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REPORT TO THE CONGRESS



BY THE COMPTROLLER GENERAL
OF THE UNITED STATES



LM100263

An Overview Of Federal Internal Audit

Office of Management and Budget and Other
Federal Departments and Agencies

Several agencies have not established appropriate internal audit as required by law. Some have staffs which are too small to provide adequate audit coverage. And some are emphasizing audits of Federal assistance programs to such an extent that their internal audit coverage has been inadequate.

The Office of Management and Budget should help smaller agencies obtain auditing services and should develop guidelines to assist Federal agency management in determining the appropriateness of the size of their audit staffs.



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report assesses the performance of the Federal agencies in implementing section 113 of the Accounting and Auditing Act of 1950 which requires each agency to establish and maintain an internal audit system.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

We are sending copies of this report to the Director, Office of Management and Budget, and to the heads of the departments, agencies, and commissions to which the 1950 act applies.

A handwritten signature in cursive script, reading "Thomas A. Steeds".

Comptroller General
of the United States

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ABBREVIATIONS

CAB Civil Aeronautics Board
DCAA Defense Contract Audit Agency
FTC Federal Trade Commission
GAO General Accounting Office
HEW Department of Health, Education, and Welfare
HUD Department of Housing and Urban Development
ICC Interstate Commerce Commission
SBA Small Business Administration
SEC Securities and Exchange Commission
VA Veterans Administration

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

AN OVERVIEW OF
FEDERAL INTERNAL AUDIT
Office of Management and
Budget and Other Federal
Departments and Agencies

D I G E S T

The Accounting and Auditing Act of 1950 requires Federal agency heads to establish and maintain appropriate internal audit to provide effective control over funds, property, and other assets.

This basic concept has been expanded by GAO's issuance of principles and procedures for internal audit which encourage auditors to identify opportunities for minimizing unnecessary or wasteful practices, and to review results of agency programs and activities to determine whether they are meeting established objectives.

GAO has attempted to find out whether the Federal departments and independent agencies had established an appropriate internal audit capability.

Several agencies had not established internal audit groups. (See p. 7.) In others the audit staffs were too small to provide reasonable coverage. (See p. 8.) GAO also noted a tendency by some audit groups to emphasize so-called external audits of Federal assistance programs, thereby reducing the amount of internal auditing being performed. (See p. 13.)

Although guidance has been provided to each agency on a number of matters relating to internal audit, the guidance regarding appropriate levels of staffing and the proper mixture of internal and external audits has not been explicit. The result has been inadequate audit coverage of the internal operations of several agencies.

To the extent that an internal audit capability is lacking, Federal expenditures in the affected agencies are not being subjected to the control contemplated by the

Accounting and Auditing Act of 1950. In addition, opportunities to reduce or eliminate unnecessary or wasteful practices and identify cost reductions are being lost.

Officials in agencies with no audit capability generally believed their operations were too small to require internal audit. Others who requested additional staff to match audit capability with workload were denied increases by their agency or by the Office of Management and Budget. Still other audit groups found that requirements to audit external programs forced them to reduce internal audits by substantial amounts.

An effective internal audit capability for all Federal agencies would

- enhance internal control,
- provide management with needed information, and
- identify areas for reducing expenditures.

The Office of Management and Budget should investigate the feasibility of having larger Federal agencies provide auditing services on a cost reimbursable basis to smaller agencies lacking an internal audit capability. However, before this is done the Office of Management and Budget said a determination should be made by the smaller agencies as to whether it would be desirable and economically justified to establish their own audit capability. In addition, the use of independent public accountants should be explored. (See p. 16.)

Most smaller agencies lacking an internal audit capability already have determined that they are not economically justified in establishing their own internal audit capability. The use of independent public accountants as an alternative could be explored. However, consideration should be given to whether the hiring of independent public accountants will be more expensive than using Federal auditors to do the same work. (See p. 17.)

GAO also proposed that the Office of Management and Budget develop guidelines for use by Federal agencies in determining the size of their audit staffs and the proper division of effort between external and internal audits. The Office of Management and Budget believed guidance in this area had already been provided in its Federal Management Circular 73-2. It believed that if audit groups prepared the plans required by this circular, agency management would have sufficient information to make the decisions implicit in GAO's proposal. (See p. 18.)

GAO believes the guidance in the Circular is not sufficient. Virtually every Federal audit organization has prepared the annual audit plan required by the circular, and many of these plans indicate that the audit staff size is inadequate to perform the audits set forth in the plan. However, agency management generally does not appear to be responding to such information by increasing audit staff sizes or taking other action to bring workloads and audit capability into balance.

Recommendations

GAO is recommending that, to overcome the lack of internal audit capability in the smaller agencies, the Office of Management and Budget reemphasize to all agencies that do not now have internal audit coverage that such coverage should be obtained, cite the alternative methods available for obtaining such coverage, and help the agencies arrange cross-servicing agreements when requested to do so.

The Office of Management and Budget also should develop guidelines to assist Federal agency management in determining the appropriateness of the size of their audit staffs. These guidelines should also address the question of the division of efforts between external and internal audits.

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CHAPTER 1

INTRODUCTION

Federal executive departments and agencies have offices located throughout the United States and abroad which employ nearly 3 million people and manage scores of programs. Effective management of such operations requires a system of internal control, including internal audit.

An agency's internal audit organization, when provided with adequate staff, organizational independence, and authority to review all agency functions, can assist management in attaining its goals by furnishing information, analyses, appraisals, and recommendations for improving operations.

The Congress underlined the importance of internal audit by enacting section 113 of the Accounting and Auditing Act of 1950 which requires the head of each executive agency to establish and maintain systems of accounting and internal control, including internal audit, to provide "effective control over and accountability for all funds, property, and other assets for which the agency is responsible."

The same act required the Comptroller General of the United States to prescribe principles and procedures for internal audit. In 1957, 1968, and 1974 we issued statements of basic principles and concepts of internal auditing to provide guidance to Federal agencies in developing internal audit organizations and procedures. In 1972 we issued "Standards for Audit of Governmental Organizations, Programs, Activities & Functions" which is intended to apply to audits performed by Federal, State, or local governments or by independent public accountants.

These statements stress the need for internal auditors to examine financial transactions to determine whether their agency is (1) maintaining effective control over its assets, liabilities, revenues and expenditures and (2) complying with the requirements of applicable laws and regulations. These statements also encourage internal auditors to be concerned with minimizing unnecessary or wasteful practices, such as using equipment inefficiently or procuring unneeded property, materials, or supplies.

These statements further broaden the scope of the internal auditor's work to include reviews of the results or benefits achieved by agency programs, and the extent to which the programs are meeting established objectives. We suggest that auditors consider such questions as:

- Is the program accomplishing the results intended, as spelled out in the legislative objective?
- Are program costs commensurate with the benefits achieved?
- Have alternative programs or procedures been examined for potential in achieving objectives with the greatest economic efficiency?
- Is there a continuing need for the program?

Federal agencies have also received guidance from the Office of Federal Management Policy of the General Services Administration through its Federal Management Circular 73-2, which sets forth policies for executive branch departments and agencies to follow when auditing Federal operations and programs. (See app. I.) The Office of Federal Management Policy was transferred into the Financial Management Branch of the Budget Review Division of the Office of Management and Budget in December 1975. Thus the Office of Management and Budget is now responsible for internal audit policy in the executive branch of the Federal Government.

In addition to complying with the requirements of the 1950 act and our principles, procedures, and standards, internal auditors must perform so-called external audits of Federal agency grants to State and local governments. Federal grant funds, which totaled only about \$2 billion in fiscal year 1950, increased to almost \$60 billion by fiscal year 1976. This assistance involves more than 1,000 grant programs for such things as health, law enforcement, education, and environmental protection.

As legislators and executives at the Federal, State, and local levels of government became increasingly concerned with getting information on how these Federal assistance funds were being spent and on whether program objectives were being achieved, auditors found they had to devote more of their effort to auditing these programs or to monitoring the work of State and local auditors or independent public accountants hired to perform the audits.

SCOPE OF REVIEW

We met with representatives of Federal departments and agencies and provided them with a questionnaire on their audit capabilities, the extent of their audit organization's involvement in both internal and external audits, and the problems being experienced in these areas. We obtained information from the following Federal departments and agencies.

Departments

Department of Agriculture

Department of Commerce:
Maritime Administration

Department of Defense:
Defense Contract Audit Agency
Deputy Assistant Secretary
of Defense (Audit)
Defense Supply Agency
Department of the Air Force
Department of the Army
Department of the Navy
U.S. Marine Corps

Department of Health, Education, and Welfare

Department of Housing and Urban Development

Department of the Interior

Department of Justice:
Law Enforcement Assistance Administration

Department of Labor

Department of State:
Office of the Inspector General of Foreign Assistance
Office of the Inspector General, Foreign Service

Department of Transportation:
Federal Aviation Administration
Federal Highway Administration
Urban Mass Transportation Administration

Department of the Treasury

Independent agencies

ACTION
Agency for International Development
Central Intelligence Agency
Civil Aeronautics Board
Civil Service Commission
Community Services Administration
District of Columbia Government

Independent agencies (continued):

Energy Research and Development Administration
Environmental Protection Agency
Federal Communications Commission
Federal Deposit Insurance Corporation
Federal Energy Administration
Federal Home Loan Bank Board
Federal Power Commission
Federal Trade Commission
General Services Administration
Government Printing Office
Interstate Commerce Commission
Library of Congress
National Aeronautics and Space Administration
Nuclear Regulatory Commission
National Science Foundation
Securities and Exchange Commission
Small Business Administration
Smithsonian Institution
U.S. Information Agency
U.S. Postal Service
Veterans Administration

The opportunity to comment on our proposed report was provided to these departments and agencies. Their responses were considered and are included, as appropriate, throughout the report.

CHAPTER 2

INCREASED AUDIT CAPABILITY

NEEDED BY SOME AGENCIES

In a 1963 report on internal audit, the House Committee on Government Operations reported that the internal audit system recommended by the Comptroller General in his 1957 statement of principles and concepts for departments and agencies had unfortunately not been adopted on a Government-wide basis.

The report said that, although internal audit groups were scattered throughout the agencies and departments, the internal audit function frequently was being compromised by inadequate staffing. This staffing problem was confirmed in our reports on the internal audit activities of departments and major independent agencies issued from July 1966 to May 1970, which frequently disclosed that the internal audit staffs were too small to provide adequate coverage.

STAFF LEVELS OF FEDERAL AUDIT ORGANIZATIONS

The heads of Federal agencies gradually increased the size of their audit staffs. As of June 30, 1975, there were more than 11,600 internal auditors throughout the civilian and defense agencies. More than \$263 million was spent to operate these audit organizations in fiscal year 1975. The following table gives the number of professional and administrative internal and external audit personnel by agency as of June 30, 1975.

<u>Department/Agency</u>	<u>Staff size</u>
Civil:	
Agency for International Development	127
Agriculture	495
Civil Service Commission	83
Commerce	157
Community Services Administration	40
D.C. Government	42
Energy Research and Development Administration	171
Environmental Protection Agency	70
Federal Deposit Insurance Corporation	21
General Services Administration	111
Health, Education, and Welfare	859
Housing and Urban Development	327
Interior	145
Justice	118
Labor	180
National Aeronautics and Space Administration	59
National Science Foundation	15
Nuclear Regulatory Commission	25
Postal Service	712
Small Business Administration	86
State	60
Transportation	458
Treasury	816
Veterans Administration	70
Miscellaneous (ACTION, Library of Congress, Smithsonian Institution, etc.)	<u>56</u>
Total Civil	5,303
Defense:	
Defense Contract Audit Agency	3,367
Deputy Assistant Secretary of Defense (Audit)	101
Defense Supply Agency	162
Air Force	1,052
Army	990
Navy	553
Marine Corps	<u>119</u>
Total Defense	<u>6,344</u>
Total staff size	<u>11,647</u>

Some Federal agencies have not established audit organizations. For example, we reported in September 1974 that the National Gallery of Art had no internal audit organization, even though it

- is responsible for assembling and maintaining a national collection of paintings, sculptures, and graphic arts valued at more than \$225 million in June 1974;
- receives significant amounts of funds each year from both Federal and private sources (\$6.2 million in Federal funds and \$1.5 million in private funds were received for fiscal year 1974 operations); and
- had a staff of 377 regular employees and 72 part-time and intermittent employees as of May 1974, and is expected to expand by about 500 additional employees within the next few years.

The Gallery's Treasurer, in response to our report, said he agreed in principle with the need for a coordinated internal audit function, but did not intend to establish an internal audit group because he believed the Gallery's operations were not large enough to justify a full-time internal audit staff.

LACK OF INTERNAL AUDIT IN REGULATORY AGENCIES

As a group, the Government's regulatory agencies have virtually no internal audit capability, although several agencies have strong external audit organizations which generally make compliance reviews of industries regulated. We found that:

- The Federal Trade Commission (FTC) has no internal audit group as such, although it does have a monitoring and accountability overview for each FTC program more in the nature of program evaluation groups rather than an internal audit group.
- The Federal Communications Commission has one person to carry out the internal audit function.
- The Securities and Exchange Commission (SEC) has no internal audit group. SEC did form an ad hoc audit group in 1975 to perform an internal audit as a result of our recommendation.

--The Civil Aeronautics Board (CAB) has no internal audit group. CAB does have a group of compliance examiners/auditors. However, these individuals are concerned with the operations of air carriers. CAB's internal audit effort in 1975 was 1/2 staff-year.

--The Interstate Commerce Commission (ICC), like CAB, has an audit group primarily performing external compliance reviews of rail carriers. Only 1 or 2 percent of its audit effort is spent on internal audit.

--The Federal Power Commission has two men who perform somewhat of an internal audit function on a part-time basis, but its audit group is almost exclusively compliance type auditors who audit power suppliers.

**TWO ADDITIONAL AUDIT ORGANIZATIONS
WHICH ARE UNDERSTAFFED**

Our reviews of two other Federal agencies in fiscal year 1976 disclosed understaffed internal audit capabilities at the Small Business Administration (SBA), and the Veterans Administration (VA).

Our review of the SBA Internal Audit Division showed that as of October 1975, 24 auditors were responsible for auditing 19 different financial assistance programs and 19 management assistance, procurement assistance, and advocacy programs in 10 regional offices and 90 district and branch offices. The auditors were able to cover only 25 of SBA's 63 district offices during fiscal years 1969 through 1974. The audit areas SBA identified as the highest priority for coverage were on a 10-year audit cycle. SBA's audit staff was reduced from 53 in 1967 (42 professionals and 11 clerical positions) to 22 (18 professionals and 4 clerical positions) in 1974. SBA was authorized to increase its internal audit staff to 40 positions in July 1974. However, after seven positions were filled, SBA curtailed further hiring because of Office of Management and Budget restraints in accordance with a general position reduction the Congress made.

VA, with a total staff of 186,200 as of June 1975, had only 70 auditors to audit \$16.7 billion in fiscal year 1975 program expenditures. This put the audit group on about a 20-year cycle for management audits of VA's 177 hospitals and regional offices.

We reported in February 1976 on the audit coverage provided to VA's Data Processing Center in Hines, Illinois, which made \$7.4 billion in compensation and pension payments in fiscal year 1975. Despite the large sums involved and the vulnerability to undetected error, misuse, and possible fraud, VA auditors had never reviewed the adequacy of controls over computer processing in the compensation and pension system. The VA internal auditor at the Hines Center said such controls had not been reviewed due to insufficient staff resources.

CHAPTER 3

IMPACT OF GRANT AUDIT REQUIREMENTS

ON INTERNAL AUDIT COVERAGE

Internal audit organizations have found that the growth to nearly \$60 billion for more than 1,000 Federal grant programs has required more external auditing on their part. This has reduced the time available for performing internal audits of agency operations.

Legislation establishing a grant program often contains a requirement that the program be audited at certain specified intervals, such as every 2 years. Accordingly, in preparing annual audit plans, internal audit organizations must determine what part of such audit requirements will be carried out by cross-servicing arrangements with other Federal audit groups, by State and local auditors, under contracts with independent public accountants, and by the audit organization itself.

CROSS-SERVICING ARRANGEMENTS

To conserve staff resources, promote efficiency, and minimize the effect of audits on the operations of organizations subject to audit, each Federal agency is required by Federal Management Circular 73-2 to fully consider establishing cross-servicing arrangements under which one Federal agency will conduct audits for another. The circular states that this is particularly applicable in the Federal grant and contract programs where two or more Federal agencies are frequently responsible for programs in the same organization or in offices located within the same geographical area.

There are numerous instances of such cross-servicing arrangements. For example, the Defense Contract Audit Agency (DCAA) and the Departments of Agriculture, the Interior, and Health, Education, and Welfare (HEW) have provided auditing services to the Department of Labor. DCAA also provides contract audit services to such agencies as the Department of Housing and Urban Development, National Aeronautics and Space Administration, and the Department of Transportation.

HEW has performed audits for the Department of Agriculture, the National Science Foundation, and DCAA. HEW also is responsible for auditing grants and contracts made by Federal agencies to more than 2,000 educational institutions throughout the United States.

STATE AND LOCAL
AUDIT ASSISTANCE

Federal Management Circular 73-2 also requires Federal auditors to coordinate their audit requirements with State and local governments to the maximum extent possible. The circular states that:

"The scope of individual Federal audits will give full recognition to the non-Federal audit effort. Reports prepared by non-Federal auditors will be used in lieu of Federal audits if the reports and supporting workpapers are available for review by the Federal agencies, if testing by Federal agencies indicates the audits are performed in accordance with generally accepted auditing standards (including the audit standards issued by the Comptroller General), and if the audits otherwise meet the requirements of the Federal agencies."

Some Federal internal audit agencies have been able to use State and local audits to reduce their workload.

--The Office of Revenue Sharing in the Department of the Treasury has agreements with 42 States and the District of Columbia to audit revenue sharing moneys of 15,000 local governments.

--The Federal Highway Administration in the Department of Transportation uses reports on Federal highway funds State auditors prepare.

--The Department of Agriculture accepts State audits of the Child Nutrition Program.

--The Law Enforcement Assistance Administration uses the work of State auditors whenever possible to satisfy its audit requirements.

--The Department of Labor uses State and local auditors to audit its Comprehensive Employment and Training Act Program.

These examples indicate the possibilities which exist for Federal use of State audit work. However, there are still some problems to be overcome, such as reimbursing State auditors for the work they perform, before State and local audit assistance achieves its full potential. A National Intergovernmental Audit Forum and 10 regional intergovernmental audit forums comprised of Federal, State, and local auditors are working to resolve the reimbursement

question and other obstacles to the increased use of State audits by Federal internal audit organizations. The Joint Financial Management Improvement Program, an organization to which all Federal agencies belong, also is working on the reimbursement issue as part of a project dealing with problems in the intergovernmental auditing area.

ASSISTANCE FROM
INDEPENDENT PUBLIC ACCOUNTANTS

Federal internal auditors increasingly have been relying on the work of independent public accountants to carry out their requirements for audits of grant and other federally funded programs. The following are examples of Federal programs audited by independent public accountants:

<u>Agency</u>	<u>Program or entity</u>
Community Services Administration	Community Action Agencies
Department of Health, Education, and Welfare	1. Medicare 2. Student Aid 3. Head Start
Department of Housing and Urban Development	1. Low Rent Housing 2. Urban Renewal Authorities 3. Community Development Block Grant Program
Department of Justice	Law Enforcement Education Program
Department of Labor	Comprehensive Employment and Training Act
Department of the Treasury	Revenue Sharing
Environmental Protection Agency	Waste Treatment Con- struction

The audits performed for Federal agencies by State and local auditors and independent public accountants must be reviewed. These reviews require a certain expenditure of staff time by the internal audit organization. Moreover, Federal internal auditors often reserve for themselves some part of the audit universe to maintain better control over the program or entity being audited.

For example, independent public accountants, rather than the internal auditors in the Department of Housing and Urban Development (HUD), are used to audit most of the 2,700 public housing authorities. HUD auditors audit those authorities with more than 5,000 units and monitor the work of the independent public accountants. Similarly, the Department of Labor audits the prime sponsors, usually major cities and States, of its Comprehensive Employment and Training Act Program while thousands of subsponsors are audited by State and local auditors or independent public accountants.

The monitoring of other auditors by Federal internal audit organizations combined with the organizations' own audits of Federal assistance programs results in more audit effort being directed toward external audits, with a corresponding decrease in audits of internal areas.

The Department of Agriculture audit office, for example, spent 33 percent of its audit effort, about 122 staff-years, on the Food Stamp, Child Nutrition, Food Distribution, Women-Infants-Children, Meat and Poultry Inspection, and Water and Waste Disposal Programs in fiscal year 1975, an increase from the 28 percent it spent in fiscal year 1974.

The Department of Health, Education, and Welfare Audit Agency spent about 80 percent, or 666 staff-years, of its audit effort on grant audits in fiscal year 1975, and only 20 percent on internal audits.

The Department of Housing and Urban Development's audit office spent about 64 percent, or 172.2 staff-years, of its audit time in fiscal year 1975 on audits of its grant programs for Model Cities, Urban Renewal/Neighborhood Development, Low Rent Housing, and four other grant programs.

The Department of Transportation employed 381 auditors in fiscal year 1975, of whom about 100 performed internal audits for the Department. The remaining auditors performed external audits exclusively for the Federal Aviation Administration, Federal Railroad Administration, U.S. Coast Guard, Federal Highway Administration, Urban Mass Transportation Administration, and the National Highway Traffic Safety Administration.

Our reviews at two agencies during fiscal year 1976 indicated that the concentration of effort on external audits was resulting in inadequate internal audit coverage.

Our review of the Environmental Protection Agency showed that virtually all of its auditors were concerned with external audits of construction and other grant programs. The review pointed out that this concentration on grants meant only a limited amount of internal auditing was being accomplished. Later the agency took two steps to improve the situation. First, 22 additional internal audit positions were provided to the Office of Audit during fiscal year 1976. Second, the agency entered into contracts with independent public accountants for external audits, which allowed its auditors to conduct more internal audits.

Our review at the Department of Labor showed that the internal auditors were spending only about 20 percent of their audit effort on internal reviews. As a result, there had been no payroll audits, no reconciliations of cash transactions with Treasury accounts, and no reviews of the collection and writeoff of receivables in recent years. In addition, very little work had been done in reviewing controls over property, cash, and advances.

CHAPTER 4

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

Progress was slow in carrying out the requirement of the 1950 Accounting and Auditing Act to establish internal audit systems until the 1970s, when a series of increases brought Federal audit staffs to a total of more than 11,600 professional and administrative personnel. However, some agencies still have not established audit groups and others are understaffed. Moreover, the growth of Federal assistance programs has required the internal audit offices of several grantor agencies to spend as much as 60 to 80 percent of their time either monitoring and reviewing the audits of State and local auditors and independent public accountants or performing such external audits themselves.

The complete or partial absence of internal audit capability means that Federal expenditures in the affected agencies are not being subjected to the important internal control provided by auditors. In addition, opportunities to reduce or eliminate unnecessary or wasteful practices and identify potential cost reductions are being lost.

The trend toward external audit is becoming a matter for concern. While it is certainly important to concentrate on Federal assistance programs, it is also important that internal audit organizations provide effective control over funds, property, and other assets for which the agencies are responsible through audits of internal operations.

Instances where agencies have not established audit organizations, have audit organizations which are understaffed, or are performing a high percentage of external audits to the detriment of internal audit are problems which have occurred because each agency establishes its audit group without benefit of guidance as to what an appropriate level of staffing should be, or how the audit organizations should split their time between internal and external audits.

The Office of Management and Budget, which has responsibility for developing internal audit policy for Federal agencies, has provided guidance in such areas as cross-servicing and the acceptance of State and local auditors' work. However, explicit guidance has not been developed regarding the appropriateness of the sizes of Federal agency audit staffs or the proper mixture of internal and external audits.

Moreover, the Office of Management and Budget has not provided policy guidance concerning the problem of the lack of internal audit in those agencies, such as the National Gallery of Art and several regulatory agencies, that believe they are too small to have their own full-time audit organization.

To correct the problems of the lack of internal audit in some agencies, understaffing of the audit function in other agencies, and the proper mixture of internal and external audits, we proposed that the Office of Management and Budget look into the possibility of having larger agencies provide auditing services on a cost reimbursable basis to small agencies lacking an internal audit capability. We also proposed that the Office of Management and Budget develop guidelines for Federal agencies regarding the determination of the size of their audit staffs and the proper division of effort between external and internal audits.

AGENCY COMMENTS AND OUR EVALUATION

In a letter dated July 27, 1976 (see app. II), the Office of Management and Budget advised us that it believed there are several ways in which the smaller agencies may meet their audit requirements. First, a determination should be made by those agencies as to whether it would be desirable and economically justified to establish their own audit capability. Second, the use of independent public accountants should be explored as an alternative. Third, cross-servicing arrangements with the larger agencies, along the lines proposed by us, should be considered.

The Office of Management and Budget also did not believe there was a need for it to develop guidelines to assist Federal agency management in determining the appropriateness of the size of their audit staff, including guidance on the division of effort between external and internal audits. According to the Office of Management and Budget, section 6 of Federal Management Circular 73-2 provides guidance and criteria for agencies to use in determining their audit coverage, and if audit groups prepare the plans required by this section, agency management will have sufficient information to make the decisions implied in our proposal. The Office of Management and Budget said the decision on resource levels and their application must remain with agency management, subject to Office of Management and Budget review, since the requirements for audits must be considered in the context of the total agency's needs and priorities.

We believe our proposal to investigate the feasibility of larger agencies providing audit services on a reimbursable basis to agencies which are too small to have their own full-time audit staff is valid. First, in many cases the smaller agencies have already made a determination that, in their judgment, they are not economically justified to establish their own audit capability. The response of the Treasurer of the National Gallery of Art to our report on the need for an internal audit organization at the Gallery (see p. 7) is typical of several smaller agencies' beliefs that their operations are not large enough to justify a full-time internal audit staff.

The Office of Management and Budget's second alternative, the use of independent public accountants, could be explored. However, consideration should be given to whether the hiring of independent public accountants will be more expensive than using Federal auditors to do the same work.

The Office of Management and Budget contends that what we have proposed is basically cross-servicing arrangements between larger agencies and small agencies with no audit capability. This is true in the broadest context of cross-servicing, which has generally been defined as an arrangement under which one Federal agency will conduct audits for another when it is in the best interests of the Federal Government to do so. However, cross-servicing has traditionally been confined to Federal grant-in-aid and contract programs (see p. 10) where two or more Federal agencies are responsible for programs in the same organization or in offices located within the same geographical area.

Perhaps one reason why cross-servicing arrangements generally have not been made for internal audits of small Federal agencies by larger ones is that it is usually the primary responsibility of the Federal agency with the predominant interest, in this case the small agency, to take the initiative in arranging for cross-servicing. The small agencies have not been making such arrangements, possibly because they are not convinced of the need for internal audit of their operations.

Since small agencies are reluctant to take the initiative in arranging for internal audits of their operations by larger agencies, we believe the Office of Management and Budget needs to become involved in this area by setting up several cross-servicing arrangements on a cost reimbursable test basis to determine whether it is feasible

to have larger agencies provide internal audit services for small ones that lack internal audit capability.

We also believe that our second proposal regarding the development of guidelines to assist Federal agency management in determining the appropriateness of the size of their audit staff, including guidance on the division of effort between external and internal audits, needs to be carried out.

The Office of Management and Budget contends that guidance in this area is provided by section 6 of the Federal Management Circular 73-2, and that if audit groups prepare the plans required by this section, agency management will have sufficient information to make decisions regarding the appropriateness of the size of their internal audit organizations and the mixture of internal and external audit. However, we have found that virtually every Federal audit organization complies with the requirement of section 6 of the Federal Management Circular 73-2 and prepares an annual audit plan. Several of these plans have indicated that substantial increases in personnel are needed to perform the required audits set forth in the plan. However, agency management generally has not responded to such information by increasing audit staff sizes or taking other action to bring workloads and audit capability into balance.

We recognize that the requirements for audit must be considered in the context of the agency's total needs and priorities. However, we believe the fact that agency management has not increased its audit staffs in situations where audit plans offer clear evidence that the internal audit organization is understaffed indicates that preparation of the plan does not necessarily provide agency management with sufficient information to determine the appropriateness of audit staff sizes. We believe guidelines are needed in this area, and that there is also a need for these guidelines to include guidance on the division of effort between external and internal audits.

RECOMMENDATIONS TO THE DIRECTOR,
OFFICE OF MANAGEMENT AND BUDGET

We recommend that, to overcome the lack of internal audit capability in the smaller agencies, the Office of Management and Budget (1) reemphasize to all agencies that do not now have internal audit coverage that such coverage should be obtained, (2) cite the alternatives available to establishing an in-house capability--such as using public accountants, when economically justifiable, and using

cross-servicing agreements--and (3) help arrange such agreements when requested to do so.

The Office of Management and Budget should also develop guidelines to assist Federal agency management in determining the appropriateness of the size of their audit staffs. These guidelines should also address the question of the division of efforts between external and internal audits.

GENERAL SERVICES ADMINISTRATION
OFFICE OF FEDERAL MANAGEMENT POLICY

FEDERAL MANAGEMENT CIRCULAR

FMC 73-2: Audit of Federal Operations and Programs
by Executive Branch Agencies

September 27, 1973

TO THE HEADS OF EXECUTIVE DEPARTMENTS AND ESTABLISHMENTS

1. Purpose. This circular sets forth policies to be followed in the audit of Federal operations and programs by executive departments and establishments.
2. Supersession. This circular supersedes Office of Management and Budget Circular No. A-73, dated August 4, 1965.
3. Policy intent. The primary objectives of this circular are to promote improved audit practices, to achieve more efficient use of manpower, to improve coordination of audit efforts, and to emphasize the need for early audits of new or substantially changed programs.
4. Applicability and scope. The provisions of this circular are applicable to all executive departments and establishments. The terms "agency" and "Federal agency" throughout this circular are synonymous with the term "departments and establishments" as defined in FMC 73-1.
5. Definitions.
 - a. The term "audit" as used in this circular means a systematic review or appraisal to determine and report on whether:
 - (1) Financial operations are properly conducted;
 - (2) Financial reports are presented fairly;
 - (3) Applicable laws and regulations have been complied with;

(4) Resources are managed and used in an economical and efficient manner; and

(5) Desired results and objectives are being achieved in an effective manner.

The above elements of an audit are most commonly referred to as financial/compliance (items 1, 2, and 3), economy/efficiency (item 4), and program results (item 5). Collectively, they represent the full scope of an audit and provide the greatest benefit to all potential users of Government audits. In developing audit plans, however, the audit scope should be tailored to each specific program according to the circumstances relating to the program, the management needs to be met, and the capacity of the audit facilities.

b. The term "audit standards" refers to those standards set forth in the Standards for Audit of Governmental Organizations, Programs, Activities & Functions issued by the Comptroller General of the United States.

6. Policies and procedures. Agencies are responsible for providing adequate audit coverage of their programs as a constructive aid in determining whether funds have been applied efficiently, economically, effectively, and in a manner that is consistent with related laws, program objectives, and underlying agreements. The audit standards will be the basic criteria on which audit coverage and operations are based. Agencies administering Federal grant, contract, and loan programs will encourage the appropriate application of these standards by non-Federal audit staffs involved in the audit of organizations administering Federal programs. Each agency will implement the policies set forth in this circular by issuing policies, plans, and procedures for the guidance of its auditors.

a. Organization and staffing. Audit services in Government are an integral part of the management process. Audit services and reports must be responsive to management needs. However, it is important in order to obtain the maximum benefit from this function that agency audit organizations have a sufficient degree of independence in carrying out their responsibilities. To provide an appropriate degree of independence, the audit organization should ordinarily be located outside the program management structure, report

to an agency management level sufficiently high to ensure proper consideration of and action on audit results, and be given reasonable latitude in selecting and carrying out assignments. Adequate and qualified staff should be assigned this important function. The audit of all programs under a single Federal department or agency must be coordinated, and where economies and a more effective audit service will result, especially in large and geographically dispersed programs, the audit operations within a department should be consolidated. It is also important to establish close coordination between audit and such other management review activities as may exist in an agency.

b. Determination of audit priorities. Each agency will establish procedures requiring periodic review of its individual programs and operations to determine the coverage, frequency, and priority of audit required for each. The review will include consideration of the following factors:

- (1) Newness, changed conditions, or sensitivity of the organization, program, activity, or function;
- (2) Its dollar magnitude and duration;
- (3) Extent of Federal participation either in terms of resources or regulatory authority;
- (4) Management needs to be met, as developed in consultation with the responsible program officials;
- (5) Prior audit experience, including the adequacy of the financial management system and controls;
- (6) Timeliness, reliability, and coverage of audit reports prepared by others, such as State and local governments and independent public accountants;
- (7) Results of other evaluations; e.g., inspections, program reviews, etc.;
- (8) Mandatory requirements of legislation or other congressional recommendations; and
- (9) Availability of audit resources.

c. Cross-servicing arrangements. To conserve manpower, promote efficiency, and minimize the impact of audits on the operations of the organizations subject to audit, each Federal agency will give full consideration to establishing cross-servicing arrangements under which one Federal agency will conduct audits for another--whenever such arrangements are in the best interest of the Federal Government and the organization being audited. This is particularly applicable in the Federal grant-in-aid and contract programs where two or more Federal agencies are frequently responsible for programs in the same organization or in offices located within the same geographical area. Under such circumstances, it will be the primary responsibility of the Federal agency with the predominant financial interest to take the initiative in collaborating with the other appropriate Federal agencies to determine the feasibility of one of the agencies' conducting audits for the others, and to work out mutually agreeable arrangements for carrying out the required audits on the most efficient basis.

d. Reliance on non-Federal audits. In developing audit plans, Federal agencies administering programs in partnership with organizations outside of the Federal Government will consider whether these organizations require periodic audits and whether the organizations have made or arranged for these audits. This consideration is especially necessary for those agencies that administer Federal grant-in-aid programs through State and local governments and which are subject to OMB Circular A-102, Attachment G. Attachment G provides standards for financial management systems of grant-supported activities of State and local governments and requires that such systems provide, at a minimum, for financial/compliance audits at least once every 2 years. Federal agencies will coordinate their audit requirements and approaches with these organizations to the maximum extent possible. The scope of individual Federal audits will give full recognition to the non-Federal audit effort. Reports prepared by non-Federal auditors will be used in lieu of Federal audits if the reports and supporting workpapers are available for review by the Federal agencies, if testing by Federal agencies indicates the audits are performed in accordance with generally accepted auditing standards (including the audit standards issued by the Comptroller General), and if the audits otherwise meet the requirements of the Federal agencies.

e. Audit plans. Based on the considerations set forth in b, c, and d, above, each agency will prepare an audit plan at least annually. At a minimum, such plans will reflect the:

- (1) Audit universe (all programs and operations subject to audit);
- (2) Programs and operations selected for audit, with priorities and specific reasons for selection;
- (3) Audit organization that will conduct the audit;
- (4) Audit cycle or frequency, the locations to be audited, and the reasons therefor;
- (5) Scope of audit coverage to be provided and the reasons therefor; and
- (6) Anticipated benefits to be obtained from the audits.

The plans should be adjusted as necessary to provide for audit coverage of unforeseen priorities.

f. Coordination of audit work. Federal agencies will coordinate and cooperate with each other in developing and carrying out their individual audit plans. Such actions will include continuous liaison; the exchange of audit techniques, objectives, and plans; and the development of audit schedules to minimize the amount of audit effort required. Federal agencies will encourage similar coordination and cooperation among Federal and non-Federal audit staffs where there is a common interest in the programs subject to audit.

g. Reports. Reporting standards are set forth in the Audit Standards for the guidance of Federal agencies. With respect to release of audit reports, each agency will establish policies regarding the release of audit reports outside the agency. Such policies will be in consonance with applicable laws, including the Freedom of Information Act, and, to the maximum extent possible, will provide for the dissemination of such reports in whole or in part to those interested in such information.

h. Agency action on audit reports. Each agency will provide policies for acting on audit recommendations. Timely action on recommendations by responsible management officials is an integral part of the effectiveness of an agency's audit system and has a direct bearing on it. Policies will provide for designating officials responsible for following up on audit recommendations, maintaining a record of the action taken on recommendations and time schedules for responding to and acting on audit recommendations, and submitting periodic reports to agency management on recommendations and action taken.

7. Responsibilities. Federal agencies will review the policies and practices currently followed in the audit of their operations and programs, and will initiate such action as is necessary to comply with the policies set forth in this circular. The head of each Federal agency will designate an official to serve as the agency representative on matters relating to the implementation of this circular. The name of the agency representative should be sent to the General Services Administration (AM), Washington, DC 20405, within 30 days after the receipt of this circular.

8. Reporting requirement. Each Federal agency will submit a report to the General Services Administration (AM), Washington, DC 20405, by December 31, 1973, on the action it has taken to implement the policies set forth in this circular. Specifically, the report will include actions taken on the issuance of policies, plans, and procedures for the guidance of its auditors; determination of audit priorities; new cross-servicing arrangements made; additional reliance on non-Federal audits; development of audit plans; and coordination of audit work between Federal agencies and between Federal and non-Federal audit staffs. Reports will be submitted at 6-month intervals on the additional actions taken until the circular is fully implemented. Copies of agency issuances on the implementation of this circular will be submitted to the Office of Federal Management Policy, General Services Administration, upon request.


APPENDIX I

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9. Inquiries. Further information concerning this circular may be obtained by contacting:

General Services Administration (AMF)
Washington, DC 20405

Telephone: IDS 183-7747
FTS 202-343-7747


ARTHUR F. SAMPSON
Administrator of General Services



EXECUTIVE OFFICE OF THE PRESIDENT

OFFICE OF MANAGEMENT AND BUDGET

WASHINGTON, D.C. 20503

JUL 27 1976

Honorable Elmer B. Staats
Comptroller General of the United States
General Accounting Office
Washington, D.C. 20548

Dear Mr. Staats:

This is in reply to a request for comments on the draft report, "An Overview of Federal Internal Audit."

The report provides valuable information on the status of agency internal audit capability. The report makes two recommendations to the Office of Management and Budget.

The first is that we investigate the feasibility of the larger agencies providing audit services on a reimbursable basis to the smaller agencies which are too small to have their own fulltime audit staff. As the report points out, we have encouraged the use of cross-servicing arrangements in Federal Management Circular 73-2, "Audit of Federal Operations and Programs by Executive Branch Agencies." Many such arrangements now exist. Such arrangements are intended to minimize overlap and duplication of audit and assure that maximum coverage is obtained from existing audit capability.

For example, audits of grants and contracts at over 2,000 colleges and universities are coordinated through FMC 73-6. The Circular assigns the responsibility for audit and negotiation to one Federal agency which acts on behalf of the others. Similarly, under FMC 74-4, cognizance assignments have been worked out for auditing and negotiating overhead costs for all State governments, the 450 major State agencies, and the 1,000 largest units of local government. Thousands of school districts and special districts are likewise assigned to a single Federal agency. And smaller units of local government are assigned on an ad hoc basis to the Federal agency with which they do the most business. Also, as you may know, the General Services Administration provides internal audit services to a number of small agencies and commissions.

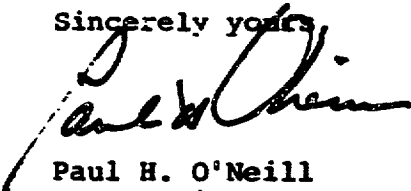
We believe there are several ways in which the smaller agencies may meet their audit requirements. First, we think a determination should be made by those agencies as to whether it would be desirable and economically justified to establish their own audit capability. Second, the use of independent public accountants should be explored as an alternative. And third, as you recommend, cross-servicing arrangements with the larger agencies should be considered. We believe each of the agencies should consider these alternatives, and decide which would be most appropriate in their particular circumstances. Any existing facilities for management analysis or program review should be a factor in this decision.

The second recommendation is that we develop guidelines to assist Federal agency management in determining the appropriateness of the size of their audit staff, including guidance on the division of effort between external and internal audits. Section 6 of FMC 73-2 provides guidance and criteria for agencies to use in determining their audit coverage. If audit groups prepare the plans required by this section, we believe agency management will have sufficient information to make the decisions implicit in your recommendation. However, the decision on resource levels and their application must remain with agency management, subject to OMB review, since the requirements for audit must be considered in the context of the total agency's needs and priorities.

We believe your report will provide the emphasis to highlight the need for improved internal auditing in the Federal agencies. The recent General Accounting Office publication, "Directory of Federal Audit Organizations," will also provide a ready reference for agency management to use in comparing the relative size of their audit staffs. We will, of course, continue to work with your staff, the departments and agencies, the Federal Audit Executive Council, and the Intergovernmental Audit Forums in an effort to improve audit operations.

We appreciate the opportunity to review the draft report.

Sincerely yours,



Paul H. O'Neill
Deputy Director

PRINCIPAL OFFICIALS
RESPONSIBLE FOR THE ACTIVITIES
DISCUSSED IN THIS REPORT

Tenure of office
From To

OFFICE OF MANAGEMENT AND BUDGET

DIRECTOR, OFFICE OF MANAGEMENT
AND BUDGET:

James T. Lynn	Feb. 1975	Present
Roy L. Ash	Feb. 1973	Feb. 1975
Caspar W. Weinberger	June 1972	Feb. 1973
George P. Shultz	July 1970	June 1972

GENERAL SERVICES ADMINISTRATION

ADMINISTRATOR OF GENERAL SERVICES:

Jack Eckerd	Nov. 1975	Present
Arthur F. Sampson	June 1973	Oct. 1975
Arthur F. Sampson (acting)	June 1972	June 1973