UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

MAR 22 1983

RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION

Mr. Russell E. Faudree, Jr.
Acting Chief Accountant,
Federal Energy Regulatory
Commission

Dear Mr. Faudree:

Subject: Efficiency and Effectiveness of OCA Audits of Compliance with Uniform Systems of Accounts

We have completed a review of the Office of the Chief Accountant (OCA), Federal Energy Regulatory Commission (FERC), regarding its audits of regulated firms' compliance with FERC's Uniform Systems of Accounts. We found that it needs to make a more thorough documentation of its evaluation of the reliance that should be placed on audit work performed by independent certified public accountants (CPAs). We also found indications that the documented evaluation could lead to a reduction in OCA's financial and compliance audit work because, without fully documenting the need, OCA auditors duplicated the CPAs' work, but the resulting adjustments required by OCA had little or no effect on subsequent rates approved by FERC.

OBJECTIVES, SCOPE AND METHODOLOGY

The objective of our review was to evaluate the economy and efficiency of OCA audits of regulated firms because this is where OCA spends the majority of its staff time. Our review was based on interviews of officials and staff in the Offices of

--the Chief Accountant (both in headquarters and Region IV in San Francisco, Ca.),

--Electric Power Regulation,

--Pipeline and Producer Regulation, and

--Administrative Law Judges.

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We also interviewed officials of

--two national CPA firms which serve as the external accountant for a number of their clients regulated by FERC,

--11 State public utility commissions, and

--4 public utilities.

We initially reviewed the workpapers and audit reports from four financial and compliance audits conducted by OCA's Branch IV to identify potential weaknesses. We made a more extensive examination of 50 audit reports issued by OCA in fiscal year 1981, including the significance of the results of these audits, and evaluated the supporting workpapers for three of them. The 50 reports were selected on the basis that the audits were among the most recent completed audits and had resulted in adjustments to the firms' plant accounts. The largest portion of the firms' assets are in the plant accounts and adjustments to these accounts, therefore, were most likely to have affected the size of subsequent changes in the rates charged the firms' customers. The three reports for which workpapers were evaluated were selected on the basis that an above-average portion of the audit time had been spent on the plant accounts, but such audit effort had resulted in minimal adjustments to the plant accounts. Our review was performed in accordance with generally accepted government audit standards.

EXTERNAL ACCOUNTANTS' WORK NOT FULLY ASSESSED AND RELIED ON

Our examination of the workpapers prepared by OCA during three audits disclosed that they did not contain a thorough written analysis of the work performed by other auditors. Such an analysis is needed to provide a sound basis for determining how much reliance OCA can place on the work of others in determining the regulated firms' compliance with the Uniform Systems of Accounts. We found that OCA auditors, without benefit of such written analyses, had extensively duplicated the work of other auditors.

The "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions", issued by the Comptroller General of the U.S., states

> "Auditors should rely upon the work of other auditors to the extent feasible if they satisfy themselves as to the other auditors' independence, capability, and performance by appropriate tests of their work or by other acceptable methods."

Therefore, an important first step in OCA audits is to evaluate audit work performed by internal auditors (in the employ of the regulated firm), external accountants (independent CPAs), and by State public utility commissions to determine the reliance that OCA could place on that work. This is particularly important in the case of the external accountants because the broad scope of their work provides a high potential for use of it in reducing the scope of OCA work. The external accountants' work provides a basis for making two certifications with respect to the regulated firms' financial statements. These are

--that the financial statements contained in the firms' annual reports have been prepared in conformity with generally accepted accounting principles (adopted by the American Institute of Certified Public Accountants), and

--that the financial statements filed with FERC conform in all material respects with requirements of FERC as set forth in its applicable Uniform Systems of Accounts and published accounting releases.

OCA's audit program instructed the OCA auditors to prepare a critique of the work performed by the external accountants. It stated that

> "The critique should include: (a) comments on the degree that such work can be relied on to reduce the scope of our audit, (b) full particulars for any areas judged to be unsatisfactorily covered by the external accountants, and (c) any suggestions regarding the specific additional audit procedures needed to improve the usefulness of their work.
>
> "These comments should be carefully prepared since they will form the bases for periodic evaluations on an overall basis of the external auditors performance and discussions with key representatives of external firms designed to promote improvements."

If OCA found that the external accountant had apparently performed an acceptable audit, OCA would only need to do limited work at the regulated firm to verify that the external accountant had actually performed the audit steps and to check the quality of that work. Another possibility is that OCA would conclude that the external accountant's scope of work in certain areas was not broad enough, and, therefore, OCA would need to perform work which, coupled with the external accountant's work, would provide a sufficiently broad scope. OCA might also find it necessary to cover areas not covered by the external accountant.

Our detailed review of the workpapers prepared by OCA during three audits disclosed that the OCA auditors had performed work at the regulated firms substantially beyond that needed to determine the quality and accuracy of the external accountant's work. Moreover, the OCA critiques did not contain the comments required by the OCA audit program that would justify doing the additional work; that is, "full particulars for any areas judged to be unsatisfactorily covered by the external accountants." OCA workpapers did not disclose whether the work OCA performed was to

--check the accuracy or quality of the external accountants' work,

--expand the total audit work to gain a higher degree of confidence that the firms had complied with the Uniform Systems of Accounts, or

--cover areas that the external accountants failed to cover.

The responsibility for preparing a proper critique of the external accountant's work in accordance with OCA instructions rests, of course, primarily on the team performing the audit. However, higher levels of OCA share that responsibility because they are responsible for assuring the quality of audit work performed by the OCA auditors. The Chief Accountant and the Director, Division of Audits, stated that Branch Chiefs in the Division of Audits make supervisory visits to the OCA audit teams during the course of the audits to check on the quality of the work and whether the audit programs were being followed. They expressed the view that the auditors' expertise within the Uniform Systems of Accounts was greater than that of the CPA firms, which gave them a basis for evaluating how much the OCA work could be reduced. They acknowledged that their examination of the three sets of OCA workpapers we had reviewed confirmed that the OCA auditors had not documented the specific bases for their judgments.

Example 1

During the audit of an electric utility, OCA's critique stated that the external accountant's work could be utilized to reduce staff audit work in the verification of mathematical accuracy of the supporting accounting records and to reduce audit work to a cursory review of six general areas. Also, no specific areas requiring extra audit work was noted. The justification for additional OCA work was summarized in the following statement. (The references to "staff" are the OCA auditors. Identification of the external accountant and the regulated firm has been deleted.)

"Staff is of the opinion that [the external accountant's] audit work was adequate to assure proper FS [financial statement] presentation, but staff will do add'l testing due to staff's expertise within the US of A [Uniform Systems of Accounts] framework."

This critique did not meet the requirements of the OCA audit program because (1) it did not fully explain the degree that the work could be relied on to reduce the OCA work, and (2) it did not describe any areas unsatisfactorily covered by the external accountants. An indication that the external accountant's work was satisfactory was that the critique contained no suggestions to improve the external accountant's work. We checked the effect this incomplete critique had on the scope of OCA's work by examining the work OCA did on a specific area--the construction-work-in-progress account. OCA reviewed the external accountant's work on this account and noted items for follow up and general interest. Without detailing deficiencies in the external accountant's work, OCA conducted extensive work.

The OCA staff prepared a summary analysis detailing all journal entries affecting construction-work-in-progress for the period December 1, 1978, through November 30, 1979. The staff also performed an analysis of 33 work orders (including five work orders that had been reviewed by the external accountant) to insure that procedures utilized were reasonable and in accordance with the Uniform System of Accounts. The OCA analysis resulted in adjustment exceptions which the OCA auditors found to be too insignificant to report. Nevertheless, OCA's staff performed a still more indepth analysis of one of the five work orders the external accountant had also reviewed and two additional work orders. On the basis of this analysis, the staff took exceptions amounting to $86,101. These and other exceptions involving the plant account totaled $160,276, or 0.0249 percent, of the value of the total net utility plant. We also examined other work areas and found that OCA had performed considerable work without an indication in the critique that reliance could not be placed on the work of the external accountant.

Although OCA's critique noted no specific areas covered by the external accountant that required additional work, OCA nevertheless performed additional work citing, as a basis, its staff's expertise regarding the Uniform System of Accounts (implying a greater expertise than that of the CPA firm). Such basis does not appear sound because the external accountant had been auditing the firm for 44 years and had 35 other clients that were required to file financial information with FERC in 1981. Thus, the external accountant has had vast experience in working with the Uniform Systems of Accounts. Furthermore, with regard to experience with the Uniform Systems of Accounts, we examined FERC records and found that 17 CPA firms had served as the external accountant for the 310 firms that were required to file financial information with FERC in 1981. Of these, 5 CPA firms had 29 or more such clients each and their relationships had been established for a number of years.

Example 2

During a second audit (also of an electric utility), OCA reviewed the audit coverage of the external accountant for the period January 1, 1975, through December 1, 1978. In the critique, the OCA staff noted areas in which the external accountant's coverage would be useful and areas in which OCA follow up work would be performed, but made no comments on the adequacy of the external accountant's coverage.

As in the first audit discussed above, following this critique of the external accountant's work, the OCA staff conducted duplicative work on the construction-work-in-progress account and related work orders beyond what would be needed to only check the quality or accuracy of the external accountant's work. The OCA workpapers indicated that the audit objectives were to determine that the amounts in the account were valid and that the internal controls over the procedures for accumulating direct construction costs were adequate. The workpapers also indicated that the scope of the OCA procedures could be reduced based on work performed by the external accountant which reviewed all open work orders that exceeded $1 million. Without stating how the external accountant did not satisfactorily cover the area or why the OCA work was needed to improve the usefulness of the external accountant's work, OCA performed additional audit work. This included an analysis of charges to the account for January through December of 1978 and a listing of all work orders with a balance of $150,000 or more included in the account at the end of each year from 1975 through 1978 noting the work orders that had significant balances for several years. In addition, we noted similar duplication of work in other audit areas.

Example 3

The third set of OCA workpapers we reviewed were prepared during an audit of a natural gas pipeline company. OCA's critique of the external accountant's work noted the scope of the external accountant's coverages in various audit areas, but gave no indication of any deficiencies in the audit work that had been performed.

Again, the critique did not pinpoint inadequacies in the external accountant's work, but the OCA auditors duplicated that work. For example, in the section of the workpapers dealing with work orders, which result in changes in the plant account or the construction-work-in-progress account, OCA had three pages from the external accountant's workpapers showing the 20 work orders that had been reviewed and the information obtained. OCA did not show how this work could reduce its own work nor did it state why additional work was necessary. Nevertheless, OCA reviewed 25 additional work orders.

OCA AUDITS HAD NO SIGNIFICANT EFFECT ON RATES, ALTHOUGH INTANGIBLE BENEFITS RESULT

The adjustments required by OCA, described in the 50 audit reports issued in fiscal year 1981 that we reviewed, had little or no effect on the firms' revenue requirements or ultimately on the rates approved by FERC. We limited our evaluations to findings which resulted in adjustments to electric or gas utility plant accounts because adjustments to these accounts have the greatest potential for affecting the revenue requirements of the regulated firms, and thus, ultimately, the rates approved by FERC. We found that the adjustments were minor when compared to the firms' net utility plant accounts and had no significant effect on the rates approved by FERC.

We believe that these minimal effects on the revenue requirements indicate that the primary goal for having the external accountant attest to the regulated firm's compliance had been achieved. That goal was to have significant deviations from the Uniform Systems of Accounts reported annually to FERC. In establishing this requirement, FPC noted that OCA's audit cycle was 5 or more years. A FPC press release stated that the requirement would, "eliminate some of the uncertainties attendant to accumulated adjustments experienced under the present program." While the goal of having significant adjustments made annually seems to have been achieved, OCA, as indicated in the previous section of this report, does not seem to have taken advantage of the potential savings in OCA audit work by placing greater reliance on the external accountants.

We believe the significance of the OCA adjustments can best be measured by calculating the effect that they have on rates paid by consumers or on the rate of return received by investors in the firms. We made our measurements in two ways. In the few instances where the firms had subsequently requested rate changes, we used FERC's conventional calculations to determine whether the rates were measurably affected. In the other cases, we roughly estimated the potential for affecting the rates by comparing the adjustments to the net utility plant accounts.

There were adjustments to plant accounts in 37 of the 50 audit reports we reviewed, including the reports on the three audits discussed above. The adjustments, as a percentage of the total value of the net utility plant accounts averaged 0.12 percent and ranged from 0.0058 to 3.47 percent. Only four adjustments were more than 1 percent. In the three audits we reviewed in detail, none of the adjustments were more than 1 percent.

We could not determine the effect of four other adjustments because the net utility plant value of the respective firms was not available.

We evaluated the effect of these adjustments on the revenue requirements of the five firms which had subsequently requested rate increases from FERC through April 1982. (These included one of the three included in our detailed review of OCA workpapers.) We found no measureable effect because the adjustments were less than 1 percent of the revenue requirements of the firms.

We agree with OCA officials that, regardless of the effect they may have on rates, OCA audits provide certain intangible benefits similar to those provided by any independent audit or review, such as by inspectors general and GAO. Such intangible benefits include

--providing additional incentive to the firms to comply with the regulatory requirements, and thus, greater assurance that the accounts are properly stated for use in setting rates,

--correcting procedures before they result in measureable effect in the ratemaking process,

--identifying trends or activities that warrant consideration by FERC for possible regulatory actions, including changes in the Uniform Systems of Accounts or other regulations, and

--meeting FERC's mission for protecting investors in the securities of utilities, as well as providing support to the Securities and Exchange Commission in its role of protecting investors.

While these intangible benefits are not susceptible to measurement, they are real. However, placing greater reliance on the work of external accountants, where justified, would not reduce these intangible benefits, except possibly the identification of matters that may warrant consideration by FERC. However, we believe OCA could devise less costly alternative audit techniques to identify such matters. Furthermore, in addition to the audits for compliance with the Uniform Systems of Accounts, OCA also spends time checking compliance with other FERC requirements and we are not suggesting that such work be reduced.

CONCLUSIONS

OCA may not have fully realized the benefits of FERC's requirement that an external accountant certify that regulated firms' financial statements conform in all material respects with the Uniform Systems of Accounts. This is because the OCA auditors have not been required to adequately document their evaluations of the work of the external accountants and so provide an adequate basis for determining the reliance that can be placed on the external accountants' work and the extent that OCA's work should be reduced. Our limited work indicates that financial audits of regulated firms by OCA could be reduced without loss of effectiveness in meeting its responsibilities.

RECOMMENDATIONS

Accordingly, we recommend that the Chief Accountant ensure that OCA auditors prepare a written summary of the work performed by the external accountants and conclusions on the reliance that can be placed on that work as required by the OCA audit program. All management and supervisory personnel in the Division of Audits should be held responsible for assuring that this is done and that the summaries and conclusions are used both in justifying audit work performed by OCA and in discussions with external accountants (individual firms and professional associations) to improve the usefulness of their work.

Copies of this report are being sent to the Chairman and the Executive Director, FERC. We appreciate the courtesy and cooperation extended to our staff during this review.

Sincerely yours,

Gerald H. Elsken

Gerald H. Elsken
Group Director