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REMARKS BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

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TO THE SEVENTH ANNUAL CONFERENCE

OF THE AMERICAN ASSOCIATION OF
SPANISH-SPEAKING CERTIFIED PUBLIC ACCOUNTANTS

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AUDIT OF GOVERNMENT CONTRACTS

Thank you for inviting me to speak to your annual conference. I expect to go away from this occasion better informed than I came because of this opportunity to meet and talk with an accomplished new group in our profession. I have spent most of my working life in Washington. In addition to being our National Capitol, it is one of those towns that--along with a few others--belong to the world. That is a good thing. But you can't see the world in proper perspective if you stay exclusively where you work, whether in Washington, London, Rome, or Tokyo. You must go out and meet people on their own ground. That is why I came to meet, and get to know you. For in Forums such as this one, our respective organizations can learn a lot from each other.

I believe the General Accounting Office and the American Association of Spanish-Speaking Certified Public Accountants share a twofold purpose to:

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--improve our profession and

--improve audit standards.

A particular important area of concern to both government and independent accounts is the crucial area of government contract auditing. I was, therefore, pleased that you asked George Egan of my staff to speak at your Harlingen Texas Convention last year on the subject of audits of government contracts. To bring you up to date on what has happened since, I'd like to build on George's presentation. At my conclusion, I'll open the floor for discussion. But before I go on, I must warn you that if your questions get too tough for me, I'm going to use the excuse that I can't answer because I have to catch a 1:40 p.m. plane back to Washington.

THE BACKGROUND
OF GAO AUDIT STANDARDS

The audit standards that existed in the early 1970s related solely to audits designed for expressing opinions on financial statements. Standards were not available for the broader concerns of efficiency and economy of operations and effectiveness of programs in achieving established goals. It was logical for the General Accounting Office to see what could be done because its mission is to keep the Congress advised of the efficiency, economy and effectiveness of Government programs, including auditing the programs.

A project for the development of audit standards that would be specifically applicable to governmental entities was undertaken. A task force composed of representatives of Federal agencies with large grant programs, State and local governments, the academic community, and professional organizations, including the American Institute of Certified Public Accountants, was assembled to begin development of the standards.

THE PART PLAYED BY GAO

First, the literature and methods³ used by Federal audit organizations was reviewed. Then a set of standards was drafted and sent for comment to Federal agencies, State and local auditors, the American Institute of Certified Public Accountants, Municipal and State organizations, and educators. More than 100 sets of comments including over 2,000 individual comments, were received. These were analyzed and considered in the preparation of the final product, a publication no doubt now familiar to most of you--"Standards for Audit of Governmental Organizations, Programs, Activities & Functions," issued by GAO in 1972.

These standards provided that a government audit include three elements:

- Financial and compliance to determine whether financial operations are properly conducted, financial reports are presented fairly, and applicable laws and regulations are complied with.

- Economy and efficiency to determine whether an entity is managing or using personnel, property, space, and so forth in an economical and efficient manner and the causes of inefficiencies or uneconomical practices, including inadequacies in management information systems, administrative procedures, or organizational structure
- Program results to determine whether desired results or benefits are being achieved, objectives established by the legislature or other authorizing body are being met, and alternatives which might yield desired results at a lower cost are being considered.

The AICPA Committee on relations with the General Accounting Office stated that its members agreed with the philosophy and objectives advocated by the GAO in its standards and "believe that the GAO's broadened definition of auditing is logical and worthwhile continuation of the evolution and growth of the auditing discipline."

THE WORK OF INDEPENDENT PUBLIC ACCOUNTANTS

While GAO has acquired much experience and related expertise in applying these standards to its Federal audits, most of the auditing of Federal programs by independent public accountants has been restricted to financial and

compliance auditing. Most of you are performing little, if any economy and efficiency or program results auditing. These are areas in which you can have a significant impact on Federal programs. GAO is encouraging the Federal agencies to include in their audit guides work steps pertaining to economy and efficiency of grantee operations as well as program results. No doubt many of you will be more and more involved in program results and economy and efficiency audit as time goes by. I will concentrate my comments today on financial and compliance audits of grants.

That is the bulk of the work which you in public practice are being called upon to do. Let me give some examples of the Federal programs audited by independent public accountants:

- The intergovernmental personnel program of the Civil Service Commission.
- Community action agencies of the Community Services Administration--medicare, student aid, and headstart programs in HEW.
- Low rent housing, urban renewal authorities, and model cities programs of HUD.
- The law enforcement education program of the Department of Justice.
- Comprehensive employment and training programs of the Department of Labor.

--Revenue sharing at Treasury.

In large programs, such as Labor's comprehensive employment training program, as many as 20,000 independent public accountants' audits per year by fiscal year 1980 could result.

PROBLEMS WITH GRANT AUDITS

GAO work shows that generally independent public accountants perform financial opinion parts of government audits satisfactorily. However, some firms are not auditing compliance items adequately, others are not doing a professional job, some fail to inform the Federal funding agencies of deficiencies in grantee operations; and some do not recognize potential grantee liabilities because of their failure to meet grant requirements.

Some firms have not learned how important the compliance elements of an audit are to Government officials and consequently do not provide them with necessary information. In these cases, firms are not out to cheat the government, they simply are not familiar with government requirements for compliance auditing.

An example can be found in GAO's assessment of HUD's use of independent public accounts to audit Public Housing Agencies. The report issued in August 1976 said:

"Independent public accountants generally performed satisfactorily the financial opinion part of audits of public housing agencies. However, they need training and guidance from the Department of Housing and Urban Development to improve their reviews of housing agencies' compliance with program regulations. At the same time, the Department needs to strengthen its monitoring of public accountants' performance and its use of the audit report as a management tool for the low-rent housing program."

GAO's examination of 15 audits showed that none of 11 independent public accountants reviewed all 17 compliance areas called for in their contracts. They should have made a total of 215 separate reviews in the compliance areas. One-hundred seventy, or 79 percent of the reviews either were not made or were inadequate.

Three factors caused this:

--HUD's audit guide did not clearly explain how public accountants should perform compliance reviews.

--Public accountants cannot always confirm financial information and do not always have access to department handbooks needed to review a housing agency's compliance with Department regulations.

--Public accountants are not sufficiently familiar with the Department's audit requirements and accounting and program regulations which differ from those applicable to commercial audit engagements.

NON-PROFESSIONAL AUDITS

In other cases GAO found that some public accountants are not doing a professional job and the Government is not getting what it is paying for. During this same review we found examples where some work by two accountants on two audits appeared to be below expected professional standards. GAO referred these two cases to the AICPA to determine whether the audit work performed was substandard and, if so, what action should be taken.

During another current review GAO found that a public accountant did not test a grantee's expenditures for salaries and wages even though such expenditures amounted to \$225,000 of the \$297,000 expended. Another accountant reported that a grantee had \$60,000 in cash at the end of its fiscal year; however, a review of his workpapers showed that balance included deposits of \$120,000 and an indeterminate amount of expenditure which occurred after the close of the grantee's fiscal year. The same accountant had prepared one workpaper file during his audit. In this file we found 5 workpapers which supported his report and 59 other workpapers which contained the management letter grant documents, and drafts of the audit report. GAO's test of the grantees records showed that this public accountant did not note the following efficiencies in the grantee's accounting systems:

--material weaknesses in cash disbursement controls including expenditures not properly authorized; supporting invoices not

available; unsupported payments for travel; inadequate control over blank checks; and unissued checks held for more than 6 months.

--Expenditure made in 1977 and charged to 1976.

--\$11,700 uncollected non-Federal matching funds included in the financial statements as amount receivable.

--Inadequate support for \$40,000 of non-Federal matching funds.

INADEQUATE REPORTING

During a recent review of audits performed by independent public accountants for Federal agencies GAO noted that while they will report serious deficiencies to a grantee they are hesitant to report them to an agency, even though Federal funds are used to pay for the audits. It seems as if independent public accountants hold more allegiance to a grantee than to a grantor agency.

GAO identified two cases where certified public accountants knew defalcations had occurred but did not notify the Federal Regional auditor or disclose the matter in their audit reports. During the audit, the CPA found that one of the grantee officials had misappropriated \$120,000 of the grantee's funds and had deposited the dollars in his personal savings account. The official had diverted the funds during the period from February to November 1976; the CPA noted the diversion in December 1976 and notified the grantee's executive director immediately. The director confronted the employee who returned the funds, including interest earned. The employee was retained as the grantee's chief financial officer until June 1977. But, the CPA did not notify the Federal agency of the misappropriation, urging instead the grantee to do so. In June 1977, the grantee's executive director

notified the agency's program officer of the misappropriation. The executive director did not fully describe the incident and included incorrect and misleading information in the notice. Neither the agency's regional director nor the regional auditors had been notified of the defalcation when GAO brought it to their attention about a week later.

According to an official of the CPA firm, they did not notify the Federal agencies, which funded the grantee, of the misappropriation because they believed the grantee was responsible to notify the appropriate Federal agencies. We believe the CPA would not have been reluctant to notify the Federal agencies of the misappropriation if the Federal agency had contracted with the CPA for the audit.

HANDLING LIABILITIES

Another significant problem facing independent public accountants is how to handle liabilities for grantees which fail to meet grant requirements such as eligibility and matching funds requirements. Sometimes, whole grants may be returnable to the Federal government if matching fund requirements or eligibility criteria are not met. Chicago recently agreed to repay about \$1 million in Federal job funds if used illegally to hire ineligible and politically favored public workers.

Eligibility requirements under some grants are difficult and time consuming to audit and some CPA firms tend to ignore verifying that these requirements have been met. Yet as can be seen in the Chicago case, the grantee may incur a substantial liability if eligibility requirements are not met.

The last problem I will address today is the proliferation of audit guides. Presently, at least 48 audit guides exist which Federal agencies have prepared

for application to audits of Federal assistance. ^{new} guides ~~was~~ prepared more or less independently, and they contain different approaches for auditing the same types of accounts. The variation in approach has caused problems for auditors auditing a single set of books which contain the accounts for several funds. For instance, if a city receives assistance funds from 20 separate grants and if audit guides applicable to each of these grants prescribe different methods for auditing cash, it would be imprudent, if not impossible, to apply all of these procedures to the single cash account in the general fund.

WHERE DO WE GO FROM HERE?

More needs to be done to inform the independent public accountants that reporting on grantee compliance with major grant requirements is just as important to the Federal Government as reporting on the grantee's financial statements. Public auditors must not assume that standard financial statements will meet the Government needs. Too often their reports do not comment on compliance requirements unless there is a deficiency which affects the grantee's financial position. Government officials generally want a specific statement as to whether or not the grantee administered the grant in compliance with the major grant requirement.

INADEQUATE REPORTING

The problem of independent public accountants not reporting serious deficiencies in grantee financial operations to the Federal grantor agency may be the result of their mental attitude or may be caused by the contractual relationship between them and Federal agencies.

GAO has found that when a Federal agency engages an independent public accountant to audit the records of its grantees, he is not hesitant to report deficiencies in the grantee's financial operations to the Federal agency. Conversely, however, when a Federal agency permits the grantee to engage the independent public accountant to audit the grant records, and to use Federal

funds to pay for the audit, he is hesitant to report any deficiencies to the grantor agency.

The practice of permitting the grantee to engage the independent public accountant to audit the Federal grant programs is in conflict with GAO's standard relating to auditor independence which states:

"When independent public accountants or other independent professionals are engaged to perform work that includes inquiries into compliance with applicable laws and regulations, efficiency and economy of operations, or achievement of program results, they should be engaged by someone other than the officials responsible for the direction of the effort being audited. This practice removes the pressures that may result if the auditors must criticize the performance of those who engaged him. To remove this obstacle to independence, governments should arrange to have such auditors engaged by officials not directly involved in operations to be audited."

In the near future GAO will begin an assignment to look at the various methods Federal agencies use to engage independent public accountants and to determine the effects of each method. For the short run, we should stress

that the Federal grantor agencies must be informed of deficiencies in grantee operations, even if the CPA is engaged by the grantee.

The problem of how to determine if the grantee may incur a substantial liability for failure to meet certain grant requirements is difficult. Compliance requirements are time consuming to check. However, the CPA must satisfy himself that the grantee has complied with grant requirements. We think that the CPA should determine whether the grantee's accounting system is designed to insure that the major grant requirements are complied with. If he determines that the system is so designed, he can sample transactions to determine whether the system is operating as designed. In this way the CPA can rely on the effectiveness of the system rather than checking out each grant in detail.

MULTIPLICITY OF AUDIT GUIDES

We have a unique approach to solving the problem of too many audit guides. We have developed another in cooperation with the National Intergovernmental Audit Forum. However, the purpose of this audit guide is to provide a uniform audit approach and uniform documentation procedures for financial audits of organizations receiving funds from several Federal agencies or under several federally assisted programs, so that the needs of each Federal funding agency for audited financial information are satisfied by a single audit. This will conserve manpower, support efficiency, and reduce the impact of audits on an agency's operations.

It is hoped that the Federal agencies will adopt this audit guide as their own and not feel a need to continue to use their own guides or to develop new ones. The title of this guide is "Audit Guidelines for Audits of Financial Operations of Federally Assisted Programs." It is in draft and will become final in the near future. We are also developing audit guides for compliance, economy and efficiency, and program results.

The compliance audit guide appears to be the most difficult to develop; over 1,000 grant programs and the huge quantity of administrative, program and legislative requirements involved. The Southwest Intergovernmental Audit Forum has completed an attempt to develop the compliance requirements for a regional metropolitan planning organization. The results are being analyzed to determine the feasibility of developing one compliance guide versus the desirability of a series of guides applicable to such broad entities as school districts, nursing homes, community action agencies, etc.

Currently the Northeast Intergovernmental Audit Forum is drafting an economy and efficiency audit guide. A draft is expected by the first of the

year. GAO's San Francisco Regional Office has developed a program results audit guide which is now in exposure draft form. The AICPA has been extensively involved in its development.

This concludes my technical discussion of what has been wrong in our recent past with grant auditing and what could and should be done to improve that auditing to strengthen the management of grant programs by Federal, State and local authorities. I hope I have made obvious how crucial strong auditing is to more satisfactory management of these programs. Government auditors, and independent public accountants all are involved and, of course, will be for a long time. The critical component is, and will continue to be, the presence of good leadership and highly trained professional people.

In this connection, I was pleased to learn from one of your members, Frank Campos of GAO's San Francisco Office, that your association is starting a scholarship program to help young Hispanics towards accounting careers. I also understand that pending the start of your own scholarship program, you have already in just this last year, obtained \$9,400 through the AICPA for scholarships for 21 Hispanic students.

I commend your efforts. For by bringing well trained talented young people into the profession, government and independent accountants can better meet the demands we face in challenging areas such as audits of grant programs.

My remarks today have previewed the material contained in a report on audits of grant programs my Office will be issuing within the next few weeks. When it is issued, I will be pleased to furnish your executive director with copies so that you will have an early opportunity to become familiar with the audit work my comments have been based on. I would like to open the floor now for discussion or questions.