Auditing Tennessee's Governments ☆☆☆

State law directs the Comptroller to make quarterly reports to the Fiscal Review Committee concerning the state's fiscal affairs. This report focuses on the auditing process for Tennessee's state, county, and municipal governments and related entities and will answer the following questions:

- Why are government audits important?
- What types of audits and other engagements are performed?
- What are management's responsibilities?
- What is independence and why is it important?
- Who "audits" the auditors?
- Why didn't the auditors catch that?

Introduction

Auditors and their work are subject to numerous misconceptions. The old joke, "An auditor is someone who arrives on the battlefield after the battle is over and bayonets the wounded" suggests that auditors generally perform audits after year-end and seem to enjoy inflicting pain (i.e., writing findings). In reality, while auditors don't enjoy writing findings or disclosing mistakes, it is their job to find errors and fraud.

Another common misconception is the idea of an auditor's role as "bean counter." In reality, auditors typically do very little bean counting; rather, they account for money in the form of assets, liabilities, revenues, and expenditures.

The reality that the word "audit" means different things to auditors and citizens has led some auditors to coin the term "expectation gap" to describe what auditors do and report compared to what users of audit reports expect. The average citizen does not understand the purpose of an audit under generally accepted government auditing standards, much less the meaning of words such as "materiality," "reasonable assurance," and "audit risk." Without an understanding of terms like these, one cannot appreciate what an audit is or does.

Under generally accepted government auditing standards, an audit is not designed to detect fraud or errors unless they are material. Materiality is different for each audit and is based on auditor judgment. Materiality can be based on either qualitative or quantitative factors. An example of qualitative materiality would be the safety of one child in custody of the state. Quantitative materiality is often based on a percentage of assets or revenues which is determined based on auditor judgment. Generally speaking, auditors would audit balances that exceed the materiality threshold and either limit audit procedures or perform no audit procedures on balances less than the materiality threshold. Accordingly, an audit is designed to provide reasonable, not absolute, assurance that material misstatements, whether caused by fraud or error, will be detected.

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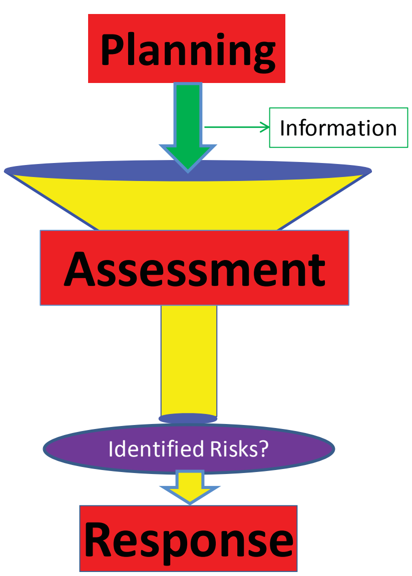
The word "audit" is often confused for an investigation, but they are not the same. Auditors use the word "audit" in a technical sense that denotes following generally accepted government auditing standards and giving an opinion about the results of their work. Investigations are not performed under generally accepted auditing standards. An investigation begins with an allegation of fraud in a specific setting, whereas an audit covers the entire government or, in the case of performance audits, has specific objectives. Unless a fraud investigation is performed in conjunction with an audit performed under generally accepted government auditing standards, the investigation should not be considered an audit.

"Audit risk" is the technical term auditors use to describe the risk that auditors will not discover an existing error or fraud when they perform their work. Audit risk is closely related to other factors such as inherent risk and control risk. Some accounts are inherently more risky than others; for example, there is a lot of risk involved with the handling of cash. Control risk is directly related to the internal controls a government has in place to manage risks of misuse or loss due to theft or other factors. While auditors have no control over either inherent risk or control risk, their audit procedures must take both into consideration.

The audit process involves three phases: planning, performance, and completion. (1) The planning phase entails a risk assessment process that points the auditor to areas with greater potential for errors or fraud that might be material to the financial statements or might impact the audit objectives. (2) In the performance phase, auditors perform audit procedures designed to focus on the risky areas identified in the planning phase. (3) The completion phase involves drawing conclusions on the audit objectives, writing findings, and issuing an opinion about the financial statements when applicable.

Risk Assessment Overview
Three Phases



Regardless of the misconceptions about auditors and audits, the truth is that the auditing process provides value to the audited organizations, the citizens of Tennessee, and Tennessee's legislature.

Why are government audits important?

The Comptroller's Office conducts financial and compliance audits and performance audits of the state's many entities to provide objective information about the state's financial condition and the performance of its programs. The office also conducts audits or ensures that audits are conducted of Tennessee's 95 counties and their municipalities, departments, agencies, and institutions.

The audits of Tennessee's state and local governments provide essential accountability and transparency for government programs. Government audits perform the following vital functions:

- provide the governments' debt information to national rating agencies who assign the credit ratings;

- disclose the amount of liabilities recognized for pensions, which have become one of the most important indicators of investment risk for external investors in the bonds of state and local governments;
- disclose fund deficits, deficit spending, going concern issues, and fraud (e.g., many local governments would never know their true financial position without an audit);
- determine risks and internal control weaknesses that could result in fraud or other loss of control of public assets;
- provide legislators with the information they need to make decisions;
- determine compliance with federal laws and regulations under the Single Audit Act for the federal government grantor agencies; and
- inform the public, who need and deserve to know how their government is operating.

The Comptroller's Office is appreciative of the foresight and wisdom of our state legislature in ensuring that all governments in Tennessee prepare financial statements in compliance with generally accepted accounting principles and are audited in accordance with *Government Auditing Standards* (commonly known as *Yellow Book* standards). Given the current challenges facing governments and their programs, the oversight provided through auditing is more critical than ever. In line with the mission of the Comptroller of the Treasury, government auditing provides objective analysis and information that the General Assembly and local governing bodies use to make the decisions necessary to make government work better.

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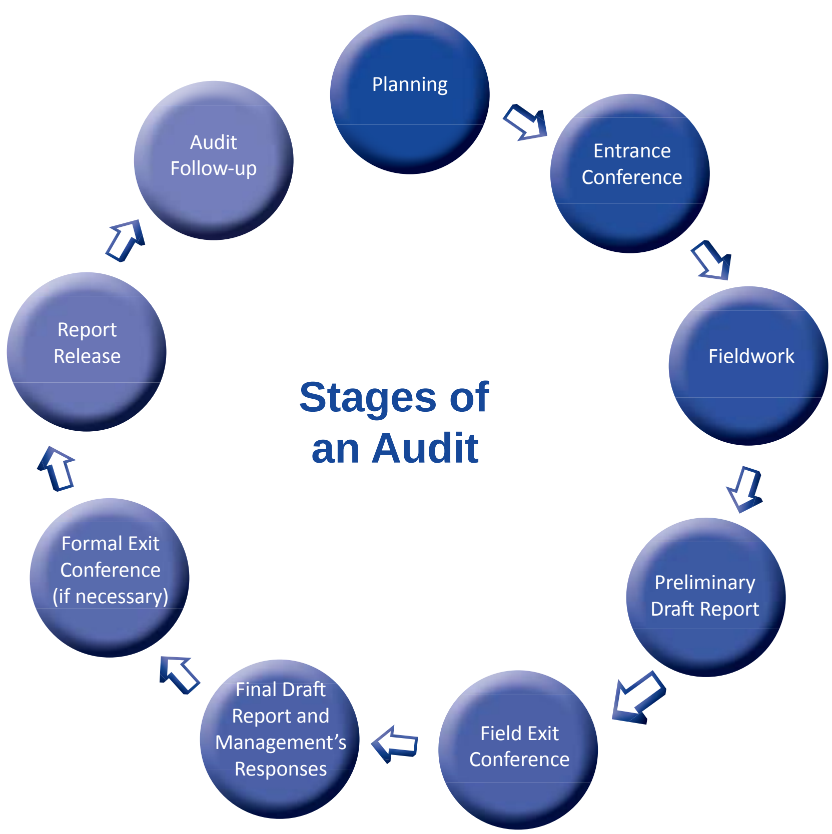
What types of audits and other engagements are performed?

The Comptroller's Office conducts financial and compliance audits; performance (Sunset and risk-based) audits; attestation engagements; and information systems audits, all of which are described below.



Financial and Compliance Audits

A financial and compliance audit involves complex accounting principles and auditing standards combined with local, state, and federal laws and regulations. Simply stated, audits of local and state governments involve gathering enough of the right types of information about the financial statements in order to conclude on the fair presentation of the financial statements as a whole. Audits involving federal programs must also look at enough transactions that account for the program's activities to conclude on the entity's compliance with federal requirements.

The Comptroller of the Treasury's financial and compliance audit work includes the following:

- Audit of the state's *Comprehensive Annual Financial Report* including
  - assets in the primary government funds of more than $7 billion and revenues of more than $28 billion;
  - investments in the state's pension plan of almost $30 billion;
  - net investment in capital assets of more than $26 billion;
  - Tennessee Housing Development Agency loans receivable of almost $2 billion;
  - the University of Tennessee system;
  - the Tennessee Board of Regents' system office and its 6 universities and 13 community colleges, including 27 technology centers;
  - the Tennessee Education Lottery Corporation;
  - the Tennessee State School Bond Authority; and
  - the Tennessee Student Assistance Corporation.
- Audit of the state's *Single Audit Report,* which included state entities' compliance with the federal requirements for more than $15 billion in federal financial assistance from federal grantor agencies.

Results: The state's *Comprehensive Annual Financial Report* for the year ended June 30, 2013, included an audit of the state's basic financial statements and an unmodified opinion on the basic financial statements. The state's *Single Audit Report* included the auditor's opinion that the Schedule of Expenditures of Federal Awards was fairly stated, in all material respects, in relation to the basic financial statements as a whole. As a result of testing the state's compliance with the requirements of laws, regulations, contracts, and grant agreements applicable to each major federal program, auditors questioned costs of $4,917,932.35. Auditors noted three deficiencies that were considered to be material weaknesses in internal control over financial reporting, as well as one instance of noncompliance considered material to the state's basic financial statements. The Comptroller's Office published 32 financial and compliance audit reports containing 56 audit findings and issued opinions on 58 sets of financial statements.

- Audits of *Comprehensive Annual Financial Reports* or *Annual Financial Reports* and *Single Audits* of 89 counties including
  - revenues of $6.8 billion and expenditures of $7.1 billion;
  - ending balances of county debt of $12.2 billion; and
  - federal grants of $606 million and state grants of $117 million.

Results: Financial and compliance audits of county and local governments revealed new cash shortages of $449,624 and total ending cash shortage balance of $775,221; disclosed fund deficits of $243 million; disclosed net position deficits of $57 million; and reported over 700 findings.

- Audits of two special school districts, a county landfill operation, and contracted audits of over 1600 municipalities and related entities.

Performance Audits

A performance audit is an independent examination of the extent to which entities of state government are faithfully carrying out their programs. The Comptroller's Office performs two types of performance audits, Sunset and risk-based. Performance audit reports assist the General Assembly and agency management by

- assessing the extent to which state entities have fulfilled their statutory mandate;

- assessing the entities' efficiency, effectiveness, and use of resources;
- providing program data, performance measures data, and financial data; and
- developing recommendations for management or legislative action that might improve the efficiency and effectiveness of the entities' operations.

Sunset performance audit work is directed by the Tennessee Governmental Entity Review Law, which requires the Joint Government Operations Committee to review each of the 258 entities under the law at least once every eight years to determine whether the entity should be continued, restructured, or terminated.

Risk-based performance audit work is based on risk assessments of state entities. Staff selects audits based on risks identified in statewide processes and programs and entity-specific operations and activities. Auditors target state entities with the greatest risks of fraud, waste, abuse, and noncompliance with state or federal program requirements.

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Results: The office released 21 performance audit reports, including 13 Sunset, 6 risk-based, and 2 special reports with highlighted recommendations to

- improve service delivery to citizens;
- improve the state's contract procurement processes for goods and services and for new system implementation;
- clarify legislation for proper alignment with program goals and policy;
- improve the efficiency and effectiveness of the government's programs and processes;
- improve entities' internal controls and compliance with laws, regulations, contracts, and grant agreements; and
- improve the government's monitoring of regulatory professions.

Attestation Engagements

Attestation engagements cover a broad range of financial or nonfinancial objectives about a particular subject matter or assertion, depending on the users' needs. Pursuant to statutes and a cooperative agreement between the Comptroller of the Treasury and the Department of Finance and Administration, Comptroller's Office staff performs annual examinations of selected nursing facilities (NFs) and intermediate care facilities for individuals with intellectual disabilities (ICFs/IID) participating in the Tennessee Medical Assistance Program under Title XIX of the Social Security Act (Medicaid). Additionally, the staff conducts desk reviews and calculates reimbursement rates for each of the providers in TennCare's $900 million NF and $200 million ICF/IID programs. Quarterly reimbursement settlements and prospective rates are also computed for the $25 million Federally Qualified Health Centers (FQHCs) and Rural Health Clinics (RHCs) programs, as required by the Benefits Improvement and Protection Act of 2000. Office staff also calculates cost settlements for Critical Access Hospitals (CAHs) in the state. In a joint effort with the Department of Commerce and Insurance, the Comptroller's Office assists in performing annual examinations of the TennCare Managed Care Organizations, who contract with the state to provide medical administrative services under the program.

Results: The office conducted desk reviews and reimbursable rate computations for 289 NF providers, all but 13 of which had an additional NF Level 2 (skilled) rate calculated, and for 150 ICFs/IID. Office staff computed reimbursement settlements and prospective rates for 37 FQHCs and 81 RHCs. The office calculated cost settlements and established interim reimbursement rates for 17 CAHs. Auditors also assisted in performing an examination of one of the TennCare Managed Care Organizations.

Information Systems Audits

The information systems review staff are responsible for obtaining and documenting an understanding of general and application controls in the computerized accounting and management information systems of entities undergoing audits.

Results: Common results from our information systems audits include

- untested, inadequate, or no disaster recovery plan;
- inadequate or unmonitored procedures to control access to information systems;
- inadequate documentation of policies and procedures to manage operations, especially change management procedures;

- inefficient and untimely installation of new or replacement systems; and
- weaknesses in application controls in computerized accounting systems.

What are management's responsibilities?

Management is responsible for preparing the entity's financial statements, in accordance with generally accepted accounting principles as prescribed by different standard-setting bodies and regulatory agencies. Management should design, implement, and monitor internal controls over financial reporting to ensure these standards are followed. In addition, management is responsible for compliance with laws, regulations, contracts, and grant agreements.

Every entity faces a variety of risks, from both external and internal sources, that could prevent the achievement of the entity's objectives. Management's risk assessment is the entity's primary method of protection from fraud, waste, and abuse. The risk assessment identifies and assesses what could go wrong in the absence of adequate controls. Management must consider not only the impact of possible changes within its own business model, but also changes in the external environment that may render internal control ineffective. Since management may establish new programs or discontinue older programs at any time, the risk assessment is ongoing as part of the daily operations of the entity. It is important to note that, even though the risk assessment process is very important, many local governments do not perform risk assessments.

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To provide an audit trail both for auditors and for management, management is responsible for documenting the risk assessment and the actions of designing, implementing, and monitoring effective internal controls. The head of the entity should review and approve the assessment and the controls. Management is also responsible for taking appropriate action to correct any deficiencies in internal control that are subsequently noted in audit findings and observations.

The Tennessee General Assembly enacted legislation in 2005 that required the creation of audit committees for any state entity that can hire and terminate employees or that is responsible for the preparation of financial statements. The ongoing responsibilities of an audit committee include, but are not limited to, overseeing financial reporting and related disclosures; evaluating the entity's risk assessment and internal control system; communicating to management and staff their responsibility for preventing, detecting, and reporting fraud, waste, and abuse; and promptly notifying the Comptroller's Office of any indications of fraud. Audit committees for local governments have essentially the same responsibilities as those of their state counterparts, with two notable exceptions: neither the audit committee nor its associated duties are mandated by state statute. Currently, 92 counties have audit committees.

What is independence and why is it important?

Generally accepted government auditing standards require audit organizations and individual auditors to be both independent in mind and in appearance. Independence of mind means that the auditor isn't affected by influences that could compromise professional judgment and, therefore, can act with integrity and exercise objectivity and professional skepticism. Independence of appearance means that, based on the circumstances of the audit, a reasonable and informed third party having knowledge of the relevant information would not conclude that an audit organization or an individual auditor's integrity, objectivity, or professional skepticism has been compromised. Generally accepted government auditing standards recognize seven distinct threats to auditor independence:

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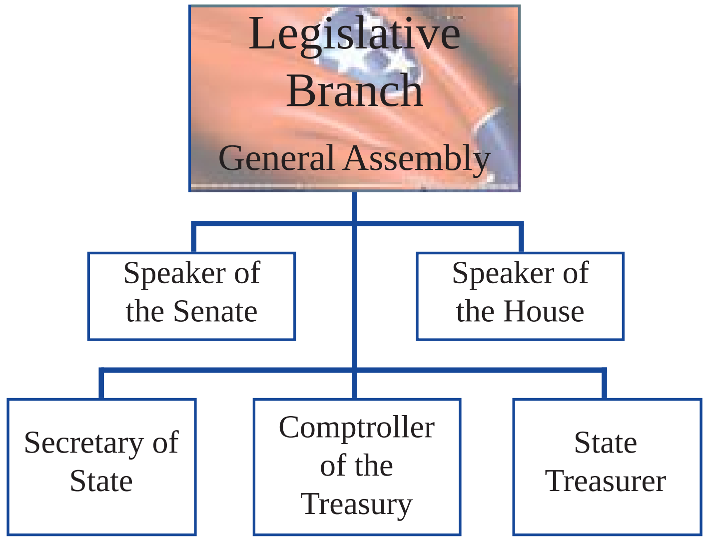
1. *Self-interest* – the auditor is interested in a financial or personal way in the entity being audited.
2. *Undue influence* – the auditor is influenced or directed by someone in authority (either inside or outside the government entity) to make choices that are not objective.
3. *Self-review* – the auditor is auditing work he/she performed on behalf of the entity (e.g., consulting).
4. *Bias* – the auditor's judgment is affected (e.g., religious or political convictions).

5. *Familiarity* – the auditor is too close to the entity being audited.
6. *Management participation* – the auditor has made operational decisions on behalf of management and then audited the results of those decisions.
7. *Structural* – the organizational placement of the audit organization is within the government being audited.

Auditors must be careful to document these threats and indicate how they were eliminated or reduced to an acceptable level. If the threat cannot be eliminated or reduced to an acceptable level, the auditor must modify the audit report to indicate that the auditor or audit organization is not independent.



You can see from the organization chart presented above that within the structure of state government, the Comptroller's Office is under the legislative branch, which establishes its independence with regard to the entities that it audits.

Who "audits" the auditors?

The Comptroller's Office undergoes a biennial quality assessment review under the auspices of the National State Auditors Association. The purpose of this external peer review is to ensure that the office is following auditing standards generally accepted in the United States of America and *Government Auditing Standards*. A team of certified professional accountants and other federal and state government professionals reviews the office's policies and procedures, staff qualifications, working papers, and published audit reports. This review determines whether the office has met auditing standards such as independence, competence, evidence, and reporting. The peer review for the year ended June 30, 2012, which was performed in August 2012, determined that the office's system of quality control was suitably designed. The next review is scheduled for July 2014.

Accounting firms that perform audits on behalf of the Comptroller's Office must have an external peer review performed by reviewers independent of the audit firm at least once every three years, as required by *Government Auditing Standards*. The external peer review encompasses a review of the firm's quality control, as well as a review of a sample of individual audit engagements. The firms are required to file the results of the peer review with the Comptroller's Office. Furthermore, as required by state statute, office staff reviews the audit working papers of the firms for the six contracted county audits and on a risk-based approach for all other contracted audits.

Why didn't the auditors catch that?

This is a commonly asked question when a fraud is discovered after an audit. An even better question would be, why didn't management either discover the fraud or have better controls to prevent the fraud? There are several valid reasons why auditors don't always "catch that":

- Auditors don't always discover errors or fraud because neither accounting nor auditing is an exact science. In addition, no government or government agency in Tennessee is managed or accounted for in exactly the same way.

- Auditing is based on the concepts of risk and materiality. Auditors focus attention on the most risky audit areas based on the concept of materiality. When the account balance is less risky, or when there are more internal controls, less extensive audit procedures may be necessary. Most frauds are very small (or "immaterial," under generally accepted government auditing standards) when compared with the total operations of the government or program. Auditors hate to miss even one dime of fraud when performing an audit, but catching such small instances of fraud isn't the purpose of an audit. Generally accepted government auditing standards require the auditor to ask not "Is there fraud?" but "Is there material fraud?"

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- Auditing is based on sampling. Auditors use sampling of transactions as a method of understanding the characteristics of a population (e.g., all disbursements) without looking at every individual transaction. The sheer number of transactions processed through most governments makes looking at each individual transaction impossible or impractical. Audit sampling is similar to the method a polling company like Gallup might use to determine information about the U.S. population without polling every U.S. citizen. Since there is a margin of error in every sample, it is conceivable that an immaterial fraud might occur and not be detected.

- Fraud is intentionally concealed. Auditors would tell you there is fraud in every government. The difference between an error and fraud is intent. When someone has the intent to hide a needle in a haystack, it probably won't be found immediately because needles are harder to find. Auditing procedures aren't designed to find the needle in a haystack; they are designed to find the pitchfork.

Conclusion ☆☆☆

Audits of Tennessee's state and local governments protect the public trust and promote transparency in government operations. The auditing process provides citizens with reasonable assurance that their hard-earned tax dollars won't fall victim to fraud, waste, or abuse. The audit results enhance public policy decisions at all levels of government and help management operate programs more efficiently. By promoting accountability, enhancing fiscal integrity, and encouraging constructive change, the Comptroller's Office seeks to make government work better.

To report fraud, waste, or abuse of government funds and property, call the hotline at 1-800-232-5454 or submit a notification electronically at: http://www.comptroller.tn.gov/hotline.

Justin P. Wilson
Comptroller of the Treasury

Office of the Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243
(615) 741-2501
Justin.Wilson@cot.tn.gov
www.tn.gov/comptroller