THE ROLE OF THE GENERAL ACCOUNTING OFFICE
IN THE DEVELOPMENT OF INTERNAL AUDITING IN GOVERNMENT

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I want to thank the conference committee for inviting me to speak at this conference. I am always pleased to have an opportunity to visit my native city and especially when it is in connection with a function of the Association of Government Accountants. More than 20 years ago I helped in the founding of the Los Angeles Chapter of AGA, which was then known as FGAA, and I served as an officer during the first few years of the chapter's existence.

The title you have chosen for this 7th Annual Educational Conference, "The Changing Role of Internal Audit," implies that the profession has undergone, or is undergoing, a period of unusual change. I believe this is true. Any profession must constantly reevaluate its objectives, procedures, and standards if it is to continue to be effective in a dynamic society. This is particularly true of a young profession, and internal auditing is one of the youngest. Many people who are still active as internal auditors today entered the profession when it was in its infancy and have witnessed and participated in profound changes in the objectives and methodology of the profession.

## THE GAO AS BOTH INTERNAL AND EXTERNAL AUDITOR

The General Accounting Office, which I have been associated with for the past 26 years, might be considered to be engaged in both internal and external auditing. From the perspective of someone outside of Government, GAO may appear to be an internal audit organization, since it is part of the government it audits and since most of its audits and reports are more similar to those of the internal auditor than to the traditional public accounting report and opinion on financial statements.

However, we do perform some public accounting type audits of government corporations and other government entities and issue opinions on their financial statements. Also, because we are a part of the legislative branch and responsible only to the Congress, we have a degree of independence from the subjects of our audits--mainly the agencies in the executive branch of the Federal Government--which surpasses anything to be found in any other internal audit organization, or for that matter in any CPA firm. The fact that we are not engaged by the agencies that we audit, and are not dependent on them for fees, gives us a degree of independence that would be the envy of most CPA firms. We rarely lose a client.

THE ACCOUNTING AND AUDITING ACT OF 1950

Because of its unique position in the Federal Government, it was natural for GAO to take a leading role in the development of internal auditing in Government. The General Accounting Office and the Bureau of the Budget were p. 426 the principal architects of the Accounting and Auditing Act of 1950, which first recognized the need for internal audit in Federal agencies. This act required the head of each agency to establish and maintain systems of internal control, including appropriate internal audit, to provide effective control over the accountability for all funds, property, and other assets for which the agency has responsibility. The same act required the Comptroller General to prescribe principles and procedures for internal audit. In fulfillment of this requirement, GAO issued "Internal Auditing in Federal Agencies" in 1957 to assist Federal agencies in developing their own internal audit organizations and procedures. This booklet was updated and reissued in 1968 and again in 1974.

The act also required GAO, in determining the procedures to be followed and the scope of its audits of other Federal agencies, to give consideration to the effectiveness of internal audit and control in those agencies. This gives GAO a proprietary interest in assuring that every Federal agency has a strong and effective internal audit organization. Without internal audit staffs in the Federal agencies, GAO would have to be much larger than its present size to do its job effectively.

INDEPENDENCE

To be effective, the internal audit organization must have a high degree of independence, and independence in turn depends to a great extent on the location of internal audit in the organization of the agency. On this subject, GAO's booklet on "Internal Auditing in Federal Agencies" states as follows:

> "To provide an adequate degree of independence, the internal auditor should be responsible to the highest practical organizational level, preferably to the agency head or to a principal official reporting directly to the agency head."

Reporting to a high-ranking official, however, even to the head of the agency, does not by itself guarantee the independence of the internal auditor. He must also have the full support of that official if he is to be truly independent. The internal auditor can be no more independent than the head of the agency allows him to be. He must have the support of the agency head to assure freedom in the selection of the areas for review or audit, and to assure access to all necessary records and the cooperation of agency officials and employees which are essential to the performance of the internal audit function.

In GAO's evaluations of internal audit in the executive agencies, one of the first things we look for is independence. We have issued a number of reports criticizing the organizational placement of internal audit as well as unreasonable restrictions placed on the auditors. For example, in a July 1977 report to the Congress, GAO made a number of criticisms of the lack of independence of the Army Audit Agency. The report pointed out that the auditors were not free to select areas for audit and to establish audit priorities because their audit plans were subject to review by a committee whose members had management responsibility for systems, programs, and functions subject to audit. Also, the auditors were restricted from auditing combat readiness or tactical activities, with the result that the most important part of the Army's operations had been excluded from audit.

To strengthen the independence of the audit agency, the report recommended that it be placed directly under the Secretary or Under Secretary of the Army and that it be headed by a professionally qualified civilian
3 rather than by a military officer. The Department of Defense concurred 5
with most of GAO's recommendations and has taken a number of actions to
4 strengthen the independence and effectiveness of the Army Audit Agency. 8/1

EFFECTIVENESS

Independence is essential to the effectiveness of internal audit, but independence is only one of the necessary ingredients. The others are the professional competence of the auditor and the support of top agency management. As in the case of independence, the internal auditor can be no more effective than the head of the agency allows him to be. He may make excellent reviews and issue reports with significant findings and recommendations, but if no action is taken on the recommendations, his efforts will have been largely wasted. And the final decision as to action to be taken on his findings must be made by management, not by the internal auditor. The following statement from the booklet "Internal Auditing in Federal Agencies" is pertinent to this question:

> "Internal auditing is a staff and advisory function, not a line-operating function. Thus, the internal auditor should not have authority to make or direct changes in his agency's procedures or operations. His job is to independently and objectively analyze, review, and evaluate existing procedures and activities; to report on conditions found; and *** to recommend changes or other action for management and operating officials to consider."

To assure that adequate consideration is given to internal audit findings and recommendations, OMB Circular No. A-73 requires that each agency establish policies for followup on audit recommendations, including the designation of officials responsible for followup, maintaining a record of the action taken on recommendations, establishing time schedules for responding to and action on recommendations, and submitting periodic reports to agency management on action taken.

In spite of this requirement, the record has been less than satisfactory. GAO has issued several reports criticizing the lack of adequate followup in individual agencies. In October of last year GAO issued a scathing report covering 34 Federal agencies, in which we pointed out that hundreds of millions of dollars were lost because of failure to take action on auditors' recommendations. While the majority of the findings arose from audits of contractors and grantees, the report also pointed out that sizeable savings in operating costs had been foregone because of the failure to act promptly on findings involving internal agency operations.

The Office of Management and Budget agreed with our conclusions and issued a strongly worded memorandum to the heads of departments and agencies instructing them to bring their followup systems into conformance with the requirements of Circular A-73. The memorandum stated: "This situation is intolerable, and corrective action must be taken at once."

THE LEGISLATIVE REORGANIZATION ACT OF 1970

To assure that adequate consideration is given to the recommendations in GAO reports, Congress included in the Legislative Reorganization Act of 1970 a requirement that, whenever a GAO report contains recommendations to the head of any Federal agency, the agency shall submit to the Committees on Government Operations and the Committees on Appropriations of both houses of Congress a statement of the action taken by the agency with respect to such recommendations.

Another provision of the Legislative Reorganizaton Act of 1970 required GAO to review and evaluate the results of government programs and activities upon its own initiative or upon the request of either house of Congress or of any congressional committee. The law also required GAO to develop methods for review and evaluation of government programs and activities. Fulfillment of this requirement led to publication of another GAO booklet, entitled "Standards for Audit of Governmental Organizations, Programs, Activities & Functions," more commonly known as the "The Yellow Book." The American Institute of CPAs had previously published audit standards applicable solely to audits for the purpose of expressing opinions on financial statements. However, standards were not then available for the broader governmental concerns of compliance with law and regulations, efficiency and economy of operations, and effectiveness of programs in achieving established goals.

To assist in the development of these standards, GAO assembled a task force which included representatives of Federal agencies, state and local governments, the academic community, and professional organizations such as the American Institute of CPAs. The resulting standards were published in 1972 and are intended for application to audits of all government organizations, programs, activities, and functions--whether they are performed by auditors employed by Federal, state, or local governments; public accountants; or others. The standards also apply to both internal audits and audits of contractors, grantees, and other external organizations performed by or for a governmental entity. The Yellow Book may be obtained from the Government Printing Office. More than 150,000 copies have already been distributed.

One of the important concepts advanced by these standards is the definition of a full scope government audit as encompassing three elements: (1) financial and compliance, (2) economy and efficiency, and (3) program results. These elements can be performed separately, and the standards recognize that concurrent performance of all three elements may not always be practical. For some government programs or activities, however, the interests of many potential government users will not be satisfied unless all three elements are ultimately performed.

OMB Circular No. A-73 requires the application of these standards in all internal and external audit functions of the executive agencies of the Federal Government. The Inspector General Act of 1978, which established Offices of Inspector General in 12 departments and agencies of the Federal Government, requires each inspector general to comply with these standards.

FINANCIAL AND COMPLIANCE AUDITS

Financial and compliance auditing is defined in the standards as the determination of whether financial operations are properly conducted, whether the financial reports of an audited entity are presented fairly, and whether the entity has complied with applicable laws and regulations. Financial auditing is, of course, the traditional audit area for both internal and external auditing, and it was not too many years ago that internal audit in most organizations was almost entirely limited to financial auditing.

A survey made by the Institute of Internal Auditors of more than 300 of its members in 1975 provides some interesting information on current practices and trends in the profession. In response to the question as to what percent of internal audit efforts were spent on financial audits and operational audits, the average of all responses indicated that effort was about evenly divided between these two areas. An important indication of trends was provided by another question which was asked in both the 1975 survey and a similar survey completed in 1968. In 1968 some 19 percent of respondents said that their audit assignments were directed primarily toward financial audits, whereas a mere 2 percent in 1975 said that primary emphasis was on financial audits. At the same time, the proportion who said that primary audit emphasis was directed to both financial and nonfinancial audits increased from 75 percent in 1968 to 93 percent in 1975.

Another question, which has implications regarding independence as well as audit emphasis, concerned the executive to whom the chief internal auditor reports. In 1968, 32 percent said the internal auditor reported to the comptroller. This had decreased to 19 percent in 1975. Most of the respondents in each survey worked in the private sector; less than 10 percent in each case were from Federal, state, and local government.

Now I hope nobody will interpret my words as derogating the importance of financial auditing. Financial audits are very important and should not be neglected. GAO's increased emphasis on economy, efficiency, and effectiveness has been intended not so much to curtail financial audit coverage as to expand the overall scope of internal auditing. In fact, GAO has in recent years issued several reports criticizing government agencies for providing inadequate audit coverage of internal financial operations.

For example, in a June 1978 report to a subcommittee of the Senate Committee on Governmental Affairs, GAO reported the results of a survey of audit practices in organizational units in the executive branch of the Federal Government. Of 418 organizational units for which we obtained information, 133 units with annual funding in excess of $20 billion said that they had not received a financial audit during fiscal years 1974 through 1976, although 58 said they had received nonfinancial audits. Some of these units served mainly as conduits for Federal assistance funds to individuals or to state and local governments, and the ultimate disposition of the funds may have been audited by Federal, state, or local auditors or by public accounting firms. Nevertheless, the fact that nearly one-third of the units included in our survey said that they had received no financial audit for a 3-year period indicates that the pendulum may have swung too far away from financial audits.

What is needed is a proper balance between the three audit elements. There are no pat formulas as to the amount of effort that should be spent on each element; this will vary according to the circumstances in each agency. However, we would expect to find in most agencies more than half of the total audit effort directed to economy and efficiency audits and program evaluations.

ECONOMY AND EFFICIENCY AUDITS

Economy and efficiency auditing is defined in the standards as the determination of whether the entity is managing or utilizing its resources (personnel, property, space, etc.) in an economical and efficient manner and the causes of any inefficiencies or uneconomical practices, including inadequacies in management information systems, administrative procedures, or organizational structure. While GAO has been a leader in the development of economy and efficiency auditing in government, I should give credit where credit is due and say that the real leaders were the authors of the Budget and Accounting Act, 1921, the law which created the General Accounting Office. That act states that:

> "The Comptroller General shall investigate, at the seat of government or elsewhere, all matters relating to the receipt, disbursement, and application of public funds, and *** he shall make recommendations looking to greater economy or efficiency in public expenditures."

Considering the state of the art of accounting and auditing in 1921, I have to admire the foresight of the framers of this legislation, who recognized at that early date that auditing had a potential which transcended the mere verification of the accuracy and reliability of the accounting records. Unfortunately, their foresight went largely unrecognized at the time. In spite of the broad mandate given to GAO by this legislation, for many years its audits were almost exclusively financial and compliance audits--a centralized, clerical, voucher-oriented affair with primary concern for the legality of individual transactions.

World War II brought many changes in government, as well as in the private sector and the professions. One significant change affecting GAO was the passage of the Government Corporation Control Act. This act required GAO to audit Federal Government corporations in accordance with the principles and procedures applicable to commercial corporate transactions.

Although the wording of the act seemed to contemplate only an audit of financial transactions, GAO delved deeply into other kinds of corporate management problems. For example, in its 1945 report on the old Reconstruction Finance Corporation, GAO severely criticized the poor quality of the Corporation's accounting and internal management control system. But, in addition, it reported on the inefficient way in which the Corporation's board of directors functioned, the Corporation's lack of business-like procedures, its undesirable contractual arrangements, the questionable use of corporate funds to augment the appropriations of other Federal agencies, the commingling of management responsibilities between the Corporation and other agencies, and the misuse of the Corporation's borrowing authority.

After the war, GAO expanded its field operations to include site audits of unincorporated agencies of the Federal Government. Under what was then known as its comprehensive audit program, it also began examining management controls, other then purely accounting controls, and reporting on the economy and efficiency of agency operations. Thus, for the first time, GAO began fulfilling the mandate of the 1921 act.

A similar movement had been underway in the private sector. Around the time of World War II, the internal audit organizations in a few of the more progressive companies expanded the scope of their audits beyond traditional financial auditing and began the practice of what has variously been called operational auditing, performance auditing, and management auditing. It is probably more than coincidence that the beginning of this movement roughly coincided with the founding in 1941 of the Institute of Internal Auditors, which to my knowledge was the first nationwide professional organization of internal auditors. This might be said to represent the birth of internal auditing as a profession.

So, rather than criticize GAO for being behind the times in earlier years, perhaps we should simply recognize that the authors of the 1921 legislation were years ahead of their time.

PROGRAM RESULTS AUDITS

The third element of a full scope government audit is an evaluation of program results. Program results auditing is defined in the standards as the determination of whether the desired results or benefits are being achieved, whether the objectives established by the legislature or other authorizing body are being met, and whether the agency has considered alternatives which might yield desired results at a lower cost. GAO began making program evaluation reviews during the mid 1960s, and the portion of our audit effort devoted to this element has been steadily increasing over the years.

Program evaluations are particularly important in view of the current movement toward sunset legislation. As you know, the objective of sunset legislation is to check the tendency of government programs to perpetuate themselves even though they may have outlived their usefulness. This is done by specifying termination dates for such programs so they cannot continue beyond such dates unless specifically reauthorized. Sunset legislation was first passed in Colorado about 3 years ago and has now been enacted in 29 states. A sunset bill passed in the U.S. Senate last year and it has been reintroduced this year in the 96th Congress.

Whether or not sunset legislation is ever enacted at the Federal Government level, there seems little doubt that the Congress will have an increasing need for sound evaluations of program results to aid it in deciding whether programs should be continued, modified, terminated, or replaced by other more effective programs.

THE INSPECTOR GENERAL ACT OF 1978

A recent development that has been very much in the news lately and has been of great concern to GAO is the disclosure of fraud and corruption in certain government agencies. Most of you are probably aware of the Inspector General Act of 1978 and of the fact that GAO recently established a toll-free hotline to receive information about fraud and corruption in government. The Inspector General Act created Offices of Inspector General in 12 departments and agencies of the executive branch of the Federal Government and placed the internal audit organization of each agency within the Office of Inspector General.

To protect the independence of the office, the law provides that the Inspector General shall report to and be under the general supervision of the head of the establishment or the officer in rank next below such head. The law also requires the Inspector General to make semiannual reports to the agency head and requires the agency head to transmit such reports, together with his own comments, to the appropriate committees of the Congress within 30 days.

GAO had a strong interest in this legislation as it moved through the Congress. The Comptroller General and other GAO officials testified on the bill and made a number of recommendations for strengthening it. Our concern has been to assure that the role of internal audit is not subordinated to the role of investigation. If the placement of internal audit under the Inspector General were to result in curtailment of the audit function in order to make auditors available as investigators, internal auditing in government would suffer a serious setback. We believe the changes made in the legislation as a result of our recommendations should reduce the possibility that this will occur, but we plan to monitor internal audit coverage in the agencies covered by the act, and to report any erosion of the internal audit function.

The American Institute of CPAs has always taken the position that the detection of fraud or embezzlement is not a primary objective of a financial audit. Reliance for the prevention and detection of fraud should be placed principally upon a system of internal control, and it should be the auditor's responsibility to evaluate the adequacy of the system and assure that it is operating effectively. This has also been GAO's position. When systems of internal control have been properly developed and are functioning as planned, the possibility for fraud or theft to occur, or to escape detection if they do occur, is greatly diminished. Conversely, where internal control is weak, it is much more likely that fraud will occur and unlikely that it will be readily detected. The old axiom that "an ounce of prevention is worth a pound of cure" is still true.

For example, an April 1977 GAO report on self-service stores operated by the Federal Supply Service of the General Services Administration noted that weaknesses in inventory controls made it extremely difficult to detect thefts. The report also pointed out that, because of inadequate staffing of the internal audit organization, many selfservice stores had not been audited in several years. The events that have occurred in the past year have, I believe, confirmed the soundness of the conclusions in that report.

The investigation and detection of fraud are, of course, important. The publicity given to the detection of fraud and the punishment of the perpetrators serves as an important deterrent to others who might be tempted to commit similar acts. More important, the detection of fraud should trigger an examination of the system of internal control to determine whether any systemic weakness invited the commission of the crime or allowed it to escape detection for long.

CONCLUSION

In discussing the role of internal audit today, I have dealt mainly with the past--how we got to where we are today. I could probably spend an equal amount of time speculating about the future, but it would be just that--speculation. I think we can safely assume that the profession of internal auditing, both in government and in the private sector, will continue to grow, develop, and change to meet the changing needs of society, business, and government. I think we can also assume that GAO will play a leading role in shaping the course of that development, at least in government.

The only certainty is that there will be change. As business and government become more and more complex, management will place new demands on the internal auditor, and the profession must develop new techniques and approaches to meet those demands.

To some, change is a threat; to others, it is a challenge. I am confident that the internal auditing profession will meet that challenge and will continue to grow and develop in ways that will make it increasingly effective as an aid to management and as an important element of internal control.