



The Ohio Society of CPAs

Ohio Budget Advisory Task Force Issue Paper

Performance Audits and Related Strategies

ISSUE: Performance Audits and Related Strategies

Almost two years into the recession, state budgets across the country are struggling to keep afloat financially. Ohio is no exception. Even more painful decisions must be made to help Ohio address the looming expected shortfall of up to \$8 billion in the coming biennium – not counting several billion dollars in federal unemployment loans that must be paid back with interest. A sustained period of austerity will likely follow as the economic downturn is expected to have an impact through FY 2012 and financial resources will remain limited. Priorities are going to have to be set, and a series of immediate steps will need to be taken to redesign, scale back or eliminate programs and services. As is occurring in other states, some existing programs likely won't make the cut.

Government leaders at the state and local levels have made progress this session in addressing fiscal problems through reductions in the work force, pay reductions for many employees, and reducing and/or streamlining some programs. But with the multi-billion dollar shortfall that must be dealt with by July 2011, plus whatever deficits that will be experienced by local governments and school districts, much, much more needs to happen. Government leaders at all levels, and taxpayers, must make difficult choices regarding the allocation of limited resources.

With each passing month, the list of available options grows smaller as government will have less time to phase in changes. Nonetheless, there are a series of immediate actions state and local public sector leaders can take to position themselves to make the best possible policy decisions in a trying time. An important first step is to identifying how to maximize program or service results, eliminate outdated or duplicative services, find where efficiencies can be gained, and highlight best practices that should be duplicated. Performance audits can help develop a roadmap for all of those things by improving accountability, oversight and government results, ultimately benefiting all Ohio citizens.

Why now?

Thus far into the recession, the typical response across the country to government budget deficits has been to reduce program funding and headcount and raise taxes and fees. Here in Ohio, in 2009 several months passed before consensus could be reached on how to fill the \$851 million budget hole. The shortfall looming over Ohio in 2011 is potentially 10 times that amount and will be exponentially harder to deal with. It's unrealistic to think that the January through June 2011 period during which the governor and legislators will be focused on the

adopting the biennial budget will allow adequate time to do the strategic work of eliminating obsolete or duplicative functions or broadening the application of best practices.

A Deloitte study¹ showed that reducing expenditures, increasing layoffs and raising taxes work against the principle of countercyclical spending and can push the economy deeper into a recession, causing second-order adverse impact on state budgets. They also noted that expenditure cuts made without a careful analysis of underlying cost drivers are rarely helpful or sustainable. With the currently high unemployment rate, combined with recently passed federal health care reform, Ohio likely will see demand for unemployment checks and Medicaid services swell for some time to come, long after the stimulus dollars are gone.

Deloitte estimates that the current down economy will be felt nationally through FY 2012, and the situation could repeat itself in a few years unless systemic, structural changes are made. One tool in particular, performance audits, are among the best ways to help identify significant, sustainable cost savings. While our state doesn't have the ability to look at every program in the next few months, we can focus on those that likely will return the "biggest bang for the buck".

What are performance audits?

Being accountable means being able to show a return on the investment of taxpayer dollars by developing quantifiable metrics that show benefits gained for revenues expended. Financial audits, which test the numbers being presented by management to ensure they are reliable, routinely are conducted on all state agencies and many local government entities. Financial audits do not, however, address the need for a deeper dive into management and administrative practices to ensure they are cost efficient and streamlined; that's where performance audits come in.

Performance audits are a valuable management tool to evaluate whether tax dollars are being spent in an effective, efficient and economically sound manner. To ensure objectivity, true performance audits are conducted by third parties and follow the U.S. General Accounting Office's Government Auditing Standards. These audits measure a program's actual performance against its goals and objectives and help to identify any waste, inefficiency or unneeded duplication of services. They also identify best practices used by similar Ohio or out-of-state public and private entities. They can be focused on a particular entity, program or

¹ Deloitte.com

service like compensation and benefits, or can delve into a broader policy area that covers multiple agencies such as state financial assistance to counties or special education. On average, performance audits conducted in Ohio over the past three years resulted in a potential return on investment rate of \$24 for every dollar spent². Many times, performance audits target a specific program or service rather than look at an entire agency's operations. New research by Deloitte encourages enterprise transformation as an effective cost reduction tool for state government. Through the use of performance audit results as a basis of understanding of current operations, state leaders can identify areas of duplication across programs, agencies and business processes. The study cites examples such as Minnesota's Drive to Excellence initiative, which identified financial management, procurement and human resource management, specifically licensing, regulation and compliance to grants management, as areas ripe for reform. The estimated saving over a six year period are a not insignificant \$350 million.²

Performance audit objectives naturally vary according to the scope of the engagement. They can include:

- Forecasting potential outcomes under various assumptions or conclusions.
- Analyzing the cost effectiveness of a program or activity and whether it is duplicative.
- Finding if a program is producing intended results and favorable cost/benefit results.
- Assessing the validity, reliability or relevance of performance measures in relation to a program's financial information, results, or efficiency.
- Analyzing whether fees assessed fall short, cover or exceed program costs.
- Determining if a program provides equitable access to intended recipients.
- Compare a public sector service, benefit or fee to that provided in the private sector or by similar public sector service providers.

While the scope of a performance audit will vary according to the area being researched, they should include efforts to identify all of the following:

- Best practices

² Ohio Auditor of State's office

- Cost savings
- Services that can be reduced, eliminated or transferred to the private sector
- Gaps or duplication in programs or services
- Opportunities to streamline administration with other government entities
- Any needed changes to the Ohio Revised Code or Ohio Administrative Code

But it is not just service delivery methods that should be examined. Through performance audits across state government, brick and mortar assets should be reviewed to determine whether the operating costs are being used for their intended purpose and, equally important, whether facilities can be combined, shared, or sold. The state of Georgia owns 15,000 building leases, 1800 properties, and oversees 1.1 million acres of land. A recent study recommend that Georgia pursuing a large-scale program to reduce real estate holdings by facility consolidation and sale or leaseback of non-core facilities.³

Performance audits work, as evidenced by Ohio's results to date. They can be conducted by management consulting firms, CPA firms, or by the Ohio Auditor of State's performance audit team; the key is that these audits be performed by an independent body to ensure fairness and objectivity. The State Auditor's office currently conducts performance audits at the request of a government entity or the Ohio General Assembly, or in cases where a school district is in fiscal distress. Auditor of State records indicate that they have conducted 261 performance audits in the past 14 years, though only 15 of them have related to state agency programs. (The majority were performed on Ohio school districts.)

No matter who performs them, we believe the number of performance audits on state agency programs should be greatly expanded, beginning as soon as possible and starting with engagements that have the greatest potential for return on investment as determined by the legislature, governor's administration, state auditor, and/or whoever policymakers deem to be appropriate.

³ Georgia State Senate Budget Task Force, page 12

Performance audits in other states

A number of states and cities regularly conduct performance audits. Some provide performance audit services through their state auditor's office, while others provide the service via "legislative auditors" reporting to the legislative branch. Pennsylvania has both a legislative auditor and a state auditor who conduct performance audits. All states largely perform the same service of evaluating state, and possibly local, government agencies, programs or services. Arizona has been performing this type of service for at least three decades. California, Colorado, Georgia, Kansas, Maine, Maryland, Michigan, New York, Utah, Washington and West Virginia are just a few states that have programs in place. Each state uses the information differently, and the adoption rate for recommendations varies. Some take advantage of the information generated better than others. One thing each has in common is the use of government auditing standards. Two programs in particular merit attention:

Washington

In 2005, taxpayers in the State of Washington voted to give their state auditor authority to conduct regularly scheduled, comprehensive, independent performance audits of state and local governments. The program has several features unique to the state:

1. The audits are paid for through a dedicated portion of sales and use tax revenue.
2. Their long-term goal is to conduct about 25% of performance audits on contract (with outside providers like management consultants or CPA firms) and the rest with in-house auditors.
3. Since it was driven by a citizen initiative, the state auditor selected audits based on input from citizens, legislators, the governor, businesses, interest groups and government employees.
4. Each performance audit is to cover nine key elements, from best practices and cost savings to privatization opportunities and any need changes to laws or regulations.

Since the program was put into place, Washington has conducted approximately 80 performance audits of local governments and state agencies and identified more than 700

recommendations—70% of which were implemented and another 17% are in process--to improve government efficiency and effectiveness, save money and make government more transparent. Since the 2005 voter mandate went into effect, Washington performance audits of state and local government entities have identified \$3.8 billion in one-time and long-term potential cost savings, unnecessary spending and financial impacts.⁴

Texas

Texas was one of the first states to enact performance auditing in the mid-1980's and has become a nationally recognized leader in the process. They began using performance audits and sunset committees in response to the "oil bust" of the 1980's when the state was experiencing a sharp decline in revenues.

Maine

Maine's Office of Program Evaluation and Government Accountability, a body of the Maine State Legislature, first became operational in January 2005. It has a unique organizational arrangement within the Legislature that allows for both independence and accountability. OPEGA's 2007-2008 report⁵ outlined the eight performance audits and studies it had conducted during that three-year period.

How can Ohio get the most bang for the buck?

Ohio currently does not have a mandate in place requiring performance audits of state agencies on a regular basis, though such legislation (S.B. 4) exists. OSCPA testified as a proponent of S.B. 4, which passed the Senate unanimously in January 2010 and now awaits action in the House. Other performance audit/review bills, H.B. 65 and H.B.343, have also been introduced. We support all efforts to require regular, *independent* performance audits be undertaken.

We agree with The Pew Center for Public Trust⁶ in its recommendation that state auditing entities should have broad authority to audit any governmental entity, program, activity or function, and an ability to conduct performance audits and evaluations free from the influence of other entities, such as the legislature or the executive branch. While the entity performing the audit must remain impartial and independent auditor and the entity being audited should be

⁴ <http://www.sao.wa.gov/EN/Audits/PerformanceAudit/Pages/PerformanceAudit.aspx>

⁵ <http://legislature.maine.gov/opega>

⁶ http://www.pewcenteronthestates.org/initiatives_detail.aspx?initiativeID=51804

encouraged to work closely together as partners, so that the final report and recommendations are beneficial and provide the tools and means to improve.

Though a strong home rule state, Ohio has the opportunity to address governmental performance at all levels. In addition to the limited performance audits that have been performed on state agencies, the Auditor of State currently provides this service for public colleges, school districts, townships, villages and cities, counties and Developmentally Disabled operations: in fact, 94% of all performance audits conducted by the AOS since 1996 have been for those levels of government. The ability to assess both state and local government operations provides Ohio and other states that do so⁷ with greater ability to improve services through various layers of government by reducing bureaucratic overlap and waste.

Performance audits themselves are not a partisan issue, as evidenced by the unanimous Senate vote. However, the political sensitivities involved when an auditor of one political party is charged with evaluating the management and operations of those in a different party appear to be a major stumbling block in Ohio. As with the case of all statewide officeholders, Ohio's Auditor of State was elected by Ohio citizens to serve government entities and taxpayers in the role they were elected to perform – not to serve their political party. The Auditor's office has had a fully functioning performance audit division for a number of years and has conducted many such audits, following Government Auditing Standards to avoid political manipulation. No matter who is elected to be Ohio's state auditor, Republican or Democrat, we support charging the auditor's office with this important role and setting politics aside for the greater good of Ohio's future. If that can't be accomplished, as an alternative Ohio should consider creating a "legislative auditor," functioning under the authority of the Ohio General Assembly and charged with the responsibility of conducting performance audits beyond the scope of those already being conducted by the Auditor of State's office. A number of states have a similar function, including West Virginia and Maine. Another option is to outsource contracts to non-government professionals for the more politically sensitive performance audits.

It's important to recognize that performance audits conducted by a third party are different from an in-house performance review. Performance audits are conducted in accordance with Government Auditing Standards (often called Yellow Book standards) by an *independent* third party. Performance reviews are conducted by management. While often providing useful information, as in the case of school district report cards, the potential cost savings from the in-

⁷ Arizona, California, Florida, Kansas, Louisiana, New York, North Carolina, Oregon and Pennsylvania

house performance review -- and politics being what it is, the reliance and trust in the results-- is greatly lessened when compared to the more in-depth, independent performance audit evaluation that will result in greater savings. In addition, a third party will not have the same pressures management might encounter to avoid research and/or recommendations in certain politically sensitive areas.

Ohio has many areas where efficiencies and possible cost savings can be identified through performance audits. For example:

- **Department of Development's employer tax credit programs.** Millions have been distributed over the past 29 years in the state's various tax credits, which were designed to support businesses that commit to creating or retaining jobs in Ohio. A performance audit could independently ensure that the funds are being used for their intended purpose, and analyze through a cost/benefit lens the number of jobs created vs. tax revenue received in correlation to taxpayer investment.
- **Medicaid. Currently, almost half of the General Revenue Fund is dedicated to health and human services funding.** A performance audit released in December 2006 identified over \$400 million in potential savings, though only about half of the recommendations were implemented. In view of the massive spending involved with the program, inherent fraud risks and recent management changes, we believe this program is ripe for additional review. Particular focus should be paid to Ohio's level of funding of nursing homes compared to in-home care for the elderly or disabled, and comparing Ohio's practices to those in other states.
- **Employee benefits.** For areas of state and local government where personnel costs are a very significant percentage of the total budget, a compensation audit is prudent to ensure retirement, health and other benefits are on par with the private sector or with like-sized government operations across the country. A City of Columbus compensation audit⁸ identified \$43 million in potential 2008 savings in retirement benefits alone. Recommendations for one agency likely can be reliable data for use by similar agencies across departmental or geographic silos. For example, as in Columbus, a determination that paying an employee's 10% share of the defined benefit plan is excessive or unsustainable in one city or school district can likely be used by others when evaluating

⁸ City of Columbus Total Compensation Audit, October 2, 2009

budgets. A separate analysis found the potential for significant pension fund savings by delaying the minimum age for the collection of retirement benefits from age 52 to age 60. We are not alone in recommending attention to this area: the Michigan Turnaround Plan,⁹ a “turnaround plan” developed by almost 75 major Michigan employers, also pointed to a need to address this segment of the public sector.

OTHER REFORM STRATEGIES

In addition to performance audits, a number of other related opportunities exist to help public entities identify best practices and more efficient operations. Some of these alternative approaches are already in place to some degree in Ohio, but could – and should -- easily be expanded. Examples include:

Employee Input

A resource that concurrently should be utilized is already in place at every state and local agency: employees. State and local workers often see ways to improve operations by doing the work day in and day out. Government should provide greater opportunities for employees to propose and implement creative changes to help reduce costs and improve operations. Including some type of recognition/reward program would encourage participation.

Grant Programs

EfficientGovNow, a program launched in 2009 by The Fund for Our Economic Future, was established to accelerate government collaboration and efficiency by encouraging local governments in a 16-county region of Northeast Ohio. The goal of the program was to encourage government entities to propose collaborative projects and compete for grant dollars to help fund their ideas. Citizens became engaged with officials and ideas; thousands of area residents ultimately voted on the winners, who received up to \$300,000 each to help implement their collaborative projects.

Last year’s EfficientGovNow¹⁰ effort issued requests for proposals from over 2,200 local government officials. Forty-five project ideas met the minimum collaboration and cost-savings qualifications. Thirty-nine applicants submitted full proposals, which collectively represented one-time savings of nearly \$40 million and anticipated annual savings of over \$22 million. The

⁹ Michigan Turnaround Plan, BusinessLeadersforMichigan.com

¹⁰ <http://www.efficientGovNow.org>

program is repeating its successful contest in 2010, with \$330,000 in grant awards on the table. This program has resulted in numerous creative, cost-saving collaborative ideas being put forth – many of which likely could be adopted as best practices by other government entities around Ohio .

Sunset Reviews

During Ohio's biennial budget process, there often isn't time to justify desired but controversial cost saving strategies to the public or the legislature. When considering the multi-billion dollar hole that Ohio must fill by July 2011, the challenge will be greater than ever in the next biennium. While it is realistically too late to have a significant impact on the coming 2012-2013 budget cycle, Ohio should consider a more comprehensive sunset review process that includes all state agencies.

Performance audits are a great way to identify efficiencies, cost savings, best practices and other changes that should be adopted. That said, they are generally too cumbersome when addressing every aspect of a very large, complex governmental agency. While performance audits work best when performed on targeted programs or services, sunset reviews are a model that effectively can be used to examine Ohio's 24 state agencies in their entirety.

Ohio has had a sunset review process in place for many years that has focused on our state's numerous boards and commissions. Every 10 years, these entities must prove they are still relevant, and justify the costs they incur and services they provide. The process works well and has identified the need for continuation, modification, elimination or other changes to boards and commissions. It needs to be expanded to include Ohio's 24 state agencies.

Public policy expert David Osborne¹¹ noted that, "Evidence from 25 years of experience with sunset laws suggests that the threat of a necktie party can indeed concentrate the minds of elected officials, government managers, and special interested – if the sunset commission takes its job seriously."

A former Colorado regulator¹² explained, "The beauty of sunset is not so much that you can get rid of something...the beauty is the chance to take an objective look at an agency and make needed changes."

¹¹ The Price of Government, David Osborne & Peter Hutchinson, pg. 98, 2004

¹² The Price of Government, David Osborne, Pg. 99

On the down side, sunset review programs by their very nature have shortcomings: typically they are limited in scope; often don't have good performance measurement systems; don't consider broader strategies to achieve outcomes; and don't look to alternative programs or providers.

What other states do with sunset reviews

Texas

The Texas Sunset Commission, the most successful sunset process in the states, has resulted in 54 agencies being abolished and 12 agencies being consolidated over the years. For every dollar invested in the sunset program, the state has earned a return of \$31, resulting in \$784.5 million in estimated savings between 1982 and 2007.

New York

To close budget gaps, then New York City Mayor Rudy Giuliani used a tool known as the Program to Eliminate the Gap (PEG)¹³. PEG demanded fiscal savings every year from city agencies and involved a continual examination of government spending and of whether government agencies were spending money efficiently. It was a budgetary exercise but also a critical management tool that forced city government to examine its programs and determine what was essential and what was not. PEG's largest savings achievement was \$527 million.

¹³ Deloitte study

SUMMARY AND OVERALL RECOMMENDATIONS:

Public entities at all levels must explore significant changes in operations and/or structure, starting immediately, to achieve a constitutionally mandated balanced budget by July 2011.

Painful decisions must be made, but they cannot be made in a vacuum: careful analysis must be undertaken to better streamline programs, cut costs, adopt operational efficiencies and make other needed - and targeted - changes. Ohio's performance audit program is a valuable tool government should embrace, along with other related OSCPAs recommendations:

- Mandate an active program of performance audits under which targeted programs, services, topics or agencies are evaluated.
- Require follow up one year or less after performance audit and relevant sunset review recommendations are released, and more often as necessary, to ensure recommendations are addressed.
- Expand the sunset review process to ensure all state agencies are evaluated every 10 years.
- Dedicate the necessary resources. Cost management does not happen on its own. Determine what financial, human capital and technology resources are necessary to support each program sufficiently.
- Strengthen accountability and empower public sector employees at all levels. Efficiency must be seen to be important to line managers and responsibility for program implementation must be given to individuals who have played an active role in its development.