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FRAUD AND ABUSE IN FEDERAL PROGRAMS: THE AUDITOR'S ROLE

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Speaking after dinner reminds me of an ancient Roman history lesson I learned in a course at King's college. The story takes place in the Roman coliseum with lions and gladiators. The Roman Emperor had just settled down in his seat in the big coliseum to watch the Christian gladators fend off the hungry lions. The first Christian was sent out into the middle of the arena. A lion was then let loose, and just as it was about to charge, the Christian ran up to the animal and whispered something in its ear. The lion assumed a thoughtful look and slowly but decidedly walked away.

The Emperor, of course, was astounded. He bellowed to one of his guards to bring him the mysterious and wonderful Christian who, with a few words, could tame the angry lion.

"Come here, Christian," the Emperor said to the man, "and I'll spare you your life if you'll only tell me what you whispered in the ear of the lion that made him walk away."

"That's easy," replied the Christian. "I told him he could have me if he liked, but there'd be speeches after dinner."

So, now that we've all had dinner, I'm going to talk about the problem of fraud, abuse, and waste in Federal programs. I also want to talk about the auditor's role in taking the preventive, detective, and corrective measures to combat this problem.

Given the magnitude of the problem--and we're talking billions of dollars here--the auditor is in the hey-day of the accounting and auditing profession. At last we can shed our green-eyeshade image for something a little more heroic. The role of the auditor today in the salvation of Federal programs has never been more crucial, more demanding, and potentially more satisfying and rewarding.

As you are all aware, GAO is the investigative arm of the Congress. We are responsible for reviewing Federal programs and related annual expenditures of more than $650 billion of the Government's purse. Our audit scope is just about as broad as the Federal Government itself. And we're no strangers to waste and management inefficiencies in Federal programs. In fact, I thought I'd start tonight by talking about areas we've all heard a little something about--problems at the General Services Administration and computer fraud.

The GSA fraud and corruption stories started making the headlines in 1978, but the actual events unfolded years before. We know most of this because of one Robert Lowry, a paint contractor, who one day decided to spill the beans. According to Lowry, he provided GSA officials with cash, trips, call girls, and free paint jobs on their homes in order to get GSA contracts to paint Federal buildings in Washington. Letters he wrote in 1975 and '76 to GSA, GAO, the FBI, and Congressmen exposed bribery and kickback schemes in detail. This started full-scale investigations and congressional hearings and is still producing a long list of indictments and convictions.

In addition to the paint scandals, investigations surfaced misuse of Government credit cards, manipulation of building leases, and assorted shady buying practices involving furniture, typewriters, calculators, overhead projectors, cameras, TV's, and you-name-it.

Between 1973 and the time the scandals broke in 1978, GAO had issued 200 reports on management improvements needed in numerous areas in GSA. Most notably, we put out a report in 1977 on GSA self-service stores. Those are small-scale office supply stores located on the premises of many Government agencies. Agency employees are issued shopping plates, and with a grocery cart, can go pick up paper, pencils, and miscellaneous office supplies needed for a particular office unit.

Our '77 report noted inadequate controls over store inventories, shopping plates, and store purchases, among other things. During that year, widespread fraud surfaced in the self-service stores. U.S. attorneys investigated, convictions were obtained, and prison sentences were handed out. Nonetheless, by last summer, we issued another report on the self-service stores with nearly identical findings: lack of adequate controls over store inventories, operations, and shopping plates--all providing the potential for further fraud.

Since the 1978 scandals, GAO has reported on the multiple award buying program, quality assurance, the repair and rehabilitation program, and furniture. The reports contain a litany of internal control recommendations. But what you won't read in the reports is that the Commissioner of the Federal Supply Service, which oversees the supply stores I just talked about, changed 8 times in a period of 3 years.

All of which brings me to the moral of the GSA story and of my talk tonight: the auditor's role in reducing
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Government fraud and corruption, can be seen only in tandem with that of the Federal program manager. I cannot overstate the importance of the Federal manager in dealing with this massive problem of fraud, abuse, and waste in Government. If the Federal manager does not implement <u>and</u>

monitor <u>and</u> follow up on the system of internal controls, the auditor can find and recommend and find again, but we'll not see an end to this staggering misuse and abuse of taxpayers' money.

Computer fraud is an area which GAO has been investigating for years, with dramatic results. At the Department of Housing and Urban Development in 1975, GAO auditors tested the agency's payroll computer. They managed to get Donald Duck on the payroll and were about to issue him a check for $99,000. Even for a real person, the idea of a check that size should have sounded some alarms, since at that time, the top Federal bureaucrat's annual salary was $47,500. GAO auditors also included Mickey and Minnie Mouse and 27 other cartoon characters on the rolls.

If this seems to be an extreme method of making a point, consider the following incident which occurred at the Social Security office in 1978. Social Security officials had boasted that their computer files and equipment were completely secure. To prove what they knew to be lax security, GAO auditors deactivated burglar alarms on exit doors by removing a couple of screws, scooped up blank Social Security and Medicaid cards from boxes of thousands lying unattended in hallways, carried secret tapes past guards after discovering that security guards didn't check lunchbags or briefcases and removed 38 of the most sensitive computer tapes from the Social Security center without challenge. These tapes contained the names of over a million Social Security recipients.

Of course, GAO returned the "stolen" tapes. But the auditors made their point. The agency had not addressed the problem of preventing fraud from occurring among people who work inside the computer room.

A few months later GAO came out with another report directed specifically at the Social Security Administration. One of the major problems featured was the ability of field office personnel to override many of the computerized system's controls. This allowed the computer to enter incorrect, incomplete, and erroneous data. This and other internal control weaknesses resulted in $25 million in erroneous benefit payments to Supplemental Security Income recipients.

GAO had its own way of testing the override problem. Supposedly the system had a number of controls that prevent random data entry changes. So when GAO auditors changed the name and address of a test file recipient to Darth Vadar--address, Lakewood County Social Security District Office--they were able to override the controls designed to stop these bogus entries. Had this entry been made on other than a test file, the Star Wars villain would have been entitled to benefits of $189.40 a month.

At this point, I'd like to stress that government has no monopoly on fraud, abuse, and mismanagement. The thirties can be remembered for the infamous McKesson & Robbins affair. A genius con artist named Philip Musica, who changed his name and credentials to Dr. F. Donald Coster, invented an uncle named Girard and created the powerful drug firm of Girard & Co. Backed by New England's finest families, he was able to absorb the prestigious but declining McKesson & Robbins drug company, which he built into a vast empire. Through mythical international subsidiaries, this financial genius made a fortune. Using limited audits by Price, Waterhouse, he borrowed millions of dollars from banks on inventories that didn't exist, which were stored in warehouses that didn't exist, and were sent abroad in ships that did not exist. The swindle was finally uncovered in 1938.

A case with fascinating parallels to the McKesson & Robbins debacle was the great salad oil swindle, which is the story of one man's manipulation of millions of gallons of non-existent salad oil. As it turned out, by 1963 two Wall Street brokerage houses were thrown into bankruptcy, an American Express subsidiary went under, the bottom dropped out of the commodities market, and the financial establishment faced a $150 million loss.

As recently as last week the Mohammed Ali Professional Sports, Inc. whose acronym is MAPS, was in the news again. Ali, by the way, lent his name to the group but has nothing to do with its management. The head of the group, Harold J. Smith, is accused of defrauding the Wells Fargo bank of $21.3 million. Smith turns out to be an alias for Ross Fields, who used to run a disco in D.C. He fled the area leaving many debts and bad checks on his trail. The Wells Fargo suit charges that Smith and MAPS associates were in cahoots with a bank official to divert bank funds by crediting MAPS accounts with deposits that were never made.

Speaking of banks, bank failures are a study in private sector mismanagement. A 1976 study by the Federal Deposit Insurance Corporation showed that compared with an earlier FDIC study, proportionately more failures were caused by poor loan management than by embezzlement. A 1977 GAO comprehensive study of banks revealed that bank failures were caused primarily by the policies used by the bank's managers. Examiners in 17 of 30 cases studied had criticized the banks' managers for following self-serving loan practices. In 26 cases, examiners considered managers incompetent. In 17 cases, examiners had warned that the banks were overconcentrating their loan risks in a single industry or to a single borrower. And in 27 of 30 cases reviewed, examiners stated that the banks' loan records were inadequate.

In this same GAO report, one case study provides a good illustration of failures caused by the mismanagement of loans in general. The bank in question was closed in the 1970's. Some years earlier, the State's capital city experienced a boom in the real estate market, and developers started many new housing projects. Some of these projects were aided by a Federal program promoting low-income housing.

The bank's directors, according to Federal examiners, were eager for the bank to grow. They approved large loans to several developers, thereby overextending the bank in the real estate area. Examiners believed that many of these loans were made on the assumption that the real estate market would continue to expand and that the bank's officers paid too little attention to the creditworthiness of the borrowers. Some of the construction projects didn't have sufficient funds to complete them.

The Federal Government announced plans to phase out its low-income housing subsidy, and the real estate market in general also suffered a decline. Loans made by the bank became overdue, and some borrowers were unable to meet their interest payments. The bank made new loans to some of these borrowers so they could make the overdue payments on the previous loans. But according to the examiners, the bank didn't accept enough collateral for these new loans.

Rumors of the bank's financial troubles caused many depositors to withdraw their funds, which severely affected the bank's liquidity. In spite of a loan from the FDIC and a line of credit at another bank, the bank in question had to close.

Nothing embodies the totality of fraud, abuse, and mismanagement in the private sector as the Equity Funding scandal in 1973, which involved an estimated loss of $2 billion. As you probably remember, the people from top management schemed to create a good earnings record to increase the value of company stock and therefore enrich themselves. What's more, inflated reported earnings and assets made it possible for Equity Funding to acquire other companies in exchange for its stock and to borrow money with which to make other acquisitions and to finance the company's operations--which were losing huge amounts each year. Later, insiders smelling imminent disaster sold out their stocks for huge profits.

An analysis of this spectacular fraud in a book by Professor Conklin from Tufts University (Illegal but not Criminal, 1977) is instructive as to certain notions which operate in the business world. First is the prestige which business confers on high profit-making firms. In the case of Equity Funding, personal theft played a small part in the fraud. The primary goal was to aggrandize the company profits first, which would then accrue to the wealth of the major stockholders.

Trust among business circles is another basic assumption which allows the commercial world to function smoothly. When abused, however, people fall victim to the likes of Robert Vesco or the conspirators of the Equity Funding Corporation. As Professor Conklin points out, trust was reinforced here through the use of computers to print out insurance policies;

the common assumption that anything that comes out of a computer must be correct was an important element in the deception.

Specialization is a third factor operating in big business. As in government, corporations have their own bureaucracies where division of tasks is often necessary. Specilization, while needed, can also be conducive to criminal activity because of poor communication among departments and lack of effective supervision. As Conklin points out, the Equity Funding scandal was in part a result of the company's complex corporate structure, which allowed some of the conspriators to lie to other department managers about their fraudulent activities.

Whether private or public sector fraud, what can the audit community do about it? First, let me speak from the Federal perspective.

GAO's emphasis in dealing with fraud has been unequivocably on prevention. Given small staff resources--which aren't going to get any bigger with major budget cuts--the Government cannot afford to manage its audit staffs inefficiently. That means we cannot spend all our time on fraud detection. Although detection is very important, it's long term effects are nearly futile in combatting future epidemics of fraud in the absence of a preventive program.

GAO audits, as well as the internal audit groups established throughout the bureaucracy, can be effective when allowed to concentrate their efforts on helping design and monitor systems of internal controls. These systems include not only proper accounting controls but administrative controls as well. This is where the Federal manager comes in.

Accounting controls cannot work in a vacuum. Management must be responsible for instituting policies and procedures that will prevent irregularities and improprieties and will reward managers for clean records. Auditors are there to test the controls and cannot substitute for the conscientious manager. This policy of prevention, in conjunction with managerial accountability, is taking shape Government-wide.

Evidence of such a policy is found, first, in the establishment of the Inspector General offices across 15

Federal departments and agencies, and second, in the proposal of legislation requiring agencies to report yearly on their systems of internal controls.

The idea behind the establishment of the Inspector General offices was to unite the previously separate audit offices and investigative offices in Federal departments and agencies. It all started when the Secretary of Agriculture in 1962, Orville Freeman, decided to consolidate his department's audit and investigative responsibilities under a single high-level official as a response to the mishandling of the Billy Sol Estes affair.

I don't know about you, but I'm old enough to remember a few things about this scandal. Agriculture started to investigate the Texas wheeler-dealer in the early fifties. But it wasn't until a decade later, when a Pecos, Texas, newspaper exposed Estes' use of nonexistent fertilizer tanks as collateral to obtain multimillion dollar loans, that the Federal Government was able to bring action. A congressional investigation surfaced Agricultures's problems in coordinating its many investigations of Estes' operations.

The Inspector General Act of 1978 established 12 IG offices initially, located in agencies which, in the aggregate, employ over 600,000 people and spend over $100 billion every year. Among the four objectives of the IG offices--to coordinate audits and investigations; to increase economy, efficiency, and effectiveness; to inform their top officials and Congress of findings; and to prevent and detect Government fraud and abuse--the last, of course, has received the most publicity and emphasis.

Consistent with his position on the auditor's role in fraud prevention, former Comptroller General Staats stressed the importance of not getting bogged down in detection. Because the resources of the IG staffs were so limited, and the numbers of people cheating the Government were not, Staats felt IG offices would be overwhelmed by the sheer number of cases they'd have to pursue. Instead, the Comptroller General pushed for IG resources to help management establish strong internal controls to prevent funds from being misused in the first place. This approach, of course, has elevated the role of the auditor whose job it is to let management know if these controls exist, function properly, or need to be changed to close any loopholes.

A second outgrowth of the prevention policy to combat fraud is found in proposed legislation. Here the emphasis is on making program managers responsible for implementing preventive controls against fraud. The new law would also give the application of internal controls a new and exciting significance.

Right now similar bills being considered in Congress are the Financial Integrity Act and the Federal Managers Accountability Act. They will require Federal agencies to strengthen their systems of internal controls. Broadly speaking, these bills will mean more accountability in Federal programs and agencies. The ability of Government officials to effectively, efficiently, and honestly administer programs was a major issue in the recent national election and has intensified the need to improve accountability at all levels of government. This proposed legislation embraces the concept of strong internal controls as a means of attaining an acceptable level of accountability.

Specifically, the legislation calls for executive agency heads to submit a report each year on their agency's system of internal accounting and administrative controls. Although the Budget and Accounting Act of 1950 has required for 30 years that agencies maintain effective internal controls, we've never really had top management's commitment and constant vigiliance, which is what this new legislation is after. It will require each agency head to address an annual report on controls to the President, making copies available to Congress and the public, with statements describing significant weaknesses in internal controls, proposing ways to correct them, and discussing unresolved findings disclosed in audit or management reports.

Having management report on the adequacy of internal controls is not unique in the Federal Government. As you may be aware, the Foreign Corrupt Practices Act--for those of you who know, hold the tomatoes please--requires private companies who file with the Securities and Exchange Commission to do pretty much the same thing; they have to report each year to the SEC on the effectiveness of their internal control systems. The problems in complying with the Act have consumed a number of pages in the Congressional Record, the chief controversy centering around unclear language which gives no guidance for standards of materiality or specific criteria for clearly determining what is bribery.

Those problems notwithstanding, and I understand amendatory legislation is underway, the intent of the law puts internal controls in the limelight. It involves management in monitoring an organization's control systems. With encouragement from the SEC, management of private companies, such as Xerox and Westinghouse, have begun to include statements of internal control systems in their annual reports to stockholders.

I'd like to think that GAO has been in the forefront of Federal fraud prevention and improved internal control activities. The very essence of our economy and efficiency audits are designed to surface at least areas of waste and potential abuse, and our reports recommend procedural and system safeguards against them. More directly, however, GAO established a fraud task force at about the same time that the Inspector General positions were being established. You may already know about one of the task force's more public activities.

Those of you who are nightowls and watch the late show must be familiar with the 800-number ads. If so, you might know, then, that in addition to calling for the new "Best of Elvis" album, you can call our nationwide toll-free fraud (800-424-5454) hotline. This is our first attempt at having private citizens contact the Government's watchdog about what they believe is waste, fraud, abuse, and illegal actions in Government activities. In the first 18 months of its existence, the hotline logged over 21,000 calls. Allegations ranged from illicit collecting of small benefit checks to illegally awarding Government contracts. Criminal cases have been referred to the Justice Department. One call resulted in recovering over $7 million from false Small Business Administration loan applications. Another tip ended up saving the taxpayers over $5 million from a Defense Department maintenance contract which was being poorly performed.

GAO has made other organizational and program changes which stress fraud prevention. Here are some positive results, with the emphasis on systemwide improvements.

--A GAO report on civilian audit organizations prompted the Government's budget office to be petitioned successfully by the new Inspector General offices for a 20-percent increase in staff--about 1,000 jobs.

--A GAO review of internal controls over community action programs helped recover over $700,000. Motivated by our review, the Government agencies involved have acted to tighten their practices over cash-on-hand and accountability of carry-over funds. Such preventive controls ought to result in additional savings for these programs.

--Our reviews of several Defense Department agencies have convinced Congress of the urgent need for an Inspector General's position in DOD.

--Acting on our recommendations, the Federal budget office has revised its instructions for improving the audits of Federal assistance programs and for strengthening the accountability for college and university grants.

--We issued guidelines for the single audit concept, a streamlined approach to auditing a multifunded program or organization.

Now I'd like to conclude with a brief summary. When it comes to fraud, an ounce of prevention is worth a pound of cure. In fact, how much would the cure cost? How much would we have to pay to catch every crook? The costs for detection and enforcement could be staggering, and to establish preventive controls for every possible contingency could strangle effective program delivery.

In making prevention a priority, the manager has to decide how to strike the appropriate balance between a system which has enough flexibility to promptly and efficiently deliver services and yet has enough internal control to prevent the financial devastation of fraud and waste.

Fraud is a costly and widespread problem. Once the Government allows fraud to happen, chances are it will never recover the loss. Not only is fraud expensive in terms of dollars and cents, but it also violates the integrity of Federal programs and makes people lose confidence in public institutions.

Good systems of internal controls would prevent much of the fraud, or would at least result in its quicker detection. Controls over Federal programs are, however, often inadequate, nonexistent, or ignored. Furthermore, Federal managers are often unconcerned with enforcing the controls needed to prevent frauds. Fraud can flourish in such an environment.

Much fraud is detected by chance. Given the poor state of controls in many programs, most fraud probably remains undetected. For those who are caught committing fraud, the chances of being prosecuted and eventually going to jail are slim. Besides, agencies only infrequently use the administrative actions available to deter persons from committing fraud.

Poor controls combined with a lack of prosecutions or administrative actions means that those who commit fraud against the Government have a good chance of going undetected, and, if detected, can often expect to get away without punishment. The sad truth is that crime against the Government often does pay. Agency Inspectors General, the Department of Justice, and GAO are all working hard to see that, in the future, it doesn't.