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A Case Study in Tennessee

Government Audit Quality and Efforts to Improve Internal Controls

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Single audit quality is a long-standing area of concern. Numerous studies have examined government audit quality, including the *Report on National Single Audit Sampling Project*, issued by the President's Council on Integrity and Efficiency (PCIE).¹ According to the report, more than 50% of the 193 single audits conducted by CPA firms in the sample population were either unacceptable or of limited reliability. Common deficiencies included failure to document an understanding and testing of internal controls over compliance

requirements, failure to document compliance testing, and misreporting coverage of major programs. Although the PCIE study primarily focused on single audits conducted by CPA firms, it did include 14 audits conducted by centralized state audit agencies; 13 (93%) were considered reliable.

Because single audits provide information on the management of federal awards and may affect future grant decisions, audit quality concerns compromise the value of the audit results. If an audit fails to identify and report deficiencies, granting agencies that rely on audit information may



reach inappropriate conclusions. CPA firms that conduct single audits often lack experience with these audits. Based on a recent study of 24,144 single audits, more than 30% are performed by firms conducting 10 or fewer audits in a given year.² These audits are less likely to identify deficiencies, probably due to a lack of specialized government audit knowledge.³ Meanwhile, centralized state audit agencies focus exclusively on government audits, many of which are single audits. It begs the question: are single audits conducted by government agencies of higher quality than those conducted by CPA firms?

Case Study Parameters

Tennessee is one of only 14 states to utilize both a centralized state audit agency and individual CPA firms to conduct single audits of local governments.^{4,5} This context affords an excellent opportunity to compare the results of audits conducted by the two types of auditors. Our research explores single audit results for Tennessee cities, audited by CPA firms, and counties, audited mainly by the centralized audit agency. Using data from the Federal Audit Clearinghouse, we trend the percentage of internal control deficiencies from 2013–2018.⁶ We also consider the impact of legislation — Tennessee

Code Annotated (TCA) §9-18-102, which took effect in the fiscal year ended June 30, 2016, and required both formal internal control systems and related documentation for local governments. The state then provided technical support from both its centralized audit agency and partner organizations to implement, document, and continuously improve local government internal controls to comply with the law.

Using internal control deficiencies as a metric of audit quality (i.e., more deficiencies indicate a more rigorous audit), we make three observations:

- 1 Tennessee, in 2013–2018, compares favorably to the rest of the nation.** Audits of local governments conducted by both the centralized audit agency — the State of Tennessee Office of the Comptroller of the Treasury Division of Local Government Audit (the TN Comptroller) — and CPA firms report a higher rate of internal control deficiencies than the national average in cities and counties.
- 2 Audits conducted by the TN Comptroller appear consistently more rigorous** than those of CPA firms, evidenced by a higher rate of internal control deficiencies noted by the TN Comptroller.
- 3 The implementation of TCA §9-18-102 made a favorable impact** on both city and county financial operations (i.e., internal control deficiencies decreased after the legislation).

Our results collectively support the consideration of centralizing the state audit function and executing additional legislation and supportive networks to improve internal controls in local governments.

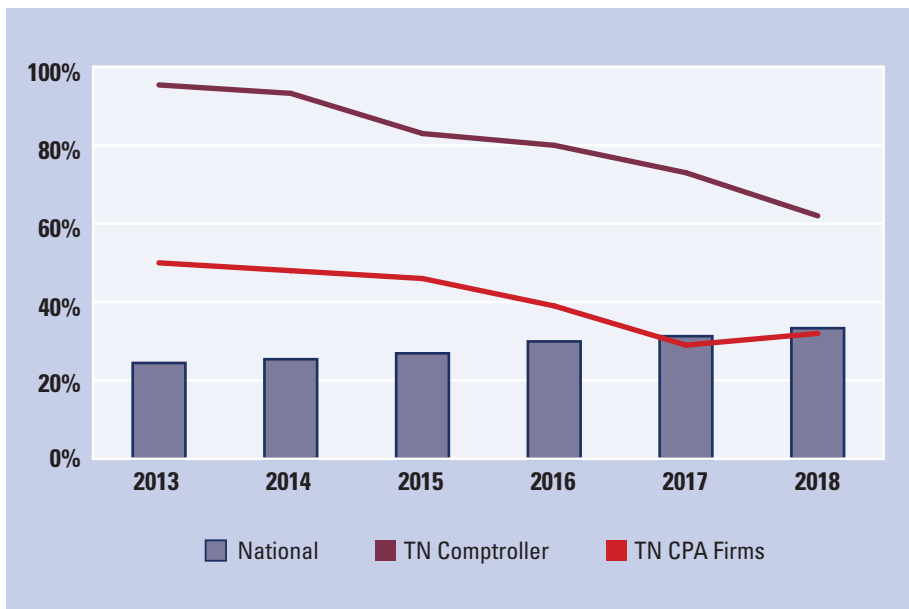
Tennessee Finance Support Network

The TN Comptroller is actively engaged in city and county audits. The office serves as the auditor for most Tennessee counties.⁷ In the remainder of counties and all cities, it participates in three-party audit contracts with each local government and its audit firm. The TN Comptroller must approve the contracts and review the final audit report for compliance with financial reporting standards. The office may also evaluate the audit firms' work papers for compliance with applicable auditing standards. Because audit firms must also follow an audit manual created by the TN Comptroller, they essentially act as agents for the TN Comptroller.

In addition to a hands-on approach to all government audits, the TN Comptroller coordinates with other agencies to ensure local government finance officers have the support they need to be successful. Two such agencies provide a wide range of support functions, including financial, legal and IT assistance: the Municipal Technical Advisory Service (MTAS), founded in 1949 to serve cities, and the County Technical Assistance Service (CTAS), founded in 1973. The University of Tennessee houses both agencies within its Institute for Public Service.

Tennessee is somewhat rare in having the two agencies' support in promoting effective local government management. In public finance, MTAS and CTAS took on more significant roles after the passage of the Certified Municipal Finance Officer and Education Act of 2007, which mandated the Certified Municipal Finance Officer (CMFO)

Figure 1. Rate of Internal Control Deficiencies



program. In 2018, the state added the non-legislated Certified County Finance Officer (CCFO) program to encourage county finance officers to participate in certification. Leading up to and following the passage of TCA §9-18-102, MTAS and CTAS partnered with the TN Comptroller to support compliance in cities and counties. The CMFO and CCFO programs added training to ensure local government finance officers understood their responsibilities in establishing and maintaining adequate internal controls. The partnership among the entities aimed beyond minimum compliance toward general improvement in internal controls.

Analysis of Uniform Guidance Audit Findings

Our study examined internal control deficiencies in financial statement preparation for all Tennessee cities and counties subject to Single Audits from 2013–2018.⁸ The localities are categorized by their auditor, either the TN Comptroller or a CPA firm. We compared the rate of internal control deficiencies to the national average of all U.S. cities and counties. During this timeframe, single audit requirements changed with the implementation of the U.S. Office of Management

and Budget’s *Uniform Administrative Requirements, Cost Principles and Audit Requirements* (Uniform Guidance.) Beginning with fiscal years ended June 30, 2016,⁹ Uniform Guidance increased internal control requirements and testing.¹⁰ Given the simultaneous implementation of TCA §9-18-102, our research scrutinized how the rate of internal control deficiencies in financial reporting changed in cities and counties outside Tennessee.

Figure 1 presents our analysis, including three clear inferences. First, audits of Tennessee local governments, whether conducted by the TN Comptroller or audit firms, appear to be more rigorous than local government audits in other states. For

example, in 2013, the TN Comptroller reported internal control deficiencies in 95% of their audits, while audit firms in Tennessee reported deficiencies in only half (50%). In contrast, the national average for audit firms was about one quarter (24%.) Despite a convergence of results for audit firms in Tennessee and the national average for the years after 2016, the TN Comptroller consistently reported a greater percentage of internal control deficiencies in its audits for the entire study period, 2013–2018. For example, in 2018, the TN Comptroller reported 62% with deficiencies when the national average was only 33%.

Also illustrated in **Figure 1** is a clear difference in the rigor of audits conducted by the TN Comptroller and audit firms in the state. For the entire six years under review, the TN Comptroller consistently reported more internal control deficiencies in its audits than did audit firms. To confirm that this difference is not due to the nature of the audits — cities versus counties, we further analyzed the results by applying entity fund count to measure audit complexity.¹¹ When we segregate local governments into high and low complexity categories, the audits conducted by the TN Comptroller still report more internal control deficiencies within each category.¹² This result is significant to the national conversation about audit quality concerns. The value of centralized audit agencies such as the TN Comptroller is evident, and other states should consider the broader adoption of audit centralization and oversight.





Moreover, **Figure 1** illustrates the effects of state efforts to improve local governments' internal controls. The training and consulting provided by the TN Comptroller, MTAS and CTAS appear to have improved controls, given the notable decrease in deficiencies found in all audits, no matter the auditor, in 2015–2016, 2016–2017, and 2017–2018. Support efforts appear to have corrected previously noted internal control deficiencies in cities (audited by firms) and counties (audited by the TN Comptroller). However, the gap between the two remains the same, supporting our conclusion that the TN Comptroller conducts more rigorous audits than audit firms, likely due to knowledge and experience.

It is important to note that Tennessee improved internal controls in local governments at the same time Uniform Guidance increased expectations for controls and audits. We expected more findings in this period, and we observed the national average began to increase after 2015. The result is a convergence of the rate of internal control deficiencies in cities and counties in other states (which increased with Uniform Guidance) with Tennessee local governments (which decreased with TCA §9-18-102).

The gap closes entirely for audits conducted by audit firms in TN and all audits conducted in other states. We interpret this to mean the effectiveness of TCA §9-18-102 resulted in internal control improvements despite the increased testing required by Uniform Guidance. Converging results notwithstanding audits conducted by the TN Comptroller still report a significantly higher rate of internal control deficiencies than the 2018 national average, underscoring the value of a centralized audit function.

A Model of Audit Quality

Tennessee offers a model for auditing local governments. For the counties the TN Comptroller audits directly, government audit expertise translates into a more thorough audit that reveals a higher rate of internal control deficiencies. For the cities monitored by a three-party audit contract, a higher rate of internal control deficiencies than the national average emerges. Although audit firms in the state have not demonstrated the same audit rigor as the TN Comptroller, the fact that the rate of deficiencies found is higher than the national average indicates successful state oversight. Also, when Tennessee

accompanied legislation with capable support, we believe it contributed to an overall decrease in internal control deficiencies and improvements in the control systems of city and county governments. This progress should be encouraging to other states considering similar legislation.

The rigor of the TN Comptroller, evidenced in the consistently higher rates of internal control deficiencies, should serve as a model for the 27 states that do not utilize a centralized audit agency in local governments' single audits.¹³ A national need for increased government audit quality persists. Replicating Tennessee's successful centralized state audit agency model can offer the solution if combined with the right legislation and oversight. ■

Endnotes

1. PICIE. *Report on National Single Audit Sampling Project*, 2007.
2. Waymire, Tammy R., T.Z. Webb & T.D. West. "A Comprehensive Analysis of Findings from Single Audits: The Implications of Auditee Type and Auditor Expertise," *Journal of Governmental & Nonprofit Accounting*, 2018, Vol. 7, No. 1, p. 55–77.
3. Waymire, Tammy R., T.Z. Webb & T.D. West. "To Audit or Not to Audit: Whether to Accept a Uniform Guidance Audit," *CPA Journal*, 2019, Vol. 89, No. 4, p. 56–58.
4. The National Association of State Auditors, Comptrollers and Treasurers. *Auditing in the States: A Summary*, 2016. (www.nasact.org)
5. For the purposes of our research, local audit is limited to audits of cities and counties. Table 4 of NASACT 2016 provides the following list as states that utilize a blend of audit agency and CPA firms to conduct the audits of cities and counties: AL, AZ, AR, IA, KY, MA, MN, MS, MO, NE, OH, OK, SD, TN.
6. Federal Audit Clearinghouse (FAC), 2013–2018. <https://harvester.census.gov/facdissem/PublicDataDownloads.aspx>
7. Of the 95 Tennessee counties, five (Nashville-Davidson, Shelby, Knox, Hamilton and McMinn) are audited by CPA firms instead of the TN Comptroller.
8. Internal control deficiencies related to financial reporting represent only one type of finding available from Uniform Guidance filings with FAC.
9. Uniform Guidance was effective for audits of fiscal years beginning on or after December 26, 2014. All Tennessee cities and counties end their fiscal years on June 30. Therefore, the first audit subject to Uniform Guidance was for fiscal year ended June 30, 2016.