Audited Financial Statements for Puerto Rico Matter...But Only a Little Bit

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What does it really mean when a government or public entity can't issue financial statements in a timely manner? Lots of things. But it's not what often gets the politicians and creditors chirping. Many, many governmental entities take more than 6 months to issue financial statements after their fiscal year ends, something that would get a corporation in big trouble with its investors, lenders and regulators. Not so in the public sector, where it is acceptable to have outdated systems, poor internal controls and insufficient resources. Add in the circumstances of extremely tight liquidity, speculation of bankruptcy, typical auditor skittishness and you have the makings for an all-out fiasco over audited numbers!

On Tuesday afternoon, Puerto Rico finally released financial reports, in draft, for the fiscal year ended June 30, 2014. Now its auditors, KPMG, can complete their work, assuming the Commonwealth provides the additional and supplemental information that has been requested. Remember: organizations prepare their financial statements and auditors render an opinion on them. Auditors **do not** prepare the numbers. Recently, KPMG Partner Ernesto Aponte testified that he expected it would take 8 to 9 weeks to complete the audit once all the information was available. For an entity with over $15 billion in revenues and expenses, this is not a surprising timeframe. What is surprising is that the Commonwealth took 19 months to prepare draft financials. Furthermore, Puerto Rico has not yet retained auditors for the year ended June 30, 2015.

Audited financial statements matter for two reasons. First, audited financial statements put a stake in the ground so that everyone knows what the "as is" state was at some point in time. This is particularly important as it relates to assets and liabilities and their reported values, how much cash existed on a particular date and what the accounts payable balance was. Once a reader of the information has confidence that some value was accurately reported at some date, moving forward and factoring in changes is simpler. Further, because audited numbers provide a relatively consistent presentation over time, an analysis of the performance trends is possible. In other words, is "bad" but getting better or is "bad" getting worse.

Second, audited financials are evidence that an organization is capable of being audited. This sounds like "accountant speak" and, to some extent, it is. If an organization cannot produce the information an auditor needs to do his or her job, it bespeaks deeper problems with financial systems and business processes. Sometimes confusion exists between this concept and that of a "going concern opinion". They are not related. If an auditor can't get the information he or she needs to perform the audit or has a significant lack of confidence in the information received, then the auditor cannot render an opinion.

Alternatively, if an auditor can perform his or her tests and audit procedures as auditing standards require, but believes that the entity may not be able to continue to operate, then the auditor will qualify the opinion to reflect this. In the case of Puerto Rico, determining if KPMG can render any opinion is more important than the "going concern" issue that garners media attention.

It is not obvious but there is a choice here. Having audited financials will not change any of the facts. Puerto Rico needs to undertake a comprehensive restructuring with all of its stakeholders, and soon. The existence, or not, of an audit will not change this.

The reason audited financials don't matter much in a restructuring is because restructuring focuses on the future while audited financials measure the past. In fact, most financially and operationally troubled businesses can develop the data needed to formulate a reasonable and feasible plan without audited financial statements. As we know from the Chapter 11 world, when a company enters bankruptcy what the public wants to know about is what are the assets, what are the liabilities, do you have cash and can you generate cash from operations. Knowing those values go a long way in figuring out what changes need to occur to reach a stable performance level sufficient to support some level of restructured debt. Restructuring is all about making changes so that what happened in the past does not continue into the future. Audited financials play a small role, if at all, in that process.

Public sector "businesses" are only a little bit different. The Commonwealth has volumes of data and credible information about many of the assets, liabilities, revenues and expenses that are components to a restructuring plan. These items and amounts can be verified without an audit of the historical information. Does this mean that there could have been leakage since audited financials were last provided almost three years ago? Yes, but, we probably know that anyway and whatever leaked out – either through fraud, waste, corruption, bad management, inattention – is gone for good. Getting controls in place to manage cash, collect revenue and control spending are much more important than providing the public with audited financial statements relating to activities only visible in the rear-view mirror.

Last, the lack of audited financial statements has provided a crutch for elected officials and creditors to delay the inevitable comprehensive restructuring that is required in Puerto Rico. While having audited financial statements would be helpful and preferable, they are not necessary to the restructuring process. With or without an audit, the Commonwealth needs a plan to undertake both operational and financial restructuring with measurable outcomes, definitive time tables and holistic participation by stakeholders. Rather than continue hand wringing about audits, the Commonwealth must address its structural inability to timely report financial results. This is more important for the restructuring of Puerto Rico, as constituents and legislators must have the ability to monitor performance once the tools are in place to facilitate the comprehensive restructuring.