



TO: Local Government Interim Committee

FROM: Local Government Services Bureau

DATE: June 22, 2018

RE: State of Montana Single Audit Act Inquiry

Dear Chairman Webb and Committee Members:

Thank you for this opportunity to address issues related to the State of Montana Single Audit Act (“SAA”) that are currently being discussed. Below are the questions the Committee has asked followed by the Department of Administration’s Local Government Services Bureau’s (Bureau) responses.

I. How often and how early are financial problems detected by audits?

The Bureau is not entirely clear what the term “financial problems” means. For purposes of this discussion, we will interpret the term to mean audit findings dealing with significant financial issues. Some examples of audit findings that the Bureau believes reflect significant financial problems deal with: deficit cash, excessive interfund cash transfers, poor or nonexistent controls over cash/investments including no cash reconciliations performed, significant budget overruns, ongoing failure to meet reporting requirements, and lack of or incomplete financial records.

The objective of a financial audit is an opinion as to whether financial statements of a historical period are fairly presented. An auditor’s opinion does not assure future viability of the entity nor the efficiency or effectiveness of management, nor is it intended to act as an early warning system. A secondary objective of an audit conducted in accordance with *Government Auditing Standards* is to report (but not opine) on significant internal control deficiencies and noncompliance.

1. How often are financial problems detected by audits:

The Bureau does not have data readily available to answer this question decisively. We have over 500 audits each year, and each of those audits would need to be reviewed on a case-by-case basis to determine if financial problems (as interpreted above) are reported. For FY2016, approximately 1,000 findings were reported in 336 audit reports, although not all findings dealt with significant financial issues. Many audit reports include only findings related to internal control weaknesses that are inherent to small local governments (for example, lack of segregation of duties and lack of ability to produce Generally Accepted Accounting Principles (GAAP)-compliant reporting).

2. How early are financial problems detected by audit:

The audit report due date is 12 months after year-end, or 9 months after year-end if the audit scope includes testing of federal assistance. Most local governments have an annual audit, but a small percentage (4% – 5%) have a biennial audit covering two years (authorized by Mont. Code Ann.§ 2-7-503(3)). In the case of a biennial audit, the report's due date is based on the second year of the biennial period. With a biennial audit, it may be at least three years from the beginning of a problem to when the public is alerted to the problem. This lag time in audit reporting also contributes to repeat findings in audits, because findings are not reported in audits until well into the next audit period (i.e., 12 months after a year-end).

3. Audit reports filed late:

The audit requirement is established upon receiving a local government's annual financial report. Audits are required at least every 2 years if the financial report shows revenue or financial assistance greater than \$750,000. See Mont. Code Ann.§ 2-7-503. Thus, if the annual financial report is late, the audit process (beginning with hiring an audit firm) is not timely initiated. Some audit reports are issued after a statutory due date, and the likelihood of that happening increases when a local government is experiencing financial or organizational distress. Circumstances leading to late submittal of audit reports may include:

- A local government may postpone contracting for an audit until audit firms are fully booked for the year.
- A local government may not have financial records organized and available for the auditors when first scheduled for the audit, so the audit firm reschedules the audit for later.
- Local governments that are known to have multiple problems and to not report timely may have a difficult time finding an audit firm willing to contract for an audit, due to higher audit risk involved in such audits.

II. What assistance is offered to local governments to correct potential and ongoing problems?

The Bureau has four FTE dedicated to assisting and training over 1,300 local governments for accounting, financial reporting, and budgeting. Examples of assistance the Bureau provides are:

- Help desk assistance is provided year around. This assistance includes but is not restricted to assistance with annual budget preparation; maximum mill levy determination; year-end closing procedures; financial statement preparation; and general accounting questions related to the standardized chart of accounts, how to record transactions, etc.
- Collaborate with local government associations and other state agencies to provide training. An example is a multi-day training offered each spring to municipal clerks, treasurers and finance officers that is hosted by the MSU Local Government Center. Bureau staff has also participated in trainings with the Montana Association of Counties; the Montana League of Cities and Towns/Montana Municipal Interlocal Authority; elected official conferences; and other State agency-sponsored training.

- Provide workshops each June, generally offered in 7 or 8 separate locations throughout the State so that they are accessible to all local governments. Topics covered generally include budget preparation and mill levy calculation, as well as any other training that is considered most relevant and needed at the time. This training is offered free of charge to any local government employees or officials who wish to attend.
- Prepare training videos that are available at any time that local government personnel wish to access them. Videos available currently include year-end closing procedures and accounting and reporting for capital assets, long-term liabilities, and taxes receivable.
- Each annual financial report submitted to the Bureau is reviewed and the results are communicated to the local governments. Staff assist local governments to correct significant deficiencies, if necessary, at the same time.
- Staff are available to answer questions related to the requirements for budgeting, annual reporting, auditing, response to audit findings, and the related due dates.
- As provided in Mont. Code Ann. § 7-1-4147, state agencies are authorized and encouraged to provide technical assistance to municipalities. That same law indicates that the State should not offer services that can be as reasonably and expeditiously obtained through the private sector. For those local governments that may need more assistance than the Bureau is able to provide, a listing of interested CPA firms is provided on the Bureau's website.

III. How does the Department of Administration use its discretionary authority under the Single Audit Act?

Because the Bureau works with over 1,300 local governments, widely varying in organization, ability and need, it is necessary and important to use its discretionary authority in various circumstances. If the Bureau was allowed no discretion in the application of the Single Audit Act and all provisions were mandatory, smaller local governments would shoulder greater burdens. The Bureau generally reviews the size, annual revenues, and organization of a local government when applying some of the Single Audit Act's discretionary provisions. If a local government doesn't have the capacity to meet current legal requirements, additional or continuing penalties will not necessarily result in the desired action or change.

Below are some examples of the discretionary authority authorized:

- Mont. Code Ann. § 2-7-503(3)(b): The Bureau may direct local governments, which are not required to be audited, to arrange for a financial review at least once every four years. Financial reviews provide for accountability, but at a lower cost than an audit. However, many of the very small local governments are unable to afford to contract for even a less-costly financial review. The average cost of a financial review is around \$3,000. The Bureau has over the years performed some financial reviews for very small local governments, but it currently does not have the staff to do so. FY2016 annual revenues reported for cemetery districts averaged \$45,000 with some reporting less than \$1,000. Similarly, television district reported an average \$17,500 for annual

revenues, with 20% reporting less than \$1,000. It's questionable whether these special districts could afford the cost of a financial review.

- Mont. Code Ann. § 2-7-503(5): The Bureau may at any time conduct or contract for a special audit or review. A special audit has not been done in many years because the Bureau does not have audit staff to perform this review. Also, additional audits/reviews may not be an efficient use of the local government's resources and may not provide additional information or assurance because if a local government is unable to comply with the initial audit requirement, it is unlikely it would be able to comply with an additional special audit requirement.
- Mont. Code Ann. § 2-7-506(5): DOA may designate an auditor if a local government does not contract with an auditor in a timely manner after receiving Bureau notification of an audit requirement. This course of action may impair auditor independence if an adversarial relationship develops between the local government and the auditor because of this action. When auditor independence is impaired, an auditor is not allowed, by professional standards, to proceed with an audit. For this reason, we have not used this discretionary provision.
- Mont. Code Ann. § 2-7-515(3): The Bureau may withhold financial assistance when the local government does not take corrective action on audit findings. Discretionary authority is imperative for this purpose, as an average of 1,200 audit findings are reported each fiscal year. Each audit report requires analysis specific to that local government's environment and the context of each finding. To withhold financial assistance, the Bureau would need to evaluate several criteria, including:
 - the severity of the related audit finding – some audit findings represent internal control problems inherent with small local governments that may be unreasonably costly to correct;
 - what types of financial assistance the local government receives that would meet the statutory criterion of “to carry out a program”;
 - the extent of the withholding – whether all federal and state withholding meeting the criteria would be withheld or if only selected assistance would be withheld; and
 - the impact withholding would have on other related taxing jurisdictions and taxpayers. Withholding financial assistance that is intended to assist the local government to carry out public works, public health, or public safety projects may have unintended and undesirable consequences. For example, we would need to consider when it would be prudent to withhold an immunization grant intended for public health purposes or a gasoline tax apportionment intended for the maintenance and repair of roads and streets during winter months. The impact on taxpayers of withholding may have very little relationship to the public officials' lack of compliance with accounting and auditing requirements. For some shared revenues, withholding assistance from a county might also penalize

other taxing jurisdictions (school districts or special purpose districts) to which the county statutorily distributes a portion of that assistance.

- Mont. Code Ann.§ 2-7-515(4) provides for prosecution where violations of law are found by auditors and reflects the general rule in Montana that prosecutors retain discretion over when and how to pursue prosecution.
- Mont. Code Ann.§ 2-7-517(4): The Bureau may grant extensions of due dates or may waive fines and penalties under certain circumstances. It may allow more latitude in providing a penalty waiver or extension of a due date to a small cemetery district with \$3,000 in annual revenues and a voluntary bookkeeper than it would a larger city with a highly-paid, highly-trained staff. During the last year, the Bureau waived penalties for 18 special purpose districts and 4 towns and counties that experienced turnover in essential accounting personnel during the period.

In Summary

Discretionary authority in the “SAA” provides flexibility and allows a majority of local governments to comply with their accountability and transparency responsibilities. Requiring one-size-fits-all statutory provisions, attempting to ensure compliance from a handful of local governments that don’t have the capacity to comply, may penalize those local governments that are currently willing and able to comply. Under current provisions, it is recognized that locally elected officials are responsible for compliance, and the State promotes and assists local government compliance through its notifications, technical assistance, and assessment of penalties. Replacing discretionary authority with mandatory provisions may increase the oversight and decision-making roles of the State over local governance.