

December 1985

FINANCIAL INTEGRITY ACT

The Government Faces Serious Internal Control and Accounting Systems Problems



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United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-216946

December 23, 1985

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

The Federal Managers' Financial Integrity Act of 1982 (31 U.S.C. 3512(b) and (c)) requires department and agency managers to identify internal control and accounting systems weaknesses that can lead to fraud, waste, and abuse in government operations. The act requires federal managers to correct the weaknesses and to report annually to the President and the Congress on their progress. The legislation provides an important impetus to the restoration of the public's confidence in the financial management of its government.

Agency reports made pursuant to the act, agency inspector general audits, and GAO reviews show that widespread and often long-standing weaknesses and breakdowns in agency internal controls continue to result in wasteful spending, poor management, and losses involving billions of dollars of federal funds. The weaknesses have also made outright fraud more feasible. Inadequate agency accounting systems and financial reports have contributed to the government's dilemma.

This report, GAO's second governmentwide report on the act, provides an overall perspective on the internal control and accounting systems problems facing the government and highlights problems which have hindered agencies' efforts to implement the Federal Managers' Financial Integrity Act.

We are sending copies of this report to the Director of the Office of Management and Budget. Because the report discusses information that should be useful to all agencies, we are also sending copies to the heads of federal agencies and are asking them to make a concerted effort to strengthen their internal control and accounting systems.

Charles A. Bowsher
Comptroller General
of the United States

Executive Summary

Fraud, waste, and abuse in federal activities and programs lead to the loss of billions of dollars of government funds, erode public confidence, and undermine the federal government's ability to operate effectively. Continuing concern over the poor condition of government internal control and accounting systems led the Congress to pass the Federal Managers' Financial Integrity Act of 1982.

Strengthening internal control and accounting systems and improving government financial management is one of GAO's top priorities. GAO has reviewed the act's implementation at 23 agencies which account for over 95 percent of federal expenditures. This second overall report on the act summarizes GAO's views on the internal control and accounting systems problems facing the government.

Background

The act requires that agency heads annually report to the President and the Congress whether their internal accounting and administrative control systems comply with the Comptroller General's internal control standards and provide reasonable assurance that

- obligations and costs are in compliance with applicable law;
- funds, property, and other assets are safeguarded; and
- revenues and expenditures are properly recorded and accounted for.

The act requires that each agency evaluate its internal control systems in accordance with guidelines prescribed by the Office of Management and Budget (OMB) and report annually any material internal control weaknesses together with plans for correction. The annual report must also include whether the agency accounting system conforms to the Comptroller General's accounting requirements.

Results in Brief

Agency reports under the Federal Managers' Financial Integrity Act, inspectors general audits, and GAO reviews continue to show that weaknesses and breakdowns in agency systems of internal control frequently result in wasteful spending, poor management, and losses totaling billions of dollars. In some cases, outright fraud has occurred, and, in others, the government's ability to carry out crucial public services has been hampered. Serious internal control problems continue in a wide range of areas, such as weapons systems procurement, social security, debt collection, property management, and automated data processing (ADP). Adding to the government's dilemma is the overall poor condition of agency accounting and financial management systems. Many systems

neither conform to the Comptroller General's accounting requirements nor provide the financial information needed to manage the government efficiently and effectively. (See chapter 2.)

While agencies generally identified their problems, their annual reports to the President and the Congress do not always provide an accurate, clear assessment of the overall status of their systems. (See chapter 3.) Agencies' programs to evaluate their internal control and accounting systems have improved since 1983 but need further strengthening to ensure that existing weaknesses are corrected, and additional weaknesses are identified. (See chapter 4.)

Principal Findings

Weaknesses Affect Federal Programs

Continuing weaknesses in agency internal control and accounting systems, many of which are long-standing, have a profound effect across the spectrum of government programs and operations. For example, agencies disclosed weaknesses that resulted in

- overpricing of spare parts and cost growth in the Defense Department's \$100 billion procurement program;
- increased vulnerability to failure and fraud in systems which processed over \$174 billion in social security benefit payments;
- over \$17 billion in delinquent debts, or 92 percent of the government's nontax delinquencies, being handled by collection systems which agencies acknowledge to have serious problems;
- inadequate accountability for billions of dollars of government property;
- increased vulnerability to fraud, waste, and abuse in ADP systems which make payments to millions of beneficiaries and process billions of dollars; and
- individuals using federally insured single-family mortgages to defraud the government.

Although conformity with the Comptroller General's accounting requirements was mandated by the Congress 35 years ago with the passage of the Accounting and Auditing Act of 1950, the agencies reported that 226 of 427 accounting systems, or 53 percent, were not in conformance or not known to be in conformance with the Comptroller General's requirements. Billions of dollars are not being adequately accounted for, managed, or financially controlled. (See pp. 17-20.)

**Progress Toward
Strengthening Systems**

Agencies are working to strengthen their internal control and accounting systems and have reported correcting a number of material weaknesses. Across the board, GAO sees a wide range of initiatives to design and implement new or enhanced systems and to strengthen financial management. Agencies have also reported having corrected thousands of less serious weaknesses which, though not individually material from an agency perspective, were collectively important and could have led to fraud, waste, and abuse. However, while there has been progress, GAO believes it will be some time before the government as a whole has adequate systems. The remaining problems are severe and may take considerable time to fully correct. Agency improvement efforts must be sustained and serious long-standing problems resolved. (See pp. 25-30).

**Inadequate Basis for
Reporting**

At the end of 1984, twelve agencies, which spent an estimated 55 percent of the federal budget in fiscal year 1985, stated that they had reasonable assurance their internal control systems, taken as a whole, met the act's requirements—despite the seriousness of the problems highlighted in their annual reports. GAO disagrees with all of these agencies' reports because (1) their programs to evaluate internal control systems had not yet evolved to the point that the agencies knew whether controls over many major programs and operations were adequate, and (2) serious uncorrected internal control and accounting system weaknesses remain. GAO attributes the reporting problem primarily to OMB's not having changed its reporting guidance as recommended last year by GAO and the House Committee on Government Operations, and to the agencies continuing to follow OMB's lead. (See pp. 34-39.)

**Problems in Evaluating
Systems**

GAO also noted a number of problems in agency programs to evaluate their internal control and accounting systems and made recommendations for improvement in individual reports to the agencies. The four most important actions to be taken are to (1) increase system testing, (2) review ADP controls, (3) reevaluate the approach for assessing internal controls, and (4) eliminate the paperwork burden associated with agency system evaluation efforts. GAO generally concurs with recommendations made by the President's Council on Management Improvement, which studied ways to streamline the internal control evaluation processes and to reduce paperwork. (See pp. 46-56.)

Recommendations

GAO is essentially restating to the Director of the Office of Management and Budget, the recommendations GAO made last year regarding the

need to strengthen annual reporting guidance and to provide additional guidance on evaluating ADP controls.

Agency Comments

OMB believes that it has already provided adequate guidance on annual reporting. GAO and OMB continue to disagree on this matter, but are in full agreement as to the high priority that must be placed on strengthening internal control and accounting systems and the need for sustained agency improvement efforts. OMB recognizes the need for more agency progress in evaluating ADP controls and stated it would work closely with the agencies to develop ADP evaluation methodology. (See pp. 43-44 and 52.)

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Abbreviations

ADP	automated data processing
DLA	Defense Logistics Agency
EPA	Environmental Protection Agency
FMS	foreign military sales
GAO	General Accounting Office
GSA	General Services Administration
HHS	Department of Health and Human Services
HUD	Department of Housing and Urban Development
IRS	Internal Revenue Service
NASA	National Aeronautics and Space Administration
OMB	Office of Management and Budget
SBA	Small Business Administration
SSA	Social Security Administration
VA	Veterans Administration

Introduction

The Congress, in September 1982, enacted the Federal Managers' Financial Integrity Act of 1982 (31 U.S.C. 3512 (b) and (c)). (See appendix I.) The goal of this legislation is to reduce fraud, waste, and abuse, and improve management of federal operations by strengthening internal control and accounting systems. The act was passed in response to continuing disclosures of fraud, waste, and abuse across a wide spectrum of government operations and to concern over the inadequacy of the government's internal control and accounting systems.

Taxpayers continue to read of overcharges for goods and services, cost overruns, overpayments, the purchase of faulty equipment, and a host of other problems related directly to inadequate government internal control and accounting systems. These problems, which have been the subject of numerous GAO and other reports over many years, cost the taxpayer billions of dollars, impede federal program operations and the delivery of services, and erode the public's confidence in its government. Pressures on the government to operate more efficiently and effectively have continued to build as our national debt has risen from \$914 billion in 1980 to over \$1.8 trillion today.

This report consolidates and highlights information on efforts to improve government control and accountability, contained in federal agencies' annual statements under the act and in individual reports we issued to 23 agencies. In this report, we seek to further demonstrate (1) the significance of internal controls in efficiently and effectively administering federal programs and operations and (2) the importance of federal agency accounting systems in providing a foundation for reforming the government's financial management structure.

Chapter 2 discusses the internal control and accounting systems problems facing the government and the corrective actions taken or planned to date. Also, it summarizes our views on what future actions are needed to successfully strengthen internal control and accounting systems. Chapter 3 contains our observations on the adequacy of agency annual reporting to the President and the Congress on the status of their systems, while Chapter 4 provides our overall view of agencies' efforts to evaluate their systems.

Requirements of the Act

The Federal Managers' Financial Integrity Act states that primary responsibility for adequate systems of internal control and accounting rests with management. It requires that agency heads prepare annual

statements on the status of their internal control and accounting systems. The act also holds managers accountable for the correction of identified weaknesses.

Section 2 of the act requires that agency systems of internal accounting and administrative control, which encompasses all facets of management control, be evaluated in accordance with guidelines established by the Office of Management and Budget (OMB) in consultation with the General Accounting Office (GAO).¹ The act specifies that agencies must annually state whether their internal control systems comply with internal control standards prescribed by the Comptroller General² and provide reasonable assurance that

- obligations and costs are in compliance with applicable law;
- funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and
- revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and of reliable financial and statistical reports and to maintain accountability over the assets.

For those agencies whose systems do not fully comply with these requirements, the act provides for the identification of any material weaknesses in their internal control systems, together with plans for corrective actions.

Section 4 of the act further requires that the agency heads' annual statements include a separate report on whether their agencies' accounting system conforms to the Comptroller General's accounting principles, standards, and related requirements.³

¹Guidelines for Evaluation and Improvement of and Reporting on Internal Control Systems in the Federal Government, OMB, December 1982.

²Standards for Internal Controls in the Federal Government, Comptroller General of the United States, June 1983.

³The GAO Policy and Procedures Manual for Guidance of Federal Agencies contains the principles, standards, and related requirements to be observed by federal agencies. Specifically, title 2 prescribes the overall accounting principles and standards, while titles 4, 5, 6, and 7 specify requirements governing claims; transportation; pay, leave, and allowances; and fiscal procedures, respectively. Also, agency accounting systems must include internal controls that comply with the Comptroller General's internal control standards and with related requirements such as the Treasury Financial Manual and OMB circulars.

GAO's First Overall Report on the Financial Integrity Act

We issued our first overall report on government internal control and accounting systems and on agencies' efforts to implement the Federal Managers' Financial Integrity Act in August 1984.⁴ In that report, we pointed out that agencies' first annual statements to the President and the Congress disclosed a wide range of material weaknesses which impeded the government's ability to control and account for billions of taxpayers' dollars. The magnitude of the reported weaknesses demonstrated the seriousness of the problems facing the government in this area.

We characterized the first-year effort as a learning experience. Agency managers were more aware of their internal control and accounting systems and had begun establishing a systematic process for evaluating, improving, and reporting on their systems. We suggested a number of ways to help correct problems with agencies' efforts to improve internal control and accounting systems, including

- testing of transactions to determine the adequacy of internal controls and the conformance of accounting systems with the Comptroller General's principles, standards, and related requirements;
- evaluating ADP controls which are integral to agency operations;
- instructing and training managers to provide a better understanding of what was required of them; and
- providing better guidance on what is meant by the terms "material weakness" and "reasonable assurance" to ensure complete and meaningful reporting in the future.

House Government Operations Committee Hearing and Report

On May 22, 1984, the Legislation and National Security Subcommittee, House Committee on Government Operations held a hearing on efforts to improve internal control and accounting systems and on the act's implementation. On August 2, 1984, the committee issued a report resulting from this hearing and the committee's own investigation.⁵ The chairman, in a press release announcing the subcommittee's hearing, emphasized the importance of the act in strengthening the federal government's management practices:

⁴Implementation of the Federal Managers' Financial Integrity Act: The First Year (GAO/OCG-84-3, Aug. 24, 1984).

⁵First Year Implementation of the Federal Managers' Financial Integrity Act, House Government Operations Committee, H.R. Rep. 98-937, Aug. 2, 1984.

“Continued reports of wasteful spending, sloppy management, and outright fraud in federal programs erode public confidence in the government. The American taxpayers expect full accountability in the use of their tax dollars, and assuring that federal agencies have the sort of sound management controls that are part of any well-run business represents a major step towards achieving that accountability. These hearings will provide a clear signal to the agencies that the subcommittee expects full compliance with the requirements of the Act.”

Following the hearing, the chairman observed that:

“According to the testimony, a good beginning has been made toward implementing the Act. It is clear, however, that much more remains to be done.... During the coming years we will be monitoring closely the activities of agency managers to assure that they fully implement the Act. This year agencies began the review process. Now, they must improve on the work they did last year and conduct in-depth internal control reviews. Above all, corrective actions must be taken on the deficiencies found. Improvements cannot be claimed just on the basis of discovered weaknesses.

“It is particularly important, during this period of escalating budgetary deficits and reduced Government services for Federal agencies to make the most of every dollar they receive. I am convinced that this initiative is an important first step toward achieving that goal.”

The committee report shared many of the views expressed in our first overall report on the act's implementation. The committee also characterized agencies' initial efforts to implement the act as a learning experience, and concluded that agencies did not yet have a sound basis for reporting that their internal control and accounting systems comply with the act's requirements. Further, the committee's report noted several potential problems that could hamper full implementation of the act. These problems are discussed in chapter 4.

Objectives, Scope, and Methodology

Strengthening internal control and accounting systems and overall government financial management remains one of GAO's top priorities. As a result, we continued to monitor efforts to implement the Federal Managers' Financial Integrity Act at the 22 agencies included in our first review. We added the Environmental Protection Agency (EPA) to our current review, bringing the total number of agencies reviewed to 23. These agencies account for over 95 percent of all government expenditures.

This report consolidates the results of our review at the 23 agencies. We issued individual reports to each of these agencies in 1985 and issued reports to all but EPA in 1984. Appendix II lists the 23 agencies included in our review and the reports issued to them in 1985.

The objective of this summary report is to provide a perspective on the internal control and accounting systems problems and related financial management issues which continue to face the government. The report will also highlight problems which we believe may be impeding agencies' efforts to improve these systems.

Our review was made in accordance with generally accepted government auditing standards, except that only in selected instances did we independently evaluate the adequacy of agency internal control and accounting systems. Instead we analyzed the agencies own reports under the act and considered prior reports we and the inspectors general issued which addressed problems reported by the agencies. We obtained official comments from OMB on the overall results of our review and from the agencies on the individual reports we issued to them.

The methodology used in our review involved

- reviewing agency efforts to strengthen their internal control and accounting systems;
- examining component and agency-level reports on the status of internal control and accounting systems to evaluate whether the reports (1) fully identified internal control and accounting system weaknesses, (2) provided comprehensive, long-range plans for improving internal control and accounting systems, and (3) properly reported on reasonable assurance for the systems of internal controls, applying the criteria discussed on pages 37 through 39, and on the conformance of accounting systems; and
- meeting to discuss the act's implementation with four primary groups: (1) agency officials working to implement the act at selected agencies, (2) the agency inspectors general and their staffs, (3) a team established by the President's Council on Management Improvement to study the paperwork and staffing requirements associated with evaluating internal control systems, and (4) representatives from public accounting firms assisting managers' efforts to implement the act.

The 23 agencies included in our review issued a total of 18 annual statements to the President and the Congress. (The Secretary of Defense issued a single report which consolidated information for all six Defense

Chapter 1
Introduction

components included in our review—Office of Secretary of Defense, Army, Navy, Air Force, Defense Logistics Agency, and Defense Mapping Agency.)

Internal Control and Accounting Systems Problems Continue to Be Serious

The government continues to face serious, widespread internal control and accounting systems weaknesses which impair its ability to meet the objectives of good management and accountability. While agencies are working to strengthen internal control and accounting systems, the major problems so far remain largely unchanged. In reporting to the President and the Congress, agencies continue to acknowledge material weaknesses across the spectrum of federal government operations.

The Federal Managers' Financial Integrity Act has provided a significant impetus to the government's attempts to improve management control and accountability by focusing attention on the systems' problems. Agencies continue to identify and are generally trying to correct their material weaknesses. They have a number of major efforts underway to improve internal control and accounting systems or have established plans for doing so. Many weaknesses may take time to fully correct, as the problems are long-standing and solutions are not always easy.

As a result of the act, agencies have also identified and reported having corrected thousands of weaknesses, which individually were not considered to be material. However, those weaknesses, which oftentimes involve the failure to comply with established agency policies and procedures, collectively are important and could have led to government fraud, waste, and abuse.

Agencies Report Serious Systems Weaknesses

The variety of weaknesses agencies reported at the end of 1984 encompassed the same eight categories as those cited in the agencies' 1983 annual statements: (1) financial management and accounting systems, (2) procurement, (3) property management, (4) cash management, (5) grant, loan, and debt collection management, (6) automated data processing (ADP), (7) personnel and organizational management, and (8) eligibility and entitlement determinations.

As in 1983, agencies reported weaknesses that continue to collectively demonstrate that poor internal controls and ineffective accounting systems, involving billions of dollars, represent a serious problem. Table 2.1 compares the number of agencies reporting material internal control weaknesses in each of the eight categories in 1983 and 1984. Appendix III provides a further breakout of the categories of material weaknesses by agency.

Chapter 2
Internal Control and Accounting Systems
Problems Continue to Be Serious

Table 2.1: Comparison of the Number of Agencies Reporting Material Weaknesses by Category

Category	Number of Agencies ^a	
	1983	1984
Financial management and accounting systems	17	17
Procurement	14	14
Property management	14	15
Cash management	12	12
Grant, loan, and debt collection management	13	13
Automated data processing	10	14
Personnel and organizational management	10	12
Eligibility and entitlement determinations	9	10

^aThe 23 agencies reviewed included six Defense agencies (Office of the Secretary of Defense, Army, Navy, Air Force, Defense Logistics Agency, and Defense Mapping Agency). Because these six agencies were included in one report to the Congress and the President, the figures in this table are based on a total of 18 agencies.

Serious Long-Standing Internal Control Weaknesses Remain

Internal control problems continue to permeate government operations. The agencies we reviewed reported 335 material internal control weaknesses in their 1984 statements that were not identified in 1983. The 1983 statements identified 467 weaknesses. Many of the weaknesses identified are long-standing and have been the subject of prior GAO and inspector general reports. For instance, the government has historically experienced problems in areas such as procurement, debt collection, and property control. Following are examples of the variety of material internal control weaknesses reported in 1984:

- The Department of Defense reported outstanding areas of material internal control weaknesses covering a wide range of its operations. Among the problems reported were weaknesses in its procurement systems, through which a projected \$100 billion will be spent this year. Defense stated it had material internal control weaknesses resulting in overpricing of spare parts, cost growth in weapons systems, and lack of competition. These problems have been repeatedly addressed over the years in reports by us, the Defense Inspector General, and the military service audit agencies. For example, on May 24, 1984, we reported that weaknesses in the cost-estimating process for weapons systems resulted in the exclusion of hundreds of millions of dollars in initial cost estimates (GAO/NSIAD-84-70). On October 3, 1985, we testified before the Legislation and National Security Subcommittee, House Government Operations Committee on selected aspects of Defense contracting practices. We pointed out that because Defense awards so many contracts without price competition (\$82 billion in fiscal year 1984), it must rely

to a great extent on cost estimates from contractors. We identified a number of significant deficiencies in Defense contracting practices and noted that improvements were needed to have greater assurance that prices were fair and reasonable. Further, in the past year, the Defense Inspector General issued reports on spare parts overpricing which have received widespread attention. In July 1985, Defense established a new assistant secretary for acquisition to address its procurement problems. The new assistant secretary has said that, while considering reforms for spare parts acquisition, he compared a 1982 GAO report to one issued in 1961 and found that "one could almost believe they were the same report." He went on to say that "over the years there have been a series of very difficult problems. It's just going to take time to root (them) out."

- The Department of Health and Human Services (HHS) reported 18 departmentwide material internal control weaknesses. For example, HHS reported weaknesses in a system implemented in January 1984 which accounted for and controlled about \$44 billion in 1984 disbursements to states, local governments, schools, and nonprofit medical resources activities. We reported similar weaknesses in 1979 in the predecessor system (FGMSD-80-6, Dec. 28, 1979). At the time, we found recipients held at least \$249 million in federal money in excess to their needs. In 1984, HHS reported that the current system still does not provide sufficient control of over-advances to recipients.
- Material weaknesses reported by the Department of Housing and Urban Development (HUD) included long-standing problems in its multibillion dollar housing programs. As of September 1984, HUD was insuring over 5 million housing loans with a reported outstanding balance of \$135 billion. Internal control problems in these programs have been the subject of numerous GAO and inspector general reports. On May 13, 1985, we reported that stronger internal controls over HUD's single-family mortgage insurance programs would discourage fraud (GAO/RCED-85-4). In this regard, in July 1985, a federal judge sentenced to prison three individuals who had defrauded the government through HUD insured single-family mortgages. The mortgages were obtained through inflated appraisals and other falsified documents. It was reported that in handing down the sentence, the judge noted that the guilty parties could not have perpetrated the fraud if HUD had better controls and that he wished he could also sentence HUD.
- Eleven agencies (Agriculture, Commerce, Defense, Education, HHS, HUD, Justice, Labor, Interior, the Small Business Administration, and Transportation) reported material weaknesses in debt collection. Collectively, these agencies reported having over \$173 billion in accounts and loans receivable at the beginning of fiscal year 1985. Over \$17 billion of this

amount was reported as delinquent, representing about 92 percent of the government's delinquent nontax debts. Debt collection problems continue, despite numerous GAO and inspector general reports on this subject and the passage of the Debt Collection Act of 1982, which broadened agencies' debt collection capabilities. (See GAO/AFMD-83-57, Apr. 28, 1983.) At the request of three members of the Congress, we are now comprehensively studying agencies' efforts to strengthen debt collection.

- Among problems reported by the Department of Agriculture were material internal control weaknesses in the Farmers Home Administration's management of its farm and other rural loan programs. These programs cover about 1.5 million active borrowers and a loan portfolio of about \$61.5 billion. Agriculture also reported material internal control weaknesses in the food stamp program, which has recognized losses of about \$1 billion annually. The program has a history of weak internal controls. For instance, in a February 4, 1983, report, we noted that of \$2 billion in food stamp overissuances in a 2-year period, only \$20 million, or 1 cent of each overissued dollar, was recovered (GAO/RCED-83-40).
- The Army and Navy reported material weaknesses in controlling government property held by Defense contractors. For almost 20 years, GAO and the Defense audit agencies have continually reported problems in this area, ranging from the lack of good accounting information to the lack of control to preclude unauthorized use of government equipment for commercial work. In March 1985, we testified before the House Committee on Government Operations on long-standing problems in controlling government property, valued at an estimated \$22 billion. In 1983, the President's Council on Integrity and Efficiency identified weaknesses in the government's control over property held by contractors. They found, for example, that contractors held over \$30 million in government property not needed for contract performance. Further, in 1984, the Defense audit agencies reviewed the use of government-furnished material at contractor plants and identified excess material worth \$24.8 million.

Many Agency Accounting Systems Do Not Conform to Comptroller General's Requirements

Weaknesses in accounting and financial management systems continue to be widespread, with 17 of 18 agencies reporting problems. Timely and accurate information from agencies' accounting and financial management systems is necessary to enable managers to analyze their operations and decide how to control, conserve, protect, and use resources. Data inaccuracy and incompleteness continue to be a major weakness in government accounting systems, and billions of dollars are not being adequately accounted for, managed, and controlled.

The agencies which we reviewed reported at the end of 1984 that they had 427 accounting systems, and that 226, or about 53 percent, were not in conformance with (or they did not know if they were in conformance with) the Comptroller General's accounting principles, standards, and related requirements.

Conformity with the Comptroller General's accounting requirements has been required for 35 years, since the passage of the Accounting and Auditing Act of 1950 (31 U.S.C. 66a). That act clearly set forth a congressional policy that agencies establish and maintain accounting systems in conformance with requirements to be prescribed by the Comptroller General. Historically, however, agency accounting systems have not conformed with the Comptroller General's requirements. (See AFMD-81-58, June 25, 1981.)

The following examples illustrate some of the serious accounting system problems facing the agencies:

- Defense reported that 86 of its 150 accounting systems did not conform with the Comptroller General's requirements. One area of nonconformance, reported by all three military services, was the absence of adequate general ledger control. A general ledger serves as an essential, high-level control over the integrity of financial balances in accounting systems and subsystems, as well as over the reliability of the financial reports those systems produce. Defense needs a general ledger to provide oversight control over assets, liabilities, and capital, totaling hundreds of billions of dollars.
- HHS reported serious problems in three of its major accounting systems, which accounted for \$218 billion in grants and payments in fiscal year 1984. For two systems, which processed \$174 billion in Social Security Administration (SSA) benefit payments, or about two-thirds of the HHS fiscal year 1984 budget, the agency reported that (1) accounting controls were inadequate to ensure that only authorized transactions were entered into the system and that those to be entered were processed and (2) controls over system operations were not sufficiently documented, were inconsistently executed, and were so fragmented across agency organizational units as to be ineffective. GAO and the inspector general have also reported that SSA's automated accounting systems are vulnerable to fraud. In reports issued August 30, 1985, and September 30, 1985, we noted that SSA's nationwide system, serving the needs of approximately 39 million program beneficiaries and about 60 million wage earners through a network of field offices, was vulnerable to failure and was deficient in its ability to protect funds from fraud (GAO/

IMTEC-85-15 and GAO/IMTEC-85-16). We identified deficiencies in all aspects of SSA's ADP environment. SSA's computer systems served as a model for other users of automated data processing throughout the 1960's. By the end of the 1970's, however, they were close to collapse and unable to process much of the work. By 1982, the systems were obsolete, difficult to maintain, and vulnerable to failure. The potential and/or actual consequences of these system deficiencies include grave risk of failing to pay benefits, exposure to the risk of fraud, and inadequate services to the public such as delays in posting earnings for up to 3 years, slow issuance of Social Security cards, and erroneous benefit payments. A 1984 HHS inspector general report pointed out instances in which, because of control weaknesses, employees defrauded SSA's automated systems. For example, an SSA claims representative was convicted for filing fictitious claims for more than 20 people, resulting in an estimated loss of about \$300,000; another SSA employee was sentenced to 3 years in jail for issuing social security checks to himself. (See p. 27 for a discussion of SSA's efforts to modernize its automated systems.)

- About \$30 billion, representing 46 percent of Education's dollar volume and 35 percent of its total financial transactions in fiscal year 1984, were processed by six accounting systems which the Department reported as not conforming to Comptroller General requirements and in the need of major upgrade or replacement. Among the problems reported for Education's general ledger system, which accounted for \$18 billion and processed 800,000 financial transactions in fiscal year 1984, was that data were unreliable and inadequate to meet internal and external management and reporting requirements. Also, about \$2.8 billion in receivables transactions during fiscal year 1984 were processed by an Education accounting system which was known to contain inaccurate information and to have limited capabilities for aging receivables, which amounted to \$10.6 billion at the end of the fiscal year. These problems have hampered the agency in its attempts to solve its long-standing problems in collecting billions of dollars of delinquent debts.
- Although the State Department is making significant improvements in its accounting systems, it reported that its existing systems did not provide adequate control over billions of dollars invested in real and personal property. For example, the Department continued to report long-standing internal control weaknesses in managing an estimated \$250 million of personal property. For at least 16 years, we, and more recently State Department auditors, have reported deficiencies in State's management and control of domestic and overseas personal property (ID-75-66, June 9, 1975). The problems stem mainly from lack of compliance with departmental regulations and procedures and a lack of a

departmentwide personal property accounting system that conforms to the Comptroller General's requirements.

- The Environmental Protection Agency (EPA) reported three material accounting weaknesses: (1) contract costs had not been recorded and charged to the proper appropriation account, (2) grant money, which remained unspent after the period of availability, had not been deobligated as required, and (3) documentation and data controls had not been established in the payroll system. For example, our testing at EPA's Atlanta regional office showed that \$3.8 million in unexpended grants for air pollution control were not properly reviewed by the agency to ensure the funds were still needed for authorized expenditures. Rather than returning these funds to the Treasury as required by law, EPA may have improperly obligated the funds after the appropriation availability period ended.
- The Defense Logistics Agency (DLA) noted material internal control weaknesses in its disbursing system, through which contractors were paid for various items before the material was received. In 1984, the agency reported that it had paid over \$22.6 million for items that it could not verify as being received. At the time of our review, an additional \$53 million had been paid for material that was over 90 days past its delivery date. Also, on August 20, 1985, as a result of work performed at the request of the chairman of the Legislation and National Security Subcommittee, House Committee on Government Operations, we reported to the director of DLA that the agency was making duplicate payments. At one payment center, we found that private businesses had returned 26 duplicate payments totaling \$8.5 million during fiscal year 1984 (GAO/AFMD-85-71).

Widespread Weaknesses in ADP Operations

Agencies also reported a wide range of ADP problems, with 14 reporting material weaknesses. The most frequently reported problem pertained to system security, including protecting automated information and the automated resources that process, maintain, and disseminate this information. Federal agencies are highly dependent on automated systems and controls to carry out their missions and administrative functions. Further, ADP systems perform a critical role in federal operations involving public safety and national defense, such as air traffic control and military command, control, and communications.

Examples of ADP weaknesses reported by the agencies follow:

- The General Services Administration (GSA) reported that ADP security was ineffective. GSA concluded that an inadequate ADP security program

could result in critical or sensitive data being altered, improperly disclosed, or destroyed, and in ADP services being disrupted or completely shutdown for unacceptable periods. GSA's major ADP systems are crucial to the accomplishment of its missions. For example, GSA's automated federal supply system supports about \$3.3 billion of annual purchases of supplies and materials, and its automated information system for the Public Buildings Service supports about \$2.2 billion spent in the leasing and owning of federal buildings.

- The Department of the Treasury continued to have a material weakness in ADP systems security. Many of its missions and functions would be impossible to perform without the aid of computers. The reported problems may expose the bureau's missions and functions to risks of deliberate or accidental misuse of computers and data. For example, the agency noted the continued potential for fraudulent diversion of electronic funds transfers totaling billions of dollars. As discussed on pages 23 and 24, the breakdown of the Internal Revenue Service (IRS) tax processing system in 1985, further highlights the importance of controls over the design, acquisition, and operation of ADP systems.
- The Department of the Interior reported the continuation of long-standing material internal control weaknesses in ADP management at the Bureau of Indian Affairs. Interior reported weaknesses in acquisition and management of ADP equipment and the lack of a long-range ADP plan to meet the needs of the Bureau and its clientele. On December 21, 1984, we reported that funds were wasted because of poor management of ADP equipment and systems development projects by the Bureau (GAO/IMTEC-85-1). In a sample of 1,325 items of ADP equipment purchased or leased by the Bureau, we found that 29 percent of the equipment was not being used. We also identified at least nine duplicative or overlapping information systems in the Bureau. In addition, we reported that the Bureau's new ADP management organization, which it had established to help address its ADP problems, had not been staffed and that its charter did not cover some significant aspects of information resources management.
- The Department of Transportation reported a material weakness in the Federal Aviation Administration's integration of information resource management projects, which could cause the agency to incur unnecessary costs, acquire incompatible or duplicative systems, and experience significant delays in implementing system improvements. We reported the possibility of similar problems in the agency's planned acquisition of a new \$725 million automated system which is intended to support the nation's air traffic control in the late 1980's and the 1990's (GAO/IMTEC-85-10, June 6, 1985).

On October 29, 1985, we testified before the Subcommittee on Transportation, Aviation and Materials, House Committee on Science and Technology, on the seriousness of ADP control problems the government faces. We surveyed ADP security for 25 automated systems at 17 civil agencies. Our survey included systems that (1) make monthly payments to millions of beneficiaries of various government programs, (2) process electronic funds transfers, and (3) maintain on-line information essential to safeguarding human safety. Effective ADP security in these systems is needed to prevent undesirable events, such as denial of benefits to citizens, unauthorized disclosure of sensitive information, loss of government money, waste of federal resources, human injury, and in extreme cases, loss of life and endangerment of the national welfare. Generally, the results of our survey showed that each of the systems is vulnerable to abuse, destruction, error, fraud, and waste because essential controls and security safeguards were not in place.

Also testifying at the hearing was the inspector general of HHS, who had chaired a task force for the President's Council on Integrity and Efficiency. The task force studied computer-related fraud and abuse in order to provide a perspective on the nature and scope of the problem. Among the findings in the study report, which was issued in May 1985, was that controls and system security were weak. Some systems did not have controls, while others had controls which were poorly implemented, simplistic, or bypassed as a matter of operating practice. Perpetrators of computer-related crimes, who were interviewed as part of the study, perceived that the systems were vulnerable.

Additional Material Weaknesses Identified

Agencies reported many of the same material internal control weaknesses as reported in 1983 and identified 335 additional weaknesses in their 1984 annual statements. Examples of material internal control weaknesses reported for the first time in 1984 follow:

- The Veterans Administration (VA) identified additional material internal control weaknesses involving the administration of its medical care programs. In this regard, on August 8, 1985, we reported that, through strengthened patient management controls, VA could save millions of dollars by cutting medically-unnecessary admissions and excessive stays (GAO/HRD-85-52). VA also reported in 1984 that because of a lack of internal controls, pharmaceuticals from the inpatient drug distribution system were susceptible to unauthorized use and loss. VA found that thousands of individuals had access to the system and, with the exception of narcotics, it was very difficult to determine whether a particular

drug was missing, or in cases where VA could tell what quantity was missing, how it disappeared.

- The National Aeronautics and Space Administration (NASA), which did not report any internal control weaknesses in 1983, identified four problem areas in its 1984 annual statement. For example, NASA reported that its spare parts procurement program needed improvement to reduce costs, increase efficiency, and strengthen controls. In 1984, NASA's inspector general reported problems with the space shuttle's spare parts procurement program, which is projected to cost as much as \$2.3 billion through 1994. These problems resulted in NASA keeping unneeded spare parts costing \$4.2 million.
- In 1984, the Army and the Navy reported material internal control weaknesses over operations of military hospitals and medical facilities. Reports by the Defense inspector general and the military service auditors point out a wide range of control problems. Included were deficiencies in record keeping, training, assuring the quality of care, and reviewing the credentials of doctors and other health care professionals who work in military hospitals.

Other Material Weaknesses Exist

As agencies progress further in evaluating their internal control and accounting systems, additional material weaknesses will undoubtedly be uncovered. We continue to identify material weaknesses that were not known and, therefore, not included in agency annual statements at the end of 1984. For example, on July 18, 1985, we reported that the government was overpaying hospitals for Medicare patients by 4.3 percent because HHS used unaudited cost reports in computing prospective payment rates for inpatient hospital services. Unaudited cost reports frequently include items that Medicare does not allow, and the law calls for setting the prospective rates based on allowable costs. We recommended that HHS correct its data base for computing the prospective rates and estimated that doing so would reduce Medicare payments by \$940 million in fiscal year 1986 and by over \$8 billion during fiscal years 1986-90 (GAO/HRD-85-74).

Another example is the problems with the IRS tax processing system. IRS could not carry out its complex and demanding mission without ADP support. In 1984, it collected \$680 billion and refunded \$86 billion. The breakdown of its \$102 million computerized tax processing system in 1985 demonstrated the serious impact of weak ADP systems. The combination of insufficient computer capacity and inefficient computer programs to process the vast workload of taxpayer returns caused processing errors and large backlogs. An IRS official confirmed that as of

September 27, 1985, the agency had paid \$40.2 million in interest on overdue refunds to over 2.1 million taxpayers in 1985, compared with about \$26.2 million to over 1.4 million taxpayers in the same period last year. The IRS official also said that through August the agency had to pay at least \$22 million in overtime in 1985 to employees involved in tax processing, about double the amount paid at the same time in 1984. (See GAO/GGD-85-89, Sept. 30, 1985, and GAO/GGD-86-25FS, Nov. 22, 1985, for information on returns processing problems at three IRS' service centers.)

We also noted four instances where weaknesses known at the end of 1984, which in our view were material, were not included in the 1984 annual statements.

- SSA had several internal control weaknesses in its benefit payment system which it did not report to HHS and were not included in the Secretary's 1984 annual statement. These weaknesses were the subject of 1983 and 1984 GAO reports (GAO/HRD-84-71, Sept. 13, 1984; GAO/HRD-84-27, Jan. 20, 1984; and GAO/HRD-83-90, Sept. 30, 1983). For example, over an extended period, SSA underpaid at least \$2 billion because of a delay in recomputing benefit amounts. Also, SSA did not identify in its 1984 assurance letter to HHS internal control weaknesses in its ADP systems acquisition process (GAO/IMTEC-84-15, July 9, 1984). We found several weaknesses, including inadequacies in the agency's management of two contracts. One contract for \$115 million, the largest ever awarded by SSA, was to install over 1,800 data communications terminals in 1,350 social security offices nationwide. Consequently, SSA acquired a data communications system which did not begin to consistently meet contractual performance requirements until nearly 2 years after the first computer terminals for the system were installed. In our 1984 report, we stated that weaknesses in SSA's systems acquisition process continued to exist and that these weaknesses presented a threat to the integrity of upcoming major system procurements by the agency.
- The Immigration and Naturalization Service, part of the Justice Department, had weak internal controls over the processing of alien applications for United States citizenship. Weaknesses included alien records that were vulnerable to alteration, inadequate separation of duties, lack of supervisory and quality assurance reviews, and poor document control. Over the past 3 years, more than 100 employees have been charged with fraudulently altering alien registration records and/or accepting bribes, and 17 have been convicted. For example, two Immigration and Naturalization Service analysts, capitalizing on weaknesses in ADP controls, were able to fraudulently authorize a service computer system

operated at a contractor's data center to issue permanent resident alien cards which were sold to aliens who had illegally entered the United States (GAO/GGD-86-9, Oct. 31, 1985). Nevertheless, Justice did not include this area as a material weakness in its annual statement.

- At DLA, we identified several material weaknesses in management practices, policies, and procedures, which in our view should have been reported in 1984. For example, we found that the Defense Inactive Item Program, established to identify and remove unneeded supply items from DLA's \$10 billion inventory, was not operating as intended. Defects in this program have caused the agency to delete needed items and keep unneeded items (GAO/NSIAD-85-148, Sept. 27, 1985). In one instance, the Navy was erroneously deleted as a potential user of 50,000 line items managed by DLA. In another case, thousands of line items, which were candidates for deletion from stock because of low demand activity, were retained because the user did not have the time or resources to assess the need for each item.
- EPA's report should have cited various ADP operations, acknowledged by its components as material weaknesses, because these operations involve a substantial part of EPA's activities. For example, six EPA regions reported that the automated hazardous waste data management system did not produce reliable and useful data. This system contains data on regulated facilities which generate, treat, store, and transport hazardous waste material and involves over \$3.5 billion in EPA funding.

Progress Toward Strengthening Systems

Agencies are working to strengthen internal control and accounting systems. While they have reported progress in correcting problems and working toward solutions, it will be some time before the government has adequate systems. As mentioned previously, many additional material weaknesses were reported in the agencies' 1984 annual statements, and more weaknesses will undoubtedly be identified in the future as agencies further evaluate their systems. Most importantly, many identified weaknesses by their very nature, may take considerable time to fully correct.

Efforts to Correct Material Weaknesses

Agencies have extensive efforts underway to strengthen their systems and reported having corrected hundreds of material weaknesses and accounting systems problems in 1984. While we did not independently assess these measures, across the board we saw a wide range of initiatives to design and implement new or enhanced internal control and accounting systems and to strengthen financial management. We do not

know the total amount being spent by agencies to improve their systems, but hundreds of millions of dollars are involved, demonstrating a commitment to strengthened systems.

The Department of Education illustrates the kind of effort we noted. In 1984, Education reported that it had corrected 13 accounting system problems identified in its 1983 annual statement. But, as the department also reported, many of its accounting problems are so serious as to require system replacement, redesign, or substantial enhancement. More time is necessary for implementing these changes, with the Financial Integrity Act providing the impetus for improvement. Education has budgeted nearly \$14 million for fiscal years 1984 through 1986 for general system enhancements ranging from minor design changes to complete system replacement. For instance, it plans to spend over \$4.5 million to improve its general ledger system and to replace its current payment system with a new automated system at an estimated cost of \$1.5 million. Education has also budgeted over \$1.1 million to replace the present automated system for the Guaranteed Student Loan Reinsurance Program in order to produce more useful management data and reports and account for costs more effectively.

While agencies are striving to strengthen their internal control and accounting systems, the long-term efforts needed will require agency managers to closely oversee the projects to ensure that they are successfully implemented.

The following examples illustrate long-term corrective actions that agencies have underway:

- All the military services reported material internal control weaknesses in the multibillion dollar foreign military sales (FMS) program. Over the past decade, GAO and Defense auditors have identified similar weaknesses in over 40 reports on the Department's failure to recover hundreds of millions of dollars owed by foreign governments and to provide adequate accountability over program costs and foreign customer funds (for example, GAO/AFMD-84-12, Dec. 12, 1983). Defense, which has had problems resolving the weaknesses in the program, has a number of corrective actions underway. For example, the Air Force was working to correct its lack of adequate internal controls to ensure (1) proper billing to foreign governments of all applicable costs and surcharges, (2) prompt reporting of deliveries to foreign governments, and (3) accurate and timely closeout of sales cases. The Air Force, which as of April 1985 was managing over 4,270 FMS cases involving about \$64 billion in sales,

has taken several short-term steps to help diminish these problems. It expects substantial improvement by July 1987, with a full solution depending on the development and implementation of an FMS management information system scheduled for completion by the end of fiscal year 1988.

- The Minerals Management Service, within the Department of Interior, implemented a new oil and gas royalty management accounting system in February 1983. This system, through which the Department accounted for collections of \$7.7 billion in fiscal year 1984, was expected to solve serious accounting and internal control problems that we and the departmental auditors had identified since 1959 (for example, FGMSD-79-24, Apr. 13, 1979; AFMD-82-6, Oct. 29, 1981; and GAO/AFMD-83-43, Jan. 27, 1983). The reported problems were of such great concern to the Department that an independent study commission was established and the Congress held a number of hearings on the inability of the Department to provide adequate control and accounting. However, despite implementation of the new system, many of the same weaknesses remain. For example, the House Committee on Interior and Insular Affairs reported in December 1984 that there were serious problems with the new system, including a lack of controls to identify non-payments and to charge interest due on late payments. Interior is proceeding with its efforts to correct the system's continuing weaknesses, and reported that it plans to have the problems corrected by fiscal year 1987.
- As discussed on page 19, by the late 1970s SSA's automated systems had degenerated to a point that its ability to perform its mission was affected. In 1982, SSA initiated a \$500-million, 5-year project to modernize its computer systems. SSA now estimates the program will cost \$863 million and the completion date has slipped to fiscal year 1989. On September 30, 1985, we reported that we were concerned that SSA's approach to implementing the modernization plan may not achieve stated objectives. While SSA has made some progress in modernizing these systems, a critical part of the plan is behind schedule. Further, SSA has not followed the original plan's approaches. Although SSA has taken some actions to improve its management and control over the plan, recurring problems still impede progress. (See GAO/IMTEC-85-16.)
- HUD has experienced accounting system problems for years. The problems have been the subject of GAO and HUD inspector general reports pointing out that the systems had not received the attention or funding necessary to keep them accurate, timely, and sufficiently automated to meet the agency's needs. Presently, the Department is either replacing or upgrading three of its major accounting systems. These are multiyear

projects. The Secretary of HUD stated that he plans to have the accounting systems in conformance with the Comptroller General's requirements by fiscal year 1988.

- The Treasury Department's Bureau of Public Debt has a major accounting system enhancement project underway. The Department is working aggressively to strengthen its system which accounts for and provides key financial information on several trillion dollars in borrowings. It hopes to have the new system fully operational by October 1988.

While agencies are making progress in implementing corrective actions, we identified instances where, in our view, agencies inadequately reported on certain corrective actions or where reporting was incomplete. Corrective actions were reported as completed when more action was needed and in some cases, the status of corrective actions was unclear in the agency's annual statement.

For example, in 1984, EPA reported that material internal control weaknesses in the multibillion dollar Superfund program had been corrected and cited 17 completed corrective actions. However, our March 29, 1985, report on this program documents several control problems which remained uncorrected at the end of 1984 (GAO/RCED-85-69). Also, in November 1984, the official primarily responsible for the Superfund program reported that control weaknesses had not been corrected in areas such as enforcement, cost control and cost recovery documentation, remedial investigations, identification and classification of hazardous waste sites, and ongoing cleanup actions.

In another case, while VA reported certain accounting system weaknesses in 1984, its reporting was incomplete. VA's current financial management systems neither (1) effectively support managers' needs for timely information nor (2) support effective internal controls over financial information. The systems are outdated, slow, and incapable of taking advantage of modern data entry, telecommunications, and database management techniques. VA recognized these problems in preparing its 5-year ADP and telecommunications plans for 1985-89, but did not address them in its 1984 annual statement. VA plans 52 major automated systems development projects and 5 major procurements of ADP equipment at an estimated cost of more than \$244 million. The plan includes 44 financial management systems projects, which represent a virtual overhaul of the VA's financial management structure. (See GAO/AFMD-85-34, Sept. 20, 1985; and GAO/HRD-86-20, Oct. 28, 1985.)

Agencies Are Identifying and Correcting Many Nonmaterial Weaknesses

While a number of the government's serious system problems will not be resolved for several years, agencies have identified and corrected thousands of internal control and accounting system weaknesses which, though not individually material from an agency perspective, are important to the operating manager and can lead to fraud, waste, and abuse. These weaknesses often result from not following existing policies and procedures and usually can be quickly fixed.

In our past work, we have often found that established internal controls and accounting policies and procedures are adequate, but are not being consistently followed. While agency policy may require such fundamental controls as periodic physical inventories of property and cash reconciliations, these controls may not always be implemented. For example, on November 4, 1985, we reported to the Secretary of the Army that weaknesses in internal controls at the Corps of Engineers, which generally occurred because established GAO, Treasury, and Corps of Engineers' policies and procedures were not consistently followed, increased the risk of waste, loss, and misuse of agency resources (GAO/AFMD-86-4). Also, our 1981 report summarizing our review of over 77,000 cases of fraud against the government disclosed that basic internal controls were often not followed (AFMD-81-57, May 7, 1981).

The number of weaknesses and corrective actions surfaced through agency evaluations of internal controls and accounting systems under the act was far greater than the number of material weaknesses reported in their annual statements to the President and the Congress. For example, the Treasury Department did not report any additional material weaknesses in its 1984 annual statement. However, Treasury's component bureaus identified 89 weaknesses they considered material and reported 127 associated corrective actions. According to Treasury's 1984 annual statement, the bureaus had completed 46 (36 percent) of these 127 corrective actions. Similarly, the military services identified and reported correcting thousands of control weaknesses at lower levels. Army managers, for example, reported correcting 3,600 internal control weaknesses in 1984 that were not considered to be material from an agency perspective.

The solutions may be as simple as putting a lock on a file cabinet, but the weaknesses are collectively important and set the climate for controlling the government at the operating level. Early detection and correction of these problems will prevent them from reaching agencywide significance.

A situation a number of years ago at the Department of Transportation highlights the importance of basic internal controls and illustrates the type of fundamental weaknesses agencies may identify through the act. A clerk was able to embezzle over \$856,000 in government funds by processing improper payments to himself because there was not adequate supervisory review or subsequent oversight of his work. This case received national publicity and was embarrassing to the government (AFMD-81-57).

Contributing to the loss of public confidence in and the ultimate demise of the Labor Department's Comprehensive Employment and Training Act program, replaced in 1983 by the Job Training Partnership Act, were numerous reported cases of fraud, waste, and abuse. The lack of basic internal controls by recipients of the program's funds, who were accountable to the Labor Department, undermined the program. For example, the chief financial officer of one recipient organization embezzled about \$750,000 in government funds due to a lack of separation of duties—a very elementary control which is fundamental to properly managed operations (GAO/AFMD-84-62, Sept. 28, 1984).

Sustained Agency Improvement Efforts Needed

Our first overall report on the act stressed that agencies need to develop viable solutions to the internal control and accounting systems problems that have and will be identified, and then follow through with corrective actions. Agencies need to move aggressively to correct the wide range of weaknesses that have been identified. Strengthening internal control and accounting systems is the "bottom line" of the act.

As we reported last year, agencies need to provide a comprehensive, integrated approach to correcting their problems. Many of the weaknesses are long-standing and cannot be treated on a piecemeal or partial basis, as has often been the case in the past. These concepts apply to all agencies, not only to those covered by our review but also to those we are issuing individual reports. Accordingly, in addition to this report, we are sending a letter to the heads of all departments and agencies, stressing the need to use the act as a tool to strengthen their internal control and accounting systems.

In beginning the long and expensive task of correcting the many material internal control weaknesses and accounting system problems, as we stated in last year's overall report, agency efforts should be channeled toward a common goal of rebuilding the agency's financial management

structure. The effort, which should be guided by an overall agency system improvement plan, should stress (1) strengthened accounting, auditing, and reporting, (2) improved planning and programming, (3) streamlined budgeting, and (4) systematic measurement of performance. Federal agencies need to develop comprehensive plans of action and maintain follow-up systems which track actions taken to correct identified weaknesses.

Also, to ensure that improvements are sustained, agencies need to stress the link between improving internal control and accounting systems and the efficient, effective management of government operations. Establishing and maintaining adequate internal control and accounting systems must become part of the normal management process.

The size and nature of the weaknesses that remain will require considerable time and effort by agency managers. Agencies need to continue to demonstrate more results from their internal control and accounting system improvement efforts each year. They must strive to have greater assurance, either that their systems have been improved or that existing systems are adequate. OMB needs to continue to play a central role in guiding and directing agencies' efforts to improve their internal control and accounting systems.

Strengthened internal control and accounting systems and improved federal financial management will continue as one of GAO's top priorities. We have strongly supported the Federal Managers' Financial Integrity Act for several reasons. First, the act provides a unique opportunity to highlight the need for effective internal control and accounting systems. Second, the act plays an important role in improving overall federal financial management. We believe that the commitment and resources devoted to improving governmental internal control and accounting systems today will yield significant future benefits, including enhancing management's ability to do more with less.

Improvements Are Needed in Annual Reporting

Agencies generally reported their systems weaknesses, but their annual statements did not always provide an accurate, clear assessment of the status of their internal control and accounting systems. Most importantly, reporting on reasonable assurance for an agency's internal controls continues to be a problem.

We concluded that 12 agencies that reported having reasonable assurance in 1984 did not have an adequate basis for doing so because (1) the programs to evaluate their internal control systems had not yet evolved to the point that the agencies knew whether controls over many of their major programs and operations were adequate and (2) the agencies had a number of uncorrected material internal control and accounting system weaknesses.

In our first overall report on the act, we recommended that OMB strengthen internal control reporting guidance. The House Committee on Government Operations expressed similar concerns and suggested alternative reporting language for agencies to use. However, OMB did not revise its guidance, and agencies largely continued to follow OMB's lead. Because of continuing uncertainty in this area, this chapter provides the criteria we believe agencies should follow in reporting on reasonable assurance.

Annual Statements on Internal Controls Required

The act requires that agency heads prepare annual statements to the President and the Congress on whether their internal control systems fully comply with the act's requirements. The act requires that the systems (1) be established in accordance with standards prescribed by the Comptroller General and (2) provide reasonable assurance that the objectives of the act are attained. To the extent systems do not fully comply, the act also provides for the annual statement to include a report which identifies any material weaknesses in the agency's systems of internal control and describes plans and schedules for corrective action.

Sample report language issued by OMB provides for agency heads to state (when appropriate) that "taken as a whole" the agency system of internal control provides reasonable assurance that the act's objectives were achieved. The OMB reporting guidance stressed full disclosure of the steps taken to evaluate internal controls, together with information on all material weaknesses identified.

Our first overall report on the act disclosed a need for additional guidance on what constitutes a material weakness and for improved reporting on what constitutes reasonable assurance. While we found that agencies' 1983 annual statements generally disclosed their internal control weaknesses, there was not a clear, consistent understanding of what was meant by the terms "material weakness" and "reasonable assurance."

Of the seventeen 1983 agency annual statements we reviewed at the time of our first overall report, three agency heads reported their evaluation programs had not progressed to a point to justify an affirmative statement of reasonable assurance. The other 14 agency heads reported they had reasonable assurance for their internal control systems, taken as a whole, even though their agencies were no further along in evaluating internal controls.

We reported last year that as agencies gained more experience in evaluating internal controls and began correcting identified weaknesses, the decisions made and opinions expressed would be more meaningful. We presented an approach for more clearly disclosing an agency's basis for its overall opinion on reasonable assurance by identifying those functions and operations where controls were (1) adequate, (2) not adequate, or (3) not yet sufficiently evaluated to determine their status. We stated our belief this would place the results of an agency's evaluation of internal controls in better perspective and lead to more informative reporting. We recommended that OMB strengthen annual reporting as discussed above or through a similar approach. We also provided criteria for determining a material weakness, which OMB has since essentially adopted. (See appendix IV.)

The House Committee on Government Operations also raised concerns with the agencies' 1983 statements on reasonable assurance. In its August 2, 1984, report, the committee questioned whether the term had been used consistently and whether meaningful reporting had been achieved. The committee was concerned that even though agencies had not yet evaluated their internal control systems, most reported they had reasonable assurance that their internal controls were adequate.

The committee was also concerned whether agencies reporting numerous material weaknesses could legitimately report that, taken as a whole, there was reasonable assurance that internal controls were adequate. The committee suggested that, rather than providing an opinion for the agency's systems as a whole, it would be more practical for some

agencies to report they “have reasonable assurance in all areas except. . .” and list those areas where they did not have such assurance. The committee recommended that OMB provide a more practical definition of the term “reasonable assurance” and revise its annual reporting guidance, but as discussed further on pages 36 and 37, OMB did not act on the committee’s or GAO’s recommendation.

Agency Reasonable Assurance Statements Misleading

Agency statements on reasonable assurance in 1984 were largely the same as in 1983. Twelve of 18 agency heads again attested in 1984 that their agencies’ internal control systems, taken as a whole, provided reasonable assurance that the act’s objectives were being achieved. The heads of Defense, Education, Energy, EPA, GSA, Justice, Labor, NASA, SBA, Transportation, Treasury, and VA, whose agencies collectively expended an estimated 55 percent of the federal budget in fiscal year 1985, took this position.

Twelve Agencies Did Not Have an Adequate Basis for Reporting Reasonable Assurance

In separate reports to these 12 agencies, we concluded that they did not have an adequate basis for stating that their systems, taken as a whole, provide reasonable assurance. While the specific circumstances supporting our position varied among the agencies, we based our conclusion on an agency’s progress in evaluating its internal control and accounting systems and on the extent of uncorrected material weaknesses.

Agencies had not yet sufficiently evaluated their internal control systems to determine whether, taken as a whole, the systems provide reasonable assurance that the act’s objectives were met. Further, as highlighted in chapter 2, some agencies reported material internal control weaknesses and accounting problems in systems that we considered so central to their operations as to also detract from their justifications for stating reasonable assurance. Examples follow.

- At VA we concluded that because of the significance of uncorrected material internal control weaknesses, problems with the agency’s accounting system, and problems in the internal control evaluation program, the agency did not have an adequate basis to state that it had reasonable assurance. We based our conclusion principally on the following factors: (1) regional offices that administered \$15.9 billion, or 62 percent of the agency’s annual budget, did not provide reasonable assurance; (2) material weaknesses existed in major programs, including the

\$3.9 billion pension program and the \$10.1 billion compensation program; (3) major programs, including the \$8.6 billion medical care program, were not adequately evaluated; (4) there was inadequate evaluation of ADP controls critical to VA's major program operations; and (5) testing of the agency's accounting systems was limited (GAO/HRD-86-20, Oct. 28, 1985).

- We concluded that GSA did not have an adequate basis for determining that it had reasonable assurance for several reasons. GSA had not completed actions to correct 16 reported material internal control weaknesses. For example, GSA reported weaknesses in controls over its billion dollar supply distribution system, which it stated present opportunities for pilferage, submission of fictitious orders, filing of false claims, and other practices that may result in fraud, waste, and abuse. Moreover, GSA's internal control evaluations could not be relied on to identify existing control deficiencies or vulnerabilities to such problems. Similarly, GSA's accounting and ADP system evaluations were of insufficient depth and scope to determine the extent to which those systems conformed to the act's requirements (GAO/GGD-86-11, Oct. 11, 1985).
- We reported to the Secretary of Defense that the department's internal control evaluation program had not matured to the point it provided an adequate basis to determine reasonable assurance. We found that the evaluation program was not fully operational throughout the department. For example, the Air Force, which had the largest ADP budget in the federal government in fiscal year 1984 with over \$2 billion obligated, had not adequately evaluated ADP controls. We also found that the Defense Department was having difficulty identifying systemic internal control problems and little testing of accounting systems had taken place (GAO/NSIAD-85-147, Sept. 27, 1985).
- We concluded that EPA did not yet have an adequate basis for reporting reasonable assurance because (1) material weaknesses cited in the Administrator's 1984 statement involve programs and functions which accounted for over 60 percent of the agency's \$4.3 billion fiscal year 1985 budget, (2) other material internal control weaknesses identified by EPA in 1983, but not included in the 1984 statement, had not been corrected, including weaknesses in the Superfund program, for which EPA received \$620 million in fiscal year 1985 (see page 28), (3) EPA experienced problems in its efforts to effectively evaluate internal controls, and (4) the agency had not yet adequately evaluated its accounting systems.

We reached similar conclusions for the other eight agencies that reported having reasonable assurance in 1984. Although these agencies were making progress in evaluating and improving internal controls, we

reported that their efforts had not yet reached the point where they had, in our opinion, an adequate basis for asserting reasonable assurance.

**The Remaining Six Agencies
Did Not Report Having
Reasonable Assurance**

Five of the remaining six agencies essentially reported they were not yet in a position to state that their systems, taken as a whole, provided reasonable assurance that they had met the act's objectives. Their reporting is in line with the intent of our and the House Committee on Government Operations recommendations last year, and we commend the agencies forthrightness.

Two agencies, Interior and State, provided statements somewhat similar to the alternative reporting language suggested by the House Committee on Government Operations. These agency heads reported that their systems, taken as a whole, provided reasonable assurance, except for specific areas in which they believed they did not have such assurance because of significant internal control weaknesses.

The heads of Agriculture, Commerce, and HUD continued to report, as they had in 1983, that for various reasons they were not in a position to provide reasonable assurance. Agriculture based its conclusion on the significance of uncorrected internal control weaknesses, while Commerce and HUD concluded that more testing of internal controls was needed.

The sixth agency is HHS. The Secretary of HHS, who reported having reasonable assurance in 1983, did not provide an opinion as to whether the agency had reasonable assurance in 1984.

**OMB Did Not Strengthen
Reporting Guidance**

In our view, the problems in reporting on reasonable assurance have continued primarily because OMB did not change its reporting guidance as we and the House Committee on Government Operations recommended last year. In a September 14, 1984, letter to the committee, OMB stated that each matter raised by the committee had been or would be addressed in supplemental guidance issued to agencies or in meetings with agency officials. However, OMB did not specifically comment on the committee's recommendation concerning annual reporting guidance.

Subsequently, on November 13, 1984, OMB wrote the committee responding to our recommendations. OMB reiterated its earlier statement in

response to the committee report but also specifically discussed guidance on annual reporting. OMB stated that while there may have been an initial misunderstanding of the sample statement language provided in its reporting guidance, it did not believe that the language needed to be altered, except as conditions required on an agency-by-agency basis. OMB said it believed that use of the sample language, to the extent appropriate, fulfilled the specific requirements and intent of the act. OMB's letter, however, did not explain when the sample language would be appropriate or, in those cases where it is not appropriate, how it should be altered.

On November 16, 1984, OMB updated its guidance on annual reporting. Reference was made to an OMB question and answer booklet, issued in August 1984, which essentially restated the reporting guidance issued in September 1983. Neither the booklet nor the memorandum provided additional guidance addressing reasonable assurance as the committee and we recommended.

GAO's Guidance on What Constitutes Reasonable Assurance

Because of continuing uncertainty over what constitutes reasonable assurance, the following guidance is provided for agencies future reporting on reasonable assurance. It represents the criteria GAO will continue to apply in assessing an agency's annual statement.

The term "reasonable assurance" requires management to exercise judgment in reaching a conclusion that the internal control systems meet the act's objectives. The size of the organization, diversity of operations, and degree of centralization illustrate the numerous conditions that agency management must consider in determining the overall status of its internal control systems. Reasonable assurance recognizes that the cost of internal controls should not exceed the benefits received. Internal control systems are not foolproof insurance against any and all problems. The concept of cost/benefit is important and needs to be considered. Because benefits and costs are often not precisely quantifiable, decisions on reasonable assurance will necessarily depend on management's estimates and judgments.

In evaluating whether agencies, in exercising this judgment, properly reached a conclusion as to reasonable assurance, four factors need to be considered: (1) the comprehensiveness and quality of the evaluation work performed, (2) the significance of the weaknesses disclosed, (3) the status of corrective actions, and (4) the extent to which accounting

systems conform to the Comptroller General's requirements. These factors, collectively, should serve as the foundation for the agency's assessment as to whether its internal control systems provide reasonable assurance.

Before expressing an opinion on its internal control systems, taken as a whole, the agency should first consider whether it has sufficient knowledge for stating an overall opinion. The comprehensiveness and quality of system evaluations are the primary criteria for determining if an agency has the information necessary to determine the overall status of the internal control systems central to its operations. The systems' evaluations can take a number of forms, including reviews of operating internal control and accounting systems, audit reports, management reviews, and consultant studies. However, as discussed further on page 48, we believe that testing of the controls in operation is important. We have often found that breakdowns in internal control systems are the result of individuals not following prescribed policies and procedures, rather than a lack of policies and procedures.

The 1984 annual statements of Commerce and HUD illustrate this concept. The Secretary of Commerce reported that although he believed Commerce's systems of internal control were in place and functioning as intended, the department had not sufficiently tested the controls to support a full assurance statement. The Secretary of HUD stated, as he did in 1983, that HUD's evaluation of its internal controls had not progressed to the point where HUD had reasonable assurance that the act's objectives have been met. The Secretary also concluded that because of the decentralization and complex nature of HUD programs, HUD must conduct many more in-depth reviews of its major activities in headquarters and the field and must further strengthen the overall evaluation process before it will have such assurance.

Agencies need to keep this point in mind when determining reasonable assurance. The act requires an evaluation of internal controls and directs agency heads to base their annual statements on this work. To have an adequate basis for reporting that their systems provide reasonable assurance that the act's objectives are being met, we believe sufficient evaluation and testing of key internal controls in operation are necessary.

In making the determination on reasonable assurance, an agency also needs to consider the magnitude and importance of the internal control weaknesses and the instances of accounting system nonconformance

identified, as well as whether corrective actions have substantially remedied those problems. If systems central to its operation have material weaknesses, in our view, the agency should not state it has reasonable assurance for its systems, taken as a whole. Agriculture cited this as its reason for being unable to provide reasonable assurance.

It must be recognized that there is a distinction between the extent of progress made by an agency in implementing the act and the ability to provide reasonable assurance. The needed evaluations and corrective actions may take several years to complete. An agency may be making good progress toward that goal, but not yet at a point where reasonable assurance can be provided. While full disclosure of material weaknesses and planned corrective actions are important, they do not by themselves provide the justification for an agency to conclude that its internal control systems, taken as a whole, meet the act's objectives.

Both the reporting approach we recommended last year and the "except for" reporting format suggested by the House Government Operations Committee, which we support, are in effect an opinion on individual internal control systems rather than on the systems "taken as a whole."

The "taken as a whole" opinion requires a weighing of the relative importance of those individual systems that fully comply with the act's requirements and contribute to reasonable assurance, against those that do not and those that have not yet been evaluated. As discussed previously, we concluded that 12 agencies that used the "taken as a whole" language in 1984 did not have an adequate basis for doing so. As additional systems are evaluated and brought into compliance with the act's requirements, reporting on the systems as a whole would become more creditable.

The "except for" format certainly would have been more appropriate in 1983 and 1984 as agencies were just beginning to implement the act. We anticipate that this will be the case for some time to come as agencies face the difficult and often long-term job of correcting their material internal control weaknesses and still must evaluate and test many of their systems. A reporting format that clearly discloses the significance of individual systems which do not provide reasonable assurance and those systems which have not yet been adequately evaluated and tested, best informs the President and the Congress of the status of an agency's internal controls and, in our view, provides credibility to the annual statement.

Reporting on Accounting System Conformance Is Also a Problem

We identified problems in reporting on the adequacy of agency accounting systems similar to the reporting problems for internal controls. We concluded that 11 agencies reported, without an adequate basis, all or some of their accounting systems as being in conformance with the Comptroller General's principles, standards, and related requirements.

The act requires that each agency head's annual statement include a separate report on whether the agency's accounting systems conform to the accounting principles, standards, and related requirements prescribed by the Comptroller General. In September 1983, OMB issued draft guidelines for evaluating and reporting on accounting system conformance. These guidelines were available for agencies to use in evaluating and reporting on their accounting systems during 1984. The draft guidelines suggested that agencies report that their accounting systems, taken as a whole, conform in all material respects, except for any known material instances of nonconformance, which should be listed in the report. However, the guidelines did not indicate how the extent of nonconformance, or the lack of system testing, should be considered in arriving at an agency's overall opinion on the status of its accounting systems.

As with its internal control systems, to have an adequate basis for reporting conformance, we believe an agency must review and test its accounting systems in operation. We found, however, that for the most part, agencies have not yet evaluated many of their systems or sufficiently tested the systems that were evaluated. The lack of adequate scope and depth in agency evaluation coverage was the prime reason we are reporting to the secretaries of Commerce, Defense, Energy, Interior, Labor, Transportation, and Treasury, and to the administrators of EPA, NASA, SBA, and VA that their agencies did not yet have an adequate basis to state that certain of their accounting systems conformed to the Comptroller General's requirements. For example:

- SBA reported in 1984 that the results of its evaluations indicated that the accounting systems reviewed, taken as a whole, conformed. We reported to SBA that in our view this statement was misleading because it did not adequately disclose the extent of assurance given. An attachment supporting SBA's statement showed that the agency had reviewed two of its six accounting systems and that the statement covered only those systems. SBA did not disclose, however, that the two systems reviewed accounted for less than 5 percent of SBA's total funds.
- Energy reported that its accounting systems generally conformed with the Comptroller General's requirements. The department, however, noted that testing was not conducted for most of its existing accounting

systems because they were to be replaced by the end of 1985. We agree with Energy's decision not to review and test systems that are about to be replaced. But we told the department that it should not state that its systems are in general conformance until the new systems have been substantially implemented, tested, and found to be in conformance.

- Commerce reported that its accounting systems conformed to the Comptroller General's requirements. However, the agency had not tested transactions for five of its accounting systems which account for about 87 percent of its approximately \$2 billion annual budget. Also, the tests conducted on the three remaining systems were limited and did not cover key aspects of those systems such as accounts receivable, grants, and reimbursable costs, which for one of the systems accounted for almost \$148 million in fiscal year 1984.

We reached similar conclusions for the other eight agency heads who generally reported their accounting systems conformed to the Comptroller General's requirements. While progress was made in 1984, these agencies had not reached the point, in our view, where they yet had an adequate basis for reporting that their accounting systems conformed.

On May 20, 1985, OMB finalized its accounting system evaluation guidelines. The guidelines revised the suggested reporting format included in OMB's earlier draft by providing alternative language to be used if an agency determines that some of its accounting systems conform and others do not. Under this alternative, an agency's report would identify the number of systems that generally conformed and the number that did not conform and would list the material instances of nonconformance. The guidelines also suggest that agencies plan, evaluate, and test each accounting system on a 3-year cycle.

While we do not expect an agency to review each system yearly, in a May 20, 1985, letter commenting on the guidelines, we cautioned OMB that an agency is not in a position to treat a system as in conformance until the system has been sufficiently evaluated. OMB's alternative language does not provide for identifying those accounting systems which have not yet been evaluated, nor does it provide for disclosing the significance of systems not in conformance or not yet evaluated.

Conclusions

This report provides the criteria which we used in determining the appropriateness of the 1984 agency annual statements we reviewed. We made recommendations, where appropriate, in reports issued to these agencies.

OMB should use the criteria in this report as a basis for providing necessary guidance to agencies in preparing their annual statements on internal controls and on accounting system conformance, and agencies should follow the approach we discuss in their future reporting under the act. The “except for” format suggested by the House Committee on Government Operations provides agencies the option of reporting on the status of their individual systems, rather than on the agency as a whole. This would alleviate the annual reporting problems we have noted.

Recommendations

We recommend that the Director, OMB, implement our prior recommendation to strengthen annual internal control reporting guidance to agencies. OMB must ensure that agencies disclose more clearly the basis for their position on reasonable assurance, considering the weaknesses identified and the scope of evaluations. Specifically, we recommend that OMB:

- Revise internal control reporting guidance as discussed in this chapter to incorporate the “except for” reporting format of the House Committee on Government Operations whereby agencies would clearly disclose the significance of
 1. those systems which do not meet the act’s requirements, and
 2. those systems which have not yet been evaluated and for which the agency does not know whether or not they comply with the act’s requirements.
- Require that for agency heads to elect the “taken as a whole” reporting format, they must clearly demonstrate that those systems that do not comply or have not been adequately evaluated are not of such significance as to detract from the credibility of an opinion on the agency as a whole.

Similarly, we recommend that OMB strengthen its guidance for reporting on accounting system conformance so that the annual report will clearly disclose the condition of an agency’s accounting systems, applying the same criteria we outlined for reporting on internal control systems. It should be clear which systems conform, which ones do not, and which ones have not been evaluated so that a conformance statement can be provided.

Agency Comments and Our Evaluation

In commenting on a draft of this report, OMB continued to take the position that its reporting guidance does not need to be revised and indicated it believes that we are looking for a far higher level of assurance than the reasonable assurance called for in the act. (OMB's comments are included in appendix VII.) OMB expressed concern that action on our recommendations would impose an audit-oriented approach requiring much more detailed testing, and result in cumbersome reporting and an inordinate increase in the paperwork burden required to assemble supporting materials. OMB continues to believe that its current guidance, which calls for an overall "taken as a whole" conclusion, adapted to individual circumstances, fairly portrays an agency's status.

As discussed in this chapter, we are not calling for absolute assurance as OMB indicates in its comments. However, an agency must have a creditable basis for reporting on the adequacy of its internal control and accounting systems. The "taken as a whole" statement prescribed by OMB represents one overall opinion on the totality of the agency's systems. It necessarily requires a weighing of the relative importance of those systems that fully comply against those that do not and those that have not yet been evaluated. The number and significance of the systems that do not comply and have not been evaluated undermine the credibility of a "taken as a whole" opinion. Under this approach, agencies have reported they have reasonable assurance even though, in our view, the status of internal controls and accounting systems, as well as the evaluation work performed, did not support such statements. Agency reports which provide reasonable assurance for an agency's systems "taken as a whole," particularly those that subsequently disclose material weaknesses, are subject to varying interpretation.

We continue to believe that most agencies should use an "except for" reporting format as suggested last year by the House Committee on Government Operations. Under this approach, an agency would express an opinion that all its systems comply "except for" those systems that do not and those that have not yet been adequately evaluated. We agree with OMB that the 335 new material weaknesses agencies disclosed in their 1984 annual reports represent an important step in effectively implementing the act and that the agencies essentially reported all their known weaknesses. We fully agree that correction of the problems is the bottom line of the act. However, this does not negate the need to provide a creditable statement to the Congress and the President on the status of their systems. By clearly disclosing the number and significance of individual systems which do not comply and have not been adequately evaluated, the "except for" statement best informs the President and the

Chapter 3
Improvements Are Needed in
Annual Reporting

Congress of the status of an agency's internal control and accounting systems, and thereby enhances the credibility of an annual statement.

As stated in this chapter, as additional systems are evaluated and brought into compliance with the act and as material weaknesses which detract from reasonable assurance are corrected, reporting on the systems taken as a whole, as OMB now prescribes, will become more creditable. However, under the present circumstances, we believe that the "except for" format continues to be the more appropriate statement of reasonable assurance. We expect this will be the case for some time to come as agencies face the long-term job of evaluating their systems and bringing them into compliance.

We share OMB's concern with the need to focus managers' efforts on strengthening their internal control and accounting systems while minimizing the amount of associated paperwork. However, we do not agree with OMB's inference that testing agency systems in operation as a basis for annual reporting imposes an audit-oriented approach that will undermine management's stewardship. As discussed further in chapter 4, adequate system evaluations provide managers information on the operations of their internal control and accounting systems. Otherwise, agencies will not know if the systems are operating properly and if their desired goals and objectives are being achieved efficiently and effectively.

Evaluations Need to Be Further Strengthened

Agencies have continued to build on initial efforts to evaluate the adequacy of their internal control and accounting systems, and managers are more aware of their responsibilities to ensure adequate control and accountability. However, in our individual reports to agencies, we are noting a number of problems in agency evaluation programs and making recommendations to improve future system evaluations.

This chapter highlights four problem areas that we believe are the most pervasive and important for agencies to address in evaluating their internal control and accounting systems: the need to (1) test systems in operation, (2) evaluate ADP controls which are integral to adequate internal control and accounting systems, (3) reexamine the vulnerability assessment approach for internal controls prescribed by OMB, and (4) address the growing concern that the evaluations have resulted in a paperwork burden.

Effective System Evaluations Are Needed

In our first overall report on the act and in our individual reports to agencies last year, we reported that agencies needed to more effectively evaluate their internal control and accounting systems in order to more fully identify and facilitate the correction of system weaknesses. We identified a number of areas in which agencies' evaluation programs needed improvement, including the need to test operating systems and to evaluate the adequacy of ADP internal controls.

The House Committee on Government Operations raised similar concerns. In its August 2, 1984, report on the act's first-year implementation, the committee concluded that agency managers must improve the systematic evaluation of their internal control and accounting systems. The committee observed that agencies had yet to conduct the detailed reviews necessary to identify internal control and accounting system weaknesses and thereby facilitate their correction. The committee also concluded, as we did, that OMB should provide agencies with additional guidance to ensure that their evaluations of ADP controls are comprehensive and consistent.

OMB's internal control evaluation guidelines provide a framework for agencies to use in evaluating, improving, and reporting on their internal control systems. The OMB approach is comprised of seven steps: (1) organizing to implement the act, (2) segmenting agency functions into assessable units, (3) assessing vulnerability, (4) planning for subsequent reviews, (5) reviewing internal controls, (6) taking corrective actions, and (7) reporting.

OMB's guidelines call for agency managers to evaluate their internal controls in the most efficient and effective manner. While a specific approach is suggested for conducting vulnerability assessments and internal control reviews, the guidelines allow agencies to tailor the approach to their unique operations. The vulnerability assessment step is intended to provide a mechanism to help agencies determine where best to allocate their resources for making in-depth reviews of internal controls. The internal control review step is to provide a means, through the evaluation of an agency's operating systems, to determine the adequacy of internal controls. A key element called for in this step is testing of internal controls to determine if an agency's systems are working as intended.

In May 1985, OMB issued "Guidelines for Evaluating Financial Management/Accounting Systems." Draft guidelines were previously provided to the agencies by OMB in September 1983. The guidelines outline an approach for agencies to use in evaluating and reporting whether their accounting systems conform to the Comptroller General's requirements. The OMB approach requires testing of an agency's accounting systems in operation not less than once every 3 years.

Agencies Continue to Build on Their Initial Evaluations

Agencies have continued to build on their initial efforts to evaluate their internal control and accounting systems. They have generally been responsive to the proposals we made last year to help them strengthen their evaluation programs. But as discussed later in this chapter, certain problems remain and additional agency work is required to evaluate their internal control and accounting systems.

Managers' involvement in implementing the act and their awareness of the importance of internal control and accounting systems have increased. In 1984, thousands of agency managers and staff were involved in evaluating in some way, thousands of agencies' programs and functions. For example, Treasury substantially increased the involvement of its managers, especially those in the field who were not involved in 1983.

A number of agencies issued or revised policies and procedures underlying their evaluation programs. These actions were generally responsive to the proposals we made to the individual agencies last year on how they could strengthen their evaluation efforts. For example, the Department of Energy revised its internal control review guidelines to improve and streamline its evaluation process. The revised guidance clarified

managers' assessment responsibilities and the inspector general's role and established specific requirements for evaluations and reporting to the Secretary.

In another instance, the Department of Interior revised its policies and procedures based on lessons learned in 1983 and on evaluations by OMB, Interior's inspector general, and us. Interior either revised or established policies in the areas of segmentation, vulnerability assessments, ADP internal control evaluations, quality assurance, and corrective action tracking and follow-up.

An additional example is the Army which, as discussed further on page 54, completely revamped its internal control evaluation approach in an attempt to make its evaluations more efficient and effective.

Testing of Internal Control and Accounting Systems Needed

While agencies reviewed more of their internal control and accounting systems in 1984, none had yet progressed to the point where they had adequately tested their systems. As we reported last year, testing is essential to determine whether internal control and accounting systems are operating as designed and in accordance with established policies and procedures.

Testing can show whether internal controls are in place and operating properly to minimize the risk of fraud, waste, and abuse, and whether accounting systems are producing accurate, timely, and useful information. Testing requires an initial investment of agency resources. However, once a system has been adequately tested and the results documented, fewer resources should be required to reevaluate the system in the future. Through adequate testing, agency managers will know whether their internal control and accounting systems are in place and operating as intended and will be able to identify and subsequently correct weaknesses.

Many agencies continued to rely heavily on vulnerability assessments, checklists, and questionnaires to evaluate their internal control and accounting systems. These approaches can be helpful in measuring managers' perceptions of the adequacy of their systems and in identifying potential weaknesses. However, a system must be tested in operation to determine if it is operating as intended. As discussed on page 38, the Secretary of Commerce reported that, while believing the systems were operating properly, his agency had not yet adequately tested its internal control systems to know whether they were in place and functioning as

intended. The factors which we believe need to be considered in testing internal control and accounting systems are addressed in our individual reports to the agencies and are summarized in appendix V.

While agencies for the most part still needed to test their internal control and accounting systems, we identified instances where, through testing, agencies identified weaknesses and developed corrective actions. For example, although the Department of the Navy tested only 2 of 201 accounting systems in operation and under design, these two evaluations identified major system weaknesses. For instance, the Navy tested the permanent change of station segment of its military financial system, which accounts for about \$550 million annually. The Navy interviewed personnel, observed operations involved in the processing of transactions at various commands, and traced the flow of transactions through the accounting system and among commands. By testing this system, the Navy identified two overall system weaknesses: (1) inadequate control over obligations, outlays, and liabilities and (2) the failure to adequately meet user needs for financial information. In addition to pinpointing system problems, testing facilitated the development of corrective action plans and the Navy has initiated action to correct the weaknesses identified.

In another case, the Department of Education tested 10 accounting systems in 1984, which together processed \$34.1 billion in transactions or about 52 percent of the \$65.1 billion handled by the Department's accounting systems in fiscal year 1984. Through testing, Education identified a number of systems' weaknesses. For example, the agency identified approximately \$5 million in personal property that was not shown on its accounting records.

SBA used an existing computerized internal control review system to evaluate internal controls at all of its 66 district offices and at 10 branch offices. These reviews encompassed major programs and administrative functions at those offices which serviced 131,000 business loans totaling about \$10.7 billion, or approximately 97 percent of the agency's business loan portfolio in fiscal year 1984. SBA's internal control reviews at these locations included an evaluation of an estimated 116,000 internal control techniques. While SBA found that 90 percent were operating as intended, for the 10 percent where weaknesses were noted about 1,200 corrective actions were identified for improving operating procedures and internal controls.

Automated Controls Need to Be Evaluated

ADP is critical to government operations. Agencies' dependence on automated systems to control and account for their activities is ever growing. Fourteen of the 18 agencies' 1984 annual statements to the President and the Congress disclosed material ADP weaknesses involving programs and operations totaling billions of dollars. Nevertheless, as we reported last year, none of the agencies we reviewed had adequately evaluated their ADP controls and operations.

Limited Progress in Reviewing ADP Controls

While progress varied, we continued to find that ADP controls were generally not evaluated. When they were, the evaluations did not fully address either general controls, which apply to the overall management of the agency's ADP function and affect the quality of services rendered to ADP users, or application controls, which affect the quality of data origination, input, processing, and output. For example,

- VA had made little progress in evaluating ADP internal controls. VA operated over 700 computers located at its 5 data processing centers and 169 computer centers at its 172 hospitals. In fiscal year 1985, the agency's automated systems disbursed about \$15.9 billion in veterans benefits and supported the \$8.6 billion nationwide medical care program. We found that VA had not evaluated ADP internal controls at its hospitals, and its review of its \$3.9 billion pension program did not evaluate ADP controls essential to the reliability and integrity of the program.
- SBA continued to give little attention to ADP controls crucial to its operations. SBA's automated systems maintain records for \$18.5 billion in loans. The agency processes daily collections averaging 12,000 transactions and totaling over \$6 million, which represent most of the agency budget and resources. In December 1983, SBA stated that the entire ADP function was highly vulnerable but did not follow through with a thorough review of the function. For example, SBA conducted its review of computer operations on a verbal basis and did not include testing of ADP internal controls.
- The Department of Education had not evaluated its ADP internal controls. ADP internal controls are particularly important in light of (1) the \$6.7 billion student financial assistance program, which relies on ADP support to process about 10 million loan and grant applications annually, and (2) the \$6.9 billion grant and other assistance programs to states and localities which rely on ADP for formula grant distribution, eligibility and entitlement data control, and funds disbursement. In this regard, the department has developed criteria for evaluating ADP which it plans to test in 1986.

- HHS, which relies heavily on automated systems to disburse over \$270 billion annually, continued to rely on its ADP security program to evaluate its ADP controls, even though we criticized this method in our report last year.⁶ The ADP security program focused on physical security over ADP equipment and did not address ADP application controls which are critical to determining whether the HHS internal control systems fully meet the act's requirements.

Guidance on ADP Evaluations Still Needed

The lack of central guidance has hampered progress in evaluating ADP internal controls. Although OMB has provided some guidance to agencies on evaluating ADP controls, we believe, as we did last year, that guidance is still needed.

Because of the limited coverage of ADP and agency uncertainty of what to do in this area, our first overall report on the act recommended that OMB provide additional guidance for evaluating ADP internal controls. We also provided our observations on what was needed to evaluate ADP internal controls in a June 21, 1984, letter⁷ to the Director of OMB. In addition, the House Committee on Government Operations recommended in its August 2, 1984, report on the first-year implementation of the act that OMB provide guidance for the review of ADP controls. The committee believed this guidance was necessary to help ensure comprehensive and consistent evaluations of this critical function.

Subsequently, in a question-and-answer booklet issued in August 1984, OMB defined ADP internal controls and described the relationship between the evaluation requirements under the Financial Integrity Act and OMB Circular A-71, which covers ADP security. Also, OMB emphasized the need to evaluate ADP controls during meetings with agency officials. Nevertheless, we found that significant problems remained in terms of what and how ADP controls should be evaluated and, as mentioned previously, that for the most part, ADP internal controls have not been evaluated.

A few agencies—for example the Departments of Defense and Energy—developed their own ADP evaluation approaches, which are generally in consonance with the ADP evaluation approach in our June 1984 letter to OMB. These evaluation approaches were not available when the agencies

⁶The Department of Health and Human Services' First-Year Implementation of the Federal Managers' Financial Integrity Act, (GAO/HRD-84-47, May 9, 1984).

⁷This letter is contained in our previous report, GAO/OCG-84-3, as appendix IV.

performed the evaluations supporting their 1984 annual statements to the President and the Congress but are to be used in the future. Also, Treasury has developed ADP guidance, which it is enhancing based on our comments. Finally, the Department of Agriculture developed ADP evaluation guidance. However, it did not require that the guidance be used, resulting in some managers evaluating their ADP internal controls while many others did not.

Recommendation

To help ensure adequate consideration of ADP internal controls, OMB must provide leadership and direction. The act requires OMB to establish internal control evaluation guidelines. OMB needs to build on the initiatives, as described previously, that some agencies have taken in developing ADP review guidance and incorporate these into OMB-issued guidance for use by other agencies. The sharing of lessons learned and best practices is important since agencies must better incorporate ADP into their system evaluation programs.

Accordingly, we recommend that the Director, OMB, act on our prior recommendation to develop guidelines for evaluating ADP internal controls, drawing upon guidance proven useful by agencies in conducting ADP evaluations.

Agency Comments and Our Evaluation

While not stating agreement with our recommendation, OMB recognized the need for more progress in agency evaluation of ADP controls. OMB stated that it has already issued, or plans to issue, supplemental guidance in the ADP area. OMB said it continues to work closely with agencies to develop evaluation methodology and plans to make exemplary evaluation methods available as they are developed. Given the central role of ADP in supporting crucial government programs and services and our report findings that the lack of guidance as to what and how ADP controls should be evaluated, we strongly agree with the actions OMB outlined, which if carried out should be responsive to our recommendations.

The Vulnerability Assessment Approach Reexamined

Agencies have devoted considerable resources to making vulnerability assessments, and the vulnerability of thousands of operations and functions have been assessed. However, these efforts have often not resulted in reliable and useful information to agency managers, and the vulnerability assessment process has been widely criticized as a paper exercise.

Vulnerability assessments are to be a preliminary analysis by agency managers on where internal control strengths and weaknesses may exist in their programs and on the susceptibility of their programs to fraud, waste, and abuse. They can provide a basis for planning detailed reviews of internal control systems and a road map on where to go next in evaluating internal controls. The OMB guidelines caution that vulnerability assessments should not involve an in-depth review of controls, but rather should use managers' existing knowledge of their operations. This should include the results of internal audits, consultant studies, management reviews, our reviews, and other improvement initiatives.

The agencies we reviewed generally followed OMB's suggested vulnerability assessment approach. This included using OMB's suggested evaluation forms which contain 16 general factors for assessing vulnerability of areas such as the budget level. The OMB guidelines do not provide detailed criteria for a manager to use in judging the conditions that would warrant a given factor being rated low, medium, or high vulnerability. To result in reliable and useful vulnerability assessments, managers need to translate the relevance of OMB's general factors to the specific risk inherent in their agency's programs and functions, and to preliminarily assess the controls in place to lessen or to eliminate the risk. In this regard, a thorough understanding of the elements necessary for an effective internal control system is needed. We reported to most of the agencies in our review that increased training is important to achieving this understanding.

To evaluate the effectiveness of the OMB vulnerability assessment approach, we conducted a pilot study of the reliability of vulnerability assessment results at Treasury with emphasis on the U.S. Customs Service's assessments. We reported to Treasury that the vulnerability assessments were unreliable and not useful to managers.⁸ Our review of 818 assessments identified inconsistencies in how managers arrived at vulnerability ratings and disclosed that managers frequently omitted major operations from the assessments. The vulnerability assessments were not tailored to each unit's specific internal control risks and to the controls in place, but used OMB's suggested forms and general assessment factors. Customs similarly concluded that its assessment results were not meaningful and reliable. As a result, Customs is formulating a

⁸Unreliable Evaluations Detract From Treasury's Progress to Implement the Financial Integrity Act (GAO/GGD-86-10, Oct. 10, 1985).

revised approach which focuses a manager's attention on the fundamental internal control concepts that pertain to the program or function being assessed.

We also found that Commerce's vulnerability assessments were not reliable. Officials responsible for implementing the act stated they lacked confidence in the reliability of the vulnerability assessments because the assessment approach, which was adopted from the OMB guidelines, did not always lead managers to identify and describe the significance of risks specific to their activities. The agency is considering altering its approach in order to address this problem.

Some agencies have developed or were developing alternative evaluation approaches which build on OMB's guidance. For example, rather than have its operating managers continue to perform vulnerability assessments, the Army is assessing vulnerability at the headquarters level, and then having its field offices focus future assessments on specific internal controls. The Army has identified over 1,300 functions and is developing standard evaluation programs for each one which will identify the applicable internal control risks and the control objectives and techniques necessary to prevent those risks from occurring. The evaluation guidance for travel pay activities, for instance, which was issued in September 1985, tells managers specifically what is important to controlling this activity and what questions they need to ask themselves. The Army estimates that this approach will save 800 to 1,000 staff years in evaluation time annually, while resulting in a more effective, consistent effort.

The Paperwork Burden

A common concern surrounding the act has centered on documentation and the view that the evaluation program has become a paper exercise. The problem with the reliability and usefulness of vulnerability assessment results discussed previously contributes to this view.

Strengthening internal control and accounting systems requires the involvement of a wide range of managers with widely differing backgrounds—from scientists to economists. This can lead to differing views of the act's requirements and how these requirements should be carried out through OMB's evaluation guidelines.

The House Committee on Government Operations, in its August 2, 1984, report, expressed concern that some agency officials believed that implementation of the act had accomplished little beyond adding to the

paperwork burden. The committee concluded if managers adopt the view that the implementation process is merely a meaningless paper exercise, this attitude will hamper efforts to achieve substantial improvement in the management of the federal government.

Earlier this year, we held a series of meetings with agency program officials and financial managers responsible for implementing the act, the inspectors general and their staffs, and representatives of major public accounting firms who have been working with agencies in implementing the act. Our purpose was to share experiences and explore what the government needs to do to make sure the act succeeds on a long-term basis.

The committee report, our review work, and the series of meetings we held show that there is a general consensus that managers believe that the evaluation process is requiring them to spend scarce resources documenting information that is not useful. The Administrator of GSA acknowledged in his 1984 annual statement to the President and the Congress that many of GSA's managers consider implementation of the act to be a paper exercise. He said this view may have skewed the results of the managers' evaluations, making it appear that GSA had greater assurance of proper operations than it really had. Concerns about the usefulness of the evaluation process must be addressed for the act to gain the full support and commitment of managers who have to implement its provisions.

Because of the perception that the act's merits were being diluted by a paper-intensive implementation process, the President's Council on Management Improvement formed an interagency team to study this issue and to propose solutions. Six agencies and GAO were represented on the study team. The study report, issued in October 1985, confirmed that paperwork, both with respect to vulnerability assessments and internal control reviews, was considered excessive.⁹

The study concluded that while agencies recognize the need to strengthen their internal controls and have made numerous efforts to do so, much of the effort has been focused on closely complying with evaluation and documentation processes which (1) have not always been efficiently translated into improved controls and (2) have resulted in a

⁹President's Council on Management Improvement, Interagency Study Report, Streamlining Internal Control Processes and Strengthening Management Controls With Less Effort, October 1985.

substantial paperwork burden, generated at great cost and with substantial effort. The study team made a series of recommendations to reduce paperwork and to improve implementation of the act so that the focus of future efforts would be more on the act's objective of strengthening controls.

The study team recommendations are grouped into three major categories: (1) reducing the effort expended on vulnerability assessments and internal control reviews without compromising the objectives of the program, (2) refocusing the emphasis of audits to strengthening internal controls, and (3) improving the direction and coordination of implementation of the act. We generally concur with the recommendations.

An interagency coordination committee through the President's Council on Management Improvement is being established to oversee the implementation effort. OMB has indicated a willingness to address the study team recommendations, including the recommendations to revise the vulnerability assessment process and address the paperwork concern. Accordingly, at this time, we are not making any recommendations concerning the paperwork issue or the vulnerability assessment process. Appendix VI, however, includes our views on documentation needs.

Federal Managers' Financial Integrity Act of 1982

An Act To amend the Accounting and Auditing Act of 1950 to require ongoing evaluations and reports on the adequacy of the systems of internal accounting and administrative control of each executive agency, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled.

SECTION 1. This Act may be cited as the "Federal Managers' Financial Integrity Act of 1982".

SEC. 2. Section 113 of the Accounting and Auditing Act of 1950 (31 U.S.C. 66a) is amended by adding at the end thereof the following new subsection:

"(d)(1)(A) To ensure compliance with the requirements of subsection (a)(3) of this section, internal accounting and administrative controls of each executive agency shall be established in accordance with standards prescribed by the Comptroller General, and shall provide reasonable assurances that—

"(i) obligations and costs are in compliance with applicable law;

"(ii) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and

"(iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets.

"(B) The standards prescribed by the Comptroller General under this paragraph shall include standards to ensure the prompt resolution of all audit findings.

"(2) By December 31, 1982, the Director of the Office of Management and Budget, in consultation with the Comptroller General, shall establish guidelines for the evaluation by agencies of their systems of internal accounting and administrative control to determine such systems' compliance with the requirements of paragraph (1) of this subsection. The Director, in consultation with Comptroller General, may modify such guidelines from time to time as deemed necessary.

"(3) By December 31, 1983, and by December 31 of each succeeding year, the head of each executive agency shall, on the basis of an evaluation conducted in accordance with guidelines prescribed under paragraph (2) of this subsection, prepare a statement—

"(A) that the agency's systems of internal accounting and administrative control fully comply with the requirements of paragraph (1); or

"(B) that such systems do not fully comply with such requirements.

Appendix I
Federal Managers' Financial Integrity Act
of 1982

"(4) In the event that the head of an agency prepares a statement described in paragraph (3)(B), the head of such agency shall include with such statement a report in which any material weaknesses in the agency's systems of internal accounting and administrative control are identified and the plans and schedule for correcting any such weakness are described.

"(5) The statements and reports required by this subsection shall be signed by the head of each executive agency and transmitted to the President and the Congress. Such statements and reports shall also be made available to the public, except that, in the case of any such statement or report containing information which is—

"(A) specifically prohibited from disclosure by any provision of law; or

"(B) specifically required by Executive order to be kept secret in the interest of national defense or the conduct of foreign affairs.

such information shall be deleted prior to the report or statement being made available to the public."

SEC. 3. Section 201 of the Budget and Accounting Act, 1921 (31 U.S.C. 11), is amended by adding at the end thereof the following new subsection:

"(k)(1) The President shall include in the supporting detail accompanying each Budget submitted on or after January 1, 1983, a separate statement, with respect to each department and establishment, of the amounts of appropriations requested by the President for the Office of Inspector General, if any, of each such establishment or department.

"(2) At the request of a committee of the Congress, additional information concerning the amount of appropriations originally requested by any office of Inspector General, shall be submitted to such committee."

SEC. 4. Section 113(b) of the Accounting and Auditing Act of 1950 (31 U.S.C. 66a(b)), is amended by adding at the end thereof the following new sentence: "Each annual statement prepared pursuant to subsection (d) of this section shall include a separate report on whether the agency's accounting system conforms to the principles, standards, and related requirements prescribed by the Comptroller General under section 112 of this Act."

Approved September 8, 1982.

Departments and Agencies Included in Our Review

Department or Agency	Report Number	Date
Department of Agriculture	GAO/RCED-86-20	10/24/85
Department of Commerce	GAO/RCED-86-21	11/05/85
Department of Defense	GAO/NSIAD-85-147	09/27/85
Department of the Army	GAO/NSIAD-85-149	09/27/85
Department of the Navy	GAO/NSIAD-85-150	09/27/85
Department of the Air Force	GAO/NSIAD-85-151	09/27/85
Defense Logistics Agency	GAO/NSIAD-85-148	09/27/85
Defense Mapping Agency	GAO/NSIAD-85-116	07/26/85
Department of Education	GAO/HRD-85-78	09/26/85
Department of Energy	GAO/RCED-86-14	10/17/85
Department of Health and Human Services	GAO/HRD-86-9	11/08/85
Department of the Interior	GAO/RCED-86-25	10/31/85
Department of Justice	GAO/GGD-86-9	10/31/85
Department of Labor	GAO/HRD-86-29	11/18/85
Department of State	GAO/NSIAD-85-135	09/25/85
Department of Transportation	GAO/RCED-86-35	10/30/85
Department of the Treasury	GAO/GGD-86-10	10/10/85
Environmental Protection Agency	GAO/RCED-86-34	11/13/85
General Services Administration	GAO/GGD-86-11	10/11/85
Housing and Urban Development	GAO/RCED-86-22	10/08/85
National Aeronautics and Space Administration	GAO/NSIAD-86-3	11/19/85
Small Business Administration	GAO/RCED-86-24	10/18/85
Veterans Administration	GAO/HRD-86-20	10/28/85

**Appendix III
Categories of Reported Material Weaknesses
by Agency - 1983 and 1984**

Grant, Loan and Debt Collection		Personnel and Organizational Management		Procurement		Property Management		Cash Management	
1983	1984	1983	1984	1983	1984	1983	1984	1983	1984
X	X	X	X	X	X	X	X	X	X
X	X				X	X	X		X
X	X		X	X	X	X	X	X	X
X	X	X	X	X	X	X	X	X	X
				X	X	X	X		
X	X	X	X	X		X			
			X	X	X	X	X		
X	X	X	X	X	X	X	X	X	X
X	X	X	X	X	X	X	X	X	X
X	X	X	X	X	X	X	X	X	X
X	X			X	X	X	X	X	X
X	X	X	X	X				X	X
		X	X		X	X	X	X	X
X	X			X		X	X	X	
X	X	X	X	X	X	X	X	X	X
13	13	10	12	14	14	14	15	12	12

^aSix Department of Defense agencies (the Office of the Secretary of Defense, Army, Navy, Air Force, Defense Logistics Agency, and Defense Mapping Agency) were included in one report to the Congress and the President.

^bNo "material weaknesses" reported in NASA's 1983 or 1984 statements. However, 1984's report did disclose weaknesses in the ADP and procurement categories.

Criteria for Determining a Material Weakness

The concept of materiality has long been considered a fundamental part of financial accounting and reporting. Although guides exist, an explicit standard of what constitutes materiality has yet to be formulated. This is especially true in reviewing program functions and operations, which the Financial Integrity Act covers, that go beyond accountability and financial reporting. Numerous factors are often considered in making materiality decisions, many of which are intuitive and involve judgment.

Our first overall report on the act (GAO/OCG-84-3, Aug. 24, 1984) and the House Committee on Government Operations August 2, 1984, report on the act's first-year implementation identify factors to consider in determining what constitutes a material weakness. These factors are:

- a loss or potential loss of resources that would impair an agency's fulfillment of a mission (ratios or percentages of budgeted dollars and relative dollar amounts based on agency criteria are common measures);
- adverse publicity or embarrassment to the agency which would diminish credibility or reputation;
- importance to the public or third parties (a good example is a Social Security payment, where the recipient depends on the timely receipt of a check in the correct amount);
- a problem which warrants the personal attention or awareness of the agency head or higher management;
- violations of statutory or regulatory requirements; and
- potential conflicts of interest.

In determining materiality, an agency should consider the magnitude of resources involved in relation to the total available to the agency. Other factors which should be considered are the sensitivity of the resources involved, such as the control over information and technology which affect national security, and the actual or potential frequency of loss.

An agency must consider its individual circumstances and those things which are important to its mission. While there are common materiality factors, their application should be tailored to the organization, and specific factors need to be developed on an agency-by-agency basis. What is of importance to the Commerce Department may not be material to the Department of Defense or the Department of Education.

Categories of Reported Material Weaknesses by Agency - 1983 and 1984

Agency	Automated Data Processing		Eligibility and Entitlement		Accounting and Financial Systems	
	1983	1984	1983	1984	1983	1984
Agriculture	X	X	X	X	X	X
Commerce		X	X		X	X
Defense ^a	X	X	X	X	X	X
Education		X	X	X	X	X
Energy					X	X
EPA		X			X	X
GSA	X	X			X	X
HHS	X	X		X	X	X
HUD			X	X	X	X
Interior	X	X	X	X	X	X
Justice					X	X
Labor	X	X	X	X	X	X
NASA ^b		X				
SBA	X		X	X	X	X
State		X			X	X
Transportation	X	X		X	X	X
Treasury	X	X			X	X
VA	X	X	X	X	X	X
Total	10	14	9	10	17	17

Factors for System Testing

Detailed procedures for testing system operations is presented in GAO's CARE¹⁰ Audit Methodology to Review and Evaluate Agency Accounting and Financial Management Systems which was issued in July 1985. While the methodology focuses on evaluating the operations of agency accounting and financial management systems, it can be easily applied to testing internal control systems and nonfinancial operations.

The CARE methodology calls for the following test procedures:

- Preparing a system test plan that (1) specifies system control objectives and system control techniques, (2) describes test objectives, scope, and impact on normal system operations, and (3) lists system transaction or event types, error conditions and input procedures to be tested, and master files to be created and used.
- Testing manual processes.
- Testing automated processes.
- Analyzing test results.
- Considering costs and benefits

System tests should cover the major types of transactions or events a system is designed to process and the key internal controls in a system to ensure that they are operating as intended. Tests should be designed to disclose whether valid transactions or events are processed properly and whether the system rejects those that are invalid.

Testing requires an initial investment of agency resources. However, once a system has been adequately tested and the results documented, fewer resources should be required to reevaluate the system in the future. The reason is that in developing test plans consideration should be given to the results of any prior system testing.

There are a number of techniques that can be used to test system operations, including

- interviewing persons who operate the systems,
- observing operating procedures,
- examining system documentation,
- determining if control techniques are effective using actual transactions,
- direct testing of computer-based systems by use of simulated transactions, and
- reviewing error reports and evaluating error follow-up procedures.

¹⁰Control and Risk Evaluation.

Appendix V
Factors for System Testing

In determining which tests would be appropriate for a system, it is important to keep in mind that in most cases, using transaction-testing as the key, more than one of the above techniques are needed to test key aspects of a system. For example, to determine if grant awards are being properly made, an agency could (1) interview persons who operate the system, (2) examine agency policies and procedures (system documentation) to identify control objectives and techniques, (3) observe the processing of grant applications through the system, and (4) trace a sample of actual applications through the system to ensure control techniques work and that improper awards have not been made.

Guidance on Documentation

Documentation of system evaluations should be a tool to assist in developing meaningful corrective actions and planning future work. The purpose of documenting a system evaluation should be to provide managers with useful information such as a record of the work performed, those who performed it, and the conclusions reached. Our advice in determining "how much documentation is enough" is that the amount and depth of documentation should be sufficient so that management can determine the basis for the conclusions reached and be able to build on the work in the future.

It is also important to keep in mind the difference between documenting the system evaluation and the system itself. Systems should be documented as they are designed and implemented and updated as design changes are made. In the past, however, systems oftentimes have not been documented initially, or documentation has not been properly updated as needed.

System documentation tells management how its internal control and accounting systems are designed to operate. Without this information, it is difficult, if not impossible, to diagnose and correct system breakdowns, particularly in an automated system. In addition, planning for system changes becomes more difficult.

Comments From Office of Management and Budget



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

NOV 25 1985

Honorable Charles A. Bowsher
Comptroller General of the
United States
General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. *Bowsher*:

This is in reponse to a draft GAO report, "Strengthening Internal Control and Accounting Systems," that deals with the second-year implementation of the Financial Integrity Act.

The report acknowledges the considerable progress made by agencies in implementing the Act. It points out that "agencies have extensive efforts underway to strengthen their systems and reported having corrected hundreds of material weaknesses and accounting system problems in 1984." Agency efforts reflect a wide range of initiatives being taken under the Act and the President's Management Improvement Program: Reform '88 to upgrade internal controls and to strengthen financial management throughout the Government.

Sustaining agency improvement efforts has been one of OMB's highest priorities. Our Financial Integrity Task Force has worked closely with the agencies to improve internal controls and strengthen financial systems. Also, during the Management Review phase of the annual budget process, we have highlighted to agency management the importance of timely and effective actions to correct weaknesses in their internal control and financial systems. The report notes that OMB needs to continue to play a central role in guiding and directing agency efforts. We have met this responsibility in the initial years of the Act's implementation, and will continue to do so until full implementation is achieved.

The draft report restates the recommendation made last year, that OMB provide additional guidance on year-end reporting, and on the evaluation of ADP controls. Each of those matters has been addressed in supplemental guidance issued by OMB, in meetings with agency officials, and in correspondence with you and with Chairman Brooks of the House Committee on Government Operations. Our specific actions and comments are summarized in the enclosure.

**Appendix VII
Comments From Office of Management
and Budget**

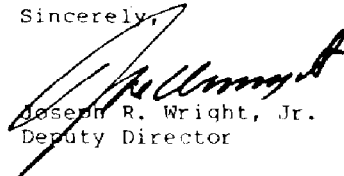
2

The report acknowledges the great concern expressed by agency managers about excessive paperwork and the need to focus future efforts on strengthening controls, rather than on generating more paper. We are concerned that complying with the GAO recommendations would impose an audit-oriented approach, require much more detailed testing, and result in cumbersome reporting and even more paperwork. This would undermine what is essentially management's self-evaluation, improvement, and reporting on its stewardship. The draft report showed only 4 instances of material weaknesses not included among the 335 disclosed by agency management -- and this disclosure, with the corrective action taken by the agencies, is truly the bottom line of the Act.

As I suggested earlier to you, by concentrating on the substance of the evaluation process, i.e., the operation of control systems, the reporting of material weaknesses, and the taking of corrective action, and less on documentation and the report language, we can work together more effectively with agency management to achieve our mutual objective of improving internal control, and financial systems throughout the Government.

We appreciate the opportunity to comment on the draft report.

Sincerely,



Joseph R. Wright, Jr.
Deputy Director

Enclosure

Enclosure

Supplemental Guidance

OMB issued supplemental guidance on year-end reporting and on evaluating ADP controls. The guidance is summarized below:

Guidance on Year-End Reporting. In my November 13, 1984, letter to Chairman Brooks, we advised him of the actions we planned to take concerning the definition of "material weakness" and improved guidance on year-end reporting.

We did adopt the suggestion of the House Committee on Government Operations concerning the four additional elements to be included in the definition of material weakness. That information was conveyed to agency management on November 16, 1984, as part of the updated guidance on preparation of the 1984 FIA reports. Rather than attempt to develop a single Government wide definition of "material weakness," we have encouraged agencies to use the broad guidance available, and then develop their own specific definition relevant to their size and individual operations. Several agencies, notably the Departments of Commerce and Defense, have done so. As with other exemplary practices, these definitions have been disseminated to other agencies through a clearinghouse maintained by the Financial Integrity Task Force.

In the same letter, we advised Chairman Brooks that we did not agree with the GAO recommendation that year-end reporting should include an "except for" provision. We believe that the sample internal control statement provided in current OMB guidance, used where conditions permit, fairly portrays the agency's status and provides for disclosure of its most significant internal control weaknesses. This is accomplished through an overall conclusion statement, adapted to individual circumstances, and a "however" provision under which any material weaknesses are reported.

As we understand the GAO recommendation on use of the "except for" provision, each agency would be expected to disclose in its report the basis for its overall conclusion, and to identify the hundreds or even thousands of functions and operations where controls were (1) adequate, (2) not adequate, or (3) not yet sufficiently evaluated to determine their status. We believe the inclusion of such elaborate details as GAO suggests would make for a confusing report, result in an inordinate increase in the paperwork burden to assemble supporting materials, and have the effect of overshadowing the agency head's conclusion.

Another issue of great concern to us is GAO's contention that agency heads did not have an adequate basis for reporting that their systems of internal control provided reasonable assurance that the objectives of the Financial Integrity Act were being achieved. We wrote you about this matter on August 26, 1985.

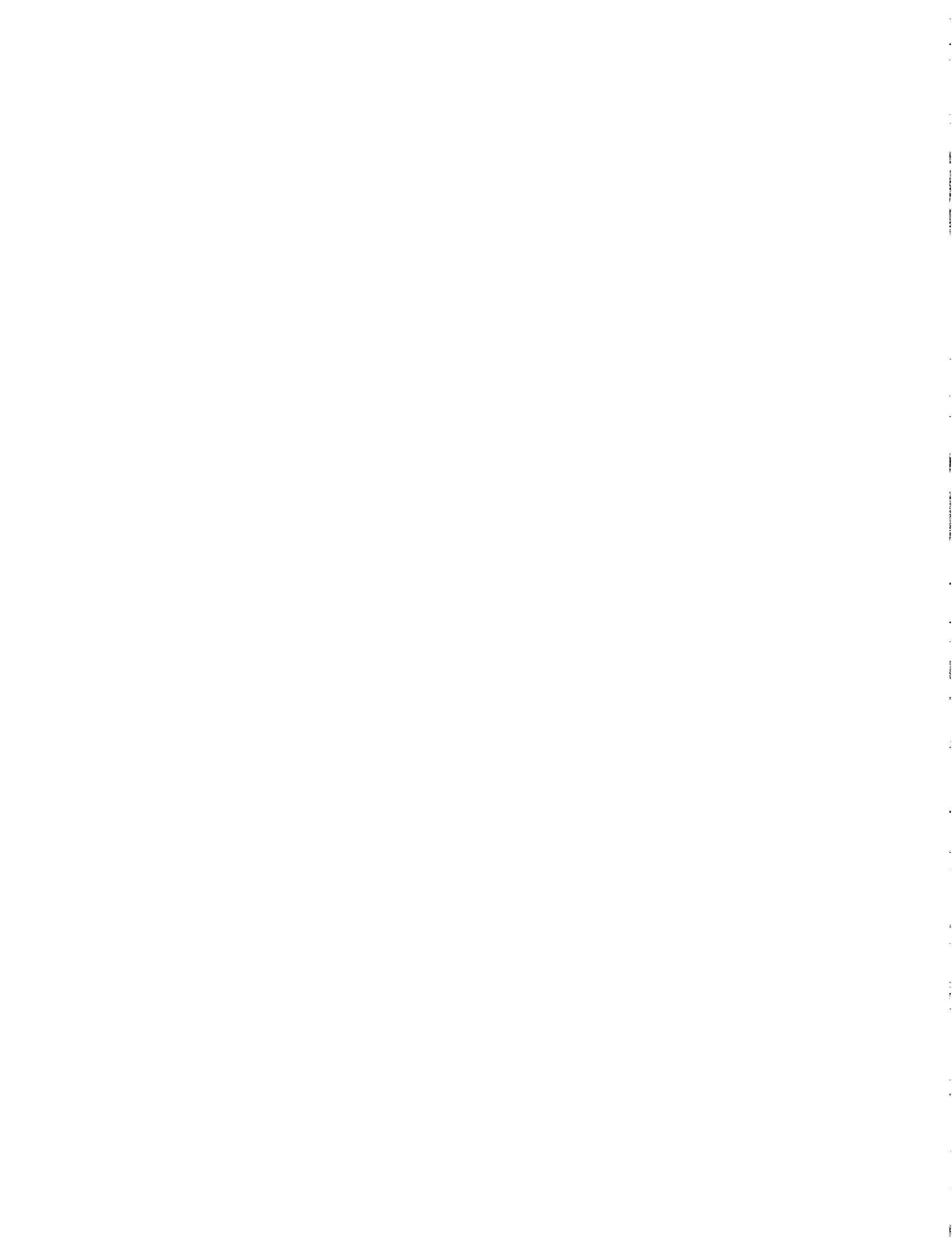
What the GAO staff continues to suggest is that there is a clearly defined level of effort that agencies must expend before they have a basis to provide a reasonable assurance statement. As we have repeatedly discussed, there is no such level, and we do not believe it is realistic to expect that one can be established.

The report and GAO staff discussions with agency management consistently suggest that (1) unless most of the agencies' control systems have been evaluated and tested, and (2) until the recommended improvements to the evaluation process have been made and the material weaknesses corrected, then the agency head does not have an adequate basis for providing a reasonable assurance statement. An enormous level of resources would be required to satisfy all of these conditions; a level far greater than available or intended by the Act.

The report also applauds the statements of those departments that say their tests were not sufficient to provide full assurance. This approach suggests that GAO is looking for a far higher level of assurance than the reasonable assurance called for by the Act. Use of terms such as "full" or "complete" closely approach an absolute assurance that would be impossible for any organization to achieve. Reporting on such a basis is totally unrealistic.

Guidance on Evaluating ADP Controls. We recognize the need for more progress in agency evaluation of ADP controls. This matter is discussed in a new OMB circular that will be issued shortly to replace Circular A-71, "Responsibilities for the Administration and Management of Automatic Data Processing Activities." Also, it is one of the three subjects identified in the guidance provided agencies concerning preparation of the 1985 FIA reports.

Evaluation requirements for information technology systems are summarized in Circulars A-71 and A-123. OMB staff continue to work closely with the agencies to develop an evaluation methodology that considers both the OMB requirements and the agencies' individual circumstances. As exemplary evaluation methods are developed, they will also be made available to all agencies.



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