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Should Someone Audit Government Auditors?

There's a push for local governments to establish independent audit committees.

The California state auditor's office raised lots of eyebrows around Sacramento last spring. In an annual review of the state's financial statements, auditors identified more than \$30 billion worth of errors. They found faulty accounting assumptions, transactions recognized incorrectly and simple arithmetic mistakes, among other problems. Fortunately, these errors were corrected before the final financial report was published.

In a state with almost \$300 billion of assets, enormous pension funds and dozens of quasi-independent entities under its purview, a few small mistakes can quickly add up to \$30 billion. Controller John Chiang, whose office prepares the financial statements, characterized many of these as honest errors attributable to understaffing and a lack of clear internal procedures — fixable problems.

In fact, there are those who think this is how public financial governance should work: An entity within the government that is also independent of it reviews that government's financial policies, procedures and reports. When that entity finds errors it shares those errors directly with the governing body. The government then fixes those mistakes. For those who subscribe to this more "corporate" style of financial governance, the California episode is an uplifting story of what's possible. It might also illustrate things to come.

Throughout the past decade, public companies have overhauled their financial governance practices. Much of that change was brought about by the 2002 Sarbanes-Oxley Act passed in the wake of the Enron scandal. Enron was a colossal mess in part because its auditors rarely questioned management's aggressive accounting and financial reporting tactics.

In the post-Sarbanes-Oxley world, public companies must establish, among other things, an independent audit committee that oversees the financial audit process, reviews financial policies and procedures, and generally monitors a company's financial inner-workings. If the audit committee spots a problem, it can circumvent management and report directly to the company's board of directors.

Experts disagree — sometimes pointedly — about whether these reforms have worked, but there's no question that these reforms changed financial governance forever.

States and big cities that elect an auditor or create an audit committee can realize many of these oversight benefits. According to some recent academic research in this area, only about one-third of smaller local governments and one-half of big cities have voluntarily established an independent audit function. Most that have not say their internal controls and other financial governance structures are strong enough. Others say audit committees are so politically sensitive that the benefits don't usually outweigh the costs.

But this might change. Around the time the California auditor's office published its findings, the

Association of Local Government Auditors (ALGA), the main professional association in this area, published its long-awaited guidance on independent audit committees. ALGA recommended that local governments not only establish an independent audit committee, but also make certain that the committee includes financial experts who are not members of the governing body. The guidance goes on to say that properly resourced audit committees should have access to outside experts who can help make sense of complex or unforeseen financial issues.

Hypothetically, this could include everything from decisions about whether to issue debt to the funding of pension plans to how much money to keep in a rainy day fund.

ALGA's message is subtle, but clear: As public finance becomes ever more complex, even small local governments need a competent, vigilant, independent and expansive voice to make sure the public's money is managed prudently. The independent audit committee model is far from perfect, but it seems to have emerged as the go-to model, for now.

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