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BY THE COMPTROLLER GENERAL



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# Report To The Congress

OF THE UNITED STATES

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## Quality Testing Of Audits Of Grantees' Records-- How It Is Done By Selected Federal Agencies And What Improvements Are Needed

Federal agencies' procedures for examining the work of independent public accountants are too superficial. GAO is recommending that more effort be devoted to this work because it believes that without effective audits, the Federal Government has little ability to detect and recoup Federal funds spent for unauthorized purposes and the Government's ability to identify and get correction of weaknesses in grantees' controls over cash and other assets is also impaired. Therefore, GAO feels this problem warrants prompt corrective measures.

The agencies involved said they had too few in-house auditors to do this work more extensively. GAO is recommending that the agencies reassess the priorities for their auditors to see if more time can be devoted to this work. GAO is also recommending a procedure to follow in making the reviews.



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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 recommends procedures for Federal agencies to follow in examining the work of independent public accountants in auditing grantees' financial and other operations. It is important that the agencies examine such audit work because audits are one of the principal bases the agencies have to see that grantees have properly handled their Federal funds. Moreover, they need such examinations to see that the Government is getting what it pays for.

We made this review as part of our current effort to expand and strengthen audit activities of Government agencies. The report is a compilation of three reviews made at different times and reported separately to the agencies involved. Work on the first of these reviews was started in February 1977. I presented the preliminary results of these reviews in a speech at the American Institute of Certified Public Accountants meeting on Federally Assisted Programs. The speech was published in the April 1979 Journal of Accountancy.

This report is also being sent today to the President of the Senate. Copies are being sent to the Director, Office of Management and Budget; the Secretaries of Commerce and of Health, Education, and Welfare; and the Director, Community Services Administration.

A handwritten signature in black ink, appearing to read "Thomas A. Stearns".

Comptroller General  
of the United States

D I G E S T

Federal grantmaking agencies are responsible for seeing that grant funds are spent for authorized purposes. Audits of grantees' records are one of the principal methods of carrying out this responsibility. Many such audits are made by Federal auditors, but an increasing number are made by State and local auditors and independent public accountants.

Federal agencies that rely on audits by State and local auditors and independent accountants are responsible for seeing that the audits are performed in accordance with (1) applicable standards and (2) audit guidelines provided by the agency. It is important that the agencies examine the audit work because the audits are one of the principal bases the agencies have to see that grantees have properly handled their Federal funds. (See p. 1.) Moreover, they need such examinations to see that the Government is getting what it pays for.

GAO has reviewed the procedures followed by three Federal agencies in making such examinations and has found them ineffective in identifying low quality work. For instance, GAO reviewed 12 audits that had been through the agencies' review process and found that 8 lacked one or more attributes necessary for a quality job. (See p. 4.) For instance:

- One agency did not detect that the auditors had not properly evaluated grantee controls over cash; GAO found that the controls were weak, and fraud or embezzlement would have been easy. (See p. 8.)
- In another case the agency reviewed the independent accountant's workpapers and a supplemental statement of work performed

and then concluded that the accountant's performance had been satisfactory. GAO found, however, that while the accountant had said the compliance review had been performed, the grantee was violating fire and safety requirements. (See p. 10.)

--Other items the agencies failed to learn about were an error in the cash account, a lack of documentation to support over \$40,000 of reported non-Federal contributions (see p. 6), and a \$120,000 embezzlement (see p. 11).

All the audits GAO examined had been made by independent accountants. GAO cautions that while the group it tested is believed to indicate weaknesses in agency review procedures, the number reviewed is too small to warrant any overall conclusions about the adequacy of work by independent public accountants in general. (See p. 26.)

The three agencies--the Departments of Commerce and of Health, Education, and Welfare and the Community Services Administration--followed different procedures in making such examinations but all relied principally on a desk review (a reading of the auditor's report) to detect weaknesses in audit work or other problems. In some cases the agencies also examined the auditors' workpapers. GAO's review of the workpapers disclosed many of the deficiencies, including some overlooked by the agencies. (See p. 20.)

Also, none of the three agencies normally reviewed grantee's records to check the accuracy of some of the audit work by the independent accountants. GAO did and found errors. (See p. 20.)

#### RECOMMENDATIONS

GAO believes the agencies' procedures for examining the work of such accountants are too superficial and is recommending that the Director, Office of Management and Budget, require Federal grantmaking agencies to

develop and implement complete and balanced quality testing processes for identifying substandard work. GAO is making this recommendation because it believes that with improvements in the review process, the Government's ability to detect and recoup Federal funds used for unauthorized purposes would be increased. More significantly, better audits should result in quicker and better identification of weaknesses in grantee internal controls, placing the Government in a better position to bring about needed corrections. GAO feels this problem warrants prompt corrective measures. (See p. 26.)

The agencies involved told GAO that they had too few in-house auditors to do this work more extensively. GAO is recommending that the agencies reassess the priorities for their auditors to see if more time can be devoted to this work. GAO is also recommending a procedure to follow in making the reviews.

#### AGENCY COMMENTS

The Office of Management and Budget agrees that Federal agencies should apply effective quality testing processes to audits made by non-Federal auditors. The agencies included in our review generally agreed with our recommendations; however, Commerce and the Community Services Administration responded that a shortage of audit staff contributes to the problems addressed in our report. (See p. 27.)

## C o n t e n t s

		<u>Page</u>
DIGEST		i
CHAPTER		
1	INTRODUCTION	1
	Audit quality and audit standards	1
	AICPA standards	2
	GAO standards	2
	Review--purpose and scope	2
2	AGENCY REVIEWS OF INDEPENDENT ACCOUNTANTS' WORK DID NOT DISCLOSE DEFICIENCIES	4
	Failure to gather sufficient evidence	4
	Failure to evaluate internal controls	7
	GAO standards	7
	Examples of inadequate evaluation of internal controls	8
	Failure to test compliance	10
	Failure to disclose a material matter	11
	GAO standards	11
	Agency audit guide	11
	Defalcation not disclosed	12
	Agencies knew of low quality work	13
3	COMPLETENESS AND EFFECTIVENESS OF QUALITY TESTING CAN BE IMPROVED	15
	Completeness of agency procedures	15
	Proper standards should be specified	16
	All audits should be included in the universe for quality testing	16
	Preaudit contract reviews should be made	17
	Data should be systematically summarized	18
	Effectiveness of application	19
	How procedures are being applied	20
	Shortage of Federal audit resources	20
4	A MODEL FOR QUALITY TESTING OF AUDITS	22
	Measuring performance against standards	22
	Contract reviews	23
	Desk reviews	23
	Workpaper reviews	23
	Onsite reviews	23
	Providing information to decisionmakers	24
	How three agencies test audit quality	24

Page

5	CONCLUSIONS, RECOMMENDATIONS, AND AGENCY COMMENTS	26
	Conclusions	26
	Recommendations	26
	Agency comments	27

APPENDIX

I	Office of Management and Budget letter of January 30, 1979	28
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ABBREVIATIONS

AICPA	American Institute of Certified Public Accountants
CPA	Certified Public Accountant
CSA	Community Services Administration
HEW	Department of Health, Education, and Welfare
GAO	General Accounting Office
OMB	Office of Management and Budget

## CHAPTER 1

### INTRODUCTION

Many executive branch agencies rely on audits by independent public accountants as part of their systems of accounting and control of funds granted to non-Federal entities. The purpose of such audits is to assure the agencies and ultimately the Congress that grantee reports are reliable, that grantee operations are complying with laws and regulations, and that Federal funds are not subject to fraud or embezzlement and are used for authorized purposes. Because these audits are so important in the accountability process, the agencies need assurances that they are getting high quality professional work. This report discusses the completeness and effectiveness of the procedures used by three Federal agencies to provide that assurance and makes recommendations to improve quality testing procedures in Federal agencies.

By law 1/ Federal agencies must establish and maintain systems of accounting and internal controls over their funds. Auditing, an important part of the accountability process, provides independent judgments on the credibility of statements about how officials have carried out their responsibilities. Auditing can also identify weaknesses in efficiency, economy, and effectiveness of agency operations. Federal audit policy 2/ recognizes the benefits of auditing and requires that agencies provide adequate audit coverage of their programs to realize these benefits. Federal audit policy also permits and encourages the agencies to rely on audits by independent public accountants, State and local auditors, and other non-Federal auditors.

### AUDIT QUALITY AND AUDIT STANDARDS

Auditing standards concern the quality and scope of audits and the characteristics of a professional and meaningful audit report. Standards are used as both a guide for and measure of quality audit performance. Thus, auditing standards are the key to audit quality.

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1/The Accounting and Auditing Act of 1950 (act of Sept. 12, 1950, CH. 946, title I, part II, 64 Stat. 834), sec. 113(a), 31 U.S.C. 66a.

2/Circular No. A-73 Revised, Office of Management and Budget, Mar. 15, 1978.



The American Institute of Certified Public Accountants (AICPA) and the Comptroller General of the United States have issued separate statements of auditing standards. In this report, the terms "AICPA standards" and "GAO standards" will be used to distinguish between the two.

#### AICPA standards

AICPA standards apply to audits made to express an opinion on statements that present an organization's financial position and results of operations. Such audits are called financial attest audits and are a test of accounting and related records. The extent of tests is determined by the auditor on the basis of professional judgment and experience.

#### GAO standards 1/

Our standards incorporate AICPA standards. However, our standards recognize that the users of Government audit reports have broader interests than can be served by financial attest audits. For this reason, our standards stress that auditing the use of public resources should concern not only the object to which resources are devoted, but also the manner and effect of their use. We require a broader inquiry into grantee compliance with Federal laws and regulations than AICPA standards require.

Federal audit policy 2/ incorporates our standards as the basic criteria for audit quality, coverage, and operations and requires that audits by independent accountants be tested to show that they meet these standards.

#### REVIEW--PURPOSE AND SCOPE

Our purpose was to assess the completeness and effectiveness of procedures employed to test the quality of audits by independent public accountants. To do so, we

--identified the procedures being used by selected agencies (see ch. 3);

--determined how the procedures had been applied to a sample of audits by independent public accountants;

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1/Standards for Audit of Governmental Organizations, Programs, Activities & Functions by the Comptroller General of the United States, 1972.

2/Op. cit.

- performed, at one location for each agency, indepth quality evaluations of four audits made by such accountants (see ch. 2);
- reviewed agency records and interviewed agency regional and headquarters officials concerning the effectiveness of quality testing; and
- obtained comments from agency officials on our observations, conclusions, and recommendations.

The agencies whose quality assurance programs we evaluated and tested were:

- the Department of Health, Education, and Welfare (HEW);
- the Department of Commerce; and
- the Community Services Administration (CSA).

The regional locations where we made our tests were Chicago, Dallas, and Boston (except the Department of Commerce).

In Dallas we performed indepth quality evaluations on four audits by independent public accountants for Commerce. In Boston we did four similar evaluations related to HEW activities, and in Chicago we did four similar evaluations related to CSA activities.

CHAPTER 2

AGENCY REVIEWS OF INDEPENDENT ACCOUNTANTS'

WORK DID NOT DISCLOSE DEFICIENCIES

The practices followed by the three agencies to determine the quality of the work of the independent public accountants were not very effective. Specifically, in 8 of the 12 cases reviewed--all of which had already been reviewed by the agencies--we found deficiencies that the agencies had not found. The 12 cases were selected to give us a mix of audits by various size firms of independent accountants.

The problems we found are summarized in the following chart. As indicated, some audits had more than one deficiency. Of the audits having deficiencies, three were reviewed by HEW, two by CSA, and three by Commerce.

<u>Audit number</u>	<u>Failure to gather sufficient evidence</u>	<u>Failure to adequately test internal controls</u>	<u>Failure to adequately test compliance with laws and regulations</u>	<u>Failure to report on a material matter</u>
1	X	X	X	
2	X	X	X	
3	X			
4	X			
5	X		X	
6	X	X	X	
7	X	X	X	
8	—	—	—	X
	<u>7</u>	<u>4</u>	<u>5</u>	<u>1</u>

Details of some cases follow.

FAILURE TO GATHER SUFFICIENT EVIDENCE

Our standards require that the auditor accumulate sufficient evidence to provide a basis for his opinions, judgments, and conclusions. However, in 7 of 12 audits we reevaluated, the independent public accounting firms' workpapers did not contain sufficient information. As a result, in some instances supplementary oral statements had to be obtained from the auditors to determine what work they had done. This lack of information violates the evidence standard and,

more importantly, hampers other auditors assessing the quality of the work and places firms in an indefensible position should the scope or quality of their work be challenged.

Because of the lack of workpapers, we could not evaluate the quality of some independent accountants' work without on-site reviews. For example, a small local firm of accountants prepared 64 workpapers during an audit of a CSA grantee.

Our review of these workpapers showed that 59 of them had included only drafts of the grantee's financial statements, a draft of its management letter, and grant documents. The workpapers do not contain any evidence that the auditors

- reviewed the minutes of the grantee's board of directors' meetings to see that all approved actions affecting finances were shown on the grantee's books,
- verified the existence of fixed assets,
- reviewed the grantee's internal controls,
- reviewed its compliance with laws and regulations,
- examined or tested its payroll system even though the payroll costs represented \$118,000 of \$226,000 expended from grant funds, and
- tested accounts payable or receivable to see that amounts owed and due were correctly shown on the books.

Our examination of the grantee's records during an on-site review showed

- An \$11,760.49 asset appearing in the grantee's financial statements as Non-Federal Fund Receivable actually represented the amount by which the grantee had failed to meet its non-Federal matching requirement; the grantee did not have a commitment or pledge to support the claimed receivable.
- Board of directors' authorizations for some cash disbursements had been obtained after payments had been made.
- A payment had been made in one fiscal year for services not received until the next fiscal year.

- Checks had not been mailed for up to 6 months after they had been written. The agency subsequently found nearly \$100,000 of signed but unmailed checks.
- There was an unexplained break in the numerical sequence of checks.
- Documentation to support over \$40,000 of the \$70,000 of reported non-Federal contributions was lacking.
- The financial statements incorrectly reported the cash balance at February 29, 1976, because the balance included \$120,000 of March deposits and an undetermined amount of March expenditures.

The agency's regional auditor had reviewed the workpapers of the independent accountant and had concluded that the accountant's examination of the financial statements had been substantially in accordance with the audit guide furnished by CSA. He also noted that

- the grantee and the independent accountant had not executed a written contract;
- the grantee had not furnished CSA directives to the accountant;
- the accountant had not obtained the required management letter from the grantee;
- the accountant's workpapers did not include an appraisal of the accounting records or an evaluation of internal controls;
- he could not verify whether the accountant had reviewed selected reports for control, reliability, and timeliness or whether such reports had been reconciled to the grantee's accounting records; and
- the accountant had not reviewed administrative costs nor commented on the composition of the grantee's board of directors.

Despite these deficiencies (which were substantially less than we found), the auditor accepted the accountant's audit.

In another case we found that the independent accountant's workpapers contained insufficient evidence that he had

- reviewed the grantee's internal controls,
- confirmed existence of the grantee's fixed assets,
- reviewed such compliance items as bonding of grantee personnel, and
- reviewed a questionable entertainment expense.

The accountant told us that he had spent 1 of the 38 days charged to this audit on location at the grantee. The remaining time was spent by two staff members examining the the grantee's records in the auditor's office.

In another case, after reviewing the workpapers of the independent accountant, Commerce's Office of Audits reported these deficiencies:

- The workpapers had not been initialed or dated by the preparer.
  - The audit report was not cross-referenced to workpapers.
  - The workpapers did not show the source of information.
- Our review showed that the grantee had not
- adequately safeguarded blank checks and
  - adequately controlled equipment purchased with Federal funds.

This audit too was accepted by the agency auditors.

#### FAILURE TO EVALUATE INTERNAL CONTROLS

Both our standards and AICPA standards require auditors to evaluate the internal controls of the accounting system being audited. However, not all the independent public accountants properly evaluated internal controls and, as a result, the reliability of these controls could not be determined.

#### GAO standards

Our standards provide that

"An evaluation is to be made of the system of internal control to assess the extent it can be relied upon to ensure accurate information, to

ensure compliance with laws and regulations, and to provide for efficient and effective operations."

The auditor's findings help him determine how much detailed examination must be done to achieve the audit objective.

Internal control comprises the plan of organization and all the coordinate methods which safeguard assets, check the accuracy of accounting data, promote operational efficiency, and encourage adherence to managerial policies. The term embraces the policies, procedures, and practices established or encouraged by management, as well as the plan of organization and other measures intended to carry them out.

A satisfactory system of internal control includes

- a plan of organization that provides segregation of duties for safeguarding resources;
- authorization and recordkeeping procedures adequate to provide effective accounting control over assets, liabilities, revenues, and expenses; and
- practices to follow in performing duties of each organizational department.

#### Examples of inadequate evaluation of internal controls

Our examination of the financial records of one Commerce grantee during an onsite review showed that the auditor, an individual practitioner, had not adequately evaluated internal controls. For example:

- The grantee had not provided for a proper separation of duties of employees having responsibility for cash receipts, thereby making the grantee much more susceptible to fraud and embezzlement than it would be with good controls over cash.
- The grantee had not properly separated duties for cash disbursements. One individual received the invoices, prepared the journal and ledger entries, prepared the checks, reconciled the general ledger account, and retained the canceled checks for her records.
- Checks had been presigned by a program director before they had been written, thereby negating the purpose of having two people examine bills for propriety, etc.

--Payrolls had been prepared and distributed even though the supervisor had not approved employee timecards.

--Grantee procedures and records for controlling property and equipment were inadequate, and a physical inventory had not been taken since fiscal year 1973. An item of equipment in the inventory had been missing for about 2 years, and some property items did not have property control numbers.

Commerce's regional audit office had reviewed the workpapers of the accountant to determine whether the auditor had performed work of a professional caliber, complied with the audit guide, and reported all material findings. The auditor concluded that the accountant had adequately evaluated the internal controls and that Commerce could rely on the accountant's work.

Commerce, in commenting on our draft report, stated that even though its regional audit office had indicated that the quality of this audit had been satisfactory, that office had determined that the scope was too limited to serve its purposes and therefore had performed the additional required audit work and issued its own audit report. We looked at the additional audit work and found that it had consisted of a verification of direct and indirect costs but that it had not evaluated the grantee's internal controls. Commerce's report stated that the internal controls were adequate. As previously stated, we found the controls inadequate. Thus, Commerce not only failed to note that the accountant had not adequately evaluated the internal controls but had not evaluated them either when it performed additional audit work.

At another grantee--the CSA grantee discussed on page 5-- we found that the independent accountant had not adequately evaluated the grantee's internal controls. Our review disclosed weaknesses in internal controls, such as:

--Expenditures had not been properly authorized.

--Disbursements had not always been adequately supported.

--Invoices had not been marked paid.

--Unissued checks had been held more than 6 months.

--Control of unsigned checks had been inadequate.



The regional audit office had reviewed the workpapers of the auditor and had listed several observations, including that the required section on internal controls was not in the workpapers. However, in appraising the auditor's work, the regional auditor said the examination of the financial books and records and preparation of the financial statements had been substantially in accordance with the CSA Accounting System Survey and Audit Guide.

#### FAILURE TO TEST COMPLIANCE

Our standards require the auditor to determine grantee compliance with laws and regulations. This requirement is particularly important because grantees must comply with many specific rules and regulations to receive Federal funds.

Our evaluation of compliance testing by the independent accountants was hampered by the lack of evidence in the workpapers. Nonetheless, we noted failures to adequately test compliance. For example, in reviewing the audit of an HEW grantee which operates Head Start centers, we found that the accountant's workpapers did not indicate that he had made a compliance review. The auditor, however, told us that a memorandum had been prepared stating that the required work had been done. We found, however, that the Head Start centers had not complied with State fire and safety requirements during the period covered by the audit and that such compliance was an item the auditor was required to check.

The regional office of the HEW Audit Agency performed a desk review of the auditor's report and management letter as well as a workpaper review. The desk review indicated some insignificant deficiencies in the form and content of the report. However, the workpaper review indicated that some of the accountant's audit effort--particularly compliance review areas--had not always been reduced to workpapers. To supplement the workpapers, the accountant gave the Audit Agency a memorandum containing additional information and explanations on how he had conducted his review. The Audit Agency concluded that the accountant's workpapers, together with his statement detailing the scope of his audit, supported the report.

In reviewing the audits made by independent accountants for CSA grantees, we found that they had performed little, if any, compliance auditing other than completing questionnaires. One auditor readily admitted that he had not performed a compliance review, while the others stated that they had performed compliance testing as part of and concurrent with their financial analyses and tests of transactions.

Our review of one compliance item--a requirement that grantees' cash balances be limited to a 30-day supply--showed that two grantees had exceeded this limit. One grantee had a cash balance of \$1.8 million, which was equal to about 5 months of expenditures, while the other had a cash balance equal to about 3 months of expenditures. The independent accountants that had audited these grantees did not comment on the excessive cash balances in their reports or management letters.

#### FAILURE TO DISCLOSE A MATERIAL MATTER

Our standards and the CSA audit guide require disclosure and reporting of defalcations. However, we found a case in which an independent public accounting firm had discovered grantee defalcations but had not adequately disclosed them in the audit report. As a result, the report was not clear and complete enough to be understood by all users; the Federal agencies which fund the grantee did not know about the defalcations until we informed them; law enforcement officials were not notified of the defalcations until we notified them; and the official who had committed the defalcations was retained as an employee for 6 months after the defalcations had been noted by the auditor.

#### GAO standards

Our standards require that audit reports contain the information necessary for users to form an opinion on the effectiveness of the stewardship exercised by the responsible public officials. The standards also state that although management is responsible for providing such information, the auditor should comment if the data provided is insufficient to disclose any matters which may have a material effect upon the financial reports. Disclosure should be fair and complete and should not be summarized to such an extent that needed background or relationships are omitted or blurred. While the materiality of an item should be considered in determining what should be reported, our standards state that malfeasance and misfeasance are indicators of materiality.

#### Agency audit guide

The CSA audit guide requires that if, during an audit, the auditor uncovers any defalcation or theft, the auditor should promptly notify the grantee and the agency's regional auditor. The guide also requires that the matter be included in the audit report with the status of action taken.

### Defalcation not disclosed

During the audit of a CSA grant, an independent public accounting firm discovered the embezzlement of about \$120,000 of HEW funds. The firm's fieldwork on the embezzlement was outstanding: audit procedures were properly extended; results were well documented; and sufficient evidence was gathered to support a clear and objective presentation of the cause, effect, and suggested resolution of the problem. However, the firm did not comply with our standards or the agency audit guide regarding reporting and disclosure. The firm contends that it did not have to report the embezzlement of HEW funds because it had been engaged to audit only CSA funds.

Funds were diverted seven times between February 28, and November 16, 1976. The firm discovered the defalcation on December 10, 1976, and immediately notified the grantee's executive director. However, neither the grantee nor the accounting firm reported the defalcation to CSA and HEW until June 1977--6 months later. Moreover, the employee responsible for the defalcation was not dismissed until June 1977.

In its audit report to the grantee, the firm did not adequately disclose the defalcation. In a management letter to the grantee's board of trustees and the agency's regional auditor, the firm stated:

"Current procedures allow checks to be prepared, signed, and issued by accounting department personnel who are authorized to approve disbursements. We suggest that an independent person review all signed checks, prior to their issuance, for adequacy of support. At the time the reviewer examines checks and supporting documentation for propriety he should also determine that the check sequence is intact."

In our opinion, this statement is not an adequate disclosure of a \$120,000 embezzlement and does not meet the requirements of our standards or the CSA audit guide. CSA accepted the firm's report after a desk review, and no workpaper review was performed.

On May 23 the independent public accounting firm which had discovered the defalcation reported it to another independent public accounting firm responsible for auditing other Federal funds held by the grantee.

In June 1977 the grantee's executive director hand-delivered a letter to a CSA representative which stated:

"It was brought to my attention that funds in the custody of this agency, which were in the main private sector funds and state funds, had been deposited by \* \* \* in interest yielding accounts for a short period of time. This was done without any knowledge on my part or any authorization which agency policy requires."

Because, in our opinion, this is not adequate disclosure as required by our standards, we informed the granting agencies and the Federal Bureau of Investigation in June of the defalcation.

In a second case, during a grantee audit, another independent public accounting firm discovered a \$9,625 misappropriation of CSA funds. The firm's fieldwork was adequately expanded to reasonably assure that \$9,625 was the total amount misappropriated. However, reporting and disclosure were not adequate.

The firm's audit report, dated October 8, 1974, did not adequately disclose the misappropriation of funds and reported the unreimbursed portion as a receivable from an employee. The misappropriation was discovered by Federal auditors in May 1975 during a limited review of the firm's workpapers.

The second case was not a part of our sample of 12 audits. It was brought to our attention during our review of the Federal agency quality testing procedures as an example of quality testing effectiveness. However, we found that the review of the firm's workpapers had resulted from a special request rather than from the quality testing process. Since the agency--CSA--whose funds were involved did not notify the Federal Bureau of Investigation of the embezzlement, we did.

#### AGENCIES KNEW OF LOW QUALITY WORK

All three agencies knew some poor quality audit work had been done. Two had referred substandard work to AICPA. The other--HEW--had performed two studies of audit quality which pointed out similar problems to those disclosed in the audits we examined.

One of the studies, which was based on a sample of 58 audits from a total of 1,500 over a 6-month period, cited the following problems with audits by independent accountants.

--Audit scope and opinions were not always supported by workpapers, and many workpapers did not contain evidence of adequate testing, analysis, and audit coverage.

--There was a lack of evidence that the operations, accounting systems, and administrative controls had been sufficiently surveyed.

--Compliance issues either were not addressed in workpapers or were not fully audited.

The other HEW study concerned audits done by certified public accountants (CPAs) under one grant program. One of the report's conclusions is cited below.

"In summary, our review of CPA audit workpapers did not show adequate evidence that 11 firms had extended their audit procedures to cover the six compliance areas cited in the Audit Guide. In these cases the scope of audit was not qualified to specific compliance areas audited. A reader of the report could draw an incorrect conclusion as to exact compliance audit work performed on 11 of the 14 audit reports. Therefore, the 'opinions' of 78% of the CPA audit reports we examined may have been overstated."

Even though all three agencies we reviewed knew of low quality work, they did not know the frequency and extent of quality problems.

CHAPTER 3  
COMPLETENESS AND EFFECTIVENESS OF  
QUALITY TESTING CAN BE IMPROVED

The three agencies had taken the initiative to design and develop procedures to test the quality of independent public accountant audits. While this initiative speaks well for their interest in assuring the quality of these audits, our work shows that application of quality assurance tests varies from agency to agency and the tests are not always complete or effective.

Complete and effectively applied testing procedures are needed because the Federal agencies and the Congress rely on such audits to assure themselves that grant funds have been properly accounted for and spent economically and effectively. In addition, the agencies need assurances that they are getting the high quality professional work they need and are paying for. While none of the agencies could supply a good estimate of the costs of audits by independent accountants, the investment is substantial. For example, we estimate that the cost to have independent accountants audit all grantees of just one program--Project Headstart--would amount to some \$4.8 million annually.

Quality testing is generally assigned to the agencies' audit groups, which by and large have been given more responsibilities than resources. As a result, in the three agencies reviewed, quality testing has not ranked very high in the priorities set for use of the audit groups' limited resources. In view of the investment and reliance the agencies must place on audits by independent accountants, we believe they should adjust their priorities and assign the resources necessary to make the quality testing process work well.

COMPLETENESS OF AGENCY PROCEDURES

None of the three agencies had developed what we consider complete procedures for quality testing. Specifically

- two agencies had not specified our standards as the desired performance level for some audits,
- two had not included all audits in the universe from which audits were selected for quality testing,
- two had no provision for testing engagement agreements before the audits began, and

--none was systematically summarizing the data flowing from quality testing.

Proper standards should be specified

Federal audit policy sets our standards as the basic criteria for determining audit quality, coverage, and operations. One agency--CSA--has not required conformance with our standards. Rather, its audit guide for independent public accountants specified conformance with AICPA standards. The Director, CSA, commented that although the guide did not refer to our standards, its audit and reporting requirements generally complied with them. She said also that CSA had been revising the guide to include our standards but had postponed the effort pending issuance of an Office of Management and Budget circular dealing with audit requirements. According to the Director, however, since issuance of the circular in July 1976, other responsibilities and activities have commanded CSA's attention.

HEW has issued audit guides for some of its programs, and these require conformance with our standards. However, guides have not been developed for most programs and the desired performance level for these programs is not specified.

HEW's Inspector General commented:

"With respect to requiring that all audits be conducted in accordance with GAO standards, we agree. Current and future audit guides for use by non-Federal auditors are or will be modified to include this requirement."

All audits should be included in the universe for quality testing

The Federal audit policy requirement that independent public accountant audits be tested for quality does not anticipate that 100 percent of the audits will be tested. However, we believe that all audits should be included in the universe from which the test sample is selected. CSA included all such audits in its universe to be tested; however, Commerce and HEW did not.

At Commerce, independent accountant audit reports for grantees under three grant programs were not included in this universe. Commerce officials told us that this had been an oversight and that all grantee audits by such accountants should have been considered for testing.

At HEW we examined 82 grantee files and found 22 reports prepared by independent accounting firms. None had been included in the universe of audits to be tested. HEW's Inspector General acknowledged that not all reports had been included because the HEW Audit Agency had not yet developed audit guidelines for these grant programs. He further stated:

"Audits prepared without Audit Agency approved guides, while susceptible to review for compliance with GAO standards, are not likely to be satisfactory in those matters of program compliance normally included in HEW audit guides. We would rather first spend our efforts on developing the guides and thereafter include these reports in our quality testing program."

We agree with the Inspector General that work by independent accountants is more responsive to compliance requirements if there is an audit guide. However, we believe that testing audits made without such a guide is still beneficial. Also, we believe that by testing the independent accountant's reports, the Department is reinforcing the guidance provided to them. Similarly, not testing could lead firms to believe that the products delivered are the products desired, when such is not always the case.

#### Preaudit contract reviews should be made

Two agencies reviewed did not provide for testing engagement agreements (contracts) before their audits began. HEW required that such reviews be performed after the fact when workpapers were to be tested. Although HEW acknowledged that before-the-fact testing of contracts might eliminate faults in them, it felt that the staff time and logistics of doing so would be substantial. Instead, HEW suggested that developing a pro forma contract agreement might be a better approach.

While we agree that a properly designed pro forma contract could be beneficial, it would not eliminate the need for preaudit testing to insure that the contract was being used. In our view, the absence of preaudit testing puts the agency in the position of establishing a requirement with no means of determining whether the requirement has been met until it is too late.

CSA approves the grantees' selection of independent public accounting firms. However, it does not perform preaudit reviews of contracts.



Although Commerce has procedures for preaudit contract reviews for audits by independent accountants, the provision has recently been deleted for audits of grantees under one of its programs. We were told that the decision to discontinue contract reviews was not related to the effectiveness of the procedure for testing the quality of audits by independent accountants, but rather was related to Commerce's attempt to reduce paperwork requirements.

The value of testing contracts is illustrated by the audits we evaluated. For example:

- The engagement letters for two audits required conformance with AICPA standards. A preaward contract review would have disclosed the need for conformance with our standards.
- The contracts for two other audits were not in writing. Without written agreements, it is difficult to insure that the audit scope is understood by all concerned.

A 1976 study by the HEW Audit Agency also identified deficiencies in contracts, further supporting a need for contract reviews. The study concluded that:

"Contractual agreements \* \* \* between the grantees and audit firms were either not used or those used were either inappropriate or unclear.\* \* \*"

Data should be systematically summarized

The information supplied by a recent HEW study and the actions that resulted clearly demonstrate the value of collective analysis of data flowing from quality testing of audits by independent accountants. Such analyses could give all Federal agencies continuing benefits of a similar nature.

HEW incorporated workpaper reviews into its quality assurance procedures in April 1976. Previously, HEW required only desk reviews. After 6 months' experience with workpaper reviews, HEW prepared a report summarizing the results of its quality testing. HEW received about 1,500 audit reports during this period and made 58 workpaper reviews. The report (1) cited a number of problems identified by the workpaper reviews (see p. 14) and (2) offered the following solutions to the problems.

- Issue more and better audit guides.
- Conduct workshops for independent accounting firms.
- Revise quality testing procedures.
- Periodically review regional offices' quality assurance procedures.

Because of this study, HEW has initiated several actions to improve its quality assurance procedures. For example, at the national level HEW is

- preparing audit guides for some programs and updating others and
- requesting recommendations from regional offices for improvements in quality control procedures.

At the regional level, one or more of the regional offices are

- upgrading desk review documentation efforts and
- preparing profile data sheets on independent accounting firms.

#### EFFECTIVENESS OF APPLICATION

Complete quality testing procedures are important. Of equal importance is the need to effectively apply them.

None of the three agencies was effectively applying its procedures. This is not to say that they were not benefiting from their quality testing. Rather, we believe that effective application would have greatly enhanced and expanded the benefits.

Specifically, we believe that quality testing procedures should be applied to a scientifically selected sample of audits by independent accountants. Further, the tests should be a balanced mix of the four types of tests--contract reviews, desk reviews, workpaper reviews, and onsite reviews. Onsite reviews should be performed when deemed necessary on the basis of a workpaper review. The results of such testing would provide a quantifiable measure of quality that could be related to all audits being done by independent accountants for an agency, a program, or an area.

## How procedures are being applied

In all three agencies, a majority of the quality tests were desk reviews. Desk reviews are properly a part of quality testing; however, they are probably the least revealing of the four quality tests. As a test of the quality of audits by independent accountants, desk reviews by their nature are limited to a test of form and format. The other benefits that arise from the desk reviews relate to interpretation and use of data in the reports rather than quality testing of accountant performance.

All three agencies also used workpaper reviews to test audit quality. However, the number of audits tested and the method of selecting audits to be tested varied. For example:

- Commerce required no workpaper reviews on some programs, but for one program, required workpaper reviews on 20 percent of all audits.
- HEW planned to do workpaper reviews on 5 percent of its audits by independent accountants.
- CSA performed workpaper reviews on 4 percent of its audits by independent accountants; however, these reviews were made only if problems were indicated or if special requests had been made.

Additionally, our examination of workpapers for the 12 independent accountants' audits included 8 audits in which the agencies had also tested the workpapers. In two of these cases, our findings differed substantially from those of the limited agency reviews. Our evaluations of these two cases raise questions about the depth and thoroughness of the agencies' workpaper reviews.

## SHORTAGE OF FEDERAL AUDIT RESOURCES

Federal agencies are required to provide adequate audit coverage for their internal operations and for over 1,000 programs that grant nearly \$85 billion to the 50 States, 3,000 counties, 90,000 localities, and innumerable non-Federal domestic organizations. During fiscal year 1976 there were about 16,500 audit personnel in the Federal Government, including support staff. Many of the required audits are made by Federal auditors, but a growing number are made by State and local auditors and by independent public accountants.

All three agencies claimed that their audit groups had more responsibilities than resources to carry them out. This

is one reason that independent accountants are engaged to audit grantees. It is also a barrier to complete and effective quality testing of audits by such accountants. That is, agencies not only do not have enough resources to make their own audits but do not have enough to test the quality of audits by independent accountants.

This condition is best illustrated by CSA, which has used all four tests at some time. The Director, CSA, stated that the tests we had proposed could not become routine procedures because staff was not available to do all four adequately, even on a sample basis. She pointed out that five CSA offices had only one auditor each and three had only two auditors each. A total staff of 17 regional auditors must perform the quality testing for some 1,700 audits by independent accountants, as well as do other work.

Nonetheless, the Director stated that for fiscal year 1978 a statistical sample of 145 independent accountant audits would be selected for workpaper reviews. Under this plan, CSA will assign a lower priority to desk reviews, special requests, and other activities.

## CHAPTER 4

### A MODEL FOR QUALITY TESTING OF AUDITS

We developed a model program for testing the work of independent public accountants and other auditors. Quality testing should include

- establishing a proper standard for performance,
- measuring performance against it, and
- providing information to decisionmakers on the nature and causes of deviations from the standard so that corrective actions can be taken.

#### MEASURING PERFORMANCE AGAINST STANDARDS

Using the above as a guideline, we developed the following steps to include in an effective testing system.

1. Review the contract agreement between the grantee and the independent accounting firm to assure that the proper level of performance is required and that the firm understands what is expected (contract reviews).
2. Review the audit report to assure that it contains required statements, that the proper format has been used, and that there are no indications of improprieties (desk reviews).
3. Examine the workpapers to assure that they contain sufficient supporting evidence and comply with auditing standards (workpaper reviews).
4. Test the workpapers against grantee records to assure that the workpapers accurately portray the condition audited (onsite reviews) when there are indications of inadequate workpapers. (An alternate approach would be to get the firm to go back and prepare proper workpapers.)

Of course, not all audit reports would be subjected to the entire process. Those to be so examined should probably be selected on a statistical basis. We believe, however, that all such audits should receive desk reviews.

### Contract reviews

The Federal agencies reviewed generally require grantees to contract with independent accountants for audits of grantee operations. The audits should be performed in accordance with agency audit guidelines, which should specify conformance with our standards and provide background data, compliance review requirements, and report format. However, because the contracts are made between the grantees and the accountants, the Federal agencies should require that the contracts be in writing and should test them before the audits to assure that proper performance is required and that the accountants understand what is expected.

### Desk reviews

Desk reviews insure that all required statements are included in the audit reports and that they have been prepared in the proper format. In addition to being a quality test, desk reviews interpret report information for use by nonaccountants in program management positions.

### Workpaper reviews

These reviews--probably the most revealing of the quality tests--can provide information on auditors' compliance with our standards, such as:

- whether the work was properly planned;
- whether compliance reviews were made;
- whether internal controls were adequately evaluated;
- whether sufficient, competent, and relevant evidence was obtained; and
- whether all material findings were reported.

### Onsite reviews

Onsite reviews compare accounting firms' workpapers with grantee records. These reviews can show

- the effect of failure to test for compliance and
- failure to document and report weaknesses in internal controls.

Onsite reviews are a logical extension of quality testing procedures when workpaper reviews raise questions about the audit scope.

#### PROVIDING INFORMATION TO DECISIONMAKERS

The primary purpose of quality testing is to give decisionmakers information on the nature and causes of sub-standard audit performances so that corrective action can be taken. This information can be used to improve the quality of work done by an individual firm. However, the benefits of quality testing are maximized when the results of testing a properly designed statistical sample of audits are systematically collected and summarized so that a conclusion can be reached about the quality of all audits performed by independent public accountants for an agency.

#### HOW THREE AGENCIES TEST AUDIT QUALITY

The chart on the following page compares the agencies' quality testing procedures with those of our model.

Quality Testing Procedures

<u>Model</u>	<u>HEW</u>	<u>Department of Commerce</u>	<u>CSA</u>
I. Establishing the proper standards—our standards.	For programs for which audit guides have been developed, our standards have been specified. However, not all programs have guides. (See p. 17.)	Our standards have been established as the desired level of performance.	Our standards have not been established as the desired performance level. (See p. 16.)
II. Measuring performance against the standards.			
a. Contract review.	Contracts are not reviewed before the audits. However, the contracts are examined if and when workpapers are reviewed.	Contracts are reviewed and, in some cases, approved before the audits. (See p. 18.)	Grantees' selections of auditors are approved, but the contracts are not reviewed or approved before the audits.
b. Desk review.	All reports received by the HEW Audit Agency are desk reviewed. However, not all reports are sent to the Audit Agency. (See p. 17.)	All reports received by the Audit Agency are desk reviewed. However, not all reports are received by the Audit Agency. (See p. 16.)	All reports received are desk reviewed. Our test did not show any reports that had not been sent to the Audit Agency.
c. Workpaper review.	Beginning in 1976, 3 percent of audit reports desk reviewed were subjected to workpaper reviews.	Depending on the program, from zero to 20 percent of audits are subjected to workpaper reviews.	Some 4 percent of audits were subjected to workpaper reviews. However, these were made only if problems were known to exist or if special requests had been made.
d. Onsite review.	Quality testing procedures do not provide for onsite reviews.	Quality testing procedures do not provide for onsite reviews.	Quality testing procedures do not provide for onsite reviews.
III. Using quality testing data.			
a. Individually.	Testing results are used in discussions with individual auditors.	Testing results are used in discussions with individual auditors.	Testing results are used in discussions with individual auditors.
b. Systematically and collectively.	Two studies of audit quality have been made but quality data is not systematically used.	No systematic collective use has been identified.	No systematic collective use has been identified.



## CHAPTER 5

### CONCLUSIONS AND RECOMMENDATIONS

Many Federal agencies rely on audits by independent public accounting firms for assurances that grantee records are reliable and that grantee operations are complying with laws and regulations. Federal audit policy permits and encourages this practice, provided the auditors' work is tested to insure quality.

#### CONCLUSIONS

The number of audits we tested was too few to support a conclusion regarding the overall quality of audits performed by independent public accountants for Federal agencies. However, our work, plus studies by HEW and the results of the quality testing programs of the three agencies reviewed, indicate that the quality problems may be widespread. The agencies reviewed cannot determine the extent of the problems because their quality testing procedures are incomplete and ineffective. Improvements in these procedures should promote better audits and reports, thereby improving the Government's ability to detect and recoup Federal funds spent for unauthorized purposes. More importantly, the improved audits would enhance the Government's ability to identify and obtain correction of weaknesses in grantee controls over cash and other assets. Therefore, we feel this problem warrants prompt corrective measures.

A shortage of Federal audit staff contributes significantly to the problems in the procedures. However, a complete and balanced approach to quality testing is feasible without greatly expanding audit resources. Such an approach would rely on testing a statistically sound sample, which could then be projected to all audits performed by independent public accountants for an agency.

#### RECOMMENDATIONS

We recommend that the Director, Office of Management and Budget, require Federal grantmaking agencies to develop and implement complete and balanced quality testing processes for identifying substandard work. Such processes should

--require that all audits be performed in accordance with our standards,

--require that all audits be included in the universe of audits to be tested,

--provide for testing a meaningful sample of audits against our standards, and

--provide for systematic and collective use of the quality testing results.

We also recommend that the Secretaries of Commerce and HEW and the Director of CSA reassess the priorities for their auditors to see if more time can be devoted to the quality testing of audits.

#### AGENCY COMMENTS

The Director, Office of Management and Budget, agreed that Federal agencies should apply effective quality testing processes to audits by non-Federal auditors.

In addition to OMB, we solicited comments from the three Federal agencies included in our review. All generally agreed with our recommendations; however, both Commerce and CSA responded that a shortage of audit staff contributes to the problems discussed in our report. The comments of the three agencies have been incorporated into the appropriate sections of the report.



## EXECUTIVE OFFICE OF THE PRESIDENT

OFFICE OF MANAGEMENT AND BUDGET

WASHINGTON, D.C. 20503

JAN 30 1979

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

Dear Mr. *Elmer* Staats:

This is in reply to your draft report, "Quality Testing of Audits of Grantees' Records--How It Is Done by Selected Federal Agencies and What Improvements Are Needed", submitted to us December 19, 1978.

We are very much concerned about the disclosures in the report of low quality audit work by independent public accountants, and by the lack of effective Federal agency procedures for identifying such low quality work. It is disappointing to think that the public accounting profession has fallen so far short of expectations. Although the draft report points out that your sample may not be entirely representative, the findings are, nevertheless, consistent with your earlier reports to the Congress on the same subject.

As you know, our Circular No. A-73, "Audit of Federal Operations and Programs", encourages the use of independent public accountants in the audit of Federal assistance programs. It calls for greater reliance upon such audit work by Federal agencies, in order to expand audit effectiveness and coverage. The disclosures of your report, however, lead us to believe that a reassessment of that policy may be in order.

We are in complete agreement that there should be an effective quality testing process applied by Federal agencies to audits made by non-Federal auditors. We believe this problem can best be dealt with in conjunction with the recommendations in another of your draft reports, "Grant Auditing", submitted to us January 3, 1979. Comments on that draft report will be submitted shortly.

Sincerely,

A handwritten signature in black ink, appearing to read "J. T. McIntyre, Jr." with a stylized flourish at the end.

James T. McIntyre, Jr.  
Director

28

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