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# *REPORT TO THE CONGRESS*

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## Need For More Effective Audit Activities

B-130515

Office of Economic Opportunity

*BY THE COMPTROLLER GENERAL OF THE UNITED STATES*

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APRIL 4, 1973

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

B-130515

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

This is our report on the need for more effective audit activities of the Office of Economic Opportunity.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

We are sending copies of this report to the Director, Office of Management and Budget; the Acting Director, Office of Economic Opportunity; the Secretary of Health, Education, and Welfare; the Secretary of Housing and Urban Development; the Secretary of Commerce; the Secretary of Labor; and the Secretary of Agriculture.

Elmer B. Staats

Comptroller General
of the United States

## Contents

## ABBREVIATIONS

| | |
|---|---|
| AICPA | American Institute of Certified Public Accountants |
| CAA | community action agency |
| CPA | certified public accountant |
| GAO | General Accounting Office |
| OEO | Office of Economic Opportunity |

*COMPTROLLER GENERAL'S REPORT TO THE CONGRESS*

NEED FOR MORE EFFECTIVE AUDIT ACTIVITIES
Office of Economic Opportunity
B-130515

## D I G E S T

### *WHY THE REVIEW WAS MADE*

This review was made to determine the adequacy of public accountants' audits of local antipoverty agencies which received grants from the Office of Economic Opportunity (OEO). 9-7

The President's fiscal year 1974 budget contains no request for direct appropriations to OEO but provides for the transfer of most of the OEO programs to other Federal agencies. Under the budget, funding community action agencies (CAAs) under the Economic Opportunity Act would cease effective July 1, 1973. The budget suggests the use of general and special revenue-sharing funds if the constituencies of individual communities desire to continue supporting the CAAs.

In January 1973 OEO announced that it would continue funding CAAs up to June 30, 1973, for up to 6-month periods through December 31, 1973. Therefore, the recommendations in this report will still require action by OEO. Also, many of the observations contained in this report may be of value to other Federal agencies that use public accountants to supplement their audits of Federal grantees, such as the Departments of Health, Education, and Welfare; Housing and Urban Development; Commerce; Labor; and Agriculture.

#### *Background*

The Congress required that each local antipoverty agency have adequate accounting and internal control systems. It required also that these agencies be audited yearly to insure that the systems are adequate and that funds are spent in accordance with law, regulations, and grant conditions.

OEO, rather than auditing about 1,500 antipoverty agencies (or grantees), required the grantees to arrange with qualified accountants--generally certified public accountants--to audit their activities. (OEO's audit staff consists of 45 professionals.)

By these annual audits, OEO attempts to keep informed of the (1) adequacy of the grantees' accounting systems and related internal controls, (2) validity of the grantees' reported expenditures and financial condition, and (3) grantees' overall accountability for program funds.

The public accountants whose audit work was selected for General Accounting Office (GAO) review were derived from a selection of OEO grantees rather than a selection of public accountants. Because of this and because the grantees were not selected at random, results of GAO's review should not be considered as representative, or typical, of audits made by all public accountants.

### *FINDINGS AND CONCLUSIONS*

#### *Deficiencies in accounting systems and controls not disclosed in audit reports*

About 60 percent of over 1,000 audit reports on grantee operations issued



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in fiscal year 1970 reported no major accounting system or internal control deficiencies. GAO reviewed 27 reports from this group. (See p. 9.)

Of the 27, 17 failed to disclose significant deficiencies in the financial operations of OEO grantees. Some public accountants informally reported such deficiencies to their grantee-clients rather than including them in their formal audit reports. The deficiencies included inadequate controls over cash, payroll, travel expense, procurement, consultant services, and property and two cases of misappropriations of funds.

Certain matters described in this report dealing with work done by public accountants could not be accepted as adequate professional performance by public accountants.

The public accountants knew of some deficiencies, including the two cases of misappropriations, and had discussed them with officials or employees of the grantees. GAO found no evidence that the public accountants had noted certain other deficiencies. (See p. 11.)

*Public accountants' independence may be affected by other services to grantee-clients*

In 10 cases the public accountants were performing services for the grantees which could affect their independence. These services included functions normally performed by a grantee's employees, such as day-to-day and/or periodic bookkeeping functions; adjusting, closing, and summarizing books of account at yearend; and preparing budgets and/or financial statements. In one case, the accountant was a member of the grantee's board of directors.

Although the accounting profession's ethical standards permit accountants to perform many of these services, the fact that these accountants did not always include significant grantee financial management deficiencies in their audit reports raises a question of whether the independence of some accountants may have been impaired. (See p. 30.)

*Independent auditors need guidance and training*

The type of findings noted by GAO indicate that some public accountants need additional OEO guidance and additional training to comply with OEO's audit requirements contained in its audit guidelines issued in 1968.

Although uniform standards for auditing Government programs have been developed by a committee consisting of GAO, OEO, and seven major Federal grantor agencies, there is a continuing need for orientation and training programs for public accountants on audits of Federal grantees.

The accounting profession in California has already begun to provide this training. (See p. 33.)

*Need for strengthening contractual relationship with independent accountants*

Several of the accountants said their allegiance and responsibility go to the grantee rather than to OEO. GAO holds that OEO should require grantees to strengthen the contractual arrangements with the auditors and to see that auditors are held responsible for their work. (See p. 34.)

*Need for better OEO monitoring of public accountants' work*

OEO's audit organization did not effectively monitor the adequacy of public accountants' audits. Much of that organization's work has been office reviews of public accountants' reports and management and financial audits of grantees rather than systematic tests of the adequacy of the public accountants' work. (See p. 37.)

*Audit deficiencies cleared without verification of corrective action*

In 4 OEO regions GAO selected for review 76 of the latest closed audit reports with monetary and/or nonmonetary audit exceptions and found that all but 12 had been closed without the regional offices' verifying whether corrective actions promised by the grantees actually had been taken. Followup reviews disclosed corrective actions were not always taken. No uniform procedures existed for reviewing grantee responses to audit exceptions, and each reviewer used his own judgment of whether reported actions by the grantee would correct the deficiencies included in an audit report. (See p. 44.)

*Questionable expenditures cleared*

GAO examined 46 of the 76 closed audit reports which had monetary exceptions totaling $9,160,000 and found that OEO had allowed $8,995,000 as charges to grant funds and had disallowed $165,000. The auditors questioned most of the costs because (1) documentation was inadequate, (2) the approved budget did not provide for the expenditure, (3) the expenditure was in excess of the approved budget, or (4) deficiencies existed in the documentation on the required non-Federal contribution.

On a nationwide basis, monetary audit exceptions with respect to OEO grantees totaled $207.9 million for the period July 1, 1966, through December 31, 1972. The total expenditures incurred under all grants audited during this period were about $5.4 billion. At December 31, 1972, of the $207.9 million in questioned costs, $113.4 million had been determined as allowable, $25.7 million was disallowed, and $68.8 million remained unresolved.

OEO generally allowed costs questioned in the audit reports as charges to grant funds if the grantees provided explanations for the expenditures. In some situations OEO disallowed the costs and attempted to recover the amounts from the grantees. (See p. 50.)

*RECOMMENDATIONS OR SUGGESTIONS*

OEO should:

1. Require grantees to spell out in contracts the auditors' responsibility to the grantee and to OEO and incorporate in the contracts OEO's specific audit and reporting requirements. (See p. 40.)

2. Contract directly for the desired audit services when the relationship between grantees and independent accountants does not adequately meet OEO audit needs. (See p. 40.)

3. Emphasize the importance of adhering to professional

standards of independence when the accountants also perform accounting or other services for the grantees. (See p. 40.)

4. Sponsor orientation and training programs to better acquaint public accountants with OEO's specialized audit requirements. (See p. 40.)

5. Withhold approval of the engagement of independent accountants whose performance has been found to have been unacceptable. (See p. 40.)

6. Devote more audit effort to quality-assurance reviews of public accountants' work. (See p. 40.)

7. Require verifications of corrective actions by independent or other accountants in all cases involving inadequate accounting systems or other significant reported deficiencies. (See p. 54.)

8. Instruct grantees to document corrective actions on less significant deficiencies so that OEO can objectively evaluate and verify such actions on a test basis. (See p.54.)

9. Require that its regional offices closely adhere to the May 1971 regulations regarding the resolution of questioned costs and the recovery of disallowed costs. (See p. 54.)

*AGENCY ACTIONS AND UNRESOLVED ISSUES*

OEO informed GAO that it generally agreed with these recommendations but that their implementation may, in some cases, require additional staff.

With respect to recommendation 2, OEO believed that, because of proposed procedural revisions, the number of situations where the contractual relationship between grantees and independent accountants did not meet OEO's audit needs would be held to a minimum. Therefore it preferred not to adopt the recommendation. OEO stated that, although adoption of recommendation 8 would provide an opportunity for it to monitor corrective actions on a test basis, as an absolute requirement it would be too burdensome. Further, because a proposed procedure would provide added safeguards that did not exist before, OEO did not believe adoption was desirable. (See pp. 40 and 54.)

*MATTERS FOR CONSIDERATION BY THE CONGRESS*

GAO is bringing this matter to the attention of the Congress because of (1) the increasing use of independent accountants for auditing Federal programs and (2) congressional interest in the continued development of sound programs and good management practices in Government.

# CHAPTER 1

# INTRODUCTION

## AUDIT REQUIREMENTS FOR OEO GRANTS

Section 243(a) of the Economic Opportunity Act of 1964, as amended (42 U.S.C. 2835), provides that no funds shall be released to any community action agency (CAA) or other anti-poverty agency receiving funds under title II[1] of the act until it has submitted to the Director of the Office of Economic Opportunity (OEO) a statement that it and its delegate agencies have established accounting systems with internal controls adequate to safeguard their assets, check the accuracy and reliability of the accounting data, promote operating efficiency, and encourage compliance with prescribed management policies. This statement may be furnished by a certified public accountant (CPA); a duly licensed public accountant; or, in the case of a public agency, the appropriate public financial officer who accepts responsibility for providing required financial services to the agency.

Section 243 (c) provides that, annually, the Director of OEO shall make or cause to be made an audit of each grant made to an agency under title II and that he shall determine, on the basis of the audit findings and conclusions, whether any of the costs or expenditures incurred shall be disallowed. Subsection (d) provides that the Director shall establish such other requirements and take such actions as he deems necessary and appropriate to insure fiscal responsibility and accountability for programs assisted under title II.

OEO has issued an audit guide ("Accounting System Survey and Audit Guide") and instructions to assist public accountants in understanding the special requirements for auditing OEO grants. The guide and instructions are not intended to be a complete manual of audit procedures or to supplant the accountant's professional judgment of the audit work required.

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[1]Predominantly CAAs.

The guide, which is incorporated by reference in the contract between the auditor and the grantee, contains a questionnaire with 101 specific questions covering the grantee's accounting system and internal controls, the audit of costs incurred, and related areas. The accountant must do sufficient work to express an opinion on (1) the adequacy of the accounting systems and internal controls, (2) the grantee's compliance with general and special grant conditions and other OEO requirements, (3) the allowability of grant costs, and (4) other areas needing improvement. In addition, weaknesses in the grantee's internal control or accounting system noted during the audit, which in the opinion of the accountant are significant (but which may not necessarily warrant classifying the system as inadequate), must be reported with specific recommendations for correcting the weaknesses. This information is set forth in a "management letter" required to be submitted with the audit report. The accountant is required to state in his management letter that he has used OEO's guide and instructions in doing his work.

At June 30, 1971, OEO was funding about 950 CAAs and 500 single-purpose grantees. OEO estimated that the CAAs may have as many as 5,000 delegate agencies, all of which are also subject to the requirement of an annual audit. Certified or otherwise duly licensed public accountants made about 88 percent of all audits of grantees. State and local government auditors and auditors of Federal agencies, such as the Defense Contract Audit Agency, made the other audits. OEO's small audit staff, which consisted of 45 professional personnel at December 31, 1972, does not annually audit its grantees.

The annual audits are one of OEO's primary methods to keep informed of (1) the adequacy of the grantees' accounting systems and related internal controls, (2) the validity of the grantees' reported expenditures and financial condition, and (3) the grantees' overall accountability for program funds.

## SCOPE OF REVIEW

We evaluated the adequacy of audits of OEO grantees made by public accountants, OEO's controls over the review and followup of deficiencies reported in audit reports, and the actions taken by OEO and grantees to implement the audit reports' recommendations for improvements.

In our evaluation we (1) audited the operations of selected grantees and determined whether the findings revealed by our audits had been reported in the independent public accountants' reports and (2) examined the disposition of expenditures questioned and the actions taken to correct internal control, accounting system, and other deficiencies reported in the independent public accountants' reports.

We made our review at OEO headquarters in Washington, D.C., and at 4 of OEO's 10 regional offices in Atlanta, Georgia; Dallas, Texas; Kansas City, Missouri; and San Francisco, California. We also made reviews at the offices of 27 selected grantees and their public accountants, which are in 13 States in the 4 OEO regions. We selected for review 76 of the latest audit reports that had monetary and/or nonmonetary exceptions and that had been marked as closed in the 4 regional offices, to evaluate OEO's bases for clearing audit exceptions.

We discussed our findings with OEO headquarters and regional officials, OEO grantees, and their public accountants. We also obtained the views of representatives of State societies of CPAs and the American Institute of Certified Public Accountants (AICPA), with respect to measures that could be taken to enhance the usefulness of the public accountants' work to OEO.

# CHAPTER 2

## PUBLIC ACCOUNTANTS' AUDITS OF OEO GRANTEES

About 60 percent of over 1,000 audit reports on grantee operations issued in fiscal year 1970 reported no major accounting system or internal control deficiencies. We selected 27 reports from this group for our review.

Of the 27 public accountants' reports, 17 did not disclose what we believe were significant deficiencies in the financial operations of OEO grantees. Some public accountants informally reported such deficiencies to their grantee-clients rather than including them in their formal audit reports. Also, some public accountants were not sufficiently familiar with OEO's special audit requirements covering compliance with grant conditions and allowability of costs.

Unless the reports fully disclose the audit results, OEO cannot take the necessary actions to protect the Government's investment in grantees' operations by having the deficiencies in accounting systems and controls promptly corrected or, failing appropriate action, by discontinuing further funding of these grantees.

Some of the public accountants whose work we reviewed furnished accounting or other management services to their grantee-clients. These services, coupled with the deficiencies not disclosed by them, raise a question as to their independence and their ability to objectively express an opinion on the grantees' financial statements and accounting and internal control systems.

We believe that our findings--although based on a limited number of grantees' audits and not necessarily representative of all audits of OEO grantees--indicate OEO's procedures for obtaining the desired assurance of its grantees' fiscal responsibility need to be improved. There is a need to provide additional guidance to grantees and their auditors regarding compliance with the special audit requirements of the authorization legislation and with OEO's implementing instructions. There is also a need for (1) strengthening the contractual relationship between grantee agencies and their auditors or for considering alternative arrangements under which OEO would contract directly for the audit services and (2) OEO's audit organization's closer monitoring of the public accountants' work.

## SELECTION OF AUDITS FOR GAO REVIEW

During fiscal year 1970, over 1,000 independent accountants' audit reports were issued in the 4 OEO regions we visited. About 40 percent of these reports indicated that the grantees' accounting systems and/or internal control systems were weak or inadequate, while the remaining 60 percent reported no major systems deficiencies in grantee operations.

From the audit reports which reported no major systems deficiencies, we selected 27 OEO grantees which received grants ranging from over $200,000 to almost $2 million during the periods covered by the audits. We did not include the smallest or the largest grantees because we believed they would not be as typical of the average grantee as those in the range selected. We considered only those grantees which had an audit report showing no adverse comments on their financial operations (unqualified opinion) and which had received a favorable opinion on their accounting systems and internal controls. After we selected grantees for review, we found that audit reports had been issued in fiscal year 1971 for 8 of the grantees selected. In these 8 cases, we reviewed the fiscal year 1971 audit report in order that we might review the most current audit reports on file.

Although we based our selection of grantees on a number of factors and discussed it with the OEO regional auditors, we had no previous knowledge that the public accountants had not adequately performed in any of the cases selected. We selected some grantees on the basis of the OEO auditors' knowledge of earlier financial management problems with a specific grantee. Some grantees were selected on the basis of factors which were possible indicators that the grantees had financial management problems, such as the grantees' failure to submit required financial reports to OEO. Other cases were selected on the basis of proximity to our regional offices. It was our view that selecting some grantees which might have had financial management problems would be a good test of the public accountants' work.

Because our selection of grantees for review was not on a random basis, no precise projection of our findings may be made to the total reports that did not report major system deficiencies.

At the 27 grantees' offices, we reviewed selected financial transactions, related documentation, and management controls and held discussions with grantee personnel. We did not review the reasonableness of specific costs charged to the grants but generally limited our review to an examination of the grantees' accounting systems and internal controls. We reviewed the public accountants' workpapers and discussed with them various deficiencies in grantees' financial operations noted in our reviews.

## DEFICIENCIES IN ACCOUNTING SYSTEMS AND CONTROLS NOT DISCLOSED IN AUDIT REPORTS

Of the 27 grantees, 17 had been operating with what we considered to be significant deficiencies in their accounting systems and/or internal controls that had not been reported in the public accountants' audit reports. Some of the matters described in this report dealing with work done by public accountants could not be accepted as adequate professional performance by public accountants.

The deficiencies included inadequate controls over cash, payroll, travel expense, procurement, consultant services, and property. In two cases, misappropriations of funds had occurred which were traceable to deficiencies in their respective grantees' management controls.

The public accountants had known of some of the deficiencies, including the two cases of misappropriations, and had discussed them with employees of the grantees. We found no evidence that the public accountants had noted certain other deficiencies revealed by our review. In several cases we were unable to ascertain the extent of the accountants' findings or scope of work because they did not prepare or retain workpapers showing the nature and extent of the audit work done. The OEO audit guide requires that such matters as defalcations, thefts, or other irregularities be immediately reported and that information on them be included in the accountants' audit reports.

It was not the intent of our review to determine the effect of internal control system deficiencies on the grantees' overall operations. We believe that the existence of system weaknesses was significant in itself and should have been brought to the attention of both OEO and the grantee so that corrective actions could have been taken.

By letter dated February 15, 1973 (see app. I), OEO took issue with our statement that internal control system deficiencies in themselves were significant. Although OEO agreed that an ideal system is desirable, it stated that such a goal may not be realistic because of the costs involved in correcting certain deficiencies.

The Economic Opportunity Act, OEO regulations, and the Audit Guide require public accountants to attest to the adequacy of a grantee's internal controls and to make specific recommendations for correcting the weaknesses.

The purpose of adequate internal control systems is to safeguard assets, check the accuracy and reliability of accounting data, promote operating efficiency, and encourage compliance with prescribed management policies. OEO prescribed the requirement that the auditors attest to the adequacy of grantee internal control systems so that it would be informed as to whether the management systems of the grantees would provide some assurance that the funds granted would be applied to the purposes intended, be used efficiently, and not be wasted. Information on system weaknesses in the auditors' reports was desired so that it could assess the risk of loss or inefficiency and judge whether changes were needed and would be worth any additional costs.

Also, correcting internal control weaknesses often does not entail additional costs and may be accomplished by changing employees' duties or requiring that the employees follow generally accepted internal control procedures. For example, in case 1 (see p. 14), we point out that the lack of control over a facsimile signature check-signing machine resulted in unauthorized payments of $7,035. In this case, no additional costs would have been required to establish proper controls, such as requiring that blank checks and the machine be kept locked and under the control of an authorized individual.

The following table shows the type and frequency of deficiencies found in our review but not reported by the public accountants. These deficiencies existed during the period covered by the public accountants' audits.

| Nature of deficiency | Number of grantees |
|---|---|
| Personnel practices: | |
| Time and attendance cards not prepared or not approved | 4 |
| Leave records not maintained or not current | 4 |
| Compensatory time advanced to employees before being earned and justifications not given | 5 |
| Travel practices: | |
| Travel orders not used to authorize travel | 5 |
| Travel advances charged to expense | 8 |
| Travel vouchers not prepared, not approved, or not sufficiently complete to support reasonableness of expense claimed | 6 |
| Procurement practices: | |
| No or inadequately written procedures and instructions | 5 |
| Purchase orders not prepared, prepared after purchase, or not used to check vendor invoices | 9 |
| Vendor invoices paid without prior approval or evidence that items ordered were received | 5 |
| Property control practices: | |
| Property records not or inadequately maintained | 8 |
| Property not marked for identification or ownership | 6 |
| No annual inventory taken or inventory not reconciled with property records | 6 |

Note: The above table does not include deficiencies found by us at only one grantee location.

The following six cases illustrate some of the deficiencies we found in grantees' accounting systems and/or internal controls that, in our opinion, should have been included in the public accountants' audit reports.

Case 1

A grantee agency in Iowa, whose CPA had reported an adequate accounting system and adequate internal controls, had been operating with several serious deficiencies in controls over funds and in personnel, travel, and procurement practices.

The CPA's report, dated January 29, 1970, listed three minor deficiencies concerning (1) the grantee's lack of a travel policy, which was corrected, (2) a filing system that was not adequate for easily examining financial records, and (3) an overexpenditure in the grantee's Conduct and Administration budget which was, however, within OEO's limitations on budget overexpenditures. The OEO regional auditor did not accept the audit report because the CPA's attesting to the adequacy of the grantee's accounting system and internal controls was not in the OEO-prescribed format. On April 14, 1970, the CPA issued a supplemental letter with the prescribed wording, and OEO accepted the report.

We found that blank checks were being stored in an unlocked desk drawer, and the facsimile signature check-signing machine was not being controlled. This enabled one employee to make unauthorized payments to himself amounting to $7,035 during a 7-month period. Of this sum, $6,565 was recorded as salary advances and $470 as travel advances. The grantee's board of directors initiated action to recover the unauthorized advances after the grantee's bookkeeper, who had discovered them, had brought them to the attention of the executive director; about 17 months later all the unauthorized advances had been recorded as recovered.

In reviewing the employee's restitution payments, we found that $760 of the amount recovered represented his refund of a payment ($1,000 less payroll deductions) for vacation leave earned but not taken. There were no time and attendance or leave records available to substantiate the propriety of the leave payment. The grantee's written leave policy did not provide lump-sum payments for vacation time earned but not taken; however, the executive director had specifically authorized the $1,000 payment. Our calculations based on the employee's length of service with the grantee and his rate of pay indicated that the employee could not have earned $1,000 in vacation pay by the time payment was made, even if he had never taken a day of vacation leave.

The CPA firm was aware of, and had discussed with grantee officials, the unauthorized advances and had recommended that the employee be discharged. Officials of the firm informed us that the audit report did not disclose these matters because complete disclosure of all facts had been made to their grantee-client and corrective action had been promised. They said that mentioning these matters in the audit report might cause OEO to terminate the funding of the grantee, which, in their opinion, would result in an injustice to the community.

During and after the period he was making restitution of funds, the employee received two extra (duplicate) salary payments totaling $705. The records did not show the basis for the extra pay, nor could the grantee officials provide us with an explanation for the extra pay. After we brought this matter to the attention of OEO, the employee was discharged and the CPA firm's engagement was terminated.

In addition to noting the lack of time and attendance and leave records for some employees, we noted that (1) employees were being granted compensatory time in excess of the amount of leave that they had earned, (2) salary increases were being granted to employees in excess of the 20-percent limitation in OEO regulations and without the required OEO waiver, (3) purchases were not properly controlled because purchase orders either were not prepared or were prepared after the purchases had been made, and (4) a significant number of travel payments were made which were not supported by travel vouchers.

The CPA informed us that he was aware of, but had not formally reported, the above weaknesses. The CPA firm informed us that its report had qualified the adequacy of the internal control system and had enumerated the weaknesses; however, OEO advised the firm that it had to state that the system was generally adequate unless it believed the system was totally inadequate. Although the CPA informed us that he had enumerated weaknesses in his report, our review, as described above, revealed a number of serious deficiencies that were not commented on in his audit report.

Case 2

A CPA firm's audit report on the operations of a grantee agency in Texas stated that the grantee's accounting system and internal controls were adequate and that no significant weaknesses requiring corrective action were noted.

We could not determine from the CPA's few workpapers the extent and scope of his audit. He informed us that the agency's accounting records constituted his workpapers because he visited the agency monthly to reconcile the bank statement, review postings and expense classifications in the accounting journals, make adjusting entries, post to the general ledger, and assist in preparing monthly financial reports required by OEO. In response to our question, he stated that he did not believe that this work impaired his independence as an auditor.

In reviewing the few workpapers that the public accountant did prepare, we noted a reference to forgery involving 16 checks totaling $917 and covering the period February through August 1970. The first 13 checks were not entered in the cash disbursements journal and had been removed from the canceled checks returned with the bank statement. The public accountant discovered the forgeries in August 1970 while reconciling the bank statement. If the bank reconciliation had been prepared on a timely basis, the forgery should have been uncovered when the February bank reconciliation was made since one of the forged checks, written on February 18, 1970, cleared the bank on February 20, 1970.

The public accountant told us that this matter was not mentioned in the audit report because the situation had been corrected by restitution of the moneys taken and the dismissal of the employee. The public accountant stated that he had discussed the matter with the grantee's board of directors and that he would have made these statements to OEO if OEO had hired him.

In our review of the grantee's financial operations, we noted other deficiencies which we believe should have been disclosed in the audit report: (1) no time and attendance records were kept on salaried employees, (2) no records were maintained on employees' leave earned or used, (3) OEO's limitation on starting salaries of grantees' employees was not complied with, (4) written purchase orders were not prepared and vendor invoices were paid without evidence that the goods had been received, and (5) property records were not maintained.

The public accountant told us that he was aware of the above conditions but that he did not consider them reportable deficiencies. He stated that his management letter opinion, indicating an adequate accounting system and adequate internal controls, did not reflect actual conditions. He told us, however, that, if he had reported to OEO that the grantee's records were not in an auditable condition, OEO probably would have diverted program funds to hire qualified personnel to correct accounting weaknesses, which he felt would have hurt the program.

Case 3

A CPA firm reporting on the activities of a grantee agency in California stated that the accounting system and internal controls were adequate. No deficiencies were reported and no costs were questioned in the audit report. Our review covering the same period disclosed numerous deficiencies that the auditor should have reported in the management letter. These included:

Personnel practices

1. About 20 percent of the employees' leave records were not being maintained on a current basis.

2. No personnel records were maintained for part-time employees; their salaries were charged to miscellaneous expense.

3. The grantee had not complied with the Internal Revenue Code requirement that Federal income and social security taxes be withheld from wages paid to employees.

4. Employees were granted compensatory time in lieu of overtime without specific approval or generally without showing the reason for working the additional hours.

Travel practices

1. Written travel authorizations were not used in conjunction with out-of-town travel.

2. Travel advances were charged directly to expense with no further accounting unless the employees' expenses exceeded the advance, in which case expense vouchers would be prepared to justify additional reimbursements.

3. Per diem was determined on a basis other than the quarter-day required by the Standardized Government Travel Regulations which apply to OEO grantees.

Procurement and property control practices

1. Purchase orders were not consistently used and, when used, were not forwarded to the accounting section to vouch vendor invoices.

2. A significant number of vendors' invoices were paid without evidence that the goods had been received.

3. Property records to control and account for nonexpendable equipment were not maintained on a current basis.

Contracting practices

1. No records were maintained showing the basis for selecting a particular contractor or determining his fees.

2. Contracts awarded by the agency were not specific about the scope of the services to be provided or the payment terms.

The public accountant informed us that he was not aware of the personnel and contracting practices mentioned above and that, although he was generally aware of the travel, procurement, and property control practices, he did not believe that they warranted reporting. He also said that he had discussed the property control deficiency with the grantee's fiscal manager.

The public accountant's workpapers did not show that any tests or reviews of the grantee's financial operations had been made, which precluded an evaluation of the adequacy of his reviews. He stated, however, that he had reviewed the grantee's accounting system but had not noted this in his workpapers and that he had told the grantee's fiscal manager about his observations.

Case 4

A licensed public accountant reviewed the operations of a California grantee and reported that (1) no significant weaknesses were noted in the accounting system and (2) only minor weaknesses in the area of personnel records were noted and corrective action had been taken.

We found, however, that (1) the grantee had poor financial controls over some of its activities, (2) the grantee's board of directors was considering holding the executive director personally liable for misuse of agency funds, (3) contracting procedures were so poor that the grantee was forced to pay for undesired services, (4) inventory shortages were not reconciled, (5) some travel costs were unauthorized or were for personal benefits, (6) books of blank airline tickets were not adequately controlled, (7) travel was 40 percent over the budget, and (8) many of the time and attendance sheets we reviewed had not been signed by an approving supervisor. We noted further that, in addition to auditing, the public accountant had been furnishing extensive bookkeeping services to the grantee.

Cash disbursements

A number of checks had been drawn to cash or to the order of employees without adequate documentation that they had been used to pay for program expenses. Two large checks ($15,000 and $7,942) were issued for the stated purpose of providing a camping experience for 1,000 Indian boys but were made out to an individual in the organization providing the services, rather than to the organization. In some cases, the disposition of funds from checks drawn to cash could not be determined. The grantee's executive director was being held liable by the grantee's board of directors for the personal use of $768 which had been entrusted to him to reimburse board members for travel.

Contracting procedures

The grantee's contracting procedures were poor. Contracts with some of the consultants hired by the grantee were not on file. Some contracts did not meet OEO's minimum requirements; for example, they were not in writing or were incomplete as to the scope of services to be provided.

The State of California was holding the grantee liable for contributions under employment and disability insurance coverage because two individuals, allegedly under contract, claimed to be employees of the grantee. Another individual who alleged a contract with the grantee was paid $972 even though a written contract did not exist and the grantee did not want the services. The grantee's board of directors assumed liability for this amount because the contractor claimed an oral agreement existed and the grantee could not prove otherwise.

### Property accountability

A physical inventory of equipment was taken by the grantee but was not reconciled with existing property listings. Several items appearing on the property listings--such as typewriters, calculators, desks, chairs, and cameras--did not appear on the physical inventory list and could not be physically accounted for at the time of our visit. We also noted the property listings were not current since several recent equipment acquisitions were not included.

### Travel costs

Travel costs as reported by the public accountant to OEO were 40 percent ($20,000) over the budget. The grantee did not maintain such customary controls as (1) approving travel prior to commencement, (2) approving travel claims prior to payment, and (3) showing the periods of travel to support the per diem claimed. These weaknesses were not mentioned in the public accountant's report. In the program year covered by the audit report, grant funds amounting to about $4,500 were expended for an unauthorized trip by grantee personnel to Alaska without the required advance approval by OEO. The grantee's board of directors later determined that the expenditure was not a proper charge to grant funds and, at the time of our review, was considering holding the executive director liable if reimbursement could not be obtained from other sources. In another instance, the lack of proper approval requirements allowed about $470 of grant funds to be used to pay for an automobile rented for the personal use of an employee. As of the date of our review, the employee was making restitution of this amount. Also books of blank airline tickets were not adequately controlled by an assigned individual.

## Payroll procedures

Many of the time and attendance sheets we reviewed had had not been approved by the supervisors, and the reasons for grantee employees' working overtime and receiving compensatory time were not shown.

## Bookkeeping services

During the year under audit, the public accountant furnished substantial accounting assistance to the grantee--he directly supervised the bookkeeping and personally made changes in accounts. He said this assistance was necessitated by the inexperience and lack of knowledge of the bookkeeper. Although OEO officials determined that the accountant's actions did not constitute a conflict of interest, they suggested that a different accountant perform the audit in the future. However, the same accountant made the next audit.

As a result of poor controls over funds, a loan to an outside activity was concealed through recording it as a loan to five grantee employees.

Both the public accountant and the grantee were aware of poor controls, and the accountant was aware also of the concealed loan. He did not review the contracting activity, although he was aware of some weaknesses, and he did not review property controls. He was aware of the weaknesses in travel controls, particularly in the uncontrolled use of credit cards, and he had recommended against their use; however, he made all recommendations verbally to the grantee. We noted that the use of credit cards was still uncontrolled in that procedures had not been established as to who would be authorized to use the cards and for what purposes. The public accountant stated that he had not attempted to trace travel advances back to individuals because the travel ledger book, the only means of identifying amounts owed by individuals, was not available. He did not recall making any recommendations to the grantee on this.

The public accountant stated he was aware of payroll weaknesses and had mentioned some of them in his audit report. He also said that he considered it most important for the grantee's personnel to be aware of the weaknesses in controls and thought that discussions with agency personnel should take care of this. He did acknowledge, however, that including the weaknesses in the management letter would have had more impact on the grantee and on OEO, which was not aware of these weaknesses.

Case 5

A CPA firm reviewed a grantee agency in Missouri and stated in its audit report that the financial statements fairly presented the financial position of the grantee at August 31, 1970, and the results of operations for the period then ended, except that prepaid leases of $18,744 had been expensed. The treatment of the prepaid leases as an expense was disclosed in a footnote to the financial statements.

The improper treatment of the lease as an expense, together with an overstatement of $12,107 in the grantee's accounts payable, resulted in a misstatement of the financial position of the agency and the results of its operations.

In the matter of the lease, on July 28, 1970, the grantee entered into an agreement to lease vehicles from an automobile rental company. The agreement set forth only general lease terms and did not specify amounts. Funds to pay the leasing costs had been entered in the grantee's books of account earlier by a charge to expense and an offsetting credit to a reserve account. At August 31, 1970, the end of the grantee's program year, the reserve account had a balance of $24,000. In November 1970 the grantee and the company executed a vehicle lease order which provided for leasing 11 vehicles at a monthly rental of $142 per vehicle; the grantee paid 1 year's advance rental of $18,744. Seven vehicles were delivered in December 1970.

Even though the lease order, the prepayment of the rental, and the first vehicle delivery did not occur until November or later, the CPA, during his review of the grantee's program year ended August 31, 1970, made an adjusting entry reducing the reserve account and the cash account by $24,000 and $18,744, respectively, and increasing the account--unused Federal funds--with the excess of $5,256 from the reserve account. This adjustment understated the grantee's cash account by $18,744 and overstated the grantee's expenses. It also understated the grantee's carryover balance of Federal funds to the next program year and enabled the grantee to receive additional Federal funds to which it was not entitled.

The CPA firm advised us that:

> * * * The regional office of the Office of Economic Opportunity had instructed the grantee, through one of their field representatives to make the adjustment recorded as an adjusting entry. This was not in conformity with generally accepted accounting principles but the opinion letter states the fact that some items are only in conformity with provisions of the Office of Economic Opportunity, including the leases.

After our discussion the firm issued a revised audit report which showed an increase of $18,744 in the grantee's cash account and the reestablishment of a reserve account of $18,744; however, no adjustment was made to reduce the expense account which had been charged with the $24,000 estimated annual cost.

Concerning the overstatement, total liabilities reflected in the financial statements amounted to $28,116, of which $23,059 represented accounts payable. Our discussion with grantee officials and our tests disclosed that $12,107 of the accounts payable pertained to orders for goods and services which had not yet been received as of the end of the program year.

The CPA stated that he believed a valid liability and expense existed as long as an order was placed before the close of the year. OEO instructions, however, provide that for a financial liability to exist (1) there must have been a need, (2) there must have been supporting evidence, such as an invoice, and (3) goods or services must have been received during the grant year. Since the goods had not been received by the end of the grant year, these transactions did not qualify as a liability. These transactions also reduced the grantee's carryover balance of Federal funds to the next program year and enabled it to receive additional Federal funds to which it was not entitled.

We discussed these matters with the OEO regional office officials who agreed to examine the situation. On March 30, 1971, OEO reduced the Federal grant by $30,851 ($18,744 plus $12,107) for the program year beginning September 1, 1970.

The CPA stated that several years earlier, when he first audited the agency, he had used the OEO Audit Guide but had not since. He said that, if the Audit Guide were to be fully followed each year, the auditing fee would have to be higher. The CPA firm stated there was a misinterpretation of what the accountant said; although the Guide is not read from cover to cover every year, it is used extensively during the audit.

Case 6

After reviewing a grantee's operations in Nevada, a CPA firm issued a report which stated that the grantee's accounting system and internal controls were adequate. The report noted no system deficiencies.

Our review of the grantee's operations during the same period disclosed the following weaknesses in personnel, travel, and procurement and property control practices.

Personnel practice

1. Salaries received by employees immediately preceding employment with the grantee were not verified to insure that salaries paid by the grantee were in accordance with OEO regulations.

2. Employees were accumulating compensatory time in lieu of overtime without specific approval or justification and were allowed to take time off in excess of earned leave.

3. Vacation and sick leave were advanced to employees without prior approval, and in many cases leave taken was not supported by leave authorizations.

Travel practices

1. Travel advances were charged directly to an expense account rather than initially to an advance account.

2. The Standardized Government Travel Regulations, which OEO grantees are required to follow, required that per diem in lieu of actual subsistence be computed on a quarter-day basis and that travelers submit vouchers to support expenditures properly chargeable to the grant. However, the grantee was computing per diem in whole days and did not require travelers to submit travel vouchers. As a result, the per diem to which employees were entitled could not be determined.

Procurement and property control practices

1. Many procurements were not supported by purchase orders.

2. Current records to control and account for nonexpendable property could not be located by the grantee for our review.

Our discussion with the CPA and a review of his workpapers disclosed that he was aware of most of the weaknesses noted above. The CPA stated that he was aware of the lack of verification of prior salaries and that, in accordance with his contractual responsibilities to the grantee, he had brought the matter to its attention.

The CPA also indicated that he was aware of the absence of specific approval or justification for compensatory time earned but did not believe this to be a significant matter. He stated that he did not know that employees were taking leave and compensatory time in excess of that accumulated by them or that leave taken was not supported by leave authorizations. He agreed, however, that vacation and sick leave taken in excess of that earned should be on a without-pay basis or specifically approved in writing by grantee officials.

The CPA stated that he was not aware of how the grantee was handling travel advances. He said that such payments should initially be established as advances and would have so recommended had he known how the grantee was handling advances. Our review of the same period examined by the CPA disclosed 10 disbursements for out-of-town travel--all of which were charged to travel expense and 8 of which were travel advances. The CPA stated that he was aware of the erroneous computation of per diem and the absence of travel vouchers and had brought them to the grantee's attention.

The CPA's workpapers indicated that he was also aware of the absence of purchase orders and property record cards. Although he did not consider the lack of purchase orders a significant weakness, he said that he had discussed the lack of control over nonexpendable property with the grantee.

The CPA believed that he is responsible not to OEO but to the grantee because the grantee hired him. If minor deficiencies noted during the audit did not affect the overall effectiveness of the grantee's programs, he felt that these were to be discussed with the grantee and that it was not necessary to mention them in the audit report. Major deficiencies, such as deliberate misuse of funds or defalcations, noted during the audit would be discussed with the grantee and also reported in the audit. The CPA also stated that, if OEO were appointing and hiring the accountant, all deficiencies--both minor and major--would be brought to the attention of OEO.

## PUBLIC ACCOUNTANTS' INDEPENDENCE MAY BE AFFECTED BY OTHER SERVICES TO GRANTEE-CLIENTS

In 10 cases reviewed the public accountants were performing services for the grantees which could affect their independence. In six cases the public accountants performed or supervised day-to-day and/or periodic bookkeeping functions. In nine cases they adjusted, closed, and summarized the books of account at yearend. In two cases they prepared budgets and/or financial statements and functioned as the grantees' financial consultants. In one case the accountant was a member of the grantee's board of directors.

Although the accounting profession's ethical standards permit accountants to perform many of these services, the fact that the accountants did not always include significant grantee financial management deficiencies in their audit reports, coupled with such services, raises a question of whether their independence may have been impaired in some situations.

AICPA, in its statement on the independence of the auditor, states:

> *** he must be without bias with respect to the client under audit, since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be.
>
> *** It is of utmost importance to the profession that the general public maintain confidence in the independence of the independent auditors. Public confidence would be impaired by evidence that independence was actually lacking and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. *** Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.

AICPA's ethical standards permit its members to perform certain bookkeeping functions for their clients, provided they do not engage in any administrative decisionmaking capacity. Although the standards permit the public accountants to perform such services, they also establish precepts to guard against the presumption of loss of independence. AICPA states "'Presumption' is stressed because the possession of intrinsic independence is a matter of personal quality rather than of rules that formulate certain objective tests."

Much of the detailed accounting work was done by the public accountants because some grantee employees lacked training or competence in accounting. Although OEO instructions anticipate that grantees will employ only persons qualified to perform their duties, grantees are required, by law and by OEO regulations, to give every consideration to providing employment opportunities to disadvantaged persons from the low-income areas they serve. Such disadvantaged persons frequently do not have the training and experience needed to fully understand the need for compliance with OEO's financial requirements or to understand the significance of highly technical verbal recommendations made to them by their auditors. This lack of training and experience is also found among some of the top officials of the grantees, who usually are drawn from fields unrelated to financial areas. OEO officials informed us that a very pragmatic problem its grantees face is a lack of available persons in low-income areas who are expert in a particular discipline and the reluctance of nonresidents who are expert to work in the target areas.

Also, the public accountant in many instances finds the books of account and other financial records to be in an unauditable condition and considers it necessary to perform basic accounting work before beginning his audit.

OEO stated that, in all of the cases mentioned in the report--with the possible exception of the accountant who was a grantee board member--it believed that the independent accountants' actions did not necessarily violate AICPA's ethical standards regarding independence and that GAO had substantiated this position by stating that the accounting profession's ethical standards permit the accountants to perform many of these services.

We recognize and note in this report that the accounting profession's ethical standards permit accountants to perform various bookkeeping and other services for their clients and also render an opinion on the clients' financial condition. The AICPA stresses that the public's confidence in a public accountant may be impaired by circumstances which reasonable people might believe likely to influence independence.

We believe that the presumption of independence is open to question for those public accountants who performed various bookkeeping and other services normally performed by clients' employees and whose audit reports did not always include significant financial management deficiencies.

The number of public accountants who provide accounting as well as auditing services for the same grantee-clients indicates a need for OEO to closely monitor such a relationship to safeguard the integrity of the audit function. Our review has shown that this matter has not received sufficient attention by the public accountants and their grantee-clients. In one case, the grantee did not heed OEO's specific advice that the two functions be assigned to different contractors. We believe that OEO should increase its emphasis on this important standard governing professional auditing work, both in its audit guidelines and in its specific instructions to all grantees to which the annual audit requirement applies.

## INDEPENDENT ACCOUNTANTS NEED GUIDANCE AND TRAINING

Our findings indicate that some public accountants need additional OEO guidance and training to fully understand and comply with OEO's audit requirements.

The audits required by OEO cover not only an examination and opinion on the fairness of the financial statements of OEO grantees--similar to an auditor's work in a commercial engagement--but also an examination and an opinion on the grantee's accounting system and internal controls and on its compliance with the grant conditions. These additional tasks are generally not required under commercial engagements and present certain difficulties and challenges, especially to auditors not fully familiar with OEO requirements.

### Professional agreement on need for training--some actions already underway

Several of the public accountants we interviewed stressed their need for some type of orientation or training to better acquaint them with the special requirements for audits of Federal grantees, particularly those dealing with compliance with grant conditions and allowability of costs. We also solicited the comments of, and had discussions with, State societies of CPAs whose representatives affirmed the desirability of such training.

The accounting profession in California has already begun to provide such training. The California Certified Public Accountants Foundation for Education and Research, with the assistance of OEO and GAO representatives, recently prepared a training program for its members to acquaint them with the requirements for audits of Federal grantees. Other major Federal grantor agencies are participating in the training program. The foundation plans to make this training program available to AICPA for use in offering similar training classes for its members.

In March 1972 AICPA, through its Committee on Auditing for Federal Agencies, issued a report ("Suggested Guidelines for the Structure and Content of Audit Guides Prepared by Federal Agencies for Use by CPAs") to assist members of the profession and the Federal agencies in standardizing the auditing of Federal assistance programs.

A group from GAO, OEO, and seven major Federal grantor agencies recently completed a joint project which developed uniform standards for auditing Government programs, whether performed by Federal, State, or local government auditors or by public accountants. The standards are designed to provide guidance for auditing financial transactions and data; determining compliance with applicable laws and regulations; and examining the efficiency, economy, and effectiveness with which program objectives are being achieved.

We believe there is a need for OEO, and other Federal agencies requiring independent annual audits of their grantees, to sponsor and actively participate in orientation and training programs similar to that being carried out in California.

## NEED FOR STRENGTHENING CONTRACTUAL RELATIONSHIP WITH INDEPENDENT ACCOUNTANTS

Because several of the accountants expressed the view that their allegiance and responsibility go to the grantee rather than to OEO, we believe that OEO should require grantees to strengthen the contractual arrangements under which (1) the auditors' services are obtained and (2) the auditors are held responsible for their work by emphasizing the auditors' concurrent responsibility to OEO. If OEO is not able to obtain a satisfactory contractual relationship between an independent auditor and a grantee, OEO should contract directly for the audit services.

Under OEO policy the agreement between the auditor and the grantee incorporates by reference OEO's audit guidelines, including the reporting responsibilities of the auditor. Each grantee selects the public accountant of its choice (OEO holds a veto power over the selection), determines the timing of the audit, and negotiates the accountant's fee. The accountant's audit report, including the management letter, is addressed to the grantee, and a copy is submitted to OEO.

Although the contractual relationship is between the grantee and the auditor, the audit report and the management letter are intended not only to serve the grantee but also to inform OEO of the grantee's financial operations through adequate disclosure of deficiencies. The auditor, in effect, has a responsibility both to the grantee and to OEO.

Despite what appears to us as a reasonably clear requirement that significant matters be reported in writing--so that OEO's needs would be satisfied--several of the public accountants whose reports we reviewed told us that they view their relationship with the grantee as the normal accountant-client relationship, because their contract is with the grantee, their fee is paid by the grantee, their reports are addressed to the grantee, and their primary responsibility is to the grantee. These accountants informed us that they had discussed many internal control weaknesses with the grantees' accounting and administrative personnel and had not considered it necessary to include these weaknesses in their audit reports and bring them to OEO's attention. We asked 12 accountants whether they would have reported to or discussed with OEO their findings on accounting and internal control weaknesses if they had been engaged directly by OEO. Six stated that they would have reported to OEO, and six said that they would have followed the same reporting practices whether under contract with the grantee or OEO because they believed their actions had been proper.

OEO's audit guidelines impose a responsibility on the auditor to include in his audit report and management letter a discussion of such weaknesses in the grantee's system which in the opinion of the auditor are material. Although auditors' professional judgments of the significance of individual weaknesses and of the need for reporting them may vary, we believe that in the situations reviewed by us there was clear need for formal reporting.

Views of State CPA societies

Although most of the State societies which responded to our inquiry about the contractual relationship between OEO, the grantee, and the accountant did not offer any suggestions, three generally believed that the contractual relationship could be strengthened and proposed that:

--If OEO is not receiving all information desired, it should contractually require more information than is normally given in commercial practice.

--All grantees should be required to use standard accounting systems and that standard contracts should be used when engaging public accountants. This would provide for standard accounting classifications, standard financial reporting, and a uniform accounting treatment of such items as in-kind contributions.

--All OEO requirements not now met should be specifically required in the engagement letter.

## NEED FOR BETTER OEO MONITORING OF PUBLIC ACCOUNTANTS' WORK

The inadequacies in the public accountants' audits stem partly from the lack of an effective monitoring system by OEO's audit organization. Much of this organization's work has been office reviews of public accountants' reports and management and financial audits of grantees--most of which were requested by OEO program offices. The OEO auditor's work was not a systematic test of the adequacy of the public accountants' work.

After our audit the OEO Audit Division initiated a review of approximately 50 public accountants' workpapers to evaluate the reporting phase of their audits. OEO was summarizing the results of this review in February 1973.

Since a major portion of OEO's statutory requirement for annual audits of its grantees is met by utilizing public accountants, we believe OEO should direct more of its audit emphasis to systematic quality-assurance reviews of public accountants' work. The monitoring of the adequacy of annual grantee audits is a responsibility which needs to be emphasized and strengthened in the light of the weaknesses discussed in this chapter.

## CONCLUSIONS

We recognize the intended benefits from OEO's system of having the grantees contract for the required audit services. These audit services, however, will not provide OEO the necessary assurance of its grantees' fiscal responsibility and accountability unless the auditors selected by the grantees (1) have the necessary independence, (2) fully disclose all significant weaknesses in grantees' accounting systems and internal controls as required in OEO's audit guidelines, and (3) adhere to generally accepted auditing standards and accounting principles in their audits of and reports on grantee activities.

The inadequacies in the public accountants' audits and reporting appear to be attributable, in large part, to three factors. First, the auditors have not sufficiently recognized that the grantees' activities involve the expenditure of public funds and that they are responsible both to the grantees and to OEO. Second, they have not been sufficiently familiar with OEO's audit requirements, which go beyond those applicable in commercial engagements, which cover the adequacy of the grantee's accounting system and internal controls and the grantee's compliance with the conditions of the grant. Third, in some situations the auditors' work was below expected professional performance.

We believe that these shortcomings can be alleviated to a large extent by (1) sponsoring orientation and training programs for public accountants interested in providing audit services under OEO and similar Federal grant programs, such as is presently being done through the California Certified Public Accountants Foundation for Education and Research, (2) strengthening the contractual relationship with the independent auditors, either through specific terms included in the grantees' contracts that will protect OEO's interest or through direct OEO contracting for the audit services, and (3) OEO's withholding its approval of firms that it finds, through its monitoring or otherwise, to be performing at less than an acceptable professional level.

The President's fiscal year 1974 budget, provides for discontinuing funding OEO as a Federal agency on June 30, 1973, and transferring most of the OEO programs to other Federal agencies. Effective July 1, 1973, funding for CAAs under the Economic Opportunity Act will cease. The budget states that, if the constituencies of individual communities desire to continue providing support to the CAAs, general and special revenue-sharing funds could be used. In January 1973 OEO announced that it would continue funding CAAs up to June 30, 1973, for up to 6-month periods through December 31, 1973. Therefore, the recommendations in this report will still require action by OEO.

Many of the observations in this report may be of value to other Federal grantor agencies, such as the Departments of Health, Education, and Welfare; Housing and Urban Development; Commerce; Labor; and Agriculture, that use public accountants to supplement their audits of Federal grantees.

## COMMENTS OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA's Director of Federal Technical Liaison stated in his letter of February 20, 1973 (see app. II), that, although AICPA recognized that the results of the review should not be considered as representative, or typical, of audits made by CPAs in general, AICPA believed a number of actions should be taken to strengthen the CPAs' ability to audit Federal grant programs.

He stated further that AICPA is taking the following actions.

1. An expanded curriculum is being developed under the Institute's Professional Development Division emphasizing the auditing and reporting aspects unique to federal grant programs.

2. A series of Studies in Federal Government will be prepared to provide Institute members with educational materials in such areas as federal accounting and auditing and operational auditing.

3. Preliminary discussions have been initiated between representatives of the Institute's Professional Ethics Division and various federal agencies to work towards the development of effective procedures to enable such agencies to refer to the Ethics Division the names of CPAs whose audit performance in government programs is considered substandard by an agency.

4. Through its Committee on Relations with the OEO, the Institute is conferring with representatives of the OEO's External Audit Division on the development of a revised "Audit Guide" for the guidance of CPAs and other auditors.

5. Discussions are continuing with all appropriate agencies on the development of effective audit guides based in part on the Institute's report, "Suggested Guidelines for the Structure and Content of Audit Guides Prepared by Federal Agencies for Use by CPAs."

He concluded by stating that, through the joint efforts of Federal agencies and AICPA, substandard professional work hopefully can be eliminated entirely.

## RECOMMENDATIONS TO THE DIRECTOR, OEO

OEO should:

1. Require grantees to strengthen the contractual relationship with their independent accountants by

   --clearly spelling out the auditors' responsibility both to the grantees and to OEO and

   --incorporating in the contracts OEO's specific audit and reporting requirements.

2. Contract directly for the desired audit services when the relationship between grantees and independent accountants does not adequately meet OEO's audit needs.

3. Emphasize to grantees and their accountants the importance of adhering to the professional standard of independence when the accountants also perform accounting or other services for the grantees.

4. Sponsor, in cooperation with other Federal agencies and the accounting profession, orientation and training programs to better acquaint public accountants with OEO's specialized audit requirements.

5. Withhold approval of the engagement of independent accountants whose performance has been found to have been unacceptable.

6. Devote more audit effort to quality-assurance reviews of public accountants' work.

## OEO COMMENTS AND GAO EVALUATIONS

Although OEO generally agreed with our recommendations, it believes that in some areas it already has initiated or has in effect procedures that are as effective as what we have proposed. OEO's response to each recommendation and our evaluation follow.

OEO stated it believed GAO's first recommendation can be considered as having been complied with because a draft revision of its Audit Guide details the relationship between auditor, grantee, and OEO and provides a sample contract for the agreement between grantee and auditor. This contract lists the specific audit and report requirements, specifies dates for performance of the audit and delivery of the audit report, shows fees agreed upon and a limit of total costs for services, and requires that the Audit Guide be followed.

We believe that the sample contract, if used, would significantly improve the existing situation; however, since the use of this contract is optional, OEO has no assurance that its grantees will use it. A mandatory requirement on the use of the contract would result in a uniform application of the procedure for strengthening the contractual relationship.

OEO objected to our second recommendation because it believes that proposed procedural revisions will hold to a minimum the number of situations where the contractual relationship between grantees and independent auditors is not adequate. OEO also noted that an experiment is being conducted in some sections of Ohio whereby OEO's State Economic Opportunity Office had contracted with an audit firm to provide annual audit services to grantees which desire to use this method rather than contract directly for the services. OEO stated that, although the experiment is not yet complete, so far it has been successful in reducing audit costs for those grantees--about 50 percent of the active CAAs in the State--that have participated.

We suggested this method as an alternative only when OEO is not able to obtain a satisfactory contractual relationship between independent auditors and grantees to meet its annual audit requirements.

With respect to our third recommendation, OEO stated that it agrees that professional standards of independence must be maintained and that the proposed revisions to the Audit Guide specifically address themselves to this issue and, if properly adhered to, will resolve it to OEO's satisfaction.

On our fourth recommendation, OEO stated it had assisted public accountants by issuing its Audit Guide in 1968 and by personally contacting public and other accountants. OEO agrees that it should sponsor and coordinate orientation and training programs for accountants auditing its grantees and will take action on this matter considering staff availability and/or authority to obtain services outside OEO.

OEO agreed with our fifth recommendation that public accountants who have made audits which are unacceptable to OEO should not be allowed to audit OEO programs again.

In commenting on our sixth recommendation, OEO stated it believed that its procedures requiring visits to public accountants and reviews of their workpapers whenever OEO auditors make staff audits can be considered quality-assurance review procedures. Also OEO considers its specific review of a selected group of public accountants' workpapers now being completed as a means of increased monitoring of their work.

This review will enable OEO to compare the accountants' findings with their reporting and to determine whether all significant matters documented in the workpapers have been included in the audit reports and management letters; however, it will not enable OEO to evaluate the adequacy of the accountants' work unless it also makes a review at the grantee locations, covering the same periods of audit, to determine whether the accountants performed professionally. This additional procedure, if carried out as a systematic test check, would enable OEO to better evaluate the quality of the work done by independent accountants.

# CHAPTER 3

## AUDIT EXCEPTIONS CLEARED WITHOUT

## ADEQUATE ASSURANCE OF CORRECTIVE ACTIONS

Our review indicated that OEO was lenient in disposing of auditors' monetary and nonmonetary exceptions and, as a result, corrective actions were not taken and the grantees' deficiencies were perpetuated in many cases. Continued leniency can foster disrespect for various OEO rules, regulations, and requirements and may give grantees the impression that the requirements imposed by the statute or by the implementing regulations and instructions are not to be taken seriously.

An audit report of grantee operations is first sent to the OEO regional auditor who reviews it for compliance with OEO requirements, such as (1) whether the report was prepared by an eligible accountant, (2) whether the report states that the accountant appraised the accounting system and internal controls and used the Audit Guide, and (3) whether the accountant submitted a statement of budgeted, incurred, and questioned costs and a combined statement of assets, liabilities, and fund balances. The report is then forwarded to the OEO Regional Director, summarizing or highlighting audit exceptions and requesting that the regional auditor be advised of actions taken within 60 days.

The Director, after a review of the report by members of his staff, requests that the grantee respond within 30 days to each recommendation in the audit report. If the report indicates that the grantee's accounting system and/or internal controls were inadequate, OEO instructions require that a certification be obtained from the accountant that he reexamined the grantee's accounting system and/or internal controls and found them adequate.

Audit review specialists under the Director review the auditors' findings of monetary and nonmonetary exceptions. They also review the grantee's response to the audit observations and recommendations, to determine if the grantee has responded satisfactorily to each of the audit findings and recommendations and has corrected all deficiencies noted in the audit report. The specialists evaluate the justification offered by the grantee on questioned costs and determine whether the costs should be disallowed as charges against grant funds. If the specialists accept the grantee's response and the Director concurs, he notifies the regional auditor to close the audit file for the period in question.

In 4 OEO regions, we selected for review 76 of the latest closed audit reports that had monetary and/or non-monetary audit exceptions and that had been marked as closed by the regional auditor; that is, the audit exceptions had been reported to the regional auditor as satisfactorily resolved. All of the reports contained audit exceptions relating to accounting system and internal control weaknesses, and 46 reports also contained monetary exceptions (costs questioned by the auditors) totaling about $9.2 million.

## AUDIT DEFICIENCIES CLEARED WITHOUT VERIFICATION OF CORRECTIVE ACTIONS TAKEN

All but 12 of the 76 reports were closed without the regional offices' verifying whether corrective actions promised by the grantee had actually been taken. Our followup reviews or reviews by public accountants at a number of these grantees showed that corrective actions were not always taken. We found that:

- Three reports were closed although no responses had been received from the grantees. Subsequent audit reports on two of these grantees and our visit to the third grantee showed that reported deficiencies had not been corrected in all cases.

- Nine reports for which responses were received were closed although the grantee letters discussed only part of the deficiencies and did not fully describe the corrective actions taken or planned.

- Fifty reports were closed solely on the basis of letters from grantees indicating the corrective actions taken or planned. Subsequent audit reports received on 28 of these grantees showed that 14 had not taken corrective actions on all deficiencies. We visited 6 of the 22 remaining grantees and determined that 5 had not corrected all of the reported deficiencies.

--Two reports with monetary exceptions were closed because an audit report covering a later program period had been received. Monetary exceptions pertaining to 1 program year should not be closed on the basis of an audit covering a different program year.

No uniform procedures existed for reviewing grantee responses. Each reviewer generally used subjective judgment to determine whether the actions reported by the grantee would correct the deficiencies included in the related audit report. Moreover, in one region the audit review determinations were made by personnel who were not qualified for the job.

Without uniform guidelines, audit review specialists follow various practices to determine when an audit file should be closed. The following cases illustrate OEO's disposition of some of the audit exceptions.

<u>Audit reports closed without responses to reported deficiencies</u>

<u>Case 1</u>

On March 3, 1970, OEO requested comments from a grantee in California on an audit report prepared by a CPA which listed eight major deficiencies.

1. Inadequate controls over petty cash fund transactions.

2. Inadequate maintenance of employees' personnel files and failure to obtain employees' former employment salary rates.

3. Incomplete and unapproved time and attendance records.

4. Failure to implement effective procurement procedures.

5. Need to improve property records and controls.

6. Need to improve procedures for processing accounts payable.

7. Travel claims paid in excess of the maximum allowances contained in the Standardized Government Travel Regulations and claims for mileage not supported in accordance with the grantee's procedures.

8. Failure to establish budgetary control reporting procedures.

The grantee replied on March 20, 1970, requesting waivers on various monetary exceptions, but made no reply to OEO about actions taken or planned to correct the above deficiencies. On September 9, 1970, OEO closed the report on the basis that corrective actions would be monitored during an upcoming field examination prior to refunding and that the grantee's lack of corrective actions would be reported in subsequent audits. We visited the grantee in March 1971 and determined that seven of the eight deficiencies had not been corrected. Grantee personnel informed us that they had not replied to the deficiencies because they were unaware that a reply was required.

Case 2

On May 18, 1970, OEO requested comments from a grantee in Texas on an audit report prepared by a CPA which listed deficiencies in the following areas.

1. Documentation and recording of non-Federal share.

2. Supervisory approval of time sheets and travel vouchers.

3. Procurement and inventory procedures.

4. Personnel files and controls.

5. Centralized program administration.

The grantee did not respond to OEO on the deficiencies, but on July 21, 1970, OEO closed the audit report with a notation that the grantee had been instructed to furnish a response to the weaknesses in the accounting system and internal controls. A subsequent audit report received by OEO in September 1970 showed that none of the deficiencies had been corrected.

## Audit reports closed on the basis of unverified responses of grantees

### Case 1

On January 22, 1970, a CPA issued an audit report on a grantee in Mississippi which listed 23 deficiencies and recommendations for corrective actions in financial management and internal controls. OEO reviewed the report and on June 1, 1970, forwarded it to the grantee for action and response. By letter dated June 11, 1970, the grantee informed OEO that it had taken steps to implement all recommendations in the audit report. Without verifying the grantee's response, OEO closed the audit file on October 21, 1970. On December 29, 1970, we visited the grantee and determined that eight of the deficiencies listed in the audit report had not been corrected. These included failure to (1) reconcile the bank statement with the books of account, (2) approve invoices before payment, (3) verify payroll to personnel records, (4) post transactions in the general ledger at regular intervals, and (5) identify the applicable invoices on check payments. The grantee informed us that it would obtain assistance from the independent accountant to correct the deficiencies.

### Case 2

A CPA issued an audit report in November 1969 which covered the activities of a grantee in Georgia and which listed 12 deficiencies in the grantee's accounting system and internal controls and recommendations for corrective actions. By letter dated November 11, 1970, the grantee informed OEO that the CPA's recommendations had been implemented, and on this basis OEO closed the audit file on November 20, 1970. We visited the grantee in December 1970 and found that the following three deficiencies still existed.

1. The bookkeeper performed the bank reconciliations, indicating an inadequate segregation of functions.

2. Travel authorizations and orders were not used to justify and support travel expenses.

3. Non-Federal contributions consisting of building rentals were based on excessive appraisal values, resulting in an overstatement of non-Federal contributions.

Case 3

In December 1969 a CPA issued an audit report which covered the operations of a grantee in Mississippi and which listed 11 weaknesses in the accounting system and internal controls with recommendations for corrective actions. On March 3, 1970, OEO instructed the grantee to implement the CPA's recommendations. By letter dated June 3, 1970, the grantee informed OEO that the CPA's recommendations had been fully implemented, and OEO closed the audit file. However, a subsequent audit report issued on December 3, 1970, showed that several deficiencies listed in the previous report had not been corrected, and in this report the CPA concluded that the internal controls of the grantee were inadequate.

Case 4

An audit report issued by a CPA on January 10, 1969, covering the operations of a grantee in Mississippi, questioned costs totaling about $85,000. The CPA stated that the accounting system and internal controls of a delegate agency were inadequate in the following areas.

1. Failure to adhere to internal control procedures concerning contractual transportation services of enrollees.

2. Failure to provide adequate internal control procedures to account for nonexpendable Government property and to safeguard the property from theft and damage.

3. Failure to seek competitive bids and proposals for certain contractual services, supplies, rentals, and equipment purchases.

4. Failure to comply with certain specific grant conditions and OEO requirements.

On April 14, 1969, OEO instructed the grantee to correct the deficiencies reported by the CPA, but the reply from the grantee dealt only with the questioned costs and did not state what, if any, actions were taken to correct the accounting system and internal control weaknesses. On October 27, 1970, OEO closed the audit file because the CPA had issued another report the previous day. However, the latter report showed that two of the deficiencies still existed.

## QUESTIONABLE EXPENDITURES CLEARED

In examining 46 closed audit reports which had monetary exceptions totaling $9,160,000, we found that OEO allowed $8,995,000 as charges to grant funds and disallowed $165,000. The auditors questioned most of the costs because (1) documentation was inadequate, (2) the expenditure was not provided for in the approved budget, (3) the expenditure was in excess of approved budgets, or (4) deficiencies existed in the documentation relative to the non-Federal contribution.

On a nationwide basis, monetary audit exceptions for OEO grantees totaled $207.9 million for the period July 1, 1966, through December 31, 1972. The total expenditures incurred under all grants audited during this period were about $5.4 billion. At December 31, 1972, of the $207.9 million in questioned costs, $113.4 million had been determined as allowable, $25.7 million was disallowed, and $68.8 million remained unresolved.

### Basis for allowing questioned costs

OEO generally allowed costs questioned in the audit reports as charges to grant funds if the grantees provided explanations for the expenditures, although in some situations OEO disallowed the costs and attempted to recover the amounts from the grantees. Generally, the grantees' responses did not state, as required by OEO, what corrective actions were taken to preclude the same type of questioned costs in future audits.

Prior to May 1971, regional officials had been provided various instructions on the circumstances under which costs questioned by auditors could be allowed. Generally, if the regional officials believed that the expenditures involved were made to achieve program objectives, they could allow questioned costs which were (1) incurred in excess of an approved budget line item, (2) for items not covered by an approved budget, and (3) for items generally unallowable unless specifically authorized in advance by OEO.

Questions relating to the grantees' non-Federal share of program costs could normally be resolved in favor of the grantee. Questioned costs relating to this area--they frequently involved the grantee's inadequate documentation of in-kind contributions, such as the value of donated space or services--constituted a substantial portion of the auditor's exceptions.

These instructions attempted to give OEO regional officials a reasonable basis for settling audit exceptions in favor of the grantees rather than in favor of the Government; the concept apparently was that requiring grantees to reimburse OEO would possibly bankrupt the grantee or cut back program operations.

The following cases illustrate the types of costs questioned in audit reports and the bases used by OEO to allow or disallow the costs.

1. In a July 20, 1970, audit report on a grantee in California, a CPA questioned grant expenditures totaling $151,000 because documentation was not available to support non-Federal contributions of about $208,000. Without the non-Federal contribution, the grant expenditures had exceeded, by the amount questioned, the 80 percent limit on total Federal expenditures. By letter dated October 5, 1970, the grantee informed OEO that it had documented the non-Federal contributions, and without examining or verifying the documentation, OEO accepted the grantee response and closed the audit file on November 24, 1970.

2. On June 30, 1970, OEO requested comments from a grantee in Kentucky after receiving an audit report on the grantee. Grantee expenditures of $298,206 were questioned because supporting documentation was not available, expenditures exceeded amounts budgeted for specific cost categories, and expenditures were made for items not included in the OEO-approved budget. In its reply to OEO the grantee agreed that $1,620 should be disallowed as charges to grant funds and that $6,910 of the non-Federal share should be disallowed; the grantee provided explanatory justification for about $123,000 and promised subsequent explanations for an additional $167,000 of questioned expenditures.

The grantee's CPA provided later explanations for about $130,000 of the questioned costs, at which time the CPA requested that OEO disallow $13,013, subject to subsequent protest, until he could reexamine certain costs; the grantee provided no explanations for approximately $24,000 of the questioned costs. On December 23, 1970, OEO informed the grantee that $14,633 in questioned costs had been disallowed, and the grantee appealed $13,013 of this amount. The grantee's CPA provided additional explanation for the $13,013, and on March 3, 1971, OEO informed the grantee that the final disallowance would be only $1,620--the initial amount agreed to by the grantee. Thus OEO allowed $6,910 which the grantee had said should be disallowed and about $24,000 for which the grantee had provided no explanations or justifications.

3. A December 1, 1969, CPA's audit report on a grantee in California questioned $47,249 of grantee expenditures because the requirement that non-Federal contributions be at least 20 percent of the total expenditures was not met. The grantee provided supporting documentation for $4,162 of the questioned cost, and the remaining $43,087 was allowed by OEO without supporting documentation on the basis of a December 8, 1970, memorandum from Washington, which gave OEO regions blanket authority to waive questioned costs of this type.

## New instructions issued

On May 11, 1971, OEO issued Staff Instruction 6808-1, its first comprehensive instruction on the resolution of costs questioned by auditors. Although this instruction continues to provide considerable latitude for OEO officials to allow questioned costs, it describes two situations for disallowing such costs: (1) a determination that a questioned cost would not have occurred if previously reported deficiencies had been properly corrected by the grantee and (2) a list of statutory limitations.

The instruction also established a procedure for obtaining restitution of disallowed costs, as follows:

1. Cash refund.

2. Increase in non-Federal share with no reduction of the Federal share in subsequent grants or contracts.

3. Reduction of the Federal share in subsequent grants or contracts commensurate with the increase in the non-Federal share in the amount of the disallowance.

The instruction had not been implemented long enough prior to the completion of our fieldwork for us to ascertain its effectiveness.

CONCLUSIONS

OEO's practice of closing out audit reports on the basis of unverified reports of corrective actions submitted by the grantees perpetuates rather than corrects deficiencies. This is apparent from the incidence of the same accounting system and internal control deficiencies in successive audits of the same grantee.

OEO has stated that helping CAAs improve their financial controls should be given priority attention. The objective of annual audits is not only to enable OEO to determine whether grantees and their delegate agencies have adequately discharged their financial responsibilities but also to identify the weaknesses in accounting systems and internal controls that adversely affect sound financial management so that corrective actions can be initiated. We question whether these objectives have been accomplished.

We recognize OEO's position and the obvious dilemma of program officials when they are faced with the prospect of asking an antipoverty agency to refund OEO funds that would otherwise be used to further the objectives of the programs. However, we believe that OEO must also consider that continued leniency in this area does not prompt corrective actions on the part of the grantees.

We believe that only through OEO's positive action will the grantees become convinced of the need to observe OEO regulations and comply with grant requirements. These positive actions could be in the form of direct recovery of funds or reductions of Federal contributions in subsequent years.

RECOMMENDATIONS

We therefore recommend that OEO establish procedures to insure proper corrective actions by grantees on monetary and non-monetary exceptions taken by accountants, and we suggest that OEO:

1. Require verifications of corrective actions by independent or other accountants in all cases involving inadequate accounting systems or internal controls or other significant reported deficiencies.

2. Instruct grantees to submit documentation of corrective action on less significant deficiencies so that OEO can objectively evaluate and verify such action on a test basis.

3. Require that its regional offices closely adhere to the May 1971 regulations on the resolution of questioned costs and the recovery of disallowed costs.

## OEO COMMENTS AND GAO EVALUATIONS

OEO concurred in our first recommendation and stated that it had considered requiring CPAs to verify grantee corrective actions when the grantees' accounting systems and internal controls were inadequate; however, grantees generally do not have sufficient program administration funds available to pay a CPA in addition to the audit costs. OEO fully supports the proposal if additional resources can be made available for this purpose.

With respect to our second recommendation, OEO stated that its instructions require grantees' written responses to observations and recommendations in annual audit reports, but only on a specific request basis. OEO agreed that submission of such documentation would provide an opportunity for monitoring on a test basis but stated it would put an often unnecessary burden on everybody concerned and in some cases would require additional personnel.

Our review showed that OEO cannot rely entirely on a grantee's assertion that it has taken corrective action. We suggested that the verifications of reported corrective actions taken be made on a test basis so that OEO would be more positively assured of the implementation of auditors' recommendations. Although adoption of our recommendations may burden some grantees, we believe that the benefits would tend to outweigh the disadvantages noted by OEO.

In commenting on our third recommendation, OEO stated that the May 1971 regulations had been implemented.

EXECUTIVE OFFICE OF THE PRESIDENT
WASHINGTON, D.C. 20506

# OFFICE OF ECONOMIC OPPORTUNITY

FEB 15 1973

BEST DOCUMENT AVAILABLE

Mr. Morton Henig
Associate Director
U. S. General Accounting Office
Manpower and Welfare Division
Washington, D. C. 20548

Dear Mr. Henig:

Thank you for the opportunity to comment on the revised draft report "Need for More Effective Audit Activities, Office of Economic Opportunity" which was reissued to us on November 30, 1972. Our comments are enclosed in this letter.

We agree with your modified position that the observations in Chapter 2 should not be considered representative or typical of audits made by public accountants as a whole.

Please let us know if you need additional information.

Sincerely,

Bert A. Gallegos
Acting Deputy Director

Enclosure

Response to Revised GAO Draft Report
On Need for More Effective Audit Activities
Office of Economic Opportunity

General Comments

We are gratified to see that GAO has revised its original draft report dated July 10, 1972, by deleting certain portions and highlighting certain statements in an effort to produce a more balanced presentation of its observations concerning OEO audit activities.

Following are comments regarding various statements in the Digest section of the report which in our opinion could also be revised to more accurately present the results of the GAO review.

[See GAO note 2, p. 64.]

Page 3a, Paragraph 1

GAO substantiated our initial response of October 3, 1972 by stating that the accounting profession's ethical standards permit the practitioner to perform many of these services. However, GAO has added language that seems to imply that accountants did not always report significant financial management deficiencies because they lacked independence or their independence was impaired. In our opinion such a correlation cannot reasonably be drawn. We believe additional evidence is necessary to demonstrate that the accountants' independence was lost or impaired, or that the lack of independence actually caused accountants not to report certain financial management deficiencies to OEO.

[See GAO note 2, p. 64.]

Page 4, Paragraph 2

We believe GAO should indicate that OEO's audit organization did monitor public accountants work but, as we agree, there is need for improvement with respect to the number of independent accountants that it reviews. This could be done by changing the caption to read--Need For Additional OEO Monitoring. We also suggest that the word effectively in the first sentence be changed to sufficiently.

Page 5, Paragraph 3

In the interest of balanced reporting we would suggest that this paragraph be deleted in its entirety. GAO's scope of review does not cover all years between 1967 and 1971. This paragraph bears no relationship to the 46 closed reports that GAO reviewed nor to the percentage of allowed, disallowed, or unresolved costs in the 4 regions reviewed by GAO. This information is meaningless by itself and may give a reader the impression that GAO's observations on the 46 audit reports can be projected to all monetary audit exceptions.

[See GAO note 2, p. 64.]

[See GAO note 1, p. 64.]

[See GAO note 1, p. 64.]

Our specific comments on each of the recommendations are provided below in the order in which they appear on page 6 of the digest section of the draft report.

RECOMMENDATION

"REQUIRE GRANTEE AGENCIES TO STRENGTHEN THE CONTRACTUAL RELATIONSHIP WITH THEIR INDEPENDENT AUDITORS BY:

(1) CLEARLY SPELLING OUT THE AUDITOR'S RESPONSIBILITY BOTH TO THE GRANTEE AND OEO; AND

(2) INCORPORATING IN THE ENGAGEMENT LETTER OEO'S SPECIFIC AUDIT AND REPORTING REQUIREMENTS."

Comment

A draft revision of our Audit Guide does detail the relationship between Auditor, Grantee, and OEO, and provides a sample contract form for the agreement between grantee and auditor. This contract (or engagement letter) lists the specific audit and report requirements, specifies dates for performance of audit and delivery of the audit report, shows fees agreed upon and a limit of total cost for services, and requires that the Audit Guide be followed. OEO's third-party relationship and the auditor's responsibility to OEO stops short of a mandatory contractual relationship (as our General Counsel sees potential disadvantages in this) although we recognize such a position could be described in somewhat stronger terms, but otherwise GAO's recommendation can be considered as complied with.

RECOMMENDATION

"IN CASES WHERE THE CONTRACTUAL RELATIONSHIP BETWEEN GRANTEES AND INDEPENDENT AUDITORS DOES NOT ADEQUATELY MEET OEO'S AUDIT NEEDS, CONTRACT DIRECTLY FOR THE DESIRED AUDIT SERVICES."

Comment

Under revised Audit Guide, we believe the cases in which the contractual relationship between the grantee and the independent auditor is not adequate will be held to the minimum. Rather than reiterate our position on direct contracting in this response, we refer you to our letter of December 17, 1971 to Henry Eschwege then Assistant Director, in which this matter was discussed in great detail.

However, we might point out here that where warranted we have modified our system to deal with unusual problems. In certain sections of Ohio our grantees had difficulty obtaining services of independent public accountants. Therefore, an experiment is being conducted in some sections of the State whereby the Ohio State Economic Opportunity Office has contracted with a CPA firm to provide annual audit services to CAA's who desire to use this method rather than contracting directly themselves.

This experiment is in its final phase and we have not evaluated it as yet. However, initial results appear to indicate that the program has been successful in reducing audit costs for those grantees who voluntarily participated in the experiment. Discussion with officials administering the plan also indicates that grantees' initial reaction to the experiment has been favorable. Since its inception, approximately 50 percent of the active CAAs in the State of Ohio are participating in the plan. At the appropriate time, we plan to evaluate all aspects of the experiment giving consideration to all the circumstances mentioned above. At that time, we will explore the feasibility of this approach as an alternative mechanism for obtaining grantee audits.

RECOMMENDATION

EMPHASIZE TO GRANTEES AND THEIR AUDITORS THE IMPORTANCE OF ADHERING TO THE PROFESSIONAL STANDARD OF INDEPENDENCE IN SITUATIONS WHERE THE AUDITOR ALSO PERFORMS ACCOUNTING OR OTHER SERVICES FOR THE GRANTEES.

Comment

OEO strongly advocates that professional standards of independence must be maintained; our proposed Audit Guide specifically addresses itself to this problem, and - if properly adhered to -, will resolve it to our satisfaction. In our monitoring of CPA's, specific attention is being given to any relationship which might tend to convey an appearance of anything less than independence. We agree that public accountants who perform audits of OEO grantees should be independent. In addition, although we do not necessarily agree in all respects with the American Institute of Certified Public Accountant's (AICPA) views regarding independence of an auditor, we expect all independent public accountants performing audits of OEO grantees to comply with the Code of Professional Ethics promulgated by the AICPA.

In all of the cases mentioned in the draft report with the possible exception of the accountant who was a grantee board member, we believe that the independent accountants' actions were not necessarily violative of the AICPA Code of Professional Ethics regarding independence. As stated earlier in these comments, GAO has substantiated this position by stating that the accounting profession's ethical standards permit the practitioners to perform many of these services.

On May 30, 1972, our External Audit Division requested a ruling from the AICPA Ethics Committee regarding whether an auditor would be considered independent if he performed all bookkeeping - accounting services for a client and was also engaged to perform the independent audit of that client.

The Ethics Committee informed us that it had previously ruled that the auditor's independence would not necessarily be considered impaired under such circumstances.

[See GAO note 2, p. 64.]

RECOMMENDATION

"SPONSOR IN COOPERATION WITH OTHER FEDERAL AGENCIES AND THE ACCOUNTING PROFESSION ORIENTATION AND TRAINING PROGRAMS TO BETTER ACQUAINT PUBLIC ACCOUNTANTS WITH OEO'S SPECIALIZED AUDIT REQUIREMENTS."

Comment

Due to recent major changes to OEO grant administration procedures and the revisions to the Audit Guide, we agree that OEO should sponsor and coordinate orientation and training programs for public accountants. OEO will take appropriate action on this matter giving consideration to all factors such as staff availability and/or authority to obtain services outside the agency.

It is apparent from the joint project underway to develop uniform standards for audit of Government programs, that there has been a long standing need throughout all Federal agencies to provide guidance to those who audit these programs. The OEO External Audit Division has recognized this need for some time and has provided assistance to GAO in developing the uniform standards. Shortly after the inception of OEO, the External Audit Division recognized that guidance was needed and attempted to satisfy this need by developing an Audit Guide for use by public accountants and other auditors. The Audit Guide which provides guidelines specifically tailored to the audit of OEO programs is issued to every independent public accountant prior to their performance of the audit. In addition, each OEO Regional Auditor provides continuing orientation and training to public accountants and governmental auditors through daily contact when approrpriate. We have provided training and guidance through lectures and meetings with various state societies of CPAs throughout the country.

RECOMMENDATION

"WITHHOLD APPROVAL OF THE ENGAGEMENT OF PUBLIC ACCOUNTANTS WHOSE PERFORMANCE HAS BEEN FOUND TO HAVE BEEN UNACCEPTABLE."

Comment

We believe that public accountants who have conducted audits which are unacceptable to OEO should not be allowed to again audit OEO programs.

OEO regulations require nomination and approval of an auditor only for a grantee receiving an initial grant. Yearly exercise of this authority for every grantee would result in an unwieldy administrative burden and would not be a practicable approach in the majority of cases. However, we propose to continue our practice of requiring the grantee to engage a different public accountant if the current public accountant did not perform in accordance with OEO audit requirements. As you can understand, this approach can only be taken as a last resort and only after an attempt has been made by OEO to obtain compliance with our audit requirements from the public accountant.

For the past two years, our Regional Auditors have been required to return unacceptable audit reports to the public accountants and request the required information. This procedure is being followed in all Regional Offices.

Whenever the Regional Auditor had knowledge of inadequate performance by a public accountant, through a review of his working papers during a staff audit or by other means, the Regional Auditor and appropriate program officials have coordinated their efforts and have required the grantee to engage a different public accountant. This has been done in about half of the cases out of the 17 referred to in the draft report. We will re-emphasize to all appropriate OEO employees the importance of obtaining acceptable audits and of taking appropriate action in cases where a public accountant's performance has been unacceptable.

In our reply to the initial GAO draft report we commented on its conclusion that public accountants failed to disclose significant deficiencies. We assumed that GAO would relate the effect of the undisclosed deficiencies on the grantees' overall operations.

In response to these comments, GAO stated on page 14 of the report that the intent of their review was not to determine the effect of system deficiencies on the grantees' overall operations. They stated that the existence of system weaknesses was significant in itself.

We take issue with the latter statement since it implies that something less than a perfect system is to be considered a significant weakness. We agree that the goal of having an ideal system is one that we all must strive toward, but one that also must be tempered by the realism of operating a day to day program which may, because of other exigencies, dictate that the benefit of preventing or correcting a system weakness at a specific point in time is not commensurate with the effort or costs involved.

RECOMMENDATION

DEVOTE MORE AUDIT EFFORT TO QUALITY ASSURANCE TYPES OF REVIEWS OF PUBLIC ACCOUNTANT'S WORK.

Comment

We believe our procedures which require our auditors to visit the independent auditor and review his workpapers whenever we start a staff audit can be considered "quality assurance" review procedures. We also hold numerous discussions with individual CPAs, and at times with groups of independent auditors. Also, as indicated by GAO, we are completing a specific review of the adequacy of CPAs working papers. We believe this effort should be expanded and we are currently exploring alternative mechanisms which will result in increased monitoring of public accountants' work.

RECOMMENDATION

REQUIRE VERIFICATIONS OF CORRECTIVE ACTIONS BY INDEPENDENT ACCOUNTANTS, OR OTHERWISE, IN ALL CASES INVOLVING INADEQUATE ACCOUNTING SYSTEMS OR INTERNAL CONTROLS OF GRANTEE OR OTHER SIGNIFICANT REPORTED DEFICIENCIES.

Comment

OEO has given consideration to requiring verification of grantee corrective action by CPAs when the grantee's accounting system and internal controls are inadequate, however, grantees generally do not have sufficient Program Administration Funds available to pay a CPA in addition to the audit costs. OEO has therefore tried to take up the slack, and the Regions have in many cases charged their Field Operations Division with this responsibility; in a few cases, this function is handled by the Financial Management unit of the Program Management Support Division. In all instances, however, lack of manpower severely limits OEO's efforts, so that in the less important cases this verification is listed for subsequent inspection at the next audit.

We fully support this recommendation, if additional resources can be made available to the Regions for this purpose.

RECOMMENDATIONS

INSTRUCT GRANTEES TO SUBMIT DOCUMENTATION OF CORRECTIVE ACTIONS ON LESS SIGNIFICANT DEFICIENCIES SO THAT OEO CAN OBJECTIVELY EVALUATE AND VERIFY SUCH CORRECTIVE ACTION ON A TEST BASIS.

REQUIRE THAT ITS REGIONAL OFFICES CLOSELY ADHERE TO THE MAY 1971 REGULATIONS REGARDING THE RESOLUTION OF DISALLOWED COSTS AND THE RECOVERY OF THOSE COSTS DISALLOWED.

Comment

OEO Instruction 6801-1 calls for a response in writing by the grantee, upon request, to observations and recommendations in annual audit reports. It stresses the need for documentation of remedial actions, but does not require its submission unless requested, only its availability for review. We feel that making submission of such documentation mandatory would provide an opportunity for monitoring on a test basis but, as an absolute requirement, would cause an often unnecessary burden on everybody concerned and in some cases may require additional personnel.

On-site inspection was provided in some regions for tests of corrective action, but any extension of this procedure is also limited by funds and personnel.

In the past the method of monitoring was incorporated into the system by verification during a subsequent audit. Now an added safeguard has been incorporated as the revised Audit Guide makes it mandatory that the auditor disclose in the management letter any prior year unresolved deficiencies.

As more time is spent on monitoring CPA reports on a test basis there will be a greater opportunity to test this phase of their work along with other parts.

The provision of both OEO Instruction 6801-1 and Staff Instruction 6808-1 are being fully enforced by the OEO Regions.

The manner of GAO's presentation of statistics and comments on page 47 of the draft report regarding 46 closed audit reports implies some impropriety that results in adverse effects. It would be preferable to explain that questioned costs, as used by OEO, include the cost items for which adequate documentation may not have been available at the time of audit, as well as those costs which appeared to be unallowable under grant conditions, or which appeared to be unreasonable. This may differ from other interpretations of questionable costs, especially as they relate to contracts wherein a questioned cost is tantamount to a disallowance. In addition, GAO has not recognized that even prior to the May 1971 instructions, a cash collection was not the only method of satisfying disallowed costs. Under the Economic Opportunity Act another method is to increase the non-Federal share requirements in the subsequent funding period.

Prior to May 1971, there were various instructions advising of circumstances under which costs questioned could be allowed. However, this did not imply a basis for "settling audit exceptions in favor of the grantee rather than the government."

The May 1971 regulations regarding the resolution of disallowed costs and their recovery was issued for clarification and to give comprehensive instructions; and they have been implemented by OEO.

GAO notes:

1. Material deleted pertains to comments on matters that did not concern the contents of this report.

2. Material deleted from this letter concerns matters included in the report draft which have been revised in the final report.

3. The page numbers in these comments refer to our draft report, not this final report.

AICPA
American Institute of Certified Public Accountants
1620 Eye Street, N W . Washington, D C 20006 (202) 872-8190

February 20, 1973

Mr. Morton E. Henig
Associate Director
Manpower & Welfare Division
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Henig:

We greatly appreciate the opportunity which you gave us to review selected parts of drafts of the GAO report on "Need for More Effective Audit Activities - Office of Economic Opportunity" and the consideration given our comments and suggestions in finalizing the report.

Naturally, we were genuinely disappointed that your review of the OEO operations turned up some inadequacies in audits and reports rendered by CPAs on OEO grantee activities. While we recognize, as you do, that the results of the GAO's review should not be considered as representative or typical of audits made by CPAs in general, we believe that a number of steps should be taken to strengthen the CPA's ability to perform audits in connection with grant programs and to deal appropriately with those few CPAs whose performance is below expected standards.

Recognizing the need to provide guidance to all of our members and to take appropriate disciplinary action against those members who are found to have performed substandard work, the Institute is engaged in the following activities:

1. An expanded curriculum is being developed under the Institute's Professional Development Division emphasizing the auditing and reporting aspects unique to federal grant programs.

2. A series of Studies in Federal Government will be prepared to provide Institute members with educational materials in such areas as federal accounting and auditing and operational auditing.

3. Preliminary discussions have been initiated between representatives of the Institute's Professional Ethics Division and various federal agencies to work towards the development of effective procedures to enable such agencies to refer to the Ethics Division the names of CPAs whose audit performance in government programs is considered substandard by an agency.

4. Through its Committee on Relations with the OEO, the Institute is conferring with representatives of the OEO's External Audit Division on the development of a revised "Audit Guide" for the guidance of CPAs and other auditors.

5. Discussions are continuing with all appropriate agencies on the development of effective audit guides based in part on the Institute's report, "Suggested Guidelines for the Structure and Content of Audit Guides Prepared by Federal Agencies for Use by CPAs".

We hope that through the joint efforts of federal agencies and the Institute, substandard professional work can be eliminated entirely. Again, let me thank you for your courtesy in allowing us to review parts of the draft report on OEO and for giving us the opportunity to present our views on it.

Sincerely,

Thomas R. Hanley /pm



Thomas R. Hanley, Director
Federal Technical Liaison

TH/pm

cc Mr. K. Brasfield
Mr. S. Brotman
Mr. G. Simonetti, Jr.

# PRINCIPAL OFFICIALS OF THE OFFICE OF ECONOMIC OPPORTUNITY RESPONSIBLE FOR THE ADMINISTRATION OF ACTIVITIES DISCUSSED IN THIS REPORT

| | Tenure of office | |
|---|---|---|
| | From | To |
| DIRECTOR: | | |
| Howard Phillips (acting) | Jan. 1973 | Present |
| Phillip V. Sanchez | Sept. 1971 | Jan. 1973 |
| Frank C. Carlucci | Dec. 1970 | Sept. 1971 |
| Donald Rumsfeld | May 1969 | Dec. 1970 |
| ASSOCIATE DIRECTOR FOR ADMINISTRATION: | | |
| J. Laurence McCarty (acting) | Feb. 1973 | Present |
| Ernest Russell | Apr. 1971 | Jan. 1973 |
| Robert C. Cassidy | Sept. 1967 | Apr. 1971 |
| OFFICE OF THE CONTROLLER: | | |
| Richard Redenius (acting) | Feb. 1973 | Present |
| William Plissner | Nov. 1971 | Feb. 1973 |
| Don I. Wortman | June 1971 | Nov. 1971 |

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