standardize and expand public accounting and reporting. However, it would be another 30 years, marked by aggressive municipal growth (and the pitfalls such growth encountered when not properly reported) for public financial reporting to enter into the next, more thorough era (Potts 1978).
The Simple Reporting Era (1934-1984)

The Simple Reporting Era is characterized by basic disclosure, cash basis accounting and budgeting, and growing standardization and professionalization. While significantly shorter than the preceding era, it was also more dynamic, involving numerous actors and rapidly-growing codifications in the search to produce a universal effective standard. For governments, the initial force was at the federal level, with the New Deal’s Securities Act of 1933 and Securities Exchange Act of 1934 creating new banking regulations and federal programs requiring accounting oversight (Coffman 1997). This increased disclosure and standardization of government finance spread in successive waves to governments, with ad-hoc groups such as the National Committee on Municipal Accounting (NCMA) and its successor, the National Committee on Governmental Accounting (NCGA) advocating for and setting the standards.

The net effect of these ad-hoc and volunteer groups was a significant improvement over the Non-Reporting Era. While not as thorough or intricate as later systems of disclosures would be, the core concepts of transparent funds presented according to generally accepted principles were widely disseminated by volunteer organizations (Freeman 1978, Gauthier 2001). This dissemination spread faster in larger governmental entities, with the federal government changing fastest, and many smaller organizations (such as cities) lagging behind.

However, the growth in standardization rapidly swamped the small volunteer groups who had done the work of disseminating and lobbying for these concepts. Volunteer professional expertise was insufficient, and the original standards lobbied for led to new, unexpected pitfalls, such as New York City’s 1975 near-default on its debt obligations (Blumenthal 2002). These new strains on the small budget of interested volunteers was too much, and in 1984 the Government Accounting Standards Board (GASB) was created by the Financial Accounting Foundation, the American Institute of Certified Public Accountants, the Government Finance Officers Association, the National Association of State Auditors, Comptrollers and Treasurers, and the seven organizations representing state and local government officials (Roybark 2012).

The Accrual Reporting Era (1984-Present)

The Accrual Era is characterized by disclosure and analysis, accrual-basis accounting, and growing transparency. Management’s Disclosure and Analysis (MD&A) by the disclosing entity has been useful in providing context, increased transparency has aided in letting community members participate in decision making, and ac-
Accrual basis accounting has helped provide a more long-term view on revenues and expenditures that can prevent situations such as 1975 New York. While the Era of Accrual Reporting has several problems of its own, it has generally been an improvement over the preceding eras in terms of disclosure, efficiency, and accountability.

The importance of describing these eras is to show how well they match the three core reporting approaches of government organizations and, from there, how well those three formats explain the Washington State School Districts. Approximately 19 percent of Washington State School Districts are still working within the Non-Reporting Era, and a further 46 percent are using a system designed for compliance with the dictates of the Simple Reporting Era. The remainder are currently in the Accrual Reporting Era but having various difficulties fully complying with all the pronouncements of Generally Accepted Accounting Principles (GAAP). Only three out of the nearly 300 districts (~one percent) have systems in place that match the quality found in Accrual Reporting Era governmental organizations elsewhere. This suggests that the scandals and dangers that befell organizations of the Non-Reporting and Simple Reporting Eras could strike these school districts in the future.

**Method**

The entire population of Washington State School Districts served as the evidence for this study. In all, there are 292 districts. We used audited financial statements from the Washington State Auditor’s website as the source. We tracked basic variables of financial reporting from each statement:

- Has audited financial statement on State Auditor’s website
- Issue year of the audit
- Length of audit period
- Existence of significant deficiencies
- Existence of material weaknesses
- Existence of a balance sheet
  - Value of the Total Liabilities and Fund Balance
- Existence of a statement of revenues
  - Total revenues
  - Total expenditures
- Whether or not the district reported capital assets
  - Amount of long-term debt
  - Mention of debt rating
- If there is a debt rating, the company that provided the rating
- If there is a debt rating, the rating itself

We coded the bold variables to provide a score for each school district based on the completeness of their reporting. Each of these variables received an “index” score (Ingram 1984, Cheng 1992, Smith 2004), with the variables chosen to meet minimum GAAP reporting standards. For example, in the population we found that the length of the audit period spanned one to three years, which we assigned the following scores: one year = one; two years = zero; and three years = negative one.¹

We measured each of the listed variables as an initial sense-making activity. This was combined with a literature review of other studies that focused on correlations between certain indexed traits and financial well-being (Ingram 1984, Banker et al 1989, Cheng 1992, Smith 2004, Carslaw et al 2007). From this review, we determined that the traits marked in bold were of recurring use in creating meaningful indices. This included existence of basic GAAP-minimum information, such as the existence of balance sheets and statements of revenue, as well as generally-accepted causes for concern, such as audit findings of material weaknesses in the past.

We then judged each variable as either a positive step, neutral step, or a negative step based on its predicted effect on financial well-being. For example, the existence of significant deficiencies is a negative fact, while a lack of significant deficiencies is a neutral step. Reporting a capital asset is “above and beyond” what is required by the State Auditor’s Office, so it is considered a positive step. Positive steps were assigned a plus one, neutral steps a zero, and negative steps a negative one. In theory this creates a ten-point scale of negative four to positive six, but certain traits (such as the lack of a financial statement altogether) preclude the more negative scores. As a result, we end with a scale of zero to six.

After coding the variables we added the indexed scores together to provide each district with an overall score regarding reporting completeness, which we call their Minimum Quality of Reporting Index (M-QRI) score.

¹ There are two conflicting views on longer audit cycles. Models around timeliness of audited information argue that longer cycles lead to less timely information, which is correlated with higher risk classification (Carslaw et al 2007). However, the State Auditor’s Office (SAO) of Washington State only allows school districts with low risk to have longer audit cycles. Because of this, the data around reporting cycles may be noisier than some of the other data points.
Table 1: Quality of Reporting Index – Scales

<table>
<thead>
<tr>
<th>Variable</th>
<th>Index Scoring Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>-1</td>
</tr>
<tr>
<td>Has Financial Statement</td>
<td>No (52)</td>
</tr>
<tr>
<td>(N=292)</td>
<td></td>
</tr>
<tr>
<td>Most Recent Issue Year</td>
<td>&lt;2013 (31)</td>
</tr>
<tr>
<td>(N=240)</td>
<td></td>
</tr>
<tr>
<td>Audit Period</td>
<td>&gt;2-Year Cycle (20)</td>
</tr>
<tr>
<td>(N=240)</td>
<td></td>
</tr>
<tr>
<td>Significant Deficiencies</td>
<td>Yes (18)</td>
</tr>
<tr>
<td>(N=240)</td>
<td></td>
</tr>
<tr>
<td>Material Weaknesses</td>
<td>Yes (19)</td>
</tr>
<tr>
<td>(N=240)</td>
<td></td>
</tr>
<tr>
<td>Has Balance Sheet</td>
<td>No (54)</td>
</tr>
<tr>
<td>(N=240)</td>
<td></td>
</tr>
<tr>
<td>Has Statement of Revenue</td>
<td>No (0)</td>
</tr>
<tr>
<td>(N=240)</td>
<td></td>
</tr>
<tr>
<td>Reported Capital Assets</td>
<td>No (234)</td>
</tr>
<tr>
<td>(N=240)</td>
<td></td>
</tr>
</tbody>
</table>

Results

The M-QRI scores ranged between zero and six, with six being the highest possible. The data shows that the majority of the data is at either end of the spectrum with relatively few districts scoring in the middle. The majority of districts that attempted reporting succeeded, while a seemingly non-trivial number made no effective attempt.²

² Discussion with the Washington State Auditor’s Office indicates that many districts that do not produce audited financial statements instead receive an “Accountability Audit”. An Accountability Audit “evaluates whether there is reasonable assurance the state agency adhered to applicable federal or state laws, regulations and its own policies and procedures” (SAO 2015). Accountability Audits are separate and distinct from an audited financial statement.
Of the 56 districts that received a score of zero, 52 (17 percent of the population) did not report in the last three or more years. Further research is necessary to determine if this is outside of normal when compared to other states, but at first glance, more than one-fifth of districts not reporting in the past three years seems alarmingly high.

Just 18 percent of districts receive a score of one, two, or three. An additional 16 percent received a score of four.

With 46 percent of districts receiving a score of five, most districts were close to but failing to achieve minimum compliance.

Only three districts in the state received the top score of six. This is largely due to the fact that just six districts in the state reported capital assets. There are particular difficulties reporting capital assets for a school district, as shown by the GASB 34 debate on capital assets and the reporting of capital assets.

**Discussion and Analysis**

Approximately six percent of school districts were found to have “significant deficiencies”. Significant deficiencies indicate a lack of proper internal controls in recording and reporting financial information. This lack of proper reporting behav-
iors can range in meaning from completely harmless to a sign of severe mismanagement. As a result, it is considered a warning sign but does not necessarily indicate that a problem will result. This is comparable to a doctor asking a patient if they are eating five to nine servings of fruit and vegetables a day and the patient replying that they are unsure. In both cases, uncertainty about compliance is worrisome but not actual proof of noncompliance.

**Significant Deficiency Example:** An organization processes many inter-organization transactions each month. Individual inter-organization transactions are not material and often just transfers between units to finance normal operations. There is a formal management policy in place to reconcile inter-organization accounts and confirm balances between business units, but there is no system in place to ensure enactment of said policy. Management conducts monthly investigations of a few large-dollar inter-organization account differences and prepares a detailed monthly variance analysis of operating expenses to assess reasonableness.

This is a significant deficiency because the magnitude of a misstatement on a financial statement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material. This is because individual inter-organization transactions are not material and the monthly investigation should catch any material misstatement. However, the company must design controls to catch smaller misstatements as well, not just material misstatements.

Similarly, seven percent of school districts were found to have “material weaknesses”. Material weaknesses indicate that the auditor identified specific places where internal controls in recording or reporting financial information were not followed or are otherwise ineffective. This is significantly more problematic than significant deficiencies, as it turns a warning sign into proof of a problem. A material weakness is not that a door was left unlocked; it is that the door was opened after it had been left unlocked. Building upon the earlier health analogy, this is the doctor checking the meal journal of a patient and seeing no fruits and vegetables eaten for significant stretches.
Material Weakness Example: An organization processes many intercompany transactions each month. In this scenario individual inter-organization transactions are frequently material and relate to a wide range of transactions. There is a formal management policy in place to reconcile intercompany accounts and confirm balances between business units, but no process to ensure that these procedures are performed on a consistent basis. Therefore, reconciliation between accounts is not timely and differences in inter-organization accounts are frequent and significant.

This is a material weakness because misstatements resulting from this deficiency would reasonably be expected to be material, as transactions are frequently material transactions relating to a wider range of activities. Furthermore, the likelihood of these misstatements are more than remote because compensating controls are not properly designed or not operating effectively. The magnitude and likelihood of misstatements resulting from this internal control meet the definition of a material weakness.

There is a relationship between significant deficiencies and material weaknesses. They are functionally the same problem in different stages of its life cycle: Deficiencies are potential control failures that will turn into material weaknesses when the potential failure becomes actual failure. However, this means that the population overlap of organizations having both is relatively rare. For most of the observed cases, the six percent deficiencies and the seven percent weaknesses were different school districts. This means approximately 13 percent of Washington State School Districts have internal control problems that are of concern to State Auditors (Rice & Weber 2012).

<table>
<thead>
<tr>
<th>Score</th>
<th>Number</th>
<th>Proportion of Population</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>56</td>
<td>19%</td>
<td>Fails</td>
</tr>
<tr>
<td>1</td>
<td>12</td>
<td>4%</td>
<td>Needs Improvement</td>
</tr>
<tr>
<td>2</td>
<td>22</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>17</td>
<td>6%</td>
<td>Considerable Progress</td>
</tr>
<tr>
<td>4</td>
<td>48</td>
<td>16%</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>134</td>
<td>46%</td>
<td>Complies</td>
</tr>
<tr>
<td>6</td>
<td>3</td>
<td>1%</td>
<td></td>
</tr>
</tbody>
</table>

Table 3: Population Distribution of Scores

Another issue noted among the population is the high rate of late audit reports
taking a year or more (~360 days). This compares unfavorably to a mean delay of ~180 days (Carslaw et al. 2007), to the municipal mean delay of ~120 days (McClelland & Giroux 2000), and to Texan Independent School Districts delay of ~80 days (Deis & Giroux 1992). For some districts, the most recent audited financial statement is from 2008. This is related to two separate traits. First, some districts are on two or three-year audit cycles. This means that some school districts are “up to date” while their most recent audit report is from 2011. At the same time, some districts simply have audits that are late (Dwyer and Wilson 1989). Only 66 percent of school districts had an audited financial report from 2014. This is equivalent to having medical records a year or more out of date when seeking diagnosis.

Nearly 20 percent of school districts are not filing audited financial reports. This is in direct contravention of healthy financial disclosure practices. Districts that are not producing audited financial reports are an informational black hole: We can make no meaningful judgment on their state of being because we cannot directly observe the state of their being. In the medical analogy, these are patients who are absent. We are unsure if they are dying, injured, asymptomatic, or even hale and hearty; without a GAAP-compliant report it is impossible to effectively discern their condition.

Roughly a third (34 percent) of school districts are struggling, scoring less than five but more than zero. These indicate school districts that are having difficulty complying with financial disclosure regulations but are making attempts to do so. These range from schools doing a severely problematic job (score of one or two; 12 percent), a moderate job (score of three; six percent), or are just short of general compliance (score of four; 16 percent). The relatively low numbers indicate an overall bimodal distribution for the population, with most districts either almost achieving compliance, or generally not attempting compliance at all. The former of these two types of districts may have a problem, but it is a solvable one: Providing further accounting capacity through training, funding, or other forms of support will likely improve their outcome.

A plurality of school districts (46 percent) are “nearly compliant”, scoring a five out of six on our M-QRI scale. This indicates nearly sufficient but not GAAP-compliant reporting. Most school districts are meeting the minimum reporting quality

---

3 As noted before, many of the reports (33 out of 48) that were not issued in the past year are due to schools on multiyear audit cycles performed with the permission of the State Auditor. However, Carslaw et al. (2007) show that multiyear cycles are correlated with higher risk classifications for school districts. Additionally, this does not account for the 15 districts that did not have permission to have a longer audit cycle.
required by state law and going no further. This is adequate to satisfy Washington State, but compares unfavorably to the higher standard private organizations and many governments reach, such as form 990s (nonprofit tax returns) or comprehensive annual financial reports (CAFRs) attain. This compares to the health of an average American: It could be better, but their current state of health is a situation of least concern compared to the more serious problems within the population.

Only one percent of the population of school districts met the minimum standard of CAFR-level disclosures by scoring a six out of six on the M-QRI. Compared to GAAP-compliant audited financial reports overall, the one percent are performing well. By comparison with the other school districts, they are exceptional.

**Conclusion**

The population analysis shows endemic poor and opaque financial reporting practices. Approximately one in three school districts is experiencing some severe problem, whether it be significant deficiencies (six percent), material weaknesses (seven percent), or failure to report (19 percent). When combined with schools that are struggling to meet current reporting standards (34 percent), roughly half of all Washington State School Districts are having serious reporting problems.

When 19 percent of a population is failing to comply with the most basic recommendations of healthy financial disclosure, it does not follow that the disclosure should be made mandatory, but it does indicate that some social good of the recommendation is not being created. This failure to comply with reporting standards indicates a problem somewhere within the reporting process. Additionally, this level of lacking audited financial reports is not seen among publically-traded securities, nonprofit organizations, or local or federal governments, all of which are much better at disclosure.

However, different forms of reporting failure require different policy interventions. For example, a school district scoring four on the index scale may only need increased technical capacity in the form of training or grants. A district that has material weaknesses perhaps needs a thorough overhaul of internal control protocols, either implemented internally or imposed from the outside, to bring its reporting into compliance. A non-reporting district, by contrast, needs some form of policy intervention to induce it to begin reporting; whether that induction should involve positive or negative reinforcement is beyond the scope of this study.

Disclosures can be costly initially, requiring additional staff training, oversight, and
technology. However, this compliance does often pay for itself over time. Baber and Gore (2008) find that municipalities who maintain GAAP-compliant disclosure standards have greater access to debt at fourteen to twenty-five basis points cheaper than noncompliant entities, and cheaper debt cost and contracting costs upon complying with GAAP. Additionally, Saito and McIntosh (2007) find that more stringent disclosure requirements reduced the nonproductive use of taxes, freeing funds to be used more effectively by Georgia school districts.

This paper suggests new avenues of fruitful research into the motivations, incentives, and difficulties school districts encounter in producing audited financial reports. We have found there is significant noncompliance with GAAP and failure by many entities to produce audited financial reports. The prevalence of noncompliance points to the possibility of structural flaws. Such flaws may be in the structure of reporting and compliance, in the technical accounting capacity of the actors within the system, or other possibilities such as location or school district size. These flaws may also portend fraud or corruption being discovered in these districts in the future. This research identifies the extent and nature of this noncompliance. Having done so, further avenues of research have been opened to describe, explain, and understand the sources and results of this noncompliance.

Acknowledgements
We would like to extend our deepest thanks to Dr. Kenneth A. Smith for providing insight, experience, and support in creating this research paper.

Author Affiliations

John Kurpierz is a social science generalist who fell in love with government accounting, earning him the nickname “Swiss Army Knife”. He earned his MPA from the Evans School of Public Affairs in 2013 with specializations in accounting/finance and local government. John currently is Research Associate for IBG, and has had his research presented at the conferences of Public Administration Review and the American Accounting Association.

Elijah Panci received his BA in Political Theory and Constitutional Democracy from James Madison College of Political Science at Michigan State University, with a specialization in Science, Technology, the Environment, and Public Policy. He is currently an MPA candidate at the Evans School of Public Policy and Governance at the University of Washington, specializing in public finance.
References


Blumethal, Ralph “Recalling New York at the Brink of Bankruptcy” New York Times, December 5, 2002


Governmental Accounting Standards Board Statement No. 34, Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments 1999


Kossinets, Gueorgi; Kleinberg, Jon, and Watts, Duncan “The Structure of Information Pathways in a Social Communication Network” Proceedings of the 14th ACM SIGKDD international conference on Knowledge discovery and data mining 2008


Saito, Yoshie, and McIntosh, Christopher S., “The Value Added by Auditing and the Hidden Costs of Regulation: Public School Operation” Submission to AAA 2007 Management Accounting Section Meeting
