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PERFORMANCE AUDITING--WHAT IS IT?



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by

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What is [performance auditing?]

The first comment one might have about this question is that it is a good one. The second comment to be made, however, is that, at least in my judgment, it is an easy question to answer.

My answer to the question is that all auditing can be called performance auditing--irrespective of labels which are often attached in an effort to draw distinctions between audits of differing activities or with differing objectives. These labelling efforts, which result in such terms as financial auditing, management auditing, operational auditing, program auditing and yes--performance auditing--are seldom very successful in conveying precise meanings.

No matter what the scope or objectives of his audit, the auditor is auditing the performance of people. He evaluates and reaches conclusions about how good a job they have done in carrying out their responsibilities.

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This simplistic commentary suggests a couple of other basic propositions about the art of auditing that I would like to lay before you before delving into some specific cases.

- The first proposition is that the full scope of the auditor's job embraces examinations of three broad but closely interrelated segments of management responsibility. These segments are:

1. Financial operations, including the handling of funds and other resources, complying with applicable laws, regulations, and requirements, and properly accounting for and reporting on the custody and use of resources.
2. Efficiency and economy in the management of funds and other resources and in carrying out operations.
3. Effectiveness of operations, that is, whether or to what extent the objectives established for the organization or activity are being achieved.

A scope of audit as comprehensive as this encompasses just about the full range of management activity--irrespective of whether the organization or activity being audited is in the public sector or in the private sector or somewhere in between. The auditor is therefore concerned with management performance and his work can properly be labelled "performance auditing" if a label is needed.

I make this observation to emphasize also the point that the conduct of financial transactions, accounting for them properly, and reporting on the results and status of operations are integral parts of management responsibility and must be included in any concept of performance auditing.

- My second proposition is that to be most effective, all auditing has to be conceived, managed and regarded as a constructive component of overall management, rather than a negative and critical function that acts more as a barrier to efficient and effective operations than as an essential method of promoting improvements.

Having stated these propositions, I could elaborate on each of them at length in conceptual terms. However, I believe it will be much more useful and interesting to review a few specific cases drawn from the work of the U.S. General Accounting Office with which I am associated to illustrate the range of management concerns with which the auditor may be associated and how he has to be concerned with performance.

SCOPE OF GAO AUTHORITY

GAO's basic audit charter, which was set forth 55 years ago in the Budget and Accounting Act of 1921, is to investigate

all matters relating to the receipt, disbursement, and application of public funds in the Federal Government. This assignment of authority and responsibility was deliberately stated in broad terms and the language used imposes no limits as to the scope of our auditing and investigative work.

Over the years, the Congress has restated the scope of our audit authority in different terms, however. For example, in the Legislative Reorganization Act of 1970 and the Congressional Budget and Impoundment Control Act of 1974, the Congress highlighted the role that our audits of Government program results can play in support of its oversight and legislative functions.

The 1974 language specifically requires the Comptroller General to "review and evaluate the results of Government programs and activities when ordered by either House of Congress, or upon his own initiative, or when requested by any committee . . . having jurisdiction over such programs and activities."

This kind of legislative action underscores the emphasis on advanced auditing that the Congress--as the key oversight body in our Government--wishes the GAO as one of its arms to specifically recognize.

REPORTING

The results of GAO audit work are reported in a variety of ways: in written reports addressed to the Congress or to its

One problem encountered in this work involved our auditors in making judgments on whether the agency should include in its accounts an estimate of the possible losses it may sustain in the future after it takes over loans that it has guaranteed. We concluded that such estimates should be included in the accounts and financial statements. The agency, however, vigorously disagreed. It argued that guaranteed loans were not its assets and therefore it need not try to project and record possible losses on those that they might take over in the future.

The issue involved is of current importance in the light of Statement of Financial Accounting Standard No. 5 on accounting for contingencies published by the Financial Accounting Standards Board about a year ago.

Grain Inspection

My second example involves a subject that has been much in the news during the past year--the sorry state of our national grain inspection system. This system has been organized and operated in such a way over the years as to permit not only dishonest practices in attesting to the quantity and quality of grain inspected but also extensive bribery. We still read almost weekly of criminal indictments being handed down and convictions of individuals for wrongdoing.

The production and sale of grain is big business. Crops in our country in 1974, for example, produced over 9 billion bushels of grains--mostly wheat and corn--worth about \$33 billion. About a third of it was exported.

In February of this year, GAO completed an extensive examination of the grain-inspection system at the specific request of two congressional committees--one in the house and one in the Senate.

The study was a far-ranging one and only a few highlights can be touched on here. For example--

- The Department of Agriculture has the job of providing overall supervision of the national grain inspection system. However, it has not been able to insure the integrity of the system which is operated by a widely dispersed group of over 100 State and private agencies and trade associations.
- Some inspection services have been satisfactory but the system has operated without effective controls, procedures, or lines of authority and conflicts of interest between grain inspection on the one hand and merchandising operations on the other have been tolerated.
- Weaknesses in the system have led to extensive criminal abuses such as intentional misgrading of grain, shortweighing, and using improperly inspected carriers.
- Foreign buyers of U.S. grain have lost confidence in our system because of misgrading and shortweighing. Some have turned to other countries when possible as their source of supply (GAO auditors interviewed grain buyers in nine foreign countries as part of the examination).
- The effectiveness of the Department of Agriculture's supervision has been limited because the system was designed in the first place to facilitate grain marketing rather than assure integrity of all transactions.

Also, important was the fact that the Department has not had enough people to do a good job (a common problem in Federal programs). But even where it became aware of weaknesses, the Department did not take aggressive action to correct them or even determine how extensive the problem was. Also, it did not establish what actions were to be taken when grading, sampling, or other inspection irregularities occurred.

GAO's main conclusion from all this was that fundamental changes were needed in the grain inspection system. Our solution which we recommended was that the Congress establish a Federal system of inspection with the costs of Federal inspection services to be reimbursed to the Federal Government. In this way, there would be no increase in net Federal expenditures but a stronger and more reliable system should result.

What will happen is still being debated. In some quarters, the idea of a Federal system is strongly endorsed, but in others it is opposed.

The Comptroller General and members of the GAO staff who participated in this examination testified on our findings before the Senate Committee on Agriculture and Forestry on February 20. Members of this Committee were favorably impressed with the report which they characterized as "the most thorough investigation of our grain marketing and inspection system ever undertaken."

For anyone who is interested in an outstanding example of the kind of light auditors can shed on a complex problem of national concern involving Federal and State Governments, farmers, private industry, trade associations, and foreign interests, this GAO report* is as good as any to be found.

Urban Rats

My next example is concerned with a much different subject and from the standpoint of what is accomplished with money spent. It also concerns a somewhat disagreeable subject but one that needs attention and effective action.

The subject is rats. Their existence anywhere is something to be concerned about because of their destructive and disease-carrying abilities.

But in our inner cities, they have become a symbol of urban blight. They contaminate food--they damage buildings with their gnawings--they outrage or frighten people whose paths they cross--and they often attack young and old people.

The Department of Health, Education, and Welfare has estimated that there are 100 million rats in the U.S.--about 1 for every 2 people. And it has estimated further that rats cost us about \$1 billion a year in direct economic losses.

*"Assessment of the National Grain Inspection System," RED-76-71, 2/12/76

Several years ago, the Federal Government started a control program based on making grants of funds to local government and private agencies to stimulate comprehensive rat control programs. About \$85 million was granted through 1974 for projects in 59 communities serving about 7 million residents.

The goal sought to be achieved through this program has been quite simple--to reduce rat populations and change the conditions they like to live in so that they are no longer a significant detriment to the health and economy of the target area.

Progress in the program is measured by the reduction in the number of confirmed rat bites per year and by the increase in the number of city blocks that have met certain sanitation standards.

Last year, GAO reviewed this program and its accomplishments and concluded simply that it was in trouble. We did observe and report* that some progress had been made as indicated by such accomplishments as:

- A 54 percent reduction in the annual number of confirmed rat bites in the 20 cities originally in the program.
- A steady increase in the number of city blocks where rat control was considered effective, and
- Greater public and local government understanding of the rat problem and what actions were needed to solve it.

*"The Urban Rat Control Program Is In Trouble," MWD-75-90, 9/29/75

However, we also concluded--and so reported--that despite these indications of progress, it was doubtful if the goals of the program were going to be achieved. For example,

- The number of city blocks with effective control was far short of the targets that had been established.
- For some projects, the improvements that had been made could not be sustained.
- Many cities had reduced their rat control efforts--for lack of enough money.
- In some places, sanitation codes were either inadequate or were not being enforced.
- Effective community support was lacking--and without this no program of this kind can possibly succeed.

We made a few recommendations aimed at improving the program.

But it seems obvious that solving a problem like rats requires a very strong local commitment and vigorous and sustained local effort--by those in authority--by property owners--and by residents.

The Federal department involved in this program knows that the program must be made more effective. However, it looks to itself as a stimulator of an activity that should be the primary responsibility of State and local governments. The Congress has displayed some interest as evidenced by the fact that representatives of the GAO testified before a congressional committee on our report a few months ago.

committees and Members; in reports addressed to agency officials; in congressional testimony; in oral presentations to and discussions with Members of Congress and their staffs, the staffs of the committees, and agency officials; in the annual reports of the Comptroller General; and in periodic publications, such as the monthly list of GAO reports which summarize information on GAO activities.

SOME SPECIFIC CASES

We complete about a thousand reports a year on the vast variety of programs and activities of Federal agencies. For this reason, I won't represent the examples selected for discussion here as necessarily representative of GAO audit work. But they do illustrate to some degree the variety of activities reviewed, the scope of audit work performed, and the effort to be constructive and produce useful information for Federal managers, policy-makers, and the Congress which we directly serve.

Small Business Loans

My first example is concerned with the lending of Federal funds--an important type of Governmental financial aid to various segments of our society and even to other countries.

I mention this particular examination because it illustrates not only operating problems where more than one level of government is involved. It also illustrates that auditors can bring an independent viewpoint to bear and produce an official report that can focus public attention on a serious nationwide problem, perhaps better than any other medium. The purpose of such auditing is constructive--to evaluate performance, to provide oversight information for the Congress which authorizes and appropriates public funds for such programs, and to suggest improvements in management and procedures to obtain better results on a social and economic program with such highly desirable objectives.

Whether in this particular program with its attendant difficulties real improvement will come about remains to be seen.

The Gama Goat

My next example takes us into the vast reaches of the Department of Defense and specifically the Army. This is the case of the Gama Goat.

Despite its unusual name, the chances are that few people ever heard of the Gama Goat.

The Small Business Act authorizes the Small Business Administration of the Federal Government to guarantee as well as make direct loans to small businesses. Over 80,000 of these loans totalling nearly \$4 billion are outstanding.

A recently completed GAO audit of this program brought to light a lot of problems that require aggressive management attention if it is to more closely achieve the objectives for which it was established, including some protection of the general taxpayer. These problems included such defects as:

- Approving loans which merely transferred the risk of obtaining repayment from banks and creditors of the borrowers to the Federal Government.
- Questionable refinancing of loans to borrowers who were already delinquent in their payments and appeared to have little chance to improve their prospects.
- Making loans to wealthy businesses who were never intended to receive such assistance.
- Failure to analyze prospective borrowers' financial condition adequately or to verify adequacy of collateral pledged.
- Not detecting borrowers who used the proceeds of their borrowings for purposes not authorized by the terms of the loans.
- Failure to visit borrowers regularly to check on their progress.

Other problems were identified in the GAO report* but those

*"The Small Business Administration Needs to Improve Its 7(a) Loan Program," GGD-76-24, 2/23/76

mentioned above are enough to illustrate the general finding that a lot of tightening up was needed. Government lending programs are usually difficult to manage and control because the borrowers are usually persons or organizations who cannot get suitable credit from private sector sources and are therefore much more risky. At the same time, in authorizing the programs, the Congress usually fixes reasonable assurance of repayment as a condition for making loans. This in turn is reasonable since any other criterion would amount to almost a "give-away" program and these are seldom acceptable except for welfare purposes.

Another problem besetting the small business loan program was the lack of adequate staff to do a better job. Auditors do well to point out such circumstances where they account--at least in part--for unsatisfactory performance. Government administrators seldom set out to do an inadequate job. In many cases, they are caught between having heavy workloads on the one hand and, on the other hand, having inadequate staffs--both in numbers and capability--to do a good job.

Auditors can do a disservice to the objectives they serve and to their profession by not recognizing that even where management problems exist there are bright spots to report. The

GAO report on the loan program of the Small Business Administration did take note of the constructive assistance the agency had provided to many small businesses and the good quality of its stated procedures for administering its loan program. The problems identified were mainly problems in the way the procedures were carried out.

In commenting on the report, the agency expressed appreciation for the overall tenor of the report, acknowledged the managerial shortcomings described, and described what it intended to do about them.

This case illustrates the constructive job an independent auditor can do in stimulating better government operations (to the taxpayers' benefit) including providing good, solid information to the Congress for its use in legislative oversight.

The report not only went to the Congress but public hearings were held on it by the Senate Select Committee on Small Business immediately and this kind of attention always stimulates better management performance--at least for a time.

Another important segment of our audit of the Small Business Administration pertains to its accounting and the reliability of its financial statements. The results of this work are now being reported to the Congress.

The Gama Goat is a 1½ ton cargo truck designed for high mobility over bad terrain. The Army has purchased over 14,000 of these trucks for over \$200 million under a program started more than 10 years ago. The truck has been controversial in many ways almost from the start.

GAO recommended 5 years ago that the Army not begin full scale production of this truck until all the bugs were worked out--and there seemed to be a lot of them. The Army's own Audit Agency and a congressional committee also were critical and said so. However, the Army went ahead anyway, claiming that the bugs had been largely overcome.

But they were not.

Last December GAO reported on a follow-up examination into whether the Gama Goat was operating satisfactorily. Based on checking with actual users and maintenance personnel in the Army and Marine Corps, we found a lot of problems with the truck. For example--

- Engine noise was so loud that it interfered with necessary and constant on-the-move radio communication. Drivers were issued ear-plugs which helped shut out the noise but also prevented them from hearing commands and instructions.
- The truck did not have adequate ability to swim and float across inland water crossings--which was one of the needs specified to avoid vehicles bunching up at bridges, ferries, and other water crossings.

Drivers were supposed to stop at the water's edge and inspect their truck for water tightness but many of them had damaged tailgates which would cause them to sink.

Also, the truck could only enter the water where the river bank was gentle and the soil was tight--and then at a speed of not more than 2 miles an hour and not at all if the water current was over 4 miles an hour or the wind was blowing more than 20 miles an hour. In actual operations, these conditions could not be depended upon to exist.

- Gears were hard to shift and had a tendency to pop out.
- Drivers had a hard time getting in and out of the truck.
- The truck was dangerous to operate on wet or muddy roads because the center wheels threw mud and water onto the inside of the windshield which the driver had to constantly wipe.

I need not list all of the problems--there were more.

Because of all of the problems, the Army was planning to spend another \$6 million to correct some of the defects.

One Senator who read our report commented: "I don't know whether to laugh or cry."

Our report questioned whether many of the problems could really be corrected without major and costly modifications. We suggested that the Department really test the truck under simulated combat conditions and that the testing be done by an independent group, that is, someone other than the Army. We felt that this should be done before spending more money on it since one possible alternative would be to replace the truck entirely.

At last report, the Department of Defense agreed in part with us. It has modified some of the trucks and these are being independently tested before going ahead with a full-scale modification program.

Other Examples

The scope of operations of the Federal Government are so vast and wide-ranging that GAO as the independent auditor for the Congress finds itself examining management and operational performance in almost every category of human endeavor. Here are a few shorter examples:

1. Mailing practices--We all use the U.S. mails. Last year the Federal Government itself spent about \$440 million on postage. We found that a large part of this cost could have been cut through use of more economical mailing practices such as:

- Using less expensive classes of service.
- Cutting down on special mail services such as special delivery, insured, and certified mail.
- Using letter-size envelopes instead of the most costly "flats" or large-size envelopes.

The postage cost paid of \$440 million related to nearly 3 billion pieces of mail. The GAO study* did not get

*"Federal Agencies Could Do More To Economize on Mailing Costs,"
GGD-75-99, 8/25/75

into how much of that was unnecessary mailing in the first place and that in itself could be a fruitful examination.

One example--during 1974 the San Francisco Mint mailed nearly 3 million announcements to advertise the availability of its coins to prospective purchasers. All of these announcements went by first-class mail. Had they been sent third-class, the postage costs would have been about \$500,000 lower. Mint officials told us, in effect, that the lower preferential treatment of third-class mail and its "junk mail" image would be detrimental to their program. But they did agree to check further into the matter.

The findings in this examination are potentially applicable to any organization and auditors should be alert to such possibilities. One of the most valuable functions of the auditor is to call attention to and question practices that have been accepted but which result in waste of resources. No institution can survive indefinitely without regard to efficient use of resources. Auditors have an important part to play here and--wherever located organizationally or functionally--they should contribute as best they can.

2. Acquiring computer systems--Auditors cannot escape computers in this day and age. Computer technology is widely used in government operations--at all levels. It is needed but it is costly. Constant vigilance is needed if costs are to be kept at a minimum and still make the fruits of the technology available.

Last year, GAO reported on its study of the possibility for large savings in acquiring computer systems under Federal grant programs.* This is a case where the Federal Government has a good, strong policy--at least the Office of Management and Budget and the General Services Administration have stated one. But as in the case of all policies, stating them is one thing and having them properly carried out is another. This is where auditors can be helpful.

In this case, the GAO report described how, under existing administrative arrangements, grantees were being allowed to do such things as--

- Obtaining new computer systems or adding to the ones they already had without thoroughly evaluating their needs.

*"Opportunity For Savings Of Large Sums In Acquiring Computer Systems Under Federal Grant Programs," FGMSD-75-34, 7/24/75

- Obtaining their own systems without fully exploring possibilities of joint use of existing facilities with other organizations.
- Leasing computer equipment for short periods without fully considering the financial benefits of purchasing or long term leasing.

While effective surveillance over operations of recipients of Federal grant funds is not the easiest thing to bring about in our system of complex intergovernmental relationships, the types of problems we found illustrate the need for much stronger procedures to help save that scarce resource--namely, Federal (that is, national taxpayers') funds.

An auditor cannot directly correct problems that he sees. But he can recommend actions he thinks will help correct them. In this case, our report included several specific recommendations, for actions which, if properly carried out, should help insure that grantees follow business-like practices in acquiring computer equipment.

3. Overpaying beneficiaries--Paying out more public money to beneficiaries than they are entitled to is a widespread management defect in many government

programs--and because of the size and complexity of most of these programs combined with problems of management and staff capabilities, these problems are difficult to correct. Disbursing funds in advance of need or entitlement is a serious variation of the overpayment defect.

Last month, GAO reported* on a billion dollar problem of this nature in the Veterans Administration. The problem was--and is--overpayments to veterans and veterans' dependents for educational assistance. The report showed that cumulative overpayments to December 31, 1975, totaled nearly \$1.4 billion of which over \$800 million occurred in the 18 months ended on that date. About \$300 million was still unrecovered at the end of 1975.

Several reasons account for such large and extensive overpayments including:

- Delays by veterans and the schools involved in reporting changes in training status such as dropping out of classes or withdrawing from school.
- Poor processing practices by the Veterans Administration.

*"Educational Assistance Overpayments, A Billion Dollar Problem--
A Look at the Causes, Solutions, and Collection Efforts,"
MWD-76-109, 3/19/76

- Making advance payments and prepayments as authorized by law but without first determining whether they were really needed.

Some of the problem has been due to failures by veterans and schools to cooperate adequately and some was due to the law that was administered in a way that led to paying out more money than was necessary. But overall the problem has been one of deficient management performance involving large sums of public funds.

The problem has not been unknown, of course, to VA officials but the GAO report brought the matter more visibly into the public arena and stimulated congressional and public interest in it.

The report presented numerous recommendations for alleviating the problem and the agency generally agreed with them.

There are many other fields that GAO auditors operate in but I think I have touched on enough examples to illustrate the scope and variety of their work, all of which involves management performance.

THE GAO ROLE

GAO occupies a unique position in the Federal Government's scheme of organization and checks and balances. Our independence as auditors of Federal operations is enhanced by several factors, including these:

- We are located in the legislative branch of the Federal Government in which authorization, financing, and oversight responsibilities for most Federal activities are lodged.
- We have been given a very broad charter of authority and responsibility in several laws enacted by the Congress.
- We are headed by two officials who are appointed for 15-year terms.

These factors have enabled us to make a great deal of progress in expanding the scope of our audit operations.

Our relative independence of operation and performance has helped lead to a considerable broadening of the audit function in other levels of government and outside government. In short, the scope of GAO audit work and our published code of auditing standards are helping to serve as beacons for other governmental audit organizations.

We think that State and local governments can definitely benefit from an advancement in the nature and scope of the audit

work performed by them or on their behalf and that such advancement can only inure to the benefit of those who contribute a share of their income and resources through taxes to finance government operations.

The public accounting profession definitely has a stake in advancing the art of auditing beyond evaluating accounting performance, integrity of financial transactions, and fairness of financial statements.

Overall professional opinions on financial data are important in our society in providing some insight into whether proper integrity exists in the financial system of the organization or activity audited and whether its financial reporting can be relied on. Unfortunately, the language that public accountants and auditors use to state their opinions on financial statements, is so elevated, abstract, and standardized as to be largely incomprehensible to the unsophisticated and not really of much help to others.

The profession might do better to bring its opinion language down to earth perhaps along the lines the late Eric Kohler talked about a few years ago. He said the unqualified, short form auditor's opinion--with all of its tired phraseology--means only that the financial statements are OK.

In any event, managers and policymakers, particularly in government, want--and need--more from auditors than stereotyped opinions on financial statements. They want independently and objectively obtained and evaluated information on operations and performance and expert advice on such things as how improvements can be made, how money can be saved or used to better advantage, and how goals or objectives can be achieved in better fashion and at less cost.

Providing such information is the continuing challenge confronting auditors in all segments of the profession. In concluding, I see this as the direction the concepts and practice of the art of auditing must take and is taking. And in doing so, it is concerned with performance of all kinds. To my way of thinking, that is what auditing is all about--evaluating performance, reaching and reporting conclusions, and pointing the way to improvement.