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Government Audit Quality and Efforts to Improve Internal Controls: A Case Study in Tennessee

Ashley B. Nipper¹
Tammy R. Waymire²

Abstract

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¹ Master of Accounting Student, Middle Tennessee State University, 1301 E. Main St., Murfreesboro, TN 37132.
Email: anb8p@mtmail.mtsu.edu

² Department of Accounting, Middle Tennessee State University, 1301 E. Main St., Murfreesboro, TN 37132.
Email: tammy.waymire@mtsu.edu

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Ashley B. Nipper
Master of Accounting Student
Middle Tennessee State University

Tammy R. Waymire
Associate Professor of Accounting
Middle Tennessee State University

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Legislative Efforts to Improve Local Government Internal Controls: A Case Study in Tennessee

Almost since Single Audits were legislated in 1984, the quality of these audits has been 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),ⁱ which found that more than 50 percent of Single Audits were either unacceptable or of limited reliability. The study primarily focused on Single Audits conducted by CPA firms, but in the limited number conducted by centralized audit agencies, audit quality was more satisfactory. Because Single Audits are designed to provide information about the way federal awards are managed and to inform future grant decisions, concerns with audit quality compromise the value of the results of the audit. If an audit fails to identify and report deficiencies that are present, granting agencies relying upon the audit may reach inappropriate conclusions related to grant monitoring and future grant award decisions. Government audit quality concerns related to audits conducted by CPA firms may be driven by lower audit fees (firms may have opportunities for engagements with a higher profit margin) and the specialized knowledge required. Centralized state audit agencies are not as hindered by these two factors, leading us to ask the question: Are audits conducted by these agencies of higher quality than those conducted by CPA firms?

Tennessee is one of only fourteen states to utilize both a centralized audit agency and individual CPA firms to conduct Single Audits of local governments,ⁱⁱ allowing a unique opportunity to compare the results of the audits conducted by the two types of auditors.ⁱⁱⁱ In this article, we explore Single Audit results for Tennessee cities (audited by CPA firms) and counties (almost all audited by the centralized audit agency) using Federal Audit Clearinghouse (FAC)

data, and we trend the percentage of internal control deficiencies over the period 2013 to 2018.^{iv} During this time period, the State of Tennessee legislated internal control requirements for its local governments effective for the fiscal year ended June 30, 2016. This legislation implemented supports that would be expected to improve internal controls and therefore result in fewer control deficiencies.

Trending internal control deficiencies, we make three observations. First, with national audit quality concerns mounting, Tennessee compares favorably to the rest of the nation over the period 2013 to 2018. Audits of Tennessee local governments conducted both by the Tennessee Office of the Comptroller of the Treasury (Comptroller's Office, i.e., centralized audit agency) and by CPA firms report a higher rate of internal control deficiencies than audits of cities and counties in other states, indicative of higher audit quality. Second, audits conducted by the Tennessee Comptroller's Office appear to be consistently more rigorous than those conducted by CPA firms, evidenced by a higher rate of internal control deficiencies noted by the Comptroller's Office. Third, the implementation of legislation requiring internal controls has had a favorable impact on internal controls of cities and counties. Collectively, the Tennessee case study results provide support for consideration of centralization of the audit function and for legislation and supportive networks to improve internal controls of local governments.

Local Government Finance Support Network in Tennessee

The State of Tennessee Office of the Comptroller of the Treasury (Comptroller's Office) Division of Local Government Audit (LGA) is actively engaged in the audit process for both counties and cities. The Comptroller's Office LGA serves as the auditor for Tennessee counties and is also a party to the three-party audit contracts with cities and their audit firms, overseeing the audit with audit firms essentially acting as an agent of the Comptroller's Office LGA. In

addition to the hands-on approach to all government audits, the Comptroller's Office LGA coordinates with other agencies to ensure local government finance officers have the support they need to be successful.

Tennessee also utilizes two agencies that provide assistance to local governments covering a wide range of support functions including financial, legal, and information technology, among others. Housed within the University of Tennessee (UT) Institute for Public Service (IPS), the Municipal Technical Advisory Service (MTAS, founded in 1949) serves cities, and the County Technical Assistance Service (CTAS, founded in 1973) serves counties. Tennessee is fairly unique in having the support of these agencies in promoting effective local government management. In the area of public finance, these agencies took on a more significant role when the State implemented the Certified Municipal Finance Officer (CMFO) program (with the Certified Municipal Finance Officer and Education Act of 2007) and the Certified County Finance Officer (CCFO) program (without legislation, but an incentive program for encouraging finance officers to participate, implemented in 2018).

Leading up to and following the passage of TCA §9-8-102 in 2016, these agencies partnered with the Comptroller's Office to provide support for cities' and counties' efforts in complying with the legislation. The certification programs (CMFO and CCFO) incorporated additional training to ensure that local government finance officers understood their responsibilities for establishing and maintaining adequate internal controls. The partnership among the Comptroller's Office, MTAS, and CTAS provided not only the support for minimum compliance with TCA §9-18-102, but also for improving internal controls beyond minimum compliance.

Analysis of Uniform Guidance Audit Findings

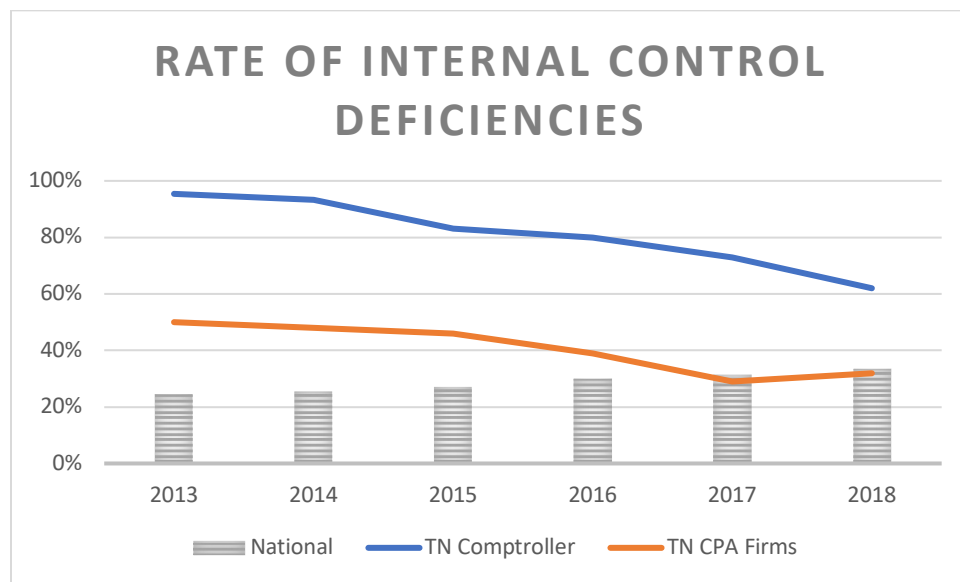
Another factor present during our case study is the 2014 issuance of Uniform Administrative Requirements, Cost Principles and Audit Requirements, also known as “Uniform Guidance.” Effective for audits of fiscal years ended June 30, 2016, this Uniform Guidance places increased requirements for internal controls and the testing of such controls in the audit.^v Given the simultaneous implementation of TCA §9-18-102, we examine how the rate of internal control deficiencies related to financial reporting changes in cities and counties outside of Tennessee. We find a 3 percent increase in findings for the period following the implementation of Uniform Guidance.

Due in large part to the implementation of legislation within Tennessee mandating internal controls, Tennessee has successfully improved controls within government entities, therefore resulting in a decline in internal control deficiencies. Conversely, the increase in audit findings nationally as a result of the Uniform Guidance suggests a failure to make adequate improvements to internal controls. The result of such is a convergence in results between Tennessee audits (completely closing the gap between CPA firms) and the rest of the nation. Despite converging results, as of 2018 the Comptroller’s Office reports 29 percent more audit findings than the national average.

Utilizing the rate of internal control deficiencies as a metric of audit quality, **Figure 1** depicts a clear discrepancy in the quality of audit in those conducted by the Tennessee Comptroller’s Office as compared to those conducted by CPA firms within the state. For the six years under review, the Comptroller’s Office consistently conducted a more rigorous audit, evidenced by an average of 40 percent more audit findings. In order to confirm that this discrepancy in audit findings is not due to the nature of the audits (cities versus counties), we

further analyzed the results by applying entity fund count as a metric of audit complexity.^{vi} When results are segregated based on complexity, the Comptroller’s Office maintains over a 40 percent increase in audit finding. **Figure 1** also illustrates the effects of heightened efforts made by the state to improve financial reporting within local government. Although the efforts have led to a decrease in the rate of internal control deficiencies for both CPA firms and the Comptroller’s Office, the gap in findings remains the same, further demonstrating an overall more rigorous audit by the Comptroller’s Office.

Figure 1



What Should Other States Consider?

The state of Tennessee is doing many things right in its local government audit. With regard to the counties which they audit directly, the expertise in government audit translates into a more diligent audit with a greater number of findings. With regard to cities which they monitor through a three-party audit contract, the guidance provided to those CPA firms conducting the

audits results in a greater number of findings than the national average. Although CPA firms within the state have not demonstrated the same level of rigor as that of the Comptroller's Office, this increased number of findings over the national average certainly indicates successful oversight by the state.

In addition, legislation, when accompanied by capable support, is associated with an overall decrease in internal control deficiencies that suggest improvement in the overall control system of city and county governments. This improvement provides encouragement for other states which may be considering the implementation of similar legislation. Furthermore, the success of the Tennessee Comptroller's Office in heightened audit findings should serve as a model for the 23 states that do not utilize a centralized audit agency in any such capacity. Nationally we need to improve the quality of our audits. Replicating Tennessee's successful prototype of a centralized state audit agency in conjunction with legislation and oversight might just be the key in doing so.

ⁱ President's Council on Integrity and Efficiency. *Report on National Single Audit Sampling Project*. 2007. <https://www.ignet.gov/sites/default/files/files/NatSamProjRptFINAL2.pdf>

ⁱⁱ The National Association of State Auditors, Comptrollers and Treasurers. *Auditing in the States. A Summary*. 2016. <http://www.nasact.org>

ⁱⁱⁱ Table 4 of NASACT 2016 provides the following list as states that utilize both a centralized audit agency and CPA firms to conduct the audits of cities and counties: AL, AZ, AR, IA, KY, MA, MN, MS, MD, NE, OH, OK, SD, TN.

^{iv} Federal Audit Clearinghouse. 2013-2018. <https://harvester.census.gov/facdissem/PublicDataDownloads.aspx>

^v Specifically, Uniform Guidance increased requirements for procurement and subrecipient monitoring standards. Related to procurement (which has implications for financial reporting), the Guidance identifies requirements for policies for selecting a vendor and documentation of such policies and procurement decisions.

^{vi} In order to control for complexity, we took an average fund count for cities and counties. Those entities that fell below the 16-fund average were placed in the low complexity group and those that fell above the average were placed in the high complexity group. The Comptroller's Office reported an average of 43 percent more audit findings in low complexity audits and 41 percent more audit findings in high complexity audits.