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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

More Stringent Revenue Sharing Act Requirements Are Upgrading State And Local Governments' Audits

The amended Revenue Sharing Act and the Office of Revenue Sharing's quality control efforts are benefiting State and local governments by requiring State audit agencies and public accounting firms to upgrade their auditing standards. Some governments will receive their first independent audits while others are taking steps to improve their financial accounting systems.

Due to the time required to revamp their audit operations, some State agencies with substandard audit practices will not be able to complete acceptable audits in a timely manner. GAO therefore recommends that the Congress amend the Revenue Sharing Act to provide waivers to governments audited by these State audit agencies.

GAO also recommends that the Secretary of the Treasury take steps to improve the Office of Revenue Sharing's statistical control system for the 11,000 audits required by the act.



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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report describes the impact of the Revenue Sharing Program's audit requirements on State and local governments. We recommend legislative changes for consideration by the Congress during the 1980 program reauthorization proceedings.

We are providing copies of this report to the Secretary of the Treasury; the Director, Office of Revenue Sharing; the Director, Office of Management and Budget; and to appropriate congressional committees.

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

Comptroller General
of the United States



COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

MORE STRINGENT REVENUE
SHARING ACT REQUIREMENTS
ARE UPGRADING STATE AND
LOCAL GOVERNMENTS' AUDITS

D I G E S T

The 1976 amendments to the Revenue Sharing Act set more stringent audit requirements for about 11,000 State and local governments. Beginning January 1, 1977, all revenue sharing recipients that receive \$25,000 or more in annual entitlement payments must have independent audits of their entire financial operations. These audits must be conducted in accordance with generally accepted auditing standards at least once every 3 years.

OFFICE OF REVENUE SHARING'S QUALITY CONTROL
IS IMPROVING AUDITING PRACTICES

Although few recipients have submitted acceptable audits, the quality of audits and financial management systems are improving. The Office of Revenue Sharing reviewed the audit work of all State audit agencies and 188 public accounting firms to determine if they were following generally accepted auditing standards. The Office cited 14 audit agencies in 12 States and 81 of the public accounting firms for material auditing deficiencies. Also, six State audit agencies were not considered independent.

Actual and planned corrective actions will improve the quality of State and local governments' audits. GAO found that State agencies and public accounting firms now place more emphasis on internal control evaluations, audit planning, training, and personnel qualification requirements.

Once all corrective action has been taken, six States will obtain their first independent audits by reorganizing their audit functions or by hiring public accounting firms. Also, four local governments considered themselves unauditible and took steps to improve their accounting systems. Officials from 53 of the 61 State and local governments visited by GAO favored the new revenue sharing audit requirements because they help strengthen accountability, provide more citizen awareness, and improve the quality of audits.

Although corrective action has already been taken or planned as a result of the revenue sharing audit requirements, State audit agencies and recipient governments have much to do before fully complying with the act. Governments audited by State agencies with auditing standards problems and governments which are found in the future to be unauditible will not be able to complete acceptable audits in a timely manner.

Recommendation to the Congress

GAO recommends that the Congress amend the Revenue Sharing Act to provide explicit authority for the Secretary of the Treasury to grant waivers to governments audited by State agencies with auditing standards or independence problems, provided the agencies are making progress to meet the act's auditing standards requirements. GAO also recommends that the Secretary of the Treasury amend existing regulations to allow future waivers for unauditible governments as authorized by existing legislation. GAO further recommends that the Secretary amend regulations to require governments requesting waivers to submit plans, timetables, and progress reports for taking appropriate corrective actions.

The Treasury Department concurred with all of GAO's recommendations. It plans to amend its regulations relating to waivers based on unauditability. It also supports legislative changes to allow waivers for governments audited by State agencies with auditing standards and independence problems. (See ch. 2.)

OFFICE OF REVENUE SHARING'S AUDIT
CONTROL SYSTEM NEEDS IMPROVEMENT

At the time of GAO's review, the first 3-year audit period had not expired. Accordingly, few recipients of revenue sharing had submitted acceptable audit reports. Therefore, GAO was unable to determine the extent of compliance with the audit requirements or to evaluate the Office's enforcement procedures.

Audit costs were not a deterrent in obtaining required audits. A large number of the recipients were probably waiting to submit audits of their fiscal year 1979 operations--the last year of the first 3-year audit period. (See pp. 16 to 18 and 23.)

The Office will likely be inundated with audit reports over the next year. To handle this influx, it must have a finely tuned system of controls that can monitor the audit status of about 11,000 recipients. GAO found major weaknesses, however, in the Office's audit control system. A due date for audit reports had not been established, statistics were inaccurate and incomplete, and the backlog of audit report reviews was growing dramatically. GAO is recommending measures to eliminate these weaknesses.

Since GAO's review, the Office has taken numerous corrective actions to improve its statistical control system. It believes these changes make the audit statistics more accurate and complete.

The Office has also established a time limitation of September 1980 for submitting audit reports. If the Office is not advised when the audit report will be submitted, the recipient's entitlement payment will be temporarily withheld.

The Office believes it can eliminate its backlog and process all audit reports it receives by September 1980. If not, a public accounting firm will assist in the review process. (See ch. 3.)



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ABBREVIATIONS

GAO General Accounting Office

ORS Office of Revenue Sharing

CHAPTER 1

INTRODUCTION

With the passage of Title I of the State and Local Fiscal Assistance Act of 1972, commonly known as the Revenue Sharing Act (Public Law 92-512), the Congress adopted a new approach to giving general financial assistance to State and local governments. State and local governments welcomed revenue sharing funds because fewer administrative requirements and controls applied to them than to other forms of Federal domestic aid. For the first 5-year period, ending on December 31, 1976, the act authorized distribution of \$30.2 billion to State and local governments.

The act's requirements included

- establishing a trust fund in which program funds and interest would be deposited;
- complying with State and local laws when spending revenue sharing funds;
- prohibiting the use of funds in ways which would discriminate; and
- paying prevailing wage rates as determined under Davis-Bacon Act provisions on certain construction projects funded with revenue sharing payments.

In terms of auditing requirements, the original act did not require each recipient to obtain financial and compliance audits. The Office of Revenue Sharing (ORS) encouraged State and local government recipients, however, to obtain such audits by State and local audit agencies and public accounting firms.

REVENUE SHARING ACT'S 1976 AMENDMENTS REQUIRE COMPREHENSIVE AUDITS

In an earlier report, 1/ we concluded this voluntary approach of obtaining audits was not working. Due to the general nature of the program, the interchangeability of Federal, State, and local funds, and the lack of accountability to the Federal Government and the citizenry, we recommended that audits of all funds be required.

1/"Revenue Sharing Act Audit Requirements Should Be Changed"
(GGD-76-90, July 30, 1976).

The 1976 amendments to the Revenue Sharing Act (Public Law 94-488) required State and local governments to have such audits conducted. The amendments also extended the program through September 30, 1980, and authorized up to \$25.6 billion to be distributed to State and local governments during the period January 1, 1977, through September 30, 1980.

The act required, beginning January 1, 1977, that all State and local governments which receive \$25,000 or more annually in revenue sharing entitlements have independent audits of their financial statements. These audits must be conducted in accordance with generally accepted auditing standards at least once every 3 years. Generally accepted auditing standards for audits of governmental entities are included in "Standards for Audit of Governmental Organizations, Programs, Activities & Functions" issued in 1972 by the Comptroller General.

In addition to financial audits, the act required compliance audits of the revenue sharing funds for all primary recipients receiving \$25,000 or more in entitlements. Secondary recipients (governmental or private organizations which receive \$25,000 or more in revenue sharing funds from the primary recipient) must also have financial and compliance audits of their revenue sharing accounts. Compliance audits test adherence to various requirements of the act, such as nondiscrimination and provisions of the Davis-Bacon Act.

State and local governments may use a series of audits over a period not exceeding 3 fiscal years if they cover in the aggregate all accounts of the recipient governments. Several States and larger local governments have elected to use the series approach.

ORS records show that about 11,000 State and local governments must complete the financial and compliance audits required by the act. Payments to these governments total about \$6.7 billion annually or 98 percent of total revenue sharing entitlements.

CHAPTER 2

MANY BENEFITS RESULT FROM THE AUDIT REQUIREMENTS BUT FEW GOVERNMENTS HAVE FULLY COMPLIED

The amended Revenue Sharing Act and ORS' quality control efforts have prompted improvements in audits of State and local governments and their accounting systems and controls. A number of State audit agencies and public accounting firms are upgrading their auditing standards, and some governments will receive their first independent audits. Also, because of the act, some local governments have determined that their operations are unauditable and are taking remedial steps to improve their financial accounting systems.

Financial audits of State and local governments identify deficiencies--especially internal control weaknesses--and lead to corrective actions. As a result, most officials we talked to favor the amended Revenue Sharing Act's audit requirements.

Since the first 3-year audit period had not expired, few recipients had submitted acceptable audit reports at the time of our review. We therefore were unable to project the extent of compliance with the audit requirements or to evaluate ORS' enforcement procedures. The governments we visited said they plan to comply with the act, and in most cases, did not view audit costs as deterrents to obtaining audits.

STATE AUDITING PRACTICES ARE IMPROVING BUT MORE TIME WILL BE REQUIRED

To administer the Revenue Sharing Act's audit requirements, ORS has reviewed the audit standards of all State audit agencies. ORS concluded that 14 audit agencies in 12 States deviated from generally accepted auditing standards required by the act.

The following table lists 14 State audit agencies ORS cited for violations of generally accepted auditing standards in their audits of State and/or local financial statements. The listing does not include State audit agencies cited for a lack of independence. This matter is discussed on pages 10 to 12.

<u>State</u>	<u>Unacceptable State audits of</u>	
	<u>State operations</u>	<u>Local governments</u>
Delaware	X	
Indiana	X	X
Iowa		X
Massachusetts	X	X
(note a)		
Maine		X
New Hampshire		X
New York		X
Ohio	X	X
Oklahoma	X	X
Rhode Island		X
West Virginia	X	X
(note a)		
Wyoming	X	X

a/Two audit agencies in these States were considered deficient.

ORS reports cited the State audit agencies for the deficiencies shown below:

<u>Auditing standard</u>	<u>Number of audit agencies not meeting the auditing standard</u>
The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.	8
The work is to be adequately planned and assistants, if any, are to be properly supervised.	11
Existing internal controls are to be properly studied and evaluated.	12
Sufficient evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.	11
Various reporting standards.	12

At the time of our review, 2 of the 14 audit agencies (the Massachusetts Department of State Auditor and the Massachusetts Bureau of Accounts) had been approved by ORS, and 7 others had made substantial progress in correcting deficiencies. For instance, the Massachusetts Bureau of Accounts, a State agency that audits local governments, made substantial improvements by (1) establishing an intensive 2-week training program, (2) hiring 31 accounting major graduates, and (3) beginning to use a formal audit program and internal control questionnaire. On the basis of these and other improvements, ORS performed a followup review and approved the Bureau of Accounts' audit operations.

ORS was unable to perform a complete review of another audit agency, the Indiana State Examiner's Office, since the office had not prepared working papers for most audits. Working papers supporting audit exceptions were prepared but were kept at the homes of auditors. We found that the State Examiner's Office established a training program and began preparing working papers and maintaining them in a central location.

To correct deficiencies cited by ORS, West Virginia's Legislative Auditor, a State audit agency charged with auditing State operations, increased the number of its employees. The State agency hired five staff members, including one experienced certified public accountant who assumed the position of Director of Post Auditing. The agency also developed a comprehensive audit handbook that included audit guidelines and an internal control questionnaire. The agency also planned to adopt a training program.

Similar progress and plans had been made in Delaware, Iowa, New Hampshire, Rhode Island, and Wyoming. The Iowa Auditor of State recently reorganized its local audit division, hired 31 accounting graduates, and implemented comprehensive training programs. Delaware and Wyoming contracted with public accounting firms to perform the required audits. Subsequent to our fieldwork, ORS approved the audit agencies in New Hampshire, Rhode Island, and West Virginia.

Recipients audited by some State
audit agencies will require waivers
for the first 3-year audit period

Five audit agencies' limited progress to correct deficiencies and other agencies' heavy workloads cast doubts on whether many State and local governments will obtain timely revenue sharing audits. Although some progress had been made, deficiencies had been corrected only to a limited degree in Oklahoma, Ohio, West Virginia (Local Government Relations Division, State Tax Department), Maine, and New York.

In February 1977 ORS issued its first report of deficiencies to the Oklahoma State Examiner and Inspector's Office. ORS issued a second report in May 1978 showing that little improvement had been made and that audits deviated materially from generally accepted auditing standards. Significant deficiencies included a lack of acceptable audit programs and internal control questionnaires, inadequate documentation of work performed, and various reporting deficiencies. We found that the Oklahoma agency had made little progress to correct these problems.

A newly elected State Auditor met with ORS officials in December 1978 and presented a plan which, according to ORS, should enable the agency to meet the audit requirements. This plan, which will require a \$6 million appropriation, calls for the State Auditor to contract with public accounting firms for joint audits of State and county governments. ORS stated that unless the plan is fully funded and implemented, Oklahoma may not be able to comply with the audit requirements.

After ORS identified numerous deficiencies in the operations of the Ohio State auditor's office, he took, or planned to take, corrective actions on most of the deficiencies. Subsequent to our fieldwork, the Ohio auditing agency developed audit guidelines and internal control questionnaires for audits of State departments and agencies and local governments. Due to a conflict with State law, the Ohio agency has not upgraded its entry level qualification requirement to include college education, as ORS recommended (more than half of the 697 employees did not have college degrees). At the time of our review, officials said they would complete required audits of the State and all local governments within 1 year after the close of fiscal year 1979 (the last fiscal year of the 3-year audit period). They now project the audits will be completed by December 31, 1981. Since their audit practices were still unapproved as of March 1980, their ability to do so appears questionable in view of the 554 local government audits and numerous State fund audits that remain to be completed.

In April 1977 ORS issued its first report to the West Virginia Local Government Relations Division outlining deficiencies in its auditing standards. Two additional reports issued in August 1978 evaluated the status of prior reported deficiencies and outlined additional deficiencies. Although it acknowledged that the audit agency acted in good faith to correct many deficiencies, ORS concluded that much more needed to be done to upgrade auditing standards.

Inadequate audit planning, insufficient workpaper support for findings, and improper financial reporting standards were

among the deficiencies cited in the followup ORS reports. In addition, ORS questioned the adequacy of the audit staff's technical training and proficiency because of the audit agency's lack of certified public accountants, substantial number of employees without college degrees, and low salary levels. Our review showed that improvements had been made, but no reports had been issued which would comply with the new audit requirements. ORS later approved the West Virginia Local Government Relations Division in November 1979.

Time did not allow Maine and New York to take corrective actions on problems outlined in ORS reports issued near the end of our fieldwork. As a result, neither State may be able to perform acceptable audits within a reasonable time after the 3-year audit period. One ORS report expressed concern as to whether the New York Comptroller's Office could make necessary changes and complete audits of the 676 local governments within a reasonable timeframe. ORS later approved the New York Comptroller's Office's auditing practices in January 1980.

Some of the audit agencies that have made considerable progress in correcting deficiencies also expressed concern over their ability to complete acceptable and timely audits for the first 3-year period. Even the ORS-approved Massachusetts Bureau of Accounts concluded it could not perform audits for the 308 local governments which must be audited under the Revenue Sharing Act. The bureau has therefore encouraged municipalities to obtain public accountant audits.

West Virginia's Legislative Auditor's ability to complete acceptable audits will depend on whether it can obtain additional staffing. Officials of the Indiana State Examiner's Office said all required audits will be completed by the end of 1980, but they said a longer period of time should have been allowed for implementation.

Since the first 3-year audit period ended in 1979, the ability of these audit organizations to complete acceptable audits within a reasonable timeframe is questionable. We believe waivers for complying with the audit requirements should be allowed for those recipients who are audited by these audit organizations if they demonstrate progress in upgrading their auditing standards.

Most officials believed corrective actions were beneficial

Officials from all 14 audit agencies cited for deficiencies by ORS believed the corrective actions taken were beneficial. A Massachusetts Bureau of Accounts official told

us that improvements in audit operations greatly benefited the bureau's reviews of local governments' financial records. Ohio State auditor officials said the revenue sharing audit requirements added impetus to changes they were already making. They said they expect future audit reports to be better management tools. The Wyoming State Examiner told us that the ORS audit requirements will help him fill a void in his auditing of State and local financial operations; in the past he had only examined cash accounts.

PUBLIC ACCOUNTING FIRMS ARE TAKING
STEPS TO CORRECT DEFICIENCIES

The Office of Revenue Sharing's quality control efforts also included reviews of selected public accounting firms' auditing practices. ORS concluded that 81 of the 188 public accounting firms it reviewed had not performed governmental audits in accordance with generally accepted auditing standards. Of the 19 firms we visited, 17 concurred with ORS observations and had taken or planned corrective actions. These firms viewed the ORS evaluations as constructive and had no objections to the ORS monitoring program or to reviews made at their individual firms.

The 19 firms' most common deficiencies are summarized in the following table.

<u>Auditing standard</u>	<u>Number of firms not meeting the auditing standard</u>
The work is to be adequately planned and assistants, if any, are to be properly supervised.	7
Existing internal controls are to be properly studied and evaluated.	12
Sufficient evidential matter is to be obtained through inspection, observation, inquiries and confirmation to afford a reasonable basis for an opinion regarding the financial statements under examination.	2
Various reporting standards.	12

Seventeen of the 19 firms we visited agreed with ORS' criticisms and have either taken or planned corrective action to bring their audits up to the standards required. These firms have placed more emphasis on internal control evaluations, audit programs, and financial reporting formats.

One firm did not plan corrective action because the municipality was hiring another firm to perform the revenue sharing audit. Only 1 of the 19 firms took exception to ORS conclusions. ORS found that the firm's audit of a city was deficient because it

- lacked evidence supporting the compliance audit;
- failed to use an internal control questionnaire;
- lacked an audit program; and
- had several reporting deficiencies, including an inadequate accountant's opinion.

The firm disagreed with this assessment and requested a second review which supported the original findings. After the firm still refused to take corrective action, ORS informed the mayor that it would not accept any of the firm's future audits.

Most firms believe ORS' monitoring program is constructive

Eighteen of the 19 firms in our sample viewed the ORS evaluations as constructive. For example, one firm that had primarily performed commercial audits informed us that the ORS review provided the firm with a better understanding of governmental audits.

Similar views have been expressed to ORS by other firms. Following are examples of written comments received by ORS:

"Our firm has always prided ourselves on the fact that we have been a leader among firms in the area to implement and comply with professional pronouncements. This is exemplified by the fact that we were the first firm in the nation to join the Small Firms Division of the AICPA. Knowing that peer review is one of the major requirements of membership, we have been trying to get our house in order. Because of this we welcomed this review by the Office of Revenue Sharing and appreciate your comments."

* * * * *

"We are a relatively small CPA firm and in the past we have always considered our output to be of the highest quality. Your review of our quality control disclosed numerous weaknesses which we have apparently

overlooked. We now feel that we have taken steps to improve the firm's quality control."

* * * * *

"I am writing to compliment your department on the fine job it is doing with respect to quality control reviews of independent revenue sharing auditors. * * * I am very much in favor of what you have done and what you expect to do in the future."

ORS officials believe that other firms will likely improve their future audits of government entities as word of the ORS reviews circulates among public accounting firms.

SOME GOVERNMENTS ARE RECEIVING
THEIR FIRST INDEPENDENT AUDITS

On the basis of its State audit agency reviews, ORS concluded that the audit agencies performing revenue sharing audits in six States--California, Hawaii, Indiana, New York, Ohio, and Wyoming--were not independent. These State audit agencies were not considered independent because the head of the agency reported to the governor or was responsible for maintaining the State's accounting records.

The 1976 amendments to the Revenue Sharing Act require independence as one of the criteria for an acceptable audit. As a basis for its detailed definition of "independence" for governmental audits, ORS used GAO's "Standards for Audit of Governmental Organizations, Programs, Activities & Functions." The following groups of auditors are independent according to ORS regulations:

1. State auditors elected by the citizens of the State.
2. State auditors elected or appointed by and reporting to the State legislature.
3. State auditors appointed by the governor and confirmed by and reporting to the State legislature.
4. Local government auditors elected by the citizens of the local government.
5. Local government auditors elected or appointed by and reporting to the governing body of the local government.

6. Local government auditors appointed by the chief executive officer and confirmed by and reporting to the governing body.
7. State auditors auditing local governments.
8. Independent public accountants who are certified public accountants.
9. Independent public accountants licensed on or before December 31, 1970, by a regulatory authority of a State or other political subdivision of the United States.

ORS also states that an auditor lacks independence if the auditor (1) maintains the official accounting records being audited or reports to the person who maintains such records, or (2) has a personal interest in the financial affairs of the government.

ORS concluded that California's audit agency, the Department of Finance, lacked independence in its financial audits of State government entities because the department was subordinate to the governor's office. The State created the Joint Revenue Sharing Task Force to perform the required audit in California. To ensure the new audit agency's independence, the task force was made up of both Department of Finance staff members and representatives of the State's Auditor General, a California audit agency that ORS had found to be independent during its review of the State's audit agencies. By serving in a supervisory review capacity on the task force, the Auditor General's representatives introduced the independence ORS had said was missing. Moreover, the Auditor General assumed full responsibility for the contents of all task force audit reports. Effective July 1, 1979, the task force was abolished, and the Department of Finance's positions were transferred to the Auditor General, an appointee of the full State legislature.

ORS did not consider the New York Comptroller's office independent since the accounting for certain funds was under the responsibility of the Comptroller's office. A special panel was formed to advise the audit agency on how to comply with the independence requirement. The panel concluded that independence could be achieved if the Comptroller audited most accounts but hired an accounting firm to audit the accounts in question. At the time of our review, the Comptroller had requested the necessary funds to employ an accounting firm. In February 1980, we were notified that public accounting firms would complete all audits by September 1980.

Hawaii and Wyoming officials have decided to hire public accounting firms to audit their States' financial operations. The Wyoming State Examiner told us the State had initially planned to reorganize the audit function under the legislature. The State decided instead to hire a public accounting firm, however, because State officials wanted an outside assessment of the auditability of their funds. Wyoming may still reorganize the State Examiner's office some time in the future.

ORS did not consider the State Examiner of Indiana independent because he reported to the governor who appointed him. The Department of the Treasury informed us that Indiana State law was recently changed by requiring the State Examiner to report directly to the legislature in meeting the revenue sharing audit requirements.

The Ohio State Auditor was not considered independent because his office maintains certain State accounting records. Ohio was considering possible legislative changes but had developed no solution at the end of our fieldwork. ORS later informed us that public accounting firms will be used to meet the independence requirements.

Although both Indiana and Ohio officials felt revenue sharing audit requirements were beneficial, they believed the length of time provided to implement the requirements was inadequate.

UNAUDITABLE GOVERNMENTS ARE
IMPROVING THEIR ACCOUNTING SYSTEMS

The revenue sharing regulations allow for waivers of audit requirements for recipient governments with unauditible accounts. The Director, ORS, could grant a waiver if a recipient government

- made a request in writing prior to March 31, 1978, accompanied by a statement from an independent auditor that the accounts were not auditible;
- submitted signed contracts or agreements with a qualified consultant to develop and implement an auditible accounting system; and
- submitted progress reports at least every 6 months.

Only four recipient governments requested waivers from ORS. All four are making progress in bringing their accounts to an auditible status.

A public accounting firm concluded that one city's accounting and financial reporting practices did not provide enough reliable or timely information to effectively manage operations or to communicate the results of those operations. Specific deficiencies included

- the lack of a general ledger;
- failure to record receivables, payables, and fixed assets; and
- inadequate internal controls over single-entry accounting transactions.

The city has established plans to bring its accounts to an auditable status. Revisions of the accounting system will cost more than \$1 million. Uncertainties about the availability of funds make it difficult to predict when it will be able to have its first acceptable audit.

A county requested a waiver for audits of its fixed assets accounts and the operations, assets, and liabilities of its county hospital. An Indian tribe based its request for a waiver on its lack of (1) adequate internal financial, budgetary, administrative, and operating controls, (2) timely or up-to-date records, and (3) ledger control over detailed records of key accounts. Both governments received waivers and are making progress toward obtaining audits for fiscal year 1980 transactions.

Prior to the 1976 amendments to the Revenue Sharing Act, the fourth local government that received a waiver had established a plan to become auditable by fiscal year 1980. Since this plan was compatible with the ORS requirements, a waiver was granted. Progress is being made, and ORS and city officials expect the fiscal year 1980 audit goal will be met.

Other governments will need extensions of the waiver deadline

ORS regulations prohibit acceptance of any audit report with a disclaimer of opinion; i.e., where the auditor cannot express an opinion because the accounts were unauditible or the scope of the audit was limited. Since the March 31, 1978, unauditible waiver deadline has expired, no other recipients can apply for the audit waiver under current ORS regulations. This places a hardship on any government found to be un-auditible after that date.

One local government in our sample recently received a disclaimer of opinion because the system of internal control for its general fund was seriously deficient.

ORS also received two other audit reports with disclaimers of opinion. In these cases, ORS merely informs the governments that their reports are unacceptable and that acceptable audits must be completed for a period no later than fiscal year 1979.

There is no method to estimate the total number of reports with disclaimers of opinions that ORS will receive. However, ORS officials believe the figure could be substantial because many previously unaudited governments are probably unauditable. Because these governments will likely submit their first audits for fiscal year 1979, we believe the deadline for waiver requests should be eliminated. As is the case for waivers already granted, ORS should monitor the progress these unauditable governments make to improve their financial management systems.

FINANCIAL AUDITS IDENTIFY DEFICIENCIES
AND LEAD TO CORRECTIVE ACTIONS

For the governments in our sample which had been audited, we found numerous examples of deficiencies in past and current audit reports and public accounting firms' management letters. As the following table shows, most audit findings pertained to internal control weaknesses.

<u>Type of government</u>	<u>Type of deficiency</u>	<u>Number of deficiencies reported</u>
Audits of State agencies (87 reports)	Internal control	321
	Violations of State law	40
	Other	44
Audits of local governments (74 reports)	Internal control	263
	Violations of State or local laws	116
	Other	<u>102</u>
Total (161 reports)		<u>886</u>

Deficiencies ranged from minor procedural problems to major weaknesses in the governments' financial management systems. The following is a list of examples of findings contained in financial audit reports or accompanying management letters.

Internal control deficiencies:

- Inadequate separation of duties of employees handling cash receipts and disbursements.
- No current physical inventories.

--Inadequate safeguards of blank payroll checks.

State/local law violations

--Deposit of funds in excess of FDIC insurance ceiling.

--Over-obligation of budget accounts.

--Failure to use competitive bidding procedures.

Other audit findings

--Administrative salary increases without prior approval.

--No policy for record retention.

--Purchasing not centralized.

In most cases, reported deficiencies led to corrective actions. We followed up on the status of recommendations in 40 financial audit reports. Of the 286 deficiencies, corrective action was taken or planned for 248, or 87 percent.

FEW GOVERNMENTS HAVE OBTAINED
ACCEPTABLE AUDITS

We visited seven States--California, Kentucky, Massachusetts, Nevada, Ohio, Texas, and Vermont--to determine the status and cost of State and local governments' revenue sharing audits. The number of State and local governments that had obtained audits acceptable to ORS was quite low. The governments we sampled said they plan to comply with the act, and in most cases did not view audit costs as deterrents to obtaining audits.

All sample governments plan to be audited

In some States, local governments send their audit reports directly to ORS, while in others State agencies send listings to ORS of local governments which have completed acceptable audits. Of the 39 local governments we visited that submit audit reports directly to ORS, only 4 had obtained acceptable audits. Most of the remaining 35 governments had received financial audits previously, but many of them would not meet the revenue sharing audit requirements for such reasons as

--compliance audits were not performed,

--all funds were not included in audits, or

--auditors were not independent.

The following table shows the local governments in our sample which submit their public accounting firm audit reports directly to ORS.

Local Governments which Submit
Their Reports to ORS

<u>State</u>	<u>Number of governments</u>		
	<u>Visited</u>	<u>Which GAO determined to have acceptable audits</u>	<u>Which plan to be audited</u>
California	10	0	10
Kentucky (cities)	6	2	4
Texas	13	2	11
Vermont	<u>10</u>	<u>0</u>	<u>10</u>
Total	<u>39</u>	<u>4</u>	<u>35</u>

All unaudited governments plan to be audited in the future. One county, however, had no such plan before our review because it erroneously believed an audit of only its revenue sharing funds was sufficient. Officials informed us that an audit covering all funds will be performed in the future.

The following table shows the States we visited where the State audit agency submits listings of completed State or public accounting firm audits to ORS.

States Which Submit Listings of
Completed Audits to ORS

<u>State</u>	<u>Number of Governments</u>	
	<u>Which receive over \$25,000 in revenue sharing funds</u>	<u>On listings submitted to ORS</u>
Kentucky (counties)	119	68
Massachusetts	308	19
Nevada	26	8
Ohio	<u>554</u>	<u>294</u>
Total	<u>1,007</u>	<u>389</u>

As the table shows, listings identifying 389 audits out of 1,007 required audits had been submitted to ORS at the time of our review. All local governments in Kentucky and

Nevada are scheduled to be audited in a timely manner. The Massachusetts Bureau of Accounts is encouraging local governments to contract with public accounting firms to obtain timely audits. Ohio local governments, however, are audited by a State agency which ORS concluded was not following generally accepted auditing standards. As discussed on page 6, it is highly doubtful that acceptable audits of Ohio local governments will be completed in a reasonable time after the end of the 3-year audit period.

Several governments did not plan to obtain compliance audits

Confusion over the compliance audit requirements existed at the State or local levels in Massachusetts, Ohio, and Texas. Prior to our review, Ohio officials had not planned a compliance audit. State of Massachusetts officials were unsure if a compliance audit was required of its revenue sharing funds used for debt retirement. State officials told us that such an audit will be performed in the future. Of the 19 Massachusetts local governments which obtain public accounting firm audits, only 2 of the audit reports had statements that compliance audits were performed.

Two recipients were also confused about requirements for compliance audits of secondary recipients. The State of Texas and one Texas county did not realize that compliance audits were required for entities which received \$25,000 or more in revenue sharing funds from the State and local governments.

ORS regulations provide specific guidance on the need for compliance audits of primary and secondary recipients. ORS officials informed us that letters would be sent out to recipients reemphasizing the need to complete both financial and compliance audits.

Audit costs are not a deterrent to obtaining audits

Since few governments in our sample had completed revenue sharing audits, only limited data was available on recipients' audit costs. In those cases where actual or estimated costs were known, incremental audit costs associated with the revenue sharing audit requirements were not a major concern to State and local officials.

The limited cost data obtained showed an inverse relationship between the size of government and the relative incremental costs. State costs were only 0.002 percent of general fund budgets and 0.08 percent of revenue sharing receipts for a 3-year period. These figures compare to 0.25

percent and 2.30 percent, respectively, for small governments receiving between \$25,000 and \$99,999 in revenue sharing entitlements.

Although audit costs were small in relative terms, the amounts were sometimes large. One county's incremental audit costs, for example, will be about \$700,000 or 0.23 percent of the county's 3-year revenue sharing receipts.

Officials from 56 of the 61 State and local governments visited viewed the added costs as neither excessive nor unreasonable. Five officials expressed concern that revenue sharing audit requirements created unnecessary expenses. Several officials pointed out that the benefits of audits outweigh the costs incurred.

MOST STATE AND LOCAL OFFICIALS FAVOR AUDIT REQUIREMENTS

Officials from 6 of 7 States and 47 of 54 local governments believed the revenue sharing audit requirements are desirable. Several officials noted that the audits provide important management information, reduce the chances of mismanagement, and help create a more professional and comprehensive approach to audits within their governmental units. Other officials said the audit requirements help strengthen accountability, provide more citizen awareness, and improve the quality of audits.

A Nevada official, however, felt that compliance audits of secondary recipients were unnecessary. Officials from six local governments felt the audit requirements represented a serious intrusion into local affairs. Taking issue with ORS definitions, one county's officials said they considered their auditor-controller independent and therefore believed they wasted money hiring a public accounting firm.

ANNUAL AUDITS SHOULD BE CONSIDERED IN THE FUTURE

Although public confidence in all levels of government has waned in recent years, the citizenry's trust and confidence can be increased by providing the electorate with more frequent, complete, and accurate information about the operations of its government and the bases used to establish levels of services and taxation. Financial statements attested by independent auditors, auditors' opinions regarding the governments' accounting practices, and auditors' findings and recommendations for improvement combine to provide the citizenry with a basis for assessing the stewardship of State and local government officials.

Many State and local governments are required by State or local laws to have their accounts audited, but the frequency of these audits varies from annually in some jurisdictions to biennially or once every 3 years in others. The Revenue Sharing Act requires larger governments to have their accounts audited at least once every 3 years.

These intermittent audits have led to accounting and financial reporting improvements at many governments and have increased the accountability of State and local government officials. The benefits derived from audits of State and local governments have been limited, however, by the sporadic audit timetable that is permitted by the Revenue Sharing Act and laws of some State and local governments.

Because the Revenue Sharing Act requires audits at least once during a 3-year period, a government's financial statements and operations for 2 out of 3 years may not be reviewed and examined by independent auditors. If only 1 year's financial statements are audited, the auditor would be required to verify opening balances in order to render an unqualified opinion. Verifying opening balances may require substantial audit effort, which a State or local government may not allow. The auditor would then be precluded from rendering an unqualified opinion.

An annual audit would be more complete and increase the value and reliability of information available to government officials and their citizenry. Many governments throughout the 50 States already have annual audits, but many others do not. We believe that annual audits of State and local governments are a desirable long-term goal.

While the revenue sharing program offers a vehicle to move toward this goal, it would be premature at this time to conclude that it is feasible to change the revenue sharing audit requirement to an annual basis. As discussed in chapter 3, very few recipient governments have submitted acceptable audit reports. Consequently, little or no data is available on

--problems encountered by recipients which were not audited previously,

--problems with ORS' enforcement procedures,

--smaller recipients' audit costs, and

--abilities of State audit agencies (especially those with substandard audit practices) to absorb increased workloads.

Therefore, we believe the requirement that recipients be audited at least once every 3 years should be retained. Experience obtained during the next few years on the existing audit requirements will provide valuable insight on the feasibility of expanding the audit requirements.

CONCLUSIONS

The revenue sharing audit requirements are improving the quality of State and local audits. The ORS Audit Division has reviewed all State audit agencies and a sample of public accounting firms. Material deviations from generally accepted auditing standards, including independence of State audit agencies, were identified, and corrective actions in most cases were taken or planned.

Improvements in financial auditing by State audit agencies and public accounting firms favorably affect all levels of government. Financial audits identify weaknesses in State and local governments' internal control procedures, violations of State and local laws, and other financial management deficiencies. Upgrading financial audit operations to meet generally accepted auditing standards will produce more comprehensive and reliable evaluations of all funds maintained by State and local governments.

Improvements in auditing standards, especially in evaluations of internal control, also complement fraud prevention and detection efforts. A strong system of internal control is a critical element in ensuring that funds are used for authorized purposes. Thorough evaluations and resulting improvements in State and local governments' overall internal control systems will give more assurance that funds are used properly.

Although substantial corrective action has already been taken or planned as a result of the revenue sharing audit requirements, many State audit agencies have much to do before their audits can be accepted. Many State and local governments audited by State agencies with auditing standards and independence problems may require waivers for the first 3-year audit period. Because such waivers would represent a material departure from the audit requirements of the act, we believe a legislative amendment would be desirable to provide the Secretary of the Treasury explicit authority to grant such waivers. This authority would be comparable to the Secretary's current authority to grant waivers for unauditible governments.

Additional waivers will be required for unauditable governments. These waivers can be granted by amending existing ORS regulations which currently contain a March 31, 1978 deadline to apply for a waiver based on unauditability. Since the deadline has passed, undue hardships are placed on any government subsequently found to be unauditable.

As a precondition for authorizing waivers, ORS should require the State agencies or governments to submit, for ORS approval, plans and timetables for taking appropriate corrective actions. In addition, State agencies or recipients that receive waivers should be required to submit periodic reports on their progress in taking corrective actions.

RECOMMENDATION TO THE CONGRESS

We recommend that the Congress amend the Revenue Sharing Act to provide explicit authority for the Secretary of the Treasury to grant waivers to governments audited by State audit agencies which ORS concluded were not following generally accepted auditing standards or were not independent, provided the State agencies are making progress to meet these requirements. Appendix I contains suggested language for revisions to the act.

RECOMMENDATIONS TO THE SECRETARY OF THE TREASURY

We recommend that the Secretary of the Treasury amend the ORS regulations to eliminate the March 31, 1978, deadline for recipients requesting waivers based on unauditability. New regulations for all types of waivers should include specific requirements for submitting plans, timetables, and progress reports of corrective actions to be taken.

AGENCY COMMENTS

The Department of the Treasury generally agreed with our findings and recommendations (see appendix II). The Department noted that ORS' efforts in implementing the audit requirements have led to changes in State audit agencies' and public accounting firms' audit practices that might not otherwise have been made. Since our fieldwork, the number of State agencies cited by ORS for deviations from generally accepted auditing standards has increased to 20 agencies in 17 States.

The Department concurred with our recommendation that the Congress should amend the Revenue Sharing Act to authorize the Secretary to grant waivers to governments audited by State agencies whose audit practices are not of an acceptable standard. To deal with these situations, the Department has

allowed some State auditors additional time to provide acceptable audits for fiscal year 1979. They agree that waivers for the first 3-year audit period is a preferable solution where State audit agencies are making substantial progress in improving their auditing practices. The Department noted that 8 of the 20 State audit agencies cited for deficiencies had been approved as of March 1980.

The Department agreed with our recommendation to eliminate the deadline in applying for a waiver because of un-auditable records. Draft regulations have been prepared which would remove the March 31, 1978, deadline for requesting such waivers. The Department also is considering amending the regulations to require recipients to submit plans, timetables, and progress reports as preconditions for waivers.

CHAPTER 3

BETTER DATA NEEDED ON STATUS OF

REVENUE SHARING AUDITS

ORS records and information obtained from our sample of governments differ in some important respects, but both show that few revenue sharing recipients have submitted acceptable audit reports to their State governments or to ORS. Since a very large proportion of the recipients will probably obtain audits of financial operations for fiscal year 1979--the last year of the 3-year audit period--ORS will likely be inundated with audit reports over the next year.

To handle this large influx of audit reports, it is important that ORS' system of controls monitor the recipients' audit status accurately. We identified major weaknesses, however, in ORS' statistical control system that must be corrected.

ORS MONITORING AND STATISTICAL CONTROL SYSTEMS SHOULD BE IMPROVED

ORS has developed a computerized statistical control system to keep records of those governments that have completed financial and compliance audits. ORS receives audit data for this system from two sources: State audit agency listings and recipient government audit reports. The listings are submitted by State agencies that have agreed to perform revenue sharing audits or review public accounting firm audits and to provide periodic listings of the results. If compliance violations are found, States also submit copies of the audit report to ORS.

In States where no agreements exist, local governments send audit reports directly to ORS. ORS then performs desk reviews which include evaluations of whether (1) generally accepted auditing standards of reporting were used, (2) all funds were covered, and (3) compliance audits were performed.

In March 1979 ORS' computerized statistical control system showed that 821 out of 12,236 local governments had submitted audits to their State governments or to ORS. As the following table illustrates, the system showed that ORS received 566 audit reports directly and obtained information on another 255 audits from listings submitted by various State agencies. Of the 821 audits, ORS considered only 402 acceptable.

	<u>Reports/listings received by ORS</u>		<u>Total</u>	<u>Reports/ listings not received by ORS</u>	<u>Total govern- ments to be audited</u>
	<u>Accept- able</u>	<u>Unaccept- able</u>			
Audit reports submitted by recipient governments (note a)	242	324	566	(unknown)	(unknown)
Audit reports on listings submitted by State agencies (note a)	<u>160</u>	<u>95</u>	<u>255</u>	(unknown)	(unknown)
Total	<u>402</u>	<u>419</u>	<u>821</u>	<u>11,415</u>	<u>12,236</u>

a/Represents total governments and excludes multiple audit reports submitted for the same government.

Subsequent to our field work, ORS reinterpreted its regulations and determined that the number of governments subject to the audit requirement decreased to 10,946. Formerly, audit submission was understood to be required if a recipient received \$25,000 or more during at least one of its fiscal years ending in 1977, 1978, or 1979. ORS recently determined that audit submission is required only if the recipient received at least \$25,000 in each of these 3 fiscal years.

As of January 31, 1980, ORS' statistics showed that 4,138 out of 10,946 governments had submitted reports to their State government or to ORS. Of these, ORS determined that 2,589 had fully complied, 1,102 partially complied, and 447 had submitted unacceptable audit reports.

Many audits are not
included in ORS statistics

An accurate and complete statistical control system is essential to properly administer the audit requirements applicable to about 11,000 recipient governments. Such a system is needed to:

- Ascertain how many and which recipients have met the audit requirements.

--Warn recipients that their revenue sharing funds may be withheld unless acceptable audits are submitted.

--Prevent erroneous warnings that revenue sharing funds may be withheld from governments that submitted acceptable audit reports.

We found that ORS statistics, however, did not accurately show the actual status of recipients' audits. As of March 1979, the statistics did not include 741 audit reports appearing on listings submitted by the 14 State audit agencies that ORS concluded were not following generally accepted auditing standards (these are discussed in chapter 2). We believe that audit reports from these 14 agencies should be included in ORS' statistics as unacceptable.

ORS' statistics were further understated because ORS had not included data from six approved State audit agencies that provided listings which did not follow ORS' prescribed reporting format. As of March 1979 ORS had received such listings containing at least 180 governments (we could not determine the exact number because ORS had misplaced listings from 1 of the 6 State agencies). Although these listings did not contain all the information ORS needed, e.g., scope of audits, fiscal year audited, etc., they should have been included in the statistics under a category requiring further action because many of the audits reported on these listings may satisfy the audit requirements. ORS should take steps to ensure that States use the proper reporting format or that they send the reports directly to ORS.

We also found that ORS statistics did not include audit reports that did not express opinions because of the governments' unauditability. Only three such reports were received as of March 1979, but the number received in the future could be substantial. ORS should maintain records on these governments for use in future followup actions.

ORS' backlog of desk reviews is growing

ORS performs desk reviews of audit reports that it receives. These reviews include evaluations of whether generally accepted auditing standards of reporting were used, all funds were covered, and compliance audits were performed.

Although ORS had received relatively few audit reports, its backlog of desk reviews had grown dramatically in the last year. As of March 1979 ORS had performed 566 desk reviews, and the backlog was 539 or almost one-half of all reports received. The backlog for June 1978 was only 96.

Although desk reviews were initially a lower priority than reviews of State audit agencies and public accounting firms, ORS officials planned to place more emphasis on desk reviews in the future. These officials expected a deluge of recipients' audit reports covering fiscal year 1979 financial statements, but they did not know when the flood would begin, since regulations did not stipulate when the audits must actually be performed.

Further, ORS had not determined how many audit reports it will receive directly from recipients. This is a necessary first step in projecting future workloads. Officials made a rough estimate that about 6,000 reports will require desk reviews or about 10 times the number of reports ORS had reviewed to date. It will be difficult for ORS to shift its priorities in time to accommodate the increased workload.

ORS is unaware of the States' audit status

ORS has the responsibility of monitoring the audits of State governments. At the time of our review, ORS did not include State governments in its computerized statistical control system. As a result, ORS could not readily monitor the status of State audits.

Under provisions of the amended Revenue Sharing Act, a State or local government is allowed to have a series of audits if, over a 3-year period, it covers all of the government's various funds and accounts. Since States have numerous departments, agencies, and fund accounts, most States have selected the series of audits approach.

To monitor these States' audits, ORS must (1) determine which States have chosen the series approach, (2) obtain listings of the subunits, or departments, agencies, etc., which constitute the series, and (3) receive periodic status reports on which subunits have been audited.

ORS initially sent letters to all States requesting this data and later started obtaining the information during its followup reviews at State agencies. As of March 1979, however, ORS did not know whether the series approach was selected or which subunits would constitute the series for 20 State governments.

Officials from four States in our sample--Massachusetts, Nevada, Texas, and Vermont--told us they intended to use a single audit in lieu of a series of audits to meet the revenue sharing audit requirements. ORS was only aware of Nevada's and Vermont's plans. Further, our review showed that Texas' single audit of the State Comptroller's Office did not meet

the audit requirements since all State funds were not included. All funds would be audited, however, during the 3-year period if Texas follows its State audit laws and audit policies, but ORS would not be able to monitor Texas' audit status because ORS did not have an inventory of Texas departments and agencies with which to follow the State's progress.

Three States we visited planned series of audits. California and Kentucky had notified ORS of their plans, but Ohio had not because a study was still underway to determine which funds had to be audited.

OTHER SYSTEM WEAKNESSES

We noted other system weaknesses which need to be corrected before the deluge of audit reports begins. When audit reports were received, they were not logged in the computerized statistical control system. A manual log was recently developed, but there were no procedures for cross-checks with the computerized statistical control system for flagging any misplaced reports or completed desk reviews which might not be key-punched into the computer system.

The statistical system also had no controls to prevent acceptance of reports from public accounting firms which ORS had concluded were not following generally accepted auditing standards. Since public accounting firms often audit more than one local government, a report submitted by a public accounting firm cited by ORS for not following accepted standards could pass a desk review before the firm's deficient auditing practices were corrected.

We found that recipients were not notified if audits performed on them by public accounting firms were found deficient during desk reviews. ORS wrote letters to the public accounting firms requesting plans for corrective action and scheduled followup visits to verify that deficiencies were corrected. The recipient governments, however, may be unaware that they failed to meet the revenue sharing audit requirements because their audits were unacceptable.

CONCLUSIONS

Since the first 3-year audit period had not expired at the time of our review, few recipients had submitted acceptable audit reports. Therefore, we could not project the extent of compliance with the audit requirements or evaluate ORS' enforcement procedures. Such an evaluation will not be possible in the future until ORS regulations are expanded to include a specific date by which audit reports must be submitted.

ORS statistics for monitoring the audit status of revenue sharing recipients were inaccurate and incomplete. ORS had not established proper controls to ensure that all audits were recorded.

Although it had received few audit reports, ORS had accumulated a substantial backlog of reports to be reviewed. With the expected influx of audit reports in the near future, it is important that all statistical control system weaknesses be remedied and a high priority be given to the timely review of submitted reports.

RECOMMENDATIONS TO THE SECRETARY OF THE TREASURY

In order to improve ORS' monitoring of the revenue sharing audit requirements, we recommend that the Secretary of the Treasury

--amend ORS regulations to establish a time limitation for submitting audit reports, and

--ensure that ORS' statistical control procedures be changed to properly account for all audit and series of audit reports.

AGENCY COMMENTS

The Department of the Treasury in commenting on this report (see appendix II), reported numerous corrective actions taken to improve ORS' statistical control system. ORS believes these changes make ORS' audit statistics more accurate and complete.

Further, ORS has established a time limitation of September 1980 for submitting audit reports. If ORS is not advised when the audit report will be submitted, the recipient's entitlement payment will be temporarily withheld.

ORS believes it can eliminate its backlog and process all audit reports it receives by September 1980. If not, ORS has a contract with a public accounting firm to assist in the review process.

CHAPTER 4

SCOPE OF REVIEW

We visited the State government and 54 local governments in California, Kentucky, Massachusetts, Nevada, Ohio, Texas, and Vermont to determine the status and cost of revenue sharing audits. We identified corrective actions taken to solve auditing standards problems in 12 States--Delaware, Indiana, Iowa, Massachusetts, Maine, New Hampshire, New York, Ohio, Oklahoma, Rhode Island, West Virginia, and Wyoming. We also evaluated efforts of six States--California, Hawaii, Indiana, New York, Ohio, and Wyoming--to obtain independent audits.

We visited 19 public accounting firms in Alabama, Connecticut, Kentucky, Maine, Mississippi, New Hampshire, Oklahoma, and Texas to determine the status of ORS-reported deficiencies in their auditing standards. We also held discussions with officials of four local governments to ascertain the progress these governments have made toward becoming auditable.

We gathered statistical data on completed audits at ORS headquarters in Washington, D.C. We also cross-checked data obtained at the governments we visited with ORS records and files.

The first 3-year revenue sharing audit period began on January 1, 1977. Our fieldwork was completed in March 1979 before the 3-year period was completed. We therefore could not project the extent of compliance with the audit requirements or evaluate ORS' enforcement procedures.

SUGGESTED REVISIONS TO THE STATE AND LOCAL
FISCAL ASSISTANCE ACT OF 1972, AS AMENDED

We suggest that section 123(c)(5) of the act be amended to read as follows:

Sec. 123. MISCELLANEOUS PROVISIONS.

(c) ACCOUNTING, AUDITING, AND EVALUATION.

(5) WAIVER.--The Secretary may waive the requirements of paragraph (1) or paragraph (2), in whole or in part, with respect to any State government or unit of local government for any fiscal period as to which he finds (in accordance with regulations prescribed by the Secretary) (A) that the financial accounts of such government for such period are not auditable, and that such government demonstrates substantial progress toward making such financial accounts auditable, or (B) that such government is audited by a State audit agency which does not follow generally accepted auditing standards or which is not independent provided that such State audit agency demonstrates progress toward meeting generally accepted auditing standards or becoming independent.



DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

March 6, 1980

Dear Mr. Voss:

Secretary Miller has asked me to respond to your letter of January 9, 1980 requesting comments by Treasury on your draft report to Congress entitled "Revenue Sharing Act Audit Requirements are Improving Audits of State and Local Governments."

The GAO staff who conducted the review of the Audit Division of the Office of Revenue Sharing (ORS) did an excellent job of summarizing the vast amount of detail that it was necessary to review. I am generally in accord with the findings and recommendations contained in the proposed report with some exceptions, which I note below.

Before I turn to my review of your report, a few comments on the audit requirement are in order. The general administrative philosophy of ORS in implementing the audit requirement has been to proceed at a deliberate speed. Accordingly, the emphasis to date has been on working with the State Auditors and independent public accountants (IPA's) to upgrade their audit practices. This process has included quality-control reviews by ORS audit staff. The approach has been constructive by encouraging State officials to make changes in their audit practices that might not otherwise have been made. This is recognized in your report. I think these efforts have made a substantial contribution to the improvement of the quality of State and local governmental auditing.

The audit requirement has produced other benefits as well. One of the major pieces of information generated so far is the surprisingly large number of governments whose financial statements are reported in conformance with generally accepted accounting principles (GAAP). Of the 4,138 governments whose audit reports had been reviewed by ORS through January 31, 1980, some 2,208, or 53 percent, were on a GAAP basis of accounting. This is a much higher percentage than had been expected by the ORS audit staff or outside observers. While it is unlikely that this ratio will be maintained in the remaining reports to be filed this year, the ORS audit staff notes that the ratio of

reports submitted on a GAAP basis of accounting has been remarkably consistent since reports were first received. Another interesting statistic is that only 9 percent of the audits reviewed by OPS through January 31, 1980 have been found to be unacceptable. Further, only 11 governments to date have been found to have unauditible books. These are far lower figures than had been anticipated, and appear to be a favorable comment on the status of State and local accounting.

My detailed comments on your report are set forth below. They are of two types: those responding to your recommendations, and those updating the status of items and statistics contained in your report. I believe you will find that most of the areas in which the report indicates that improvement is needed have been brought to a satisfactory status subsequent to the completion of your field work, and that the remainder are in the process of being corrected. I commend you and your staff for this helpful and cooperative approach to its review responsibilities.

Monitoring and Statistical Control Systems

The draft report notes, on pages 23-28, several problems with the ORS system of monitoring the number of audits received. Statistical-control information on audits received by ORS has been upgraded substantially since GAO staff visited ORS in March 1979. In May 1979, ORS completed implementation of a computerized statistical-control system that furnishes current data vital to the management of the audit program.

The new statistical controls, the Audit Reporting System (ARS), provide the following improvements, some of which relate to matters questioned in your report:

- The reporting of audits made on listings by State Auditors is now in the ARS on a current and accurate basis.
- Data regarding the status of State audits are now in the ARS. Almost all State Auditors have furnished the components of their "Series of Audits to ORS." In addition, each State Auditor was sent a letter in January 1980 inquiring whether his or her State would submit either a series of audits or a single audit to satisfy the requirement.
- Audit reports are now logged into the ARS as received and are assigned an identifying number.

- Information identifying unauditible recipients is now in the ARS.
- A complete record of each government that is required to have an audit is also in the ARS. This record is in the form of a specific listing for each recipient.
- Information is generated by the ARS in the form of a monthly report. Reports can be produced more frequently if necessary.

It is our view that the ARS now provides a monitoring and reporting capability that satisfies the issues raised in your draft report.

Status of Compliance

Your report suggests, as have other observers, that many governments may not be able to complete acceptable audits in a timely manner. The evidence to date suggests otherwise. A review of the status of compliance with the audit requirement as of January 31, 1980, is set forth in Table 1. These data also demonstrate the capability of the ARS.

Several comments are in order regarding the data. First, the number of governments subject to the audit requirement is 10,946. This is somewhat lower than the figure of 12,000 that has been previously used and reported in the press. The figure has been revised because the interpretation of the regulations has been changed as to what governments must submit an audit. Formerly, audit submission was understood to be required if a recipient received \$25,000 or more during at least one of its fiscal years ending in 1977-79. ORS recently determined, with the concurrence of its Chief Counsel, that audit submission is required only if the recipient received \$25,000 in each of its fiscal years ending in 1977, 1978, and 1979. Thus, the 10,946 is somewhat lower than previously cited figures.

Second, as can be seen, differences exist between the number of audits and the number of governments reporting. The variation exists for several reasons, including:

- Most State governments are submitting an audit for each fund. More than 100 separate audits have been received from some States to satisfy the requirement.

TABLE 1
STATES OF COMPLIANCE OF
RECIPIENTS WITH AUDIT REQUIREMENT
AT JANUARY 31, 1980

			Totals	
	Audits	Governments	Audits	Governments
Governments subject to the audit requirement	-		-	<u>10,946</u>
Governments reporting and audits reviewed through September 30, 1979:				
	<u>Audits</u>	<u>Governments</u>		
Fully complied	2,139	1,543		
Partially complied	1,561	1,044		
Unacceptable	<u>521</u>	<u>416</u>		
Subtotals	4,221	3,003	4,221	3,003
	=====	=====		
Governments reporting and audits reviewed between October 1, 1979 and January 31, 1980:				
	<u>Audits</u>	<u>Governments</u>		
Fully complied	1,664	1,046		
Partially completed	336	58		
Unacceptable	<u>49</u>	<u>31</u>		
Subtotals	2,049	1,135	<u>2,049</u>	<u>1,135</u>
	=====	=====		
Totals			<u>6,270</u>	<u>4,138</u>
			=====	=====
Governments not yet reviewed by January 31, 1980	-		-	<u>6,808</u>
				=====
Audits received and entered in ARS through January 31, 1980, but not recognized above	2,577		2,577	1,700*
Governments that have not yet reported	-		-	<u>5,108</u>
				=====

Source: ORS Audit Reporting System.

*OPS estimate.

- A local government may submit an audit for its general fund, a separate compliance audit, and additional audits for its enterprise funds. Some localities have combined the compliance and financial audits in one report. It is difficult to predict how many audits a government will submit because frequently the auditors only decide this during or after completion of the audit. For this reason, ORS has made no attempt to predict the number of audit reports to be received.
- Some governments that complied in 1977 or 1978 have submitted audits for succeeding years. ORS reviews these audits for compliance.

Third, partially completed audits do not necessarily indicate failure to comply. Under the Act, recipients can submit a series of audits over the three-year period. This is particularly true of State governments, most of which are submitting separate reports for each of their many departments.

Fourth, unacceptable audits do not imply unauditability. (Unauditable governments are discussed below.) Rather, unacceptable audits mean one or more departures in the audit report from generally accepted auditing standards. When this has occurred in the past, corrective action has been to inform both the recipient and its independent auditor that the report was unacceptable. The recipient was also told that it had up to 60 days to make arrangements to correct the deficiencies. Because recipients were slow in taking corrective actions, ORS has recently adopted a new policy. Now, if positive steps to correct the audit are not initiated and so communicated to ORS, letters are sent informing recipients that entitlement funds will be withheld in the future if action is not started within 60 days to correct the reports.

Fifth, as noted above, only 11 governments were identified as having unauditible books by January 31, 1980. Corrective procedures to remedy unauditible books are discussed later in this letter. Because their books were unauditible, the 11 governments did not submit audit reports, and thus are not included in the statistics in Table 1.

More fundamentally, of the 10,946 recipients that must submit audits, roughly half--in 25 States--will be reports submitted through State Auditors. ORS estimates this at approximately 5,500 recipients and 7,500 audits. ORS had determined, through a series of quality-control reviews, that these State Auditors' practices were of a high enough quality that the State Auditors could review the reports for compliance instead of ORS. Thus ORS will not have the burden of reviewing these audits for compliance. Instead, ORS will be supplied by the State Auditor with a list including:

- the name of the government,
- what year the audit was done for,
- what funds were covered by the audit,
- who did the audit (State Auditor or IFA),
- whether the audit is in accordance with GAAS and GAAP, and
- whether there was a compliance audit.

By January 31, 1980, some 3,630 of these reports had been submitted by State Auditors and another 513 had been received but not processed, for a total of 4,143. This is 55 percent of the expected total of 7,500 audits.

In addition to the computerized statistical control system, ORS conducted a special telephone survey during October and November 1979 to determine the audit plans of the 150 cities and counties receiving the majority of Revenue Sharing funds. These cities and counties, in conjunction with State governments, receive approximately 60 percent of the total Revenue Sharing funds. As of January 31, 1980, fully acceptable audit reports have been submitted by 52 of the 150 governments, and partially acceptable audit reports have been submitted by 27 governments.

While not required under the statute, still another interesting figure is the number of governments on a GAAP basis of accounting. As noted earlier, at January 31, 1980, of 4,138 governments reports reviewed, 2,208 (53 percent) are on GAAP, 1,196 (29 percent) are on cash basis of accounting, and 734 (18 percent) utilize other methods.

Backlog

Your draft report also comments on the capability of ORS to review the remaining audits. First, pages 25 and 26 indicate that a deluge of audit reports will descend on ORS and strain its systems beyond the breaking point. Second, you state on page 26 that ORS has not determined how many audit reports it will receive directly from recipients.

The massive backlog projected in your report does not exist now. These views are well supported by Table 1, which shows details of the status of compliance on January 31, 1980. The figures also should allay the concern expressed by others that many governments will not comply with the audit requirement.

- By the end of Federal FY 1979, 3,003 recipients had submitted all or parts of their audits pursuant to the requirement. All of these audits have been reviewed by ORS.
- In the four months ending January 31, 1980, another 1,135 recipients submitted audit reports that have been reviewed by ORS. Thus, a cumulative total of 38 percent of all governments that must submit an audit have already done so.

Therefore, entering what has been described as the deluge period, ORS has already processed 4,138 (or 38 percent) of the governments that must submit audits. While the actual number of audits received is substantially larger than the number of governments--6,270 compared with 4,138--it indicates the progress the ORS audit staff has made. It should be recognized that of this amount--6,270 audits--some 2,640 have been processed by ORS and 3,630 by State and independent auditors. However, the ORS audit division is involved in continual quality-control checks of State Auditors.

Let me now review how ORS proposes to manage the review of the remaining audits to be submitted. First, it is important to determine the approximate number of audits remaining to be submitted under the Act. ORS, has estimated the number of audits to be received, as set forth below:

Estimate of audits to be received by ORS directly under the Act.	7,500 ^a
Less: Audits received and reviewed by ORS through January 31, 1980.	2,640
Audits to be reviewed by Deloitte, Haskins & Sells	<u>800^b</u>
Estimate of remaining audits to be reviewed by ORS under Act.	4,060 =====

^aAs discussed elsewhere, 5,500 governments will submit their audits--numbering an estimated 7,500--through State Auditors. Thus, ORS must review only the remaining governments, half the 10,946 total, or approximately 5,500 also anticipated to have 7,500 audits.

^bOf this amount, 123 audits had been reviewed by January 31, 1980.

Based on the estimated 4,060 audits remaining to be reviewed, ORS projects it can review 500-600 a month, thus completing the review by the end of Federal FY 1980. As a contingency measure, if a backup occurs, ORS is considering extending its contract with Deloitte, Haskins & Sells, a nationally recognized CPA firm that is currently reviewing 800 audits.

We believe that a September 1980 completion date for ORS audit review is reasonable. Forty-four percent of recipients' fiscal years end in December alone. Set forth below is percentage breakout indicating the month in which Revenue Sharing recipients' fiscal years end:

<u>Month</u>	<u>Percentage</u>	<u>Month</u>	<u>Percentage</u>
January	0.2	July	0.6
February	.6	August	.5
March	2.9	September	9.3
April	3.6	October	.5
May	1.6	November	1.1
June	33.5	December	44.0
		Unknown	1.6
			<u>100.0%</u>

Well over half of the recipients' fiscal years end after June 30. Thus, in many cases, local government audits for fiscal year 1979 will not be completed until late spring or summer. It is quite normal for an audit to take six months to be completed. If the audit is being prepared in late winter, when many private accountants are especially busy with tax work, nine months may not be unreasonable. Moreover, many of the audits to be filed will be the jurisdictions' first ever, and allowance of additional time appears reasonable for such cases. This is particularly true for the 44 percent of the governments whose fiscal years end on December 31.

While a backlog of 2,577 audits existed on January 31, 1980, ORS currently estimates that these reports will be managed in an orderly fashion.

As indicated in the table below, the audit-review rate reached a reasonable level during January.

AUDIT REVIEWS COMPLETED - FY 1980 TO DATE

<u>Oct.</u>	<u>Nov.</u>	<u>Dec.</u>	<u>Jan.</u>
23	173	175	439

Additionally, production during the past several weeks has been 147 for the week ending February 1, 210 for the week ending February 8, 162 for the week ending February 15, 93 for the week ending February 22 (a four-day week), and 163 for the week ending February 29. Thus, based on this recent performance, it is not unreasonable to conclude that ORS can successfully review the audits expected to be submitted in the coming months.

Waivers of Audit Requirements

Assuming renewal of the Revenue Sharing Program, I concur with the recommendation on page 22 of your report that the Act be amended to authorize the granting of waivers to governments audited by State agencies whose audit practices are not currently of an acceptable standard, when the agencies are making substantial progress in the implementation of improvements that will correct the deficiencies. To deal with these situations, we have allowed some State auditors additional time to provide acceptable audits for fiscal year 1979. Under current arrangements, the agencies that have been given extensions have agreed to submit audits for FY 1979 and 1980. However, we agree with you that a preferable solution would be to allow ORS the discretion to waive the audit requirements in cases where substantial progress is being made.

Any such amendment should clearly stipulate that the waiver will only apply to the audit requirement for the three-year period ending in fiscal year 1979. The government should be required to have a GAAS audit for the fiscal year ending in 1980 unless the Secretary is convinced that reasonable progress in upgrading the standards of the cognizant State agency requires additional time.

We agree with your recommendation to eliminate the deadline for applying for a waiver because of unauditible records. ORS has already taken action to change this; on December 31, 1979, draft regulations were published that, among other things, remove the March 31, 1978 deadline for requesting such waivers.

Procedures that require an unauditible recipient to submit plans, timetables, and progress reports are contained in the Revenue Sharing Audit Guide rather than in the Revenue Sharing regulations. All 11 of the recipients that have been granted waivers are observing these procedures, and their progress is being monitored by the ORS Audit Division. It would, therefore, be a simple matter to include the Audit Guide requirements in the Revenue Sharing regulations.

Communications With Recipients

Your draft report indicates, on page 18, that some recipients are unsure whether a compliance audit is necessary. Other concerns are also voiced regarding ORS' communication with State and local governments.

Recipients were sent copies of interim audit regulations as early as 1977. Periodically, letters accompanying quarterly payments to recipients have also notified them of the audit requirement, including notice of the need for a separate compliance audit. To avoid any confusion or misunderstanding among recipients, ORS recently sent reminder letters to all recipients whose audits are not made by a State auditor advising them of the audit requirement and requesting that they furnish an audit report to ORS by March 1, 1980, or advise when a report will be submitted. They were also informed that the audit report must be submitted no later than September 1, 1980, and that, if a reply was not received by March 1, 1980, subsequent entitlement payments will be withheld until acceptable audit reports or audit plans are received.

Replies to these letters are being entered in the computer and will provide, for the first time, complete information on the status of compliance with the audit requirements of the Act. The early response to these letters has been very positive. A total of 319 governments submitted audit reports during the week of February 12.

Your report also notes on page 27 that recipients have not been notified if audits performed by IPA's have been found deficient by ORS. Previously, this was correct but ORS policy has since been changed to notify the recipient, as well as the IPA, of unacceptability. We are also in the process of notifying recipients whose reports are acceptable.

Letters have recently been sent to State auditors containing lists of recipients for which an approved audit report has not been received and which they will audit, or whose IPA report they will review. The letters request them to advise ORS within 10 days whether an audit has been made or will be made.

Acceptance of State Auditors' Reviews of Independent Public Accountants Audit Reports

Your draft report says on page 25 that, if a State auditor's practice is unacceptable, ORS does not accept IPA audits submitted to ORS by these unacceptable State auditors.

This is not the case. The audits of local governments performed by the State are considered unacceptable; however, IPA-performed audits of local governments are considered acceptable.* The IPA's have been subjected in the past to quality-control reviews on a selected basis. Quality-control reviews of the unacceptable State audit agencies are conducted at least annually. Part of this review process involves a review of the State auditor's practices in reviewing IPA-performed-audit reports. Deficiencies found in a State's review process are included in the ORS letter-report issued to the State auditor following the conclusion of the review, together with recommendations for improvement. It is anticipated that all State auditors will eventually perform completely acceptable reviews of IPA-performed audits.

Independence

All of the problems of independence of the six State Auditors mentioned on pages 10-13 of your report have been resolved. In most cases, either IPA's were retained to audit the funds in question or the State audit-function was reorganized to provide the necessary independence. Concerning the State of New York, the panel was formed to arbitrate a difference of opinion between the State Comptroller and ORS. The State of New York has agreed to retain independent auditors to audit the funds in question. These audits are currently in progress. In Ohio, plans call for retaining a private firm to review all accounts maintained by the State auditor. Indiana recently changed its law to require the State Auditor to report directly to the State Legislature in performing the Revenue Sharing audit.

Update of Statistics as of January 31, 1980

Updates of statistics in your report are discussed below. Twenty State audit agencies in 17 States have been found to have unacceptable practices. Another three audit agencies complied with GAAS, but had unauditible records or State laws precluded auditing of all funds. Of these, eight have brought their practices to an acceptable status and two have engaged IPA's to conduct their audits. All of the remaining 13 have programs in progress geared towards bringing their practices to an acceptable status no later than December 31, 1981. It was necessary to grant this extension of time in order to allow States to hire personnel, establish training programs, and develop internal procedures.

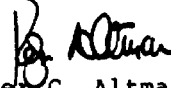
Of the 217 quality-control reviews of IPA's conducted by January 31, 1980, 90 were found to be unacceptable. Replies have been received from 85 indicating that corrective action is

*GAO note: This procedure was not being followed at the time of our review. The material referred to was deleted from this report.

being taken. Two have been referred to the American Institute of CPA's, one was referred to a State Board of Accountants, and two IPA's have not yet replied.

If you have further questions or need any additional information with regard to the matters discussed above, please do not hesitate to so advise me.

Sincerely,



Roger C. Altman
Assistant Secretary

Mr. Allen R. Voss
Director
U. S. General Accounting Office
Washington, D.C. 20548

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