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STATEMENT OF  
DONALD L. SCANTLEBURY, DIRECTOR  
FINANCIAL AND GENERAL MANAGEMENT STUDIES DIVISION  
BEFORE THE SUBCOMMITTEE ON FEDERAL  
SPENDING PRACTICES AND OPEN GOVERNMENT  
COMMITTEE ON GOVERNMENTAL AFFAIRS  
UNITED STATES SENATE  
CONCERNING THE [COMPREHENSIVE AUDIT AT  
THE COUNCIL FOR ECONOMIC OPPORTUNITY  
IN GREATER CLEVELAND]

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Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our investigation into the allegations of fraud and abuse disclosed by the various audits of government programs operated by the Council for Economic Opportunities in Greater Cleveland and its sub-grantees. With me are Robert Raspen of the Financial and General Management Studies Division and John Dowell and Joseph Stanziale of our Cleveland office.

On March 22, 1979, we testified before the Senate's Subcommittee on Labor, and Health, Education and Welfare, Committee on Appropriations, on the preliminary results of our review. We described instances of diverted and embezzled funds, improper loans, dual and excessive travel costs, and

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improper credit card charges. We also reported internal control weaknesses at the Council's subgrantees, as well as inadequate documentation for and accountability over expenditures, dual reimbursements for food costs, and other areas of program abuse.

Since that testimony we have been analyzing these instances to determine whether breakdowns of internal controls permitted them to occur. We found that internal control breakdowns occurred at both the Council and the Federal agencies administering the programs.

Good internal controls are the most effective deterrent to fraud, embezzlement and related illegal acts. A system of internal controls in the broadest sense encompasses (1) safeguarding assets, (2) promoting accuracy and reliability in accounting and operating data and (3) assuring compliance with directives and laws. In the simplest form, internal controls are the body of checks and balances which organizations set up to spread work out in such a way that one person or function checks on what another person or function does. We found that the Council violated good internal controls. In fact, we found few checks and balances and that the accounting records and reports could not always be relied on because, in some cases they were used to help conceal fraud and abuse.

Today I would like to discuss the breakdowns of internal controls which permitted the fraud and abuse to occur and

the breakdowns of auditing procedures which permitted them to go undetected or uncorrected.

Diversion of funds

The diversion of Federal funds into three unrecorded savings accounts took place in 1973 and 1976. In 1973, the Council received \$974,000 for a grant that was previously cancelled and deposited the money into an interest-bearing savings account. Over the next 15 months the funds were transferred in increments to the Council's regular checking account. Again in 1976, the Council on six occasions deposited checks totaling \$852,000 into an interest-bearing savings account and after 9 to 31 days transferred the money to its regular checking account.

Neither the savings accounts nor the interest earned on them were recorded on the Council's books or reported to CSA. In fact, the Council's executive director, in July 1977, denied the existence of any savings account while, at that time, the Council had two such accounts.

An effective internal control system would have prevented the establishment of unrecorded bank accounts or at least would have disclosed their existence. An effective system would have separated the physical receipt and depositing of cash, the recording of cash receipts in the accounting records, and the receipt of bank statements. At the Council, these functions were controlled by one individual.

The auditors reviewing the CSA funds did not discover the diversion because they did not perform an audit procedure which would have alerted them to the diversions. This procedure is to confirm with CSA the amounts and dates of funds transferred to the Council. Such confirmation is required by CSA regulations and had it been performed, the auditors would have been unable to reconcile the checks with the dates and amounts of deposits shown on the bank statements and accounting records. Furthermore, the confirmation would have disclosed that CSA provided the Council with a \$974,000 check that was not entered in its accounting records. Also, had the auditors confirmed check payments when it made its audit for the year ended January 31, 1977, the 1976 diversion may have been disclosed.

CSA did not discover the diversion because it did not adequately analyze the auditor's report which showed that CSA owed the Council \$448,000. However, because of the unrecorded check, the Council actually owed CSA \$349,000. Had CSA analyzed the audit report, it would have been apparent that the Council's records were inaccurate and that the \$974,000 payment had not been recorded.

#### Embezzlement

As we previously testified, the former Finance Director was convicted of embezzling \$120,000 by depositing idle HEW funds into a personal savings account. He was able to do this because he had complete control over cash disbursements

and he used idle funds from unaudited accounts. An effective internal control system over cash disbursements could have prevented this embezzlement because it would have segregated duties so that one person would not have control over the entire transaction. But as I stated above there was not a proper segregation of duties at the Council.

The CPA firm auditing CSA funds recognized and reported a year before the embezzlement, that internal controls over disbursements were weak; however, neither CSA nor the Council took action to correct the problem until after the embezzlement was discovered. Specifically, the auditors reported that one person--the former finance director--had control over (1) payroll preparation; (2) operating the facsimile signature machine; (3) the supply of unused checks; and (4) distribution of checks. The auditors also reported that bank reconciliations were not timely and cash disbursements were not supported by documentation.

#### Improper loans

Over the past several years, the Council freely loaned money between Federal programs. Such loans are normally not allowable under agency guidelines. This practice resulted in Federal funds being used for purposes other than intended and may have been used to conceal shortages. A loan was used to conceal part of the \$120,000 embezzlement.

Neither the Council nor the Federal agencies know the extent of the loans. Nor do they know if all loans have been repaid.

Deloitte, Haskins & Sells, the public accounting firm now performing the single audit of the Council, is reviewing all loans and interfund transfers to determine (1) the need for such loans and transfers; (2) the purpose for which the funds were used; and (3) timing of the transactions relative to possible substitution to offset or conceal shortages in the program accounts to which the loans or transfers were made.

Since top Council officials were involved in transferring the funds between programs and accounts, no system of internal controls would have prevented the improper loans. However, the auditors on several occasions reported the unauthorized loans to HEW and CSA but neither agency acted to have the practice discontinued. The loans continued until January 1979.

#### Excess cash

In addition to the internal control breakdowns and the lack of followup on deficiencies reported in audits, one factor significantly contributed to the three instances of abuse and misuse of Federal funds which I just discussed. This factor is an excessive amount of Federal cash in the hands of the Council. The excessive cash held by the Council and other grantees results in the Treasury unnecessarily paying interest on borrowed funds. As you know, in recent months the Treasury has been paying record interest rates.

The Council was able to amass large cash balances because: (1) it drew down cash before it was needed; (2) the Federal agencies did not recoup funds in expired or terminated grant

accounts; and (3) the Council may have received dual reimbursement for certain costs. Some of the excess cash was embezzled, diverted into interest-bearing savings accounts, or loaned improperly to other programs. Failure of the Federal agencies to monitor cash balances contributed to the problem.

Federal policy requires grantees to maintain no more than a minimum of cash on hand. This has been defined by CSA as a 30-day supply and by HEW as a 3-day supply. On January 31, 1979, the Council reported that it held \$1.8 million of CSA funds on hand. Based upon average disbursements for the prior 6 months, this was 10 times its average monthly disbursement needs. Similarly, on that date, the Council reported to HEW that it had cash of \$312,000, or about \$120,000 more than its monthly disbursement rate for the prior 12 months.

The Council was able to accumulate large cash balances because it drew down funds before it needed them. In reviewing the quarterly financial reports to CSA, we noted that during the quarter ending October 31, 1978, the Council withdrew \$1.4 million and expended only \$502,000. Thus the Council withdrew nearly \$900,000 more than it needed during this quarter. Similarly, for the quarter ended April 30, 1979, the Council reported a balance of CSA cash of \$1.6 million. This occurred because the Council withdrew \$700,000 even though it had a \$1.8 million balance on hand at the beginning of the quarter. CSA related expenditures during

this quarter amounted to \$1.3 million. After we began questioning these high cash balances, the Council stopped the practice of withdrawing more cash than its disbursement needs. As of May 19, 1980, the Council had only \$136,000 of CSA cash on hand.

Had the Federal agencies reviewed the Council's quarterly financial reports, they would have identified the excessive cash balances. The Council was supposed to explain any large balances but did not. Since the quarterly reports show the cash on hand and disbursements made during the quarter, even a cursory review of the reports would have highlighted the excess cash position. HEW and CSA regional officials told us that they did not have the staff to review the reports.

Another factor contributing to excessive cash on hand is inactive program accounts. For example on April 30, 1979, the Council had over \$170,000 in 12 inactive bank accounts. Some of these accounts have been inactive for at least 4 years.

Still another source of excess funds arises from both Agriculture and HEW reimbursing food costs. Grantees such as the Council and its delegates can receive reimbursement for food and food-related costs from both agencies. While each agency can reimburse grantees for these costs, both should not reimburse for the same costs.

Although Agriculture is primarily responsible for reimbursing grantees for food-related costs, the Council was also



using HEW funds to purchase food. As a result, the Agriculture checking account usually had large cash balances. In this regard, we noted that 28 loans totaling \$450,000 were made from this account and, as of early 1979, \$42,000 of loans were still outstanding. As of September 1979, the Council had \$156,000 in the Agriculture bank account. Both the outstanding loans and large cash balances indicates that the Council has more cash than it needs.

As part of its single audit, Deloitte, Haskins & Sells is examining food reimbursements.

#### Other abuses

As discussed in previous testimony, we referred several cases of credit card and travel abuses to the Department of Justice; however, because of the small dollar amounts, Justice has taken no action. Our followup to determine if corrective action had been taken to prevent future occurrences showed that such action had not been taken. For example, our test of 25 transactions showed that 8 involve some sort of abuse of Federal funds. We referred the 8 cases to HEW's Inspector General who confirmed our findings and referred them to Justice. Again, Justice will not prosecute because of the small dollar amounts involved. This indicates to us that the Federal agencies must insist on strong internal controls and take administrative actions to recover Federal funds involved in minor cases of program abuse. In addition,

the Federal agencies must insist that individuals involved in such abuse are subject to administrative action.

I will now discuss other aspects of our work at the Council including prior audits of HEW programs, excess program authority and corrective measures.

#### PRIOR AUDITS OF HEW PROGRAMS

HEW has not accepted Ernst & Whinney's audit reports on the Council's HEW activities for the 3-years ended January 31, 1978, because of unresolved differences. The Chicago HEW audit staff has been attempting to reconcile the differences and has reviewed the Ernst & Whinney working papers. During this review the HEW auditors raised a number of questions about the audit work and as a result requested Deloitte, Haskins & Sells to do additional work during its audit of the Council including the following:

- analyze receipts and disbursements, including Agriculture reimbursements, to determine if all receipts were properly accounted for, disbursements were proper, and funds were promptly deposited and properly recorded,
- compare receipts and disbursements with approved budgets and final expenditure reports,
- review letter of credit withdrawals to determine if too much cash was withdrawn,
- analyze unused Federal funds at the beginning and end of each program year,

- audit in-kind contributions since the auditor's working papers do not indicate any audit of cost sharing was considered,
- audit additional transactions to the extent necessary to realistically determine the allowability and reasonableness of amounts claimed,
- review food costs since the auditor's working papers do not indicate that either the nutritional program or food costs were reviewed, and
- analyze accounts receivable for the 3-year period.

#### EXCESS PROGRAM AUTHORITY

The accumulation of excess cash at the Council, as well as other grantees around the country, occurs because the grantees receive too much funding authority in the first place. When Federal agencies approve grants, they approve letters of credit whereby, grantees can draw money to carry out the programs. However, at the end of the program year, the grantees can no longer spend the money unless they receive approval from the Federal agency. In Cleveland we found that the Council frequently drew down the entire amount of the grant even though actual expenditures were less than the grant. Thus, the Council would end the year with excess cash and with funding authority available for reprogramming.

The audit reports show that CSA and HEW funds available for reprogramming grew from \$656,000 in January 1975, to \$1.6 million

in January 1978. While audited data is not yet available, the balance as of January 1979 was probably even larger.

Until 1979, HEW and CSA permitted grantees with limited justification to add funds leftover from prior program years to funds authorized for the current year. For example, in early 1979, HEW authorized the Council to reprogram \$132,000 of unspent Head Start funds from 1972 through 1975 to the current program year.

Beginning in 1979, both CSA and HEW changed this procedure by requiring that grantees provide detailed justification for reprogramming funds and by deducting reprogrammed funds from the amount approved for the current program year. This approach appears fruitful. For example, in late 1979 the Council requested HEW approval for reprogramming \$1.7 million left over Head Start programs funds for years ended January 31, 1978 and 1979. The Council was later required to provide additional justification on the planned use of the funds. We were informed by a Council official that HEW will only approve \$1.1 million of the \$1.7 million requested.

We believe that these actions, coupled with increased attention to audit reports and quarterly financial statements, will reduce excess cash balances and lessen opportunities for fraud and abuse.

#### CORRECTIVE ACTIONS

The Federal agencies have taken other corrective actions which we believe will substantially improve conditions in Cleveland.

As you may recall in prior testimony, we pointed out that conditions at the Council were never fully disclosed because different public accounting firms were hired to audit individual programs, rather than one firm auditing all Council activities concurrently. Some programs were never audited. For many years the General Accounting Office has advocated single audits at organizations like the Council. Therefore, we believe that the engagement of Deloitte, Haskins & Sells to do the single audit at the Council is a major step forward. The audit, which covers the 4 year period ended January 31, 1979, started last November, is well underway and is expected to be completed in a few months. Since HEW will testify on the single audit, we are not providing details but will do so if you desire. We did note that ACTION had contracted for an audit of its program at the Council for \$2,400 but, after we brought the single audit to its attention, ACTION cancelled the audit.

Other actions in Cleveland include the following:

- the \$76,000 in the hidden savings account has been returned to CSA,
- the Council returned \$34,000 from inactive checking accounts to HEW,
- CSA withdrew \$500,000 in program authority from the Council,
- the cash held by the Council has been substantially reduced, and
- the Council's payroll procedures have been improved.

(Currently the FBI is investigating the extent of dual payments made to a Council official.)

Also, as a result of our work in Cleveland and other locations:

- CSA has initiated a nationwide review of draw downs under the letter of credit method of financing,
- HEW has begun an across the board survey of excess cash held by grantees,
- HEW added three people to its grants administration staff in the Chicago Region to review quarterly financial reports and to make field visits to grantees, and
- CSA regional personnel have now begun to review quarterly financial reports and audit reports, and have added this requirement to job descriptions.

This concludes my statement and I will try to answer any questions you may have.